CHAPTER 1

lzf/Shutterstock

Introduction to Financial Statements

COPYRIGHTED MATERIAL

Chapter Preview

If you own a business, how do you determine whether it is making or losing money? How should you finance expansion—should you borrow, should you issue stock, should you use your own funds? How do you convince banks to lend you money or investors to buy your stock? Success in business requires making countless decisions, and decisions require financial information.

The purpose of this chapter is to show you what role accounting plays in providing financial information.

The **Chapter Preview** describes the purpose of the chapter and highlights major topics.

The **Feature Story** helps you picture how the chapter topic relates to the real world of accounting and business.

Feature Story

Knowing the Numbers

Many students who take this course do not plan to be accountants. If you are in that group, you might be thinking, "If I'm not going to be an accountant, why do I need to know accounting?" Well, consider this quote from Harold Geneen, the former chairman of **IT&T**: "To be good at your business, you have to know the numbers—cold." In business, accounting financial statements are the means for communicating the numbers. If you don't know how to read financial statements, you can't really know your business.

Knowing the numbers is sometimes even a matter of corporate survival. Consider the story of **Columbia Sportswear Company**, headquartered in Portland, Oregon. Gert Boyle's family fled Nazi Germany when she was 13 years old and then purchased a small hat company in Oregon, Columbia Hat Company. In 1971, Gert's husband, who was then running the company, died suddenly. Gert took over the small, struggling company with help from her son Tim, who was then a senior at the University of Oregon. Somehow, they kept the company afloat. Today, Columbia has more than 4,000 employees and annual sales in excess of $1 billion. Its brands include Columbia, Mountain Hardwear, Sorel, and Montrail.

Employers such as Columbia Sportswear generally assume that managers in all areas of the company are "financially literate." To help prepare you for that, in this text you will learn how to read and prepare financial statements, and how to use key tools to evaluate financial results using basic data analytics.

Chapter Outline

The **Chapter Outline** presents the chapter's topics and subtopics, as well as practice opportunities.

LEARNING OBJECTIVES	REVIEW	PRACTICE
LO 1 Identify the forms of business organization and the uses of accounting information.	• Forms of business organization • Users and uses of financial information • Data analytics • Ethics in financial reporting	**DO IT! 1a** Business Organization Forms **1b** Using Financial Information
LO 2 Explain the three principal types of business activity.	• Financing activities • Investing activities • Operating activities	**DO IT! 2** Business Activities
LO 3 Describe the four financial statements and how they are prepared.	• Income statement • Retained earnings statement • Balance sheet • Statement of cash flows • ESG reporting • Interrelationships of statements • Elements of an annual report	**DO IT! 3a** Financial Statements: Parts 1–4 **3b** Components of Annual Reports

Go to the Review and Practice section at the end of the chapter for a targeted summary and practice applications with solutions.

Additional tutorials and practice opportunities are available in the Wiley online course.

1.1 Business Organization and Accounting Information Uses

LEARNING OBJECTIVE 1

Identify the forms of business organization and the uses of accounting information.

Suppose you graduate with a business degree and decide you want to start your own business. But what kind of business? You enjoy working with people, especially teaching them new skills. You spend most of your free time outdoors, kayaking, backpacking, skiing, rock climbing, and mountain biking. You think you might successfully combine your teaching skills and outdoor interest by starting an outdoor guide service.

Forms of Business Organization

What organizational form should you choose for your business? You have three choices—sole proprietorship, partnership, or corporation.

Sole Proprietorship

You might choose the sole proprietorship form for your outdoor guide service.

- A business owned by one person is a **sole proprietorship**.
- It is **simple to set up** and **gives you control** over the business.

Small owner-operated businesses such as barber shops, law offices, and auto repair shops are often sole proprietorships, as are farms and small retail stores.

Partnership

Another possibility is for you to join forces with other individuals to form a partnership.

- A business owned by two or more persons associated as partners is a **partnership**.
- Partnerships often are formed because one individual does not have **enough economic resources** or other **unique skills or resources** to initiate or expand the business.

You and your partners should formalize your duties and contributions in a written partnership agreement. Retail and service-type businesses, including professional practices (lawyers, doctors, architects, and certified public accountants), often organize as partnerships.

Corporation

As a third alternative, you might organize as a corporation.

- A business organized as a separate legal entity owned by stockholders is a **corporation**.
- Investors in a corporation receive shares of stock to indicate their ownership claim.

Buying stock in a corporation is often more attractive than investing in a partnership because shares of stock are **easy to sell** (transfer ownership). Selling a proprietorship or partnership interest is much more involved. Also, individuals can become **stockholders** by investing relatively small amounts of money (see **Alternative Terminology**).

Therefore, it is **easier for corporations to raise funds** compared to sole proprietorships or partnerships. Successful corporations often have thousands of stockholders, and their stock is traded on organized stock exchanges like the **New York Stock Exchange**. Many businesses start as sole proprietorships or partnerships and eventually incorporate.

Other factors to consider in deciding which organizational form to choose are **taxes and legal liability**. Sole proprietorships or partnerships, generally receive more favorable tax treatment than corporations. However, proprietors and partners are personally liable for all debts and legal obligations of the business; corporate stockholders are not. In other words, corporate stockholders generally pay higher taxes but have no personal legal liability. We will discuss these issues in more depth in a later chapter.

