

Chapter 1

Elements of Business Accounting

In This Chapter

- ▶ Working with the accounting equation
- ▶ Understanding the differences between cash- and accrual-basis accounting
- ▶ Examining the three primary business financial statements
- ▶ Seeing the effects of crooked accounting on financial statements

The starting point in accounting is identifying the *entity* being accounted for. A business entity can be legally organized as a *partnership*, *corporation*, *limited liability company*, or other structures permitted by law. Alternatively, a business entity simply may consist of the business activities of an individual, in which case it's called a *sole proprietorship*. Regardless of how the business entity is legally established, it's treated as a separate entity or distinct person for accounting purposes.

Keeping the Accounting Equation in Balance

If you've ever studied accounting, you probably recall the *accounting equation*:

$$\text{Assets} = \text{Liabilities} + \text{Owners' equity}$$

The accounting equation says a lot in very few words. It's like the visible part of an iceberg — a lot of important points are hidden under the water. Notice the two sides to the equation: assets on one side and the *claims* against the assets on the other side. These claims arise from credit extended to the business (liabilities) and capital invested by owners in the business (owners' equity). (The claims of liabilities are significantly different than the claims of owners; liabilities have seniority and priority for payment over the claims of owners.)

Suppose a business has \$10 million total assets. These assets didn't fall down like manna from heaven (as my old accounting professor was fond of saying). The money for the assets came from somewhere. The business's creditors (to whom it owes its liabilities) may have supplied, say, \$4 million of its total assets. Therefore, the owners' equity sources provided the other \$6 million.



Business accounting is based on the two-sided nature of the accounting equation. Both assets *and* sources of assets are accounted for, which leads, quite naturally, to *double entry accounting*. Double entry, in essence, means two-sided. It's based on the general economic exchange model. In economic transactions, something is given and something is received in exchange. For example, I recently bought an iPod from Apple Computer. Apple gave me the iPod and received my money. Another example involves a business that borrows money from

its bank. The business gives the bank a legal instrument called a *note* promising to return the money at a future date and to pay interest over the time the money is borrowed. In exchange for the note, the business receives the money. (Chapter 3 explains how to implement double entry accounting.)



Q. Is each of the following equations correct? What key point does each equation raise?

- a. \$250,000 Assets = \$100,000 Liabilities + \$100,000 Owners' equity
- b. \$2,345,000 Assets = \$46,900 Liabilities + \$2,298,100 Owners' equity
- c. \$26,450 Assets = \$675,000 Liabilities – \$648,550 Owners' equity
- d. \$4,650,000 Assets = \$4,250,000 Liabilities + \$400,000 Owners' equity

A. Each accounting equation offers an important lesson.

- a. Whoops! This accounting equation doesn't balance, so clearly something's wrong. Either liabilities, owner's equity, or some combination of both is \$50,000 too low, or the two items on the right-hand side could be correct, in which case total assets are overstated \$50,000. With an unbalanced equation such as this, the accountant definitely should find the error or errors and make appropriate correcting entries.
- b. This accounting equation balances, but, wow! Look at the very small size of liabilities relative to assets. This kind of contrast isn't typical. The liabilities of a typical business usually account for a much larger percentage of its total assets.
- c. This accounting equation balances, but the business has a large negative owners' equity. Such a large negative amount of owners' equity means the business has suffered major losses that have wiped out almost all its assets. You wouldn't want to be one of this business's creditors (or one of its owners either).
- d. This accounting equation balances and is correct, but you should notice that the business is *highly leveraged*, which means the *ratio of debt to equity* (liabilities divided by owners' equity) is very high, more than 10 to 1. This ratio is quite unusual.

1. Which of the following is the normal way to present the accounting equation?
- a. Liabilities = Assets – Owners' equity
 - b. Assets – Liabilities = Owners' equity
 - c. Assets = Liabilities + Owners' equity
 - d. Assets – Liabilities – Owners' equity = 0

Solve It

2. A business has \$485,000 total liabilities and \$1,200,000 total owners' equity. What is the amount of its total assets?

Solve It

3. A business has \$250,000 total liabilities. At start-up, the owners invested \$500,000 in the business. Unfortunately, the business has suffered a cumulative loss of \$200,000 up to the present time. What is the amount of its total assets at the present time?