Hybrid Forms of Organization

Finally, while sole proprietorships, partnerships, and corporations represent the main types of business organizations, hybrid forms are now allowed in all states.

- Hybrid business forms combine the tax advantages of partnerships with the limited liability of corporations.
- Probably the most common among these hybrid types are limited liability companies (LLCs) and subchapter S corporations (these forms are discussed extensively in business law classes).

The combined number of proprietorships and partnerships in the United States far exceeds the number of corporations. However, the revenue produced by corporations is many times greater. Most of the largest businesses in the United States—for example, **Apple**, **Google**, **Verizon**, **Visa**, and **Microsoft**—are corporations. Because the majority of U.S. business is done by corporations, the emphasis in this text is on the corporate form of organization.

Sole Proprietorship

- Simple to establish
- Owner-controlled
- Tax advantages

Partnership

- Simple to establish
- Shared control
- Broader skills and resources
- Tax advantages

Corporation

- Easier to transfer ownership
- Easier to raise funds
- No personal liability

ALTERNATIVE TERMINOLOGY

Stockholders are sometimes called *shareholders*.

Alternative Terminology notes present synonymous terms that you may come across in practice.

DO IT! exercises prompt you to stop and review the key points you have just studied. The **Action Plan** offers you tips about how to approach the problem.

ACTION PLAN

- **Know which organizational form best matches the business type, size, and preferences of the owner(s).**

DO IT! 1a | Business Organization Forms

In choosing the organizational form for your outdoor guide service, you should consider the pros and cons of each. Identify each of the following organizational characteristics with the organizational form or forms with which it is associated (sole proprietorship, partnership, or corporation).

1. Easier to raise funds.
2. Simple to establish.
3. No personal legal liability.
4. Tax advantages.
5. Easier to transfer ownership.

Solution

1. Easier to raise funds: Corporation.
2. Simple to establish: Sole proprietorship and partnership.
3. No personal legal liability: Corporation.
4. Tax advantages: Sole proprietorship and partnership.
5. Easier to transfer ownership: Corporation.

Related exercise material: BE1.1, DO IT! 1.1a, and E1.2.

Users and Uses of Financial Information

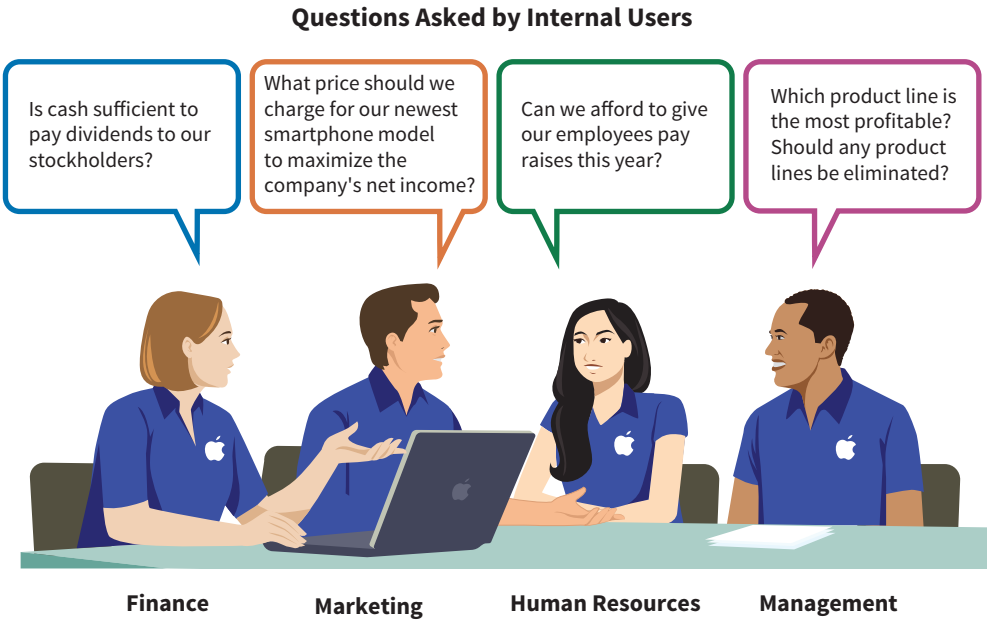
The purpose of financial information is to provide inputs for decision-making.

- **Accounting** is the information system that identifies, records, and communicates the economic events of an organization to interested users.
- **Users** of accounting information can be divided broadly into two groups: internal users and external users.

Internal Users

Internal users of accounting information are managers who plan, organize, and run a business. These include **marketing managers**, **production supervisors**, **finance directors**, **and company officers**. In running a business, managers must answer many important questions, as shown in **Illustration 1.1**.

ILLUSTRATION 1.1 **Questions that internal users ask**



To answer these and other questions, you need detailed information on a timely basis. For internal users, accounting provides internal reports, such as financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year. In addition, companies present summarized financial information in the form of financial statements.

Accounting Across the Organization boxes show applications of accounting information in various business functions.

Accounting Across the Organization Clif Bar & Company

carterdayne/Getty Images

Owning a Piece of the Bar

The original Clif Bar energy bar was created in 1990 after six months of experimentation by Gary Erickson and his mother in her kitchen. Today, the company has approximately 1,000 employees and was named one of Landor's Breakaway Brands.

One of **Clif Bar & Company**'s proudest moments was the creation of an employee stock ownership plan (ESOP). This plan gives its employees 20% ownership of the company. The ESOP also resulted in Clif Bar enacting an open-book management program, including the commitment to educate all employee-owners about its finances.