Solve It

4. A business has \$175,000 total liabilities. At start-up, the owners invested \$250,000 capital. The business has earned \$190,000 cumulative profit since its creation, all of which has been retained in the business. What is the total amount of its assets?

Solve It

Distinguishing Between Cash- and Accrual-Basis Accounting

Cash-basis accounting refers to keeping a record of cash inflows and cash outflows. An individual uses cash-basis accounting in keeping his checkbook because he needs to know his day-to-day cash balance and he needs a journal of his cash receipts and cash expenditures during the year for filing his annual income tax return. Individuals have assets other than cash (such as cars, computers, and homes), and they have liabilities (such as credit card balances and home mortgages). Hardly anyone I know keeps accounting records of their noncash assets and their liabilities (aside from putting bills to pay and receipts for major purchases in folders). Most people keep a checkbook, and that's about it when it comes to their personal accounting.

Although it's perfect for individuals, cash-basis accounting just doesn't cut it for the large majority of businesses. Cash-basis accounting doesn't provide the information that managers need to run a business or the information needed to prepare company tax returns and financial reports. Some small personal service businesses (such as barber shops, lawyers, and real estate brokers) can get by using cash-basis accounting because they have virtually no assets other than cash and they pay their bills right away.

The large majority of businesses use *accrual-basis accounting*. They keep track of their cash inflows and outflows, of course, but accrual-basis accounting allows them to record all the assets and liabilities of the business. Also, accrual-basis accounting keeps track of the money invested in the business by its owners and the accumulated profit retained in the business. In short, accrual-basis accounting has a much broader scope than cash-basis accounting.

A big difference between cash- and accrual-basis accounting concerns how they measure annual *profit* of a business. With cash-basis accounting, profit simply equals the total of cash inflows from sales minus the total of cash outflows for expenses of making sales and running the business, or, in other words, the net increase in cash from sales and expenses. With the accrual-basis accounting method, profit is measured differently because the two components of profit — sales revenue and expenses — are recorded differently.



When using accrual-basis accounting, a business records sales revenue when a sale is made and the products and/or services are delivered to the customer, whether the customer pays cash on the spot or receives credit and doesn't pay the business until sometime later. Sales revenue is recorded before cash is actually received. The business doesn't record the cost of the products sold as an expense until sales revenue is recorded, even though the business paid out cash for the products weeks or months earlier. Furthermore, with accrual-basis accounting, a business records operating expenses as soon as they're incurred (as soon as the business has a liability for the expense), even though the expenses aren't paid until sometime later.

Cash-basis accounting doesn't reflect economic reality for businesses that sell and buy on credit, carry inventories of products for sale, invest in long-lived operating assets, and make long-term commitments for such things as employee pensions and retirement benefits. When you look beyond small cash-based business, you quickly realize that businesses need the comprehensive recordkeeping system called accrual-basis accounting. I like to call it "economic reality accounting."

The following example question focuses on certain fundamental differences between cash-basis and accrual-basis accounting regarding the recording of sales revenue and expenses for the purpose of measuring profit.



- Q.** You started a new business one year ago. You've been very busy dealing with so many problems that you haven't had time to sit down and look at whether you made a profit or not. You haven't run out of cash (which for a start-up venture is quite an accomplishment), but you understand that the sustainability of the business depends on making a profit. The following two summaries present cash flow information for the year and information about two assets and a liability at year-end:

Revenue and Expense Cash Flows For First Year

\$558,000 cash receipts from sales
 \$375,000 cash payments for purchases of products
 \$340,000 cash payments for other expenses

Two Assets and a Liability at Year-End

\$52,000 receivables from customers for sales made to them during the year
 \$85,000 cost of products in ending inventory that haven't yet been sold
 \$25,000 liability for unpaid expenses

Compare the profit or loss of your business for its first year according to the cash- and accrual-basis accounting methods.

- A.** Profit according to cash-basis accounting equals the cash inflow from sales minus the total of cash outflows for expenses (and the total of cash outflows for expenses equals the purchases of products plus other expenses). Thus, under cash-basis accounting, your business has a \$157,000 loss for the year (\$558,000 sales revenue – \$715,000 expenses = \$157,000 loss).

Under accrual-basis accounting, you record different amounts for sales revenue and the two expenses, which are calculated as follows:

\$558,000 cash receipts from sales +
 \$52,000 year-end receivables from customers = \$610,000 sales revenue
 \$375,000 cash payments for purchases of products – \$85,000 year-end inventory of unsold products = \$290,000 cost of products sold expense
 \$340,000 cash payments for other expenses + \$25,000 year-end liability for unpaid expenses = \$365,000 other expenses

Deducting cost of products sold and other expenses from sales revenue gives a net loss of \$45,000 (\$610,000 sales revenue – \$290,000 cost of products sold – \$365,000 other expenses = \$45,000 net loss for year).

To answer Questions 5 through 8, please refer to the summary of revenue and expense cash flows and the summary of two assets and a liability at year-end presented in the preceding example question.

5. What would be the amount of accrual-basis sales revenue for the year if the business's year-end receivables had been \$92,000?

Solve It

6. What would be the amount of accrual-basis cost of products sold expense for the year if the business's cost of products held in inventory at year-end had been \$95,000?

Solve It

7. What would be the amount of accrual-basis other expenses for the year if the business's liability for unpaid expenses at year-end had been \$30,000?

Solve It

8. Based on the changes for the example given in Questions 5, 6, and 7, determine the profit or loss of the business for its first year.

Solve It

Summarizing Profit Activities in the Income (Profit & Loss) Statement

As crass as it sounds, business managers get paid to make profit happen. Management literature usually stresses the visionary, leadership, and innovative characteristics of business managers, but these traits aren't worth much if the business suffers losses year after year or fails to establish sustainable profit performance. After all, businesses are profit-motivated, aren't they?

It's not surprising that the *income statement* takes center stage in business financial reports. The income statement summarizes a company's revenue and other income, expenses, losses, and bottom-line profit or loss for a period. The income statement gets top billing over the other two primary financial statements (the balance sheet and the statement of cash flows), which I discuss later in this chapter. The income statement is referred to informally as the *Profit & Loss* or *P&L statement*, although these titles are seldom used in external financial reports. (Alternatively, it may be titled *Earnings Statement* or *Statement of Operations*.)

Financial reporting standards demand that an income statement be presented in quarterly and annual financial reports to owners. But financial reporting rules are fairly permissive regarding exactly what information should be reported and how it's presented (see Chapter 5 for the full scoop on income statement disclosure).



- Q.** Take a look at this extremely abbreviated and condensed income statement for a business's most recent year. (**Note:** A formal income statement in a financial report must disclose more information than this.)

Income Statement for Year

Sales revenue	\$26,000,000
Expenses	<u>24,310,000</u>
Net income	\$1,690,000

This business sells products, which are also called *goods* or *merchandise*. The cost of products sold to customers during the year was \$14,300,000. Expand the condensed income statement to reflect this additional information.

- A.** Income statement reporting requires a company to show the cost of goods (products) sold as a separate expense and deduct it immediately below sales revenue. The difference must be reported as *gross margin* (or *gross profit*). Therefore, the condensed income statement should be expanded as follows:

Income Statement for Year

Sales revenue	\$26,000,000
Cost of goods sold	<u>14,300,000</u>
Gross margin	\$11,700,000
Other expenses	<u>10,010,000</u>
Net income	\$1,690,000

9. One rule of income statement reporting is that interest expense and income tax expense be reported separately. The \$10,010,000 “Other expenses” in the income statement for the answer to the example question includes \$350,000 interest expense and \$910,000 income tax. Rebuild the income statement given the information for these additional two expenses. *Hint:* Profit before interest expense is usually labeled “operating earnings,” and profit after interest and before income tax expense is usually labeled “earnings before income tax.”

Solve It

10. No specific rule governs income statement disclosure of advertising expense. Suppose the \$10,010,000 “Other expenses” in the income statement for the answer to the example question includes \$5,000,000 of advertising expense. Would you favor reporting this as a separate expense in the income statement? *Hint:* This question calls for your opinion only.

Solve It

11. No specific rule governs income statement disclosure of executive-level compensation. Suppose the \$10,010,000 “Other expenses” in the income statement for the answer to the example question includes \$3,000,000 of executive-level compensation that includes both base salaries and generous bonuses. Would you favor reporting this as a separate expense in the income statement? *Hint:* This question calls for your opinion only.