Armed with basic accounting knowledge, employees are more aware of the financial impact of their actions, which leads to better decisions.

What are the benefits to the company and to the employees of making the financial statements available to all employees? (Answer is available at the end of the chapter.)

External Users

There are several types of **external users** of accounting information. **Investors** (owners) use accounting information to make decisions to buy, hold, or sell stock. **Creditors,** such as suppliers and bankers, use accounting information to evaluate the risks of selling on credit or lending money. Some questions that investors and creditors may ask about a company are shown in **Illustration 1.2**.

ILLUSTRATION 1.2 **Questions that external users ask**

The information needs and questions of other external users vary considerably.

- **Taxing authorities**, such as the Internal Revenue Service, want to know whether the company complies with the tax laws.
- **Customers** are interested in whether a company like **Tesla** will be able to honor product warranties and otherwise support its product lines.
- **Labor unions**, such as the Major League Baseball Players Association, want to know whether the owners have the ability to pay increased wages and benefits.
- **Regulatory agencies**, such as the Securities and Exchange Commission or the Federal Trade Commission, want to know whether the company is operating within prescribed rules.

For example, **Enron**, **Dynegy**, **Duke Energy**, and other big energy-trading companies reported record profits at the same time as California was paying extremely high prices for energy and suffering from blackouts. This disparity caused regulators to investigate the energy traders to make sure that the profits were earned by legitimate and fair practices.

Data Analytics

Accounting software systems collect vast amounts of data about a company's economic events as well as its suppliers and customers. Business decision-makers take advantage of this wealth of data by using data analytics to gain insights and therefore make more informed business decisions.

Helpful Hints further clarify concepts being discussed.

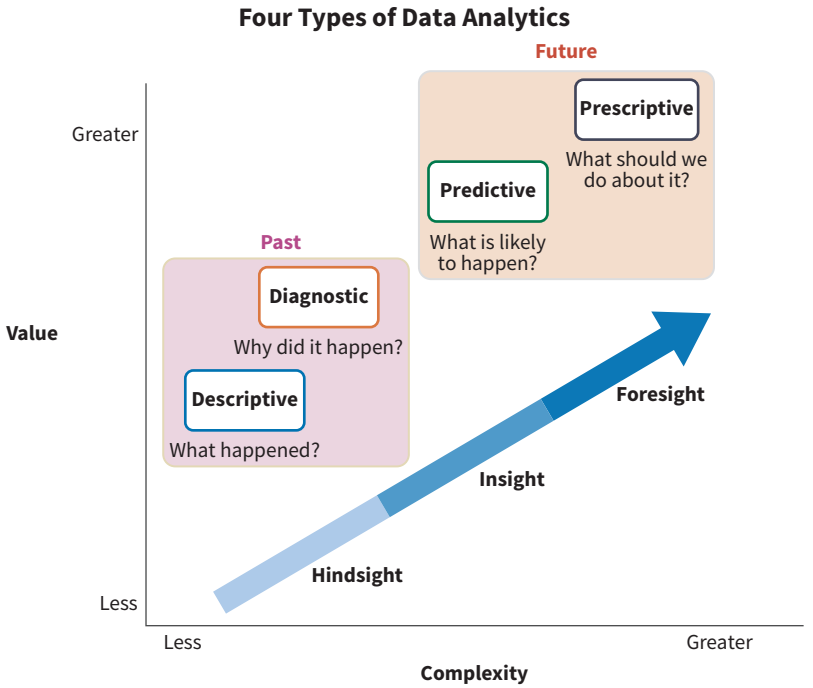
HELPFUL HINT

Throughout this text, we will highlight examples where accounting information is used to support business decisions using data analytics.

- **Data analytics** involves analyzing data, often employing both software and statistics, to draw inferences.
- As both data access and analytical software improve, the use of data analytics to support decisions is becoming increasingly common at virtually all types of companies (see **Helpful Hint**).

Illustration 1.3 shows the four most common types of data analytics that help answer questions ranging from what happened and why did it happen, to what is likely to happen and what should we do about it? Analytics range from simple analysis that can be performed using spreadsheets with tools like pivot tables and graphs, to complex statistical software and even artificial intelligence. More complex analysis often provides greater value to the business.

ILLUSTRATION 1.3
Four types of data analytics



Insight boxes provide examples of business situations from various perspectives—ethics; investor; international; environmental, social, and governance; and data analytics.

Data Analytics Insight Netflix

MohamadFaizal/Adobe Stock

Using Data Science to Create Art

Technology provides decision-makers and problem-solvers with access to a large volume of information called "big data." And **Netflix**, the world's leading subscription streaming entertainment service, is tapping into this big data as part of its efforts to ramp up its original content production.

In a recent year, Netflix planned to spend $8 billion on content creation. Producing content involves a blend of creativity, technology, and business decisions, all of which result in costs. And by analyzing the large amounts of data from past productions, such as filming locations and production

schedules, Netflix can more precisely estimate costs for future productions.

Further, consider that the production of a TV show or film involves hundreds of tasks. Here again, Netflix uses data science, in this case to visualize where bottlenecks might occur or where opportunities might exist to increase the efficiency of the production process.

Source: Based on Ritwik Kumar et. al., "Data Science and the Art of Producing Entertainment at Netflix," *The Netflix Tech Blog* (March 26, 2018).