Solve It

12. Please refer to the income statement for the answer to the example question. Suppose the business distributed \$650,000 cash to its shareowners from its profit (net income) for the year. Is this cash disbursement treated as an expense?

Solve It

Assembling a Balance Sheet

The *balance sheet* is one of the three primary financial statements that businesses report (the other two being the income statement and the statement of cash flows). It's also called the *financial condition statement* or *statement of financial position*. The balance sheet summarizes the assets, liabilities, and owners' equity accounts of a business at an instant in time. Prepared at the close of business on the last day of the profit period, the balance sheet presents a "freeze frame" look at the business's financial condition.



Preparing and reporting a balance sheet takes time, so by the time you read a balance sheet, it's already somewhat out-of-date. The business's stream of activities and operations doesn't stop, which means that from the date at which the balance sheet was prepared to when you read it, the business will have engaged in many transactions. These subsequent transactions may have significantly changed its financial condition. For more on the balance sheet, turn to Chapter 6.



In accounting, the term *balance* refers to the dollar amount of an account, after recording all increases and decreases in the account caused by business activities. The balance sheet reports the balances of asset, liability, and owners' equity accounts, but it also refers to the equality, or balance, of the accounting equation (see the section "Keeping the Accounting Equation in Balance" earlier in this chapter).



Q. The following list summarizes the assets and liabilities of a business at the close of business on the last day of its most recent profit period:

Amounts owed by customers to the business: \$485,000

Cost of unsold products (that will be sold next period): \$678,000

Cash balance on deposit in checking account with bank: \$396,000

Amounts owed by business for unpaid purchases and expenses: \$438,000

Notes payable to bank (on which interest is paid): \$500,000

Original cost of long-term operating assets that are being depreciated over their useful lives to the business: \$950,000

Accumulated depreciation of long-term operating assets: \$305,000

Using this information, prepare the business's balance sheet.

A. Cash	\$396,000	Accounts Payable	\$438,000
Accounts Receivable	\$485,000	Notes Payable	\$500,000
Inventory	\$678,000	Owners' Equity*	<u>\$1,266,000</u>
Fixed Assets (Net of Accumulated Depreciation)	<u>\$645,000</u>		
Total Assets	\$2,204,000	Total Liabilities and Owners' Equity	\$2,204,000

*Owners' equity is determined by deducting the sum of liabilities from total assets.

Note: This balance sheet isn't classified into current assets and current liabilities. Also, owners' equity isn't classified. (Chapter 6 explains the balance sheet in greater detail.)

Use the balance sheet shown in the preceding example to answer Questions 13 through 16.

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Part I: Business Accounting Basics

- 13.** Suppose \$950,000 of owners' equity consists of profit earned and not distributed by the business. What is this amount usually called in the balance sheet? And, what is the other amount of owners' equity called in the balance sheet?

Solve It

- 14.** It appears that the business can't pay its liabilities. The two liabilities total \$938,000, but the business has a cash balance of only \$396,000. Do you agree?

Solve It

- 15.** Can you tell the amount of profit the business earned in the period just ended?

Solve It

- 16.** In a balance sheet, assets usually are listed in the order of their "nearness" to cash. Cash is listed first, followed by the asset closest to being converted into cash, and so on. Is the sequence of assets according to normal rules for presenting assets in balance sheets?

Solve It

Partitioning the Statement of Cash Flows

You could argue that the statement of cash flows is the most important of the three primary financial statements. Why? Because in the long run everything comes down to cash flows. Profit recorded on the accrual basis of accounting has to be turned into cash — and the sooner the better. Otherwise, profit doesn't provide money for growing the business and paying distributions to owners.

By themselves, the income statement and balance sheet don't provide information about the cash flow generated by the business's profit-making, or *operating*, activities. But people who use financial reports (business managers, lenders, and investors) want to see cash flow information. In short, financial reporting standards require a statement of cash flows. The statement begins with reporting the cash flow from operating activities and also reports the other sources and uses of cash during the period, which are divided into the following:

- ✓ **Investing activities:** Include the purchase and construction of long-term operating assets such as land, buildings, equipment, machinery, vehicles, and tools. If a business realizes cash from the disposal of such assets, the proceeds are included in this category of cash flows.
- ✓ **Financing activities:** Include borrowing money from debt sources and paying loans at maturity as well as raising capital from shareowners and returning capital to them. Cash distributions from profit are included in this category of cash flows.



- Q.** The statement of cash flows for a business's most recent year is presented as follows. Based on the information provided, is it possible to determine the amount of cash flow from operating activities?

Cash flow from operating activities: ?????

Cash flow from investing activities:

Capital expenditures (\$2,345,000)

Proceeds from disposal of real estate \$225,000 (\$2,120,000)

Cash flow from financing activities:

Increase in debt \$1,625,000

Issue of capital stock shares \$550,000

Cash dividends to shareholders (\$400,000) \$1,775,000

Net cash increase during year \$355,000

- A.** You can determine the amount of cash flow from operating activities by the following calculations:

\$2,120,000 net cash needed for capital expenditures + \$355,000 cash balance increase = \$2,475,000 total cash needed

\$2,475,000 total cash needed – \$1,775,000 net cash provided from financing activities = \$700,000 cash flow from operating activities

Cash flow from operating activities is explained in more detail in Chapter 8.

You can condense a statement of cash flows, such as the one for the example, into its four basic components as follows (negative numbers appear in parentheses):

Cash flow from operating activities	\$700,000
Cash flow from investing activities	(\$2,120,000)
Cash flow from financing activities	\$1,775,000
Net increase in cash during the year	\$355,000



If you know three of the four components in a condensed statement of cash flows, you can determine the fourth factor. Suppose you know the increase or decrease in cash during the year (which is easy enough to determine by comparing the ending cash balance with the beginning cash balance). And suppose you can quickly determine the cash flow from investing activities and the cash flow from financing activities (because there aren't many transactions of these two types during the year). Knowing these three factors, you can quickly determine the cash flow from operating activities. The remainder of the increase or decrease in cash during the year is attributable to operating activities.

Questions 17 through 20 give you three of the four components in a condensed statement of cash flows and ask you to solve for the unknown factor.

- 17.** Three of the four components of cash flow for the year of a business are as follows:

Cash flow from operating activities	\$450,000
Cash flow from investing activities	(\$725,000)
Cash flow from financing activities	<u>\$50,000</u>
Net increase (decrease) in cash during the year	????

Determine the increase or decrease in cash during the year.

Solve It

- 18.** Three of the four components of cash flow for the year of a business are as follows:

Cash flow from operating activities	\$2,680,000
Cash flow from investing activities	????
Cash flow from financing activities	<u>\$1,250,000</u>
Net increase (decrease) in cash during the year	\$400,000

Determine cash flow from investing activities for the year.

Solve It

- 19.** Three of the four components of cash flow for the year of a business are as follows:

Cash flow from operating activities	\$650,000
Cash flow from investing activities	(\$925,000)
Cash flow from financing activities	_____
Net increase (decrease) in cash during the year	(\$65,000)
Determine cash flow from financing activities for the year.	

Solve It

- 20.** Three of the four components of cash flow for the year of a business are as follows:

Cash flow from operating activities	????
Cash flow from investing activities	(\$480,000)
Cash flow from financing activities	_____
Net increase (decrease) in cash during the year	\$150,000
Determine cash flow from operating activities for the year.	

Solve It

Tracing How Dishonest Accounting Distorts Financial Statements

It goes without saying that a business should keep its accounting system as honest as the day is long. In preparing its financial statements, a business should be forthright and not misleading. As the late sportscaster Howard Cosell would say, "Tell it like it is." I regret to tell you that some businesses cheat in their accounting and financial reporting. Now, there's cheating and then there's *real* cheating. So what's the difference?

Many businesses perform cosmetic surgery on their accounts, touching up their financial condition and profit performance. This practice is popularly called *massaging the numbers*. Professional investors (as in mutual fund managers) and lenders (as in banks) know that a certain amount of accounting manipulation goes on by many businesses, and as a practical matter not much can be done about it.