How can "big data" improve decision-making? (Answer is available at the end of the chapter.)

Ethics in Financial Reporting

People won't gamble in a casino if they think it is "rigged." Similarly, people won't "play" the stock market if they think stock prices are rigged. At one time, major financial scandals at **Enron**, **WorldCom**, **HealthSouth**, and **AIG** led to a mistrust of financial reporting in general.

A *Wall Street Journal* article noted that "repeated disclosures about questionable accounting practices have bruised investors' faith in the reliability of earnings reports, which in turn has sent stock prices tumbling." Imagine trying to carry on a business or invest money if you could not depend on the financial statements to be honestly prepared. Information would have no credibility. A well-functioning economy depends on accurate and reliable financial reporting.

U.S. regulators and lawmakers were very concerned that the economy would suffer if investors lost confidence in corporate accounting because of unethical financial reporting.

- Congress passed the **Sarbanes-Oxley Act (SOX)** to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals (see **Ethics Note**).
- As a result of SOX, top management must now certify the fairness of financial information.
- In addition, penalties for fraudulent financial activity are much more severe.
- Also, SOX increased both the independence of the outside auditors who review the accuracy of corporate financial statements and the oversight role of boards of directors.

Effective financial reporting depends on sound ethical behavior. When analyzing ethics cases and your own ethical experiences, you should apply the three steps outlined in **Illustration 1.4**.

ETHICS NOTE

Circus-founder P.T. Barnum is alleged to have said, "Trust everyone, but cut the deck." What Sarbanes-Oxley does is to provide measures that (like cutting the deck of playing cards) help ensure that fraud will not occur.

Ethics Notes help sensitize you to some of the ethical issues in accounting.

ILLUSTRATION 1.4 **Steps in analyzing ethics cases**

Solving an Ethical Dilemma

1. **Recognize an ethical situation and the ethical issues involved.**
   Use your personal ethics to identify ethical situations and issues. Some businesses and professional organizations provide written codes of ethics for guidance in some business situations.

2. **Identify and analyze the principal elements in the situation.**
   Identify the **stakeholders**—persons or groups who may be harmed or benefited. Ask the question: What are the responsibilities and obligations of the parties involved?

3. **Identify the alternatives, and weigh the impact of each alternative on various stakeholders.**
   Select the most ethical alternative, considering all the consequences. Sometimes there will be one right answer. Other situations involve more than one right solution; these situations require you to evaluate each alternative and select the best one.

Ethics Insight Dewey & LeBoeuf LLP

Alliance/Adobe Stock

I Felt the Pressure—Would You?

"I felt the pressure." That's what some of the employees of the now-defunct law firm of **Dewey & LeBoeuf LLP** indicated when they helped to overstate revenue and use accounting tricks to hide losses and cover up cash shortages. These employees worked for the former finance director and former chief financial officer (CFO) of the firm. Here are some of their comments:

- "I was instructed by the CFO to create invoices, knowing they would not be sent to clients. When I created these invoices, I knew that it was inappropriate."
- "I intentionally gave the auditors incorrect information in the course of the audit."

What happened here is that a small group of lower-level employees over a period of years carried out the instructions of their bosses. Their bosses, however, seemed to have no concern about unethical practices as evidenced by various e-mails with one another in which they referred to their financial manipulations as accounting tricks, cooking the books, and fake income.

Sources: Based on Ashby Jones, "Guilty Pleas of Dewey Staff Detail the Alleged Fraud," *Wall Street Journal* (March 28, 2014); and Sara Randazzo, "Dewey CFO Escapes Jail Time in Fraud Case Sentencing," *Wall Street Journal* (October 10, 2017).

Why did these employees lie, and what do you believe should be their penalty for these lies? (Answer is available at the end of the chapter.)

ACTION PLAN

- **Review forms of business organization, users of financial information, approach to ethical dilemmas, and definition of data analytics.**

DO IT! 1b | Using Financial Information

There are a variety of users and uses of financial information. Match each of the following terms with its definition, classification type, or associated phrase.

a. ____ Data analytics.
b. ____ Internal users of financial information.
c. ____ Element of Sarbanes-Oxley Act.
d. ____ External users of financial information.
e. ____ Steps in solving an ethical dilemma.

1. Marketing managers, finance directors.
2. Management must certify the fairness of financial information.
3. Often employs both software and statistics to draw inferences.
4. Identify the alternatives and weigh the impact of each alternative on various stakeholders.
5. Investors, labor unions.

Solution

a. 3 **b.** 1 **c.** 2 **d.** 5 **e.** 4

Related exercise material: BE1.2, BE1.3, DO IT! 1.1b, E1.3, and E1.4.

1.2 The Three Types of Business Activity

LEARNING OBJECTIVE 2

Explain the three principal types of business activity.

Businesses engage in three types of activity—financing, investing, and operating. For example, consider Gert Boyle's parents, the founders of **Columbia Sportswear**.

1. The Boyles obtained cash through **financing** (from personal savings and outside sources like banks) to start and grow their business.

2. The family then **invested** the cash in equipment to run the business, such as sewing equipment and delivery vehicles.
3. Once this equipment was in place, they began the **operating** activities of making and selling clothing.

The **accounting information system** keeps track of the results of each of the various business activities—financing, investing, and operating. Let's look at each type of business activity in more detail.

Financing Activities

It takes money to make money. **Financing activities involve raising money from outside sources.** The two primary sources of outside funds for corporations are borrowing money (debt financing) and issuing (selling) shares of stock in exchange for cash (equity financing).

Columbia Sportswear may borrow money in a variety of ways. For example, it can take out a loan at a bank or borrow directly from investors by issuing debt securities called bonds. Persons or entities to whom Columbia owes money are its **creditors**.

Equity Financing

Debt Financing

- Amounts owed to creditors—in the form of debt and other obligations—are called **liabilities**.
- Specific names are given to different types of liabilities, depending on their source. Columbia may have a **note payable** to a bank for the money borrowed to purchase delivery trucks.
- Debt securities sold to investors that must be repaid at a particular date some years in the future are **bonds payable**.

Corporations also obtain funds by selling shares of stock to investors. **Common stock** is the term used to describe the total amount paid in by stockholders for the shares they purchase.

The claims of creditors differ from those of stockholders. If you loan money to a company, you are one of its creditors. In lending money, you specify a payment schedule (e.g., payment at the end of three months). As a creditor, you have a legal right to be paid at the agreed time. In the event of nonpayment, you may legally force the company to sell property to pay its debts. In the case of financial difficulty, creditor claims must be paid before stockholders' claims.

Stockholders, on the other hand, have no claim to corporate cash until the claims of creditors are satisfied. Suppose you buy a company's stock instead of loaning it money. You have no legal right to expect any payments from your stock ownership until all of the company's creditors are paid amounts currently due. However, many corporations make payments to stockholders on a regular basis as long as there is sufficient cash to cover required payments to creditors. These cash payments to stockholders are called **dividends**.

Investing Activities

Once the company has raised cash through financing activities, it uses that cash in investing activities. **Investing activities involve the purchase of the resources a company needs in order to operate.** Resources owned by a business are called **assets**. A growing company purchases many assets, such as computers, delivery trucks, furniture, and buildings.

Investing

- Different types of assets are given different names; Columbia Sportswear's sewing equipment is a type of asset referred to as **property, plant, and equipment** (see **Alternative Terminology**).
- **Cash** is one of the more important assets owned by Columbia or any other business.
- If a company has excess cash that it does not need for a while, it might choose to invest in securities (stocks or bonds) of other corporations, a type of asset referred to as **investments**.

ALTERNATIVE TERMINOLOGY

Property, plant, and equipment is sometimes called *fixed assets*.

Operating Activities

Operating

Once a business has the assets it needs to get started, it begins operating activities. **Operating activities are the day-to-day actions taken by a company to produce and sell a product, or provide a service.** Columbia Sportswear is in the business of selling outdoor clothing and footwear. It sells TurboDown jackets, Millennium snowboard pants, Sorel snow boots, Bugaboots, rainwear, and anything else you might need to protect you from the elements. We call amounts earned from the sale of these products **revenues**.

- **Revenue** is the increase in assets or decrease in liabilities resulting from the sale of goods or the performance of services in the normal course of business; Columbia records revenue when it sells a footwear product.
- Revenues arise from different sources and are identified by various names depending on the nature of the business; Columbia's primary source of revenue is the sale of sportswear (but it also generates interest revenue on debt securities held as investments).
- Sources of revenue common to many businesses are **sales revenue**, **service revenue**, and **interest revenue**.

The company purchases its longer-lived assets through investing activities as described earlier. Other assets with shorter lives, however, result from operating activities.

- **Supplies** are assets used in day-to-day operations (rather than sold to customers).
- Goods available for future sales to customers are assets called **inventory**.
- The right to receive money in the future is called an **account receivable**. If Columbia sells goods to a customer and does not receive cash immediately, then the company has a right to expect payment from that customer in the near future.

Before Columbia can sell a single Sorel boot, it must purchase wool, rubber, leather, metal lace loops, laces, and other materials. It then must process, wrap, and ship the finished product. It also incurs costs like salaries, rents, and utilities. All of these costs, referred to as **expenses**, are necessary to produce and sell the product.

- In accounting language, **expenses** are the cost of assets consumed or services used in the process of generating revenues.
- Expenses take many forms and are identified by various names depending on the type of asset consumed or service used.

For example, Columbia keeps track of these types of expenses: **cost of goods sold** (such as the cost of materials), **selling expenses** (such as the cost of salespersons' salaries), **marketing expenses** (such as the cost of advertising), **administrative expenses** (such as the salaries of administrative staff, and telephone and heating costs incurred at the corporate office), **interest expense** (amounts of interest paid on various debts), and **income tax expense** (corporate taxes paid to the government).

Columbia may also have liabilities arising from these expenses.

- For example, Columbia may purchase goods on credit from suppliers. The obligations to pay for these goods are called **accounts payable**.
- Additionally, Columbia may have **interest payable** on the outstanding amounts owed to the bank.
- It may also have **wages payable** to its employees and **sales taxes payable**, **property taxes payable**, and **income taxes payable** to the government.

Columbia compares the revenues of a period with the expenses of that period to determine whether it earned a profit. When revenues exceed expenses, **net income** results. When expenses exceed revenues, a **net loss** results.

DO IT! 2 | Business Activities

Classify each item as an asset, liability, common stock, revenue, or expense.

1. Cost of renting property.
2. Truck purchased.
3. Notes payable.
4. Issuance of ownership shares.
5. Amount recorded from performing services.
6. Amounts owed to suppliers.