On another level, some businesses resort to *accounting fraud* to put a better sheen on profit performance and conceal financial problems. Accounting fraud is popularly called *cooking the books*. Think of massaging the numbers as fibbing or putting a spin on the truth and accounting fraud as out-and-out lying with the intent to deceive and mislead. In recent years the incidence of accounting fraud has risen alarmingly. (Do Enron, WorldCom, and Waste Management ring any bells?) Accounting fraud is illegal and perpetrators are subject to prosecution under criminal law. Plus, victims can sue the persons responsible for the fraud.



- Q.** Suppose a business has engaged in some accounting fraud to boost its profit for the year just ended. Assume that the business didn't commit any accounting fraud before this year (which may not be true, of course). As the result of fraudulent entries in its accounts, the \$2,340,000 bottom-line profit reported in its income statement was overstated \$385,000. How does this dishonest accounting distort the business's balance sheet?
- A.** Owners' equity is overstated \$385,000 because profit increases owners' equity. And the overstatement of profit may have involved the overstatement of assets, the understatement of liabilities, or a combination of both. To correct this error, owners' equity should be decreased \$385,000. As well, assets should be decreased \$385,000, or liabilities should be increased \$385,000 (or some combination of both).

- 21.** Suppose a business commits accounting fraud by deliberately not writing down its inventory of \$268,000, which is the cost of certain products that it can no longer sell and will be thrown in the junk heap. How should its balance sheet be adjusted to correct for this accounting fraud, ignoring income tax effects? (Use the answer template provided.)

Solve It

Cash		Accounts Payable	
Accounts Receivable		Notes Payable	
Inventory		Owners' Equity	
Fixed Assets (Net of Accumulated Depreciation)	_____		_____
Total Assets		Total Liabilities and Owners' Equity	

- 22.** Suppose a business commits accounting fraud by deliberately not recording \$465,000 liabilities for unpaid expenses at the end of the year. How should its balance sheet be adjusted to correct for this accounting fraud, ignoring income tax effects? (Use the answer template provided.)

Solve It

Cash		Accounts Payable	
Accounts Receivable		Notes Payable	
Inventory		Owners' Equity	
Fixed Assets (Net of Accumulated Depreciation)	_____		_____
Total Assets		Total Liabilities and Owners' Equity	

Answers to Problems on Elements of Business Accounting

The following are the answers to the practice questions presented earlier in this chapter.

- 1 Which of the following is the normal way to present the accounting equation?

c. Assets = Liabilities + Owners' equity

The other three accounting equations are correct from the algebraic equation point of view. However, the accounting equation is usually shown with assets on one side and the two broad classes of claims against the assets on the other side. **Note:** You see answer (b) (Assets – Liabilities = Owners' equity) when the purpose is to emphasize the *net worth* of a business, or its assets less its liabilities.

- 2 A business has \$485,000 total liabilities and \$1,200,000 total owners' equity. What is the amount of its total assets?

Total assets = \$1,685,000, which is the total of \$485,000 liabilities plus \$1,200,000 owners' equity.

- 3 A business has \$250,000 total liabilities. When it was started the owners invested \$500,000 in the business. Unfortunately, the business has suffered a cumulative loss of \$200,000 up to the present time. What is the amount of its total assets at the present time?

Total assets = \$550,000, which is the total of \$250,000 liabilities plus \$300,000 owners' equity.

Notice that the original \$500,000 that the owners invested in the business is reduced by the \$200,000 cumulative loss of the business, and owners' equity is now only \$300,000.

- 4 A business has \$175,000 total liabilities. Originally, at the time of starting the business, the owners invested \$250,000 capital. The business has earned \$190,000 cumulative profit since it started (all of which has been retained in the business). What is the total amount of its assets?

Total assets = \$615,000, which is the total of \$175,000 liabilities and \$440,000 owners' equity.

Notice that in addition to the original \$250,000 capital invested by owners, the business has earned \$190,000 profit, so its total owners' equity is \$440,000.

- 5 What would be the amount of accrual-basis sales revenue for the year if the business's year-end receivables had been \$92,000? (For the original numbers, see the section "Distinguishing Between Cash- and Accrual-Basis Accounting.")