ACTION PLAN

- **Classify each item based on its economic characteristics. Proper classification of items is critical if accounting is to provide useful information.**

Solution

1. Cost of renting property: Expense.
2. Truck purchased: Asset.
3. Notes payable: Liability.
4. Issuance of ownership shares: Common stock.
5. Amount recorded from performing services: Revenue.
6. Amounts owed to suppliers: Liability.

Related exercise material: BE1.4, DO IT! 1.2, and E1.8.

1.3 The Four Financial Statements

LEARNING OBJECTIVE 3

Describe the four financial statements and how they are prepared.

Assets, liabilities, expenses, and revenues are of interest to users of accounting information. This information is arranged in the format of four different **financial statements**, which form the backbone of financial accounting:

1. **Income statement.** Shows how successfully your business performed during a period of time, by subtracting expenses from revenues.
2. **Retained earnings statement.** Indicates how much of previous income was distributed to owners of your business in the form of dividends, and how much was retained in the business to allow for future growth.
3. **Balance sheet.** Presents a picture at a point in time of what your business owns (its assets) and what it owes (its liabilities).
4. **Statement of cash flows.** Shows where your business obtained cash during a period of time and how that cash was used.

To introduce you to these statements, we have prepared the financial statements for your outdoor guide service, Sierra Corporation, after your first month of operations (see **International Note**).

To summarize, you officially started your business in Truckee, California, on October 1, 2027. Sierra provides guide services in the Lake Tahoe area of the Sierra Nevada mountains. Its promotional materials describe outdoor day trips, such as rafting, snowshoeing, and hiking, as well as multi-day backcountry experiences. To minimize your initial investment, your customers either bring their own equipment or rent equipment through local outfitters. The financial statements for Sierra's first month of business are provided in the following pages.

International Note

The primary types of financial statements required by International Financial Reporting Standards (IFRS) and U.S. generally accepted accounting principles (GAAP) are the same. However, in practice, some format differences do exist in presentations commonly employed by IFRS companies as compared to GAAP companies.

International Notes highlight differences between U.S. and international accounting standards.

Income Statement

HELPFUL HINT

The financial statement heading identifies the company, the type of statement, and the time period covered.

The **income statement** reports a company's revenues and expenses and resulting net income or loss for a period of time (see **Decision Tools**). To indicate that its income statement reports the results of operations for a **specific period of time**, Sierra Corporation dates the income statement "For the Month Ended October 31, 2027." The income statement lists the company's revenues followed by its expenses. Finally, Sierra determines the net income (or net loss) by deducting expenses from revenues. Sierra's income statement is shown in **Illustration 1.5** (see **Helpful Hint**). Congratulations, you are already showing a profit!

ILLUSTRATION 1.5
Sierra Corporation's income statement

Sierra Corporation
Income Statement
For the Month Ended October 31, 2027

Revenues		
Service revenue		$10,600
Expenses		
Salaries and wages expense	$5,200	
Supplies expense	1,500	
Rent expense	900	
Interest expense	50	
Insurance expense	50	
Depreciation expense	40	
Total expenses		7,740
Net income		$ 2,860

Decision Tools

The income statement helps users determine if the company's operations are profitable.

Decision Tools that are useful for business decision-making are highlighted throughout the text. A summary of the Decision Tools is also provided in each chapter.

Why are financial statement users interested in net income?

- **Investors are interested in a company's past net income because it provides useful information for predicting future net income.** Investors buy and sell stock based on their beliefs about a company's future performance. If investors believe that Sierra will be successful in the future and that this will result in a higher stock price, they will buy its stock.
- **Creditors use the income statement to predict future earnings.** When a bank loans money to a company, it believes that it will be repaid in the future. If it didn't think it would be repaid, it wouldn't loan the money. Therefore, prior to making the loan the bank loan officer uses the income statement as a source of information to predict whether the company will be profitable enough to repay its loan.

ETHICS NOTE

When companies find errors in previously released income statements, they restate those numbers. Perhaps because of the increased scrutiny shortly after Sarbanes-Oxley was implemented, companies filed a record 1,195 restatements.

Thus, reporting a strong profit will make it easier for Sierra to raise additional cash either by issuing shares of stock or borrowing.

Amounts received from issuing stock are not revenues, and amounts paid out as dividends are not expenses. As a result, they are not reported on the income statement. For example, Sierra Corporation does not treat as revenue the $10,000 of cash received from issuing new stock (see Illustration 1.8), nor does it regard as a business expense the $500 of dividends paid (see Illustration 1.6) (see **Ethics Note**).

ACTION PLAN

- **Report the revenues and expenses for a period of time in an income statement.**

DO IT! 3a | Financial Statements—The Income Statement

Part 1: CSU Corporation began operations on January 1, 2027. The following information is available for CSU on December 31, 2027.

Accounts receivable	$ 1,800	Retained earnings	$ 0	Supplies expense	$ 200
Accounts payable	2,000	Equipment	16,000	Cash	1,400
Rent expense	9,000	Insurance expense	1,000	Dividends	600
Notes payable	5,000	Service revenue	17,000		
Common stock	10,000	Supplies	4,000		

Prepare an income statement.

Solution

CSU Corporation Income Statement For the Year Ended December 31, 2027		
Revenues		
Service revenue		$17,000
Expenses		
Rent expense	$9,000	
Insurance expense	1,000	
Supplies expense	200	
Total expenses		10,200
Net income		$ 6,800

Related exercise material: BE1.7, DO IT! 1.3a, E1.10, E1.11, E1.15, E1.16, E1.17, and E1.20.

Retained Earnings Statement

If Sierra Corporation is profitable, at the end of each period it must decide what portion of profits to pay to shareholders in dividends. In theory, it could pay all of its current-period profits, but few companies do this. Why? Because they want to retain part of the profits to allow for further expansion. High-growth companies, such as **Google** and **Meta**, often pay no dividends. **Retained earnings** is the net income retained in the corporation.

The **retained earnings statement** shows the amounts and causes of changes in retained earnings for a specific time period (see **Decision Tools**). The time period is the same as that covered by the income statement. The beginning retained earnings amount appears on the first line of the statement. Then, the company adds net income and deducts dividends to determine the retained earnings at the end of the period. If a company has a net loss, it deducts (rather than adds) that amount in the retained earnings statement. **Illustration 1.6** presents Sierra's retained earnings statement (see **Helpful Hint**).

Decision Tools

The retained earnings statement helps users determine the company's policy toward dividends and growth.

HELPFUL HINT

The heading of this statement identifies the company, the type of statement, and the time period covered by the statement.

ILLUSTRATION 1.6

Sierra Corporation's retained earnings statement

Sierra Corporation Retained Earnings Statement For the Month Ended October 31, 2027	
Retained earnings, October 1	$ 0
Add: Net income	2,860
	2,860
Less: Dividends	500
Retained earnings, October 31	$2,360

By monitoring the retained earnings statement, financial statement users can evaluate dividend payment practices.

- Some investors seek companies, such as **Dow Chemical**, that have a history of paying high dividends.
- Other investors seek companies, such as **Amazon.com**, that reinvest earnings to increase the company's growth instead of paying dividends.
- Lenders monitor their corporate customers' dividend payments because any money paid in dividends reduces a company's ability to repay its debts.

ACTION PLAN

- **Show the amounts and causes (net income and dividends) of changes in retained earnings during the period in the retained earnings statement.**

DO IT! 3a | Financial Statements—The Retained Earnings Statement

Part 2: CSU Corporation began operations on January 1, 2027. The following information is available for CSU on December 31, 2027.

Accounts receivable	$ 1,800	Retained earnings	$ 0	Supplies expense	$ 200
Accounts payable	2,000	Equipment	16,000	Cash	1,400
Rent expense	9,000	Insurance expense	1,000	Dividends	600
Notes payable	5,000	Service revenue	17,000		
Common stock	10,000	Supplies	4,000		

Prepare a retained earnings statement. Refer to **DO IT! 3a Part 1** for net income.

Solution

CSU Corporation
Retained Earnings Statement
For the Year Ended December 31, 2027

Retained earnings, January 1	$ 0
Add: Net income	6,800
	6,800
Less: Dividends	600
Retained earnings, December 31	$6,200

Related exercise material: BE1.11, DO IT! 1.3a, E1.10, E1.11, E1.17, E1.18, and E1.19.

Balance Sheet

Decision Tools

The balance sheet helps users determine whether the company relies on debt or stockholders' equity to finance its assets.

The **balance sheet** reports assets and claims to assets at a specific **point** in time (see **Decision Tools**). Claims to assets are subdivided into two categories: claims of creditors and claims of owners. As noted earlier, claims of creditors are called **liabilities**. The owners' claim to assets is called **stockholders' equity**.

Illustration 1.7 shows the relationship among the categories on the balance sheet in equation form.

- This equation is referred to as the **basic accounting equation**.
- This relationship is where the name "balance sheet" comes from. Assets must balance with the claims to assets.

ILLUSTRATION 1.7
Basic accounting equation

Assets = Liabilities + Stockholders' Equity

HELPFUL HINT

The heading of a balance sheet must identify the company, the statement, and the date.

ALTERNATIVE TERMINOLOGY

Liabilities are also referred to as *debt*.

As you can see from looking at Sierra Corporation's balance sheet in **Illustration 1.8**, the balance sheet presents the company's financial position as of a specific date—in this case, October 31, 2027 (see **Helpful Hint**). It lists assets first. Assets are listed in the order of their liquidity, that is, how quickly they could be converted to cash.

Assets are followed by liabilities and stockholders' equity (see **Alternative Terminology**). Stockholders' equity is comprised of two parts: (1) common stock and (2) retained earnings. As noted earlier, common stock results when the company sells new shares of stock;

retained earnings is the net income retained in the corporation. Sierra has common stock of $10,000 and retained earnings of $2,360, for total stockholders' equity of $12,360.

ILLUSTRATION 1.8
Sierra Corporation's balance sheet

Sierra Corporation
Balance Sheet
October 31, 2027

Assets		
Cash		$15,200
Accounts receivable		200
Supplies		1,000
Prepaid insurance		550
Equipment, net		4,960
Total assets		$21,910
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$ 5,000	
Accounts payable	2,500	
Unearned service revenue	800	
Salaries and wages payable	1,200	
Interest payable	50	
Total liabilities		$ 9,550
Stockholders' equity		
Common stock	10,000	
Retained earnings	2,360	
Total stockholders' equity		12,360
Total liabilities and stockholders' equity		$21,910

Creditors analyze a company's balance sheet to determine the likelihood that they will be repaid.