Sales revenue (\$558,000 cash receipts + \$92,000 year-end receivables) = \$650,000

- 6 What would be the amount of accrual-basis cost of products sold expense for the year if the business's cost of products held in inventory at year-end had been \$95,000? (For the original numbers, see the section "Distinguishing Between Cash- and Accrual-Basis Accounting.")

Cost of products sold (\$375,000 cash payments – \$95,000 year-end inventory) = \$280,000

- 7 What would be the amount of accrual-basis other expenses for the year if the business's liability for unpaid expenses at year-end had been \$30,000? (For the original numbers, see the section "Distinguishing Between Cash- and Accrual-Basis Accounting.")

Other expenses (\$340,000 cash payments + \$30,000 year-end liability) = \$370,000

- 8 Based on the changes to the example given in Questions 5, 6, and 7, determine the profit or loss of the business for its first year.

In this case, the total of the two expenses (cost of products sold and other expenses) happens to be \$650,000, which is exactly equal to sales revenue. So the business *breaks even* for the year. This outcome is unusual, of course; the total of expenses for the year is almost always different than total sales revenue for the year.

- 9 One rule of income statement reporting is that interest expense and income tax expense be reported separately. The \$10,010,000 “Other expenses” in the income statement for the answer to the example question includes \$350,000 interest expense and \$910,000 income tax. Rebuild the income statement given the information for these additional two expenses. *Hint:* Profit before interest expense is usually labeled “operating earnings,” and profit after interest and before income tax expense is usually labeled “earnings before income tax.”

Income Statement for Year

Sales revenue	\$26,000,000
Cost of goods sold	<u>14,300,000</u>
Gross margin	\$11,700,000
Other expenses	<u>8,750,000</u>
Operating earnings	\$2,950,000
Interest expense	<u>350,000</u>
Earnings before income tax	\$2,600,000
Income tax expense	<u>910,000</u>
Net income	\$1,690,000



Burying interest expense or income tax expense in a broader expense category such as “other expenses” or “general expenses” is unacceptable. Interest and income tax expenses are reported toward the bottom of the income statement. They’re viewed as *nonoperating expenses*, which means that they depend on how the business is financed and its income tax situation.

- 10 No specific rule governs income statement disclosure of advertising expense. Suppose the \$10,010,000 “Other expenses” in the income statement for the answer to the example question includes \$5,000,000 of advertising expense. Would you favor reporting this as a separate expense in the income statement? *Hint:* This question calls for your opinion only.

Well, there’s no rule against disclosure of advertising expense — that’s for sure. Because it’s such a large expense, I favor disclosing it in the income statement. But most businesses are very sensitive about disclosing their advertising expense and, in fact, don’t disclose this expense in their income statements.

- 11 No specific rule governs income statement disclosure of executive-level compensation. Suppose the \$10,010,000 “Other expenses” in the income statement for the answer to the example question includes \$3,000,000 of executive-level compensation that includes both base salaries and generous bonuses. Would you favor reporting this as a separate expense in the income statement? *Hint:* This question calls for your opinion only.

Oh boy! This is a hot potato question. I’m all for open, frank, and transparent disclosure in financial reports, but this is like believing in Santa Claus. Most businesses are very reluctant to disclose executive-level compensation in their income statements or elsewhere in their financial reports. With no rule forcing such disclosure in their income statements, most businesses don’t reveal this piece of information. You can ask for executive-level compensation information if you’re on the board of directors of the business, but as an outside shareowner, don’t expect to get this information.

- 12** Please refer to the income statement for the answer to the example question. Suppose the business distributed \$650,000 cash to its shareowners from its profit (net income) for the year. Is this cash disbursement treated as an expense?

No, cash distributions from profit to the shareowners of a business aren't an expense. In other words, net income is before any distributions to shareowners.



Income statements generally don't disclose information regarding distributions from profit (net income) during the year. To be more accurate, I should say that an income statement doesn't *have to* disclose this information. However, some businesses don't end their income statements at bottom-line net income: They add net income to the retained earnings balance at the start of the year and deduct distributions from net income during the year to arrive at the year-end balance of retained earnings. But such disclosure isn't common practice. Distributions from net income usually are reported in a separate financial statement called the Statement of Changes in Owners' Equity, which I discuss in Chapter 8.

- 13** Suppose \$950,000 of owners' equity consists of profit earned and not distributed by the business. What is this amount usually called in the balance sheet? And, what is the other amount of owners' equity called in the balance sheet?

The \$950,000 of owners' equity over and above the amount of capital invested by the owners typically is called *retained earnings*. To be more precise, business corporations and limited liability companies use this term. (If a business is organized legally as a partnership, it follows different practices for reporting the partners' equity.)

- 14** It appears that the business can't pay its liabilities. The two liabilities total \$938,000, but the business has a cash balance of only \$396,000. Do you agree?

A business isn't expected to hold cash equal to the total of its liabilities. In my opinion, this business wouldn't be judged insolvent, although this judgment depends on how conservative or strict you are in evaluating solvency. The business's cash flow prospects are the key factor. The accounts receivable will be collected in the short-run, and this incoming cash will be available for paying the business's liabilities. Also, the inventory held by the business will be sold during the short-run and will generate cash flow.

- 15** Can you tell the amount of profit the business earned in the period just ended?

No, a balance sheet doesn't report profit (net income) for the most recent period. You look to its income statement for this key figure.

- 16** In a balance sheet, assets usually are listed in the order of their "nearness" to cash. Cash is listed first, followed by the asset closest to being converted into cash, and so on. Is the sequence of assets according to normal rules for presenting assets in balance sheets?

Yes, the sequence is correct according to conventional rules for reporting assets in a balance sheet. Cash is listed first, followed by assets according to their "nearness" to cash. In the example, the business doesn't have short-term investments in marketable securities. So, its accounts receivable asset is listed second, after cash, because these receivables will be collected in the short-term. Inventory is listed after accounts receivable because this asset consists of products that have to be sold before they can be converted into cash.

- 17** Based on the three of four components of cash flow for the year of a business that follow, determine the increase or decrease in cash during the year.

Cash flow from operating activities	\$450,000
Cash flow from investing activities	(\$725,000)
Cash flow from financing activities	<u>\$50,000</u>
Net increase (decrease) in cash during the year	????
Cash decreased \$225,000 during the year.	

- 18** Based on the three of four components of cash flow for the year of a business that follow, determine cash flow from investing activities for the year.

Cash flow from operating activities	\$2,680,000
Cash flow from investing activities	????
Cash flow from financing activities	<u>\$1,250,000</u>
Net increase (decrease) in cash during the year	\$400,000

Cash flow from investing activities for the year is a *negative* \$3,530,000. In other words, the net cash *decrease* from investing activities was \$3,530,000 during the year.

- 19** Based on the three of four components of cash flow for the year of a business that follow, determine cash flow from financing activities for the year.

Cash flow from operating activities	\$650,000
Cash flow from investing activities	(\$925,000)
Cash flow from financing activities	<u>????</u>
Net increase (decrease) in cash during the year	(\$65,000)

Cash flow from financing activities for the year is \$210,000. In other words, the net cash increase from financing activities was \$210,000 during the year.

- 20** Based on the three of four components of cash flow for the year of a business that follow, determine cash flow from operating activities for the year.

Cash flow from operating activities	????
Cash flow from investing activities	(\$480,000)
Cash flow from financing activities	<u>(\$150,000)</u>
Net increase (decrease) in cash during the year	\$150,000

Cash flow from operating activities for the year is \$780,000. In other words, the net cash increase from sales and expense (operating) activities was \$780,000 during the year.

- 21** Suppose a business commits accounting fraud by deliberately not writing down its inventory of \$268,000, which is the cost of certain products that it can no longer sell and will be thrown in the junk heap. How should its balance sheet be adjusted to correct for this accounting fraud, ignoring income tax effects?

The changes in the balance sheet to correct the fraudulent error are:

Cash		Accounts Payable	
Accounts Receivable		Notes Payable	
Inventory	(\$268,000)	Owners' Equity	(\$268,000)
Fixed Assets (Net of Accumulated Depreciation)	<u> </u>		<u> </u>
Total Assets	(\$268,000)	Total Liabilities and Owners' Equity	(\$268,000)

Accounts Receivable	Notes Payable	
Inventory	Owners' Equity	(\$465,000)
Fixed Assets (Net of Accumulated Depreciation)		
Total Assets	Total Liabilities and Owners' Equity	