- Creditors carefully evaluate the nature of the company's assets and liabilities.
- In operating Sierra's guide service, the balance sheet will be used to determine whether cash on hand is sufficient for immediate cash needs.
- The balance sheet will also be used to evaluate the relationship between debt and stockholders' equity to determine whether the company has a satisfactory proportion of debt and common stock financing.

DO IT! 3a | Financial Statements—The Balance Sheet

Part 3: CSU Corporation began operations on January 1, 2027. The following information is available for CSU on December 31, 2027.

Accounts receivable	$ 1,800	Retained earnings	$ 0	Supplies expense	$ 200
Accounts payable	2,000	Equipment	16,000	Cash	1,400
Rent expense	9,000	Insurance expense	1,000	Dividends	600
Notes payable	5,000	Service revenue	17,000		
Common stock	10,000	Supplies	4,000		

Prepare a balance sheet. Refer to **DO IT! 3a Part 2** for the ending balance in Retained Earnings.

ACTION PLAN

- **Present the assets and claims to those assets (liabilities and stockholders' equity) at a specific point in time in the balance sheet.**

Solution

CSU Corporation Balance Sheet December 31, 2027		
Assets		
Cash		$ 1,400
Accounts receivable		1,800
Supplies		4,000
Equipment		16,000
Total assets		$23,200
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$ 5,000	
Accounts payable	2,000	
Total liabilities		$ 7,000
Stockholders' equity		
Common stock	10,000	
Retained earnings	6,200	
Total stockholders' equity		16,200
Total liabilities and stockholders' equity		$23,200

Related exercise material: BE1.6, BE1.8, BE1.9, BE1.10, BE1.11, DO IT! 1.3a, E1.13, E1.17, E1.18, and E1.23.

Statement of Cash Flows

Decision Tools

The statement of cash flows helps users determine if the company generates enough cash from operations to fund its investing activities.

The primary purpose of a **statement of cash flows** is to provide financial information about the cash receipts and cash payments of a business for a specific period of time (see **Decision Tools**). To help investors, creditors, and others in their analysis of a company's cash position, the statement of cash flows reports the cash effects of a company's **operating**, **investing**, and **financing** activities. In addition, the statement shows the net increase or decrease in cash during the period, and the amount of cash at the end of the period.

Users are interested in the statement of cash flows because they want to know what is happening to a company's most important resource. The statement of cash flows provides answers to these simple but important questions:

- Where did cash come from during the period?
- How was cash used during the period?
- What was the change in the cash balance during the period?

HELPFUL HINT

The heading of this statement identifies the company, the type of statement, and the time period covered by the statement. Negative numbers are shown in parentheses.

The statement of cash flows for Sierra Corporation, in **Illustration 1.9**, shows that cash increased $15,200 during the month (see **Helpful Hint**). This increase resulted because operating activities (services to clients) increased cash $5,700, and financing activities increased cash $14,500. Investing activities used $5,000 of cash for the purchase of equipment.

ILLUSTRATION 1.9

Sierra Corporation's statement of cash flows

Sierra Corporation Statement of Cash Flows For the Month Ended October 31, 2027		
Cash flows from operating activities		
Cash receipts from operating activities	$11,200	
Cash payments for operating activities	(5,500)	
Net cash provided by operating activities		$ 5,700

ILLUSTRATION 1.9
(continued)

Cash flows from investing activities		
Purchased office equipment	(5,000)	
Net cash used by investing activities		(5,000)
Cash flows from financing activities		
Issuance of common stock	10,000	
Issuance of note payable	5,000	
Payment of dividend	(500)	
Net cash provided by financing activities		14,500
Net increase in cash		15,200
Cash at beginning of period		0
Cash at end of period		$15,200

ESG Reporting: Beyond the Four Financial Statements

Columbia Sportswear does not just focus on financial success. Several of its factories continue to participate in a project to increase health awareness of female factory workers in developing countries. Columbia is also a founding member of the Sustainable Apparel Coalition, which strives to reduce the environmental and social impact of the apparel industry. In addition, the company monitors all of the independent factories that produce its products to ensure that they comply with the company's Standards of Manufacturing Practices. These standards address such issues as forced labor, child labor, harassment, wages and benefits, health and safety, and the environment.

With that in mind, should we expand our financial statements to take into account environmental, social, and governance performance (**ESG reporting**), in addition to financial results, in evaluating a company?

- The idea is that a company's responsibility lies with anyone who is influenced by its actions.
- In other words, a company should be interested in benefiting many different parties, instead of only maximizing stockholders' interests.

A socially responsible business does not exploit or endanger any group of individuals. It follows fair trade practices, provides safe environments for workers, and bears responsibility for environmental damage. Measurement of these factors is difficult, but many interesting and useful efforts are underway.

Interrelationships of Statements

Illustration 1.10 shows the financial statements of Sierra Corporation (see **Helpful Hints**). Because the results on some financial statements become inputs to other statements, the statements are interrelated. These interrelationships can be seen in Sierra's financial statements, as follows.

1. **The retained earnings statement uses the results of the income statement.** Sierra reported net income of $2,860 for the period. Net income is added to the beginning amount of retained earnings to determine ending retained earnings.
2. **The balance sheet and retained earnings statement are also interrelated.** Sierra reports the ending amount of $2,360 on the retained earnings statement as the retained earnings amount on the balance sheet.
3. **The statement of cash flows relates to information on the balance sheet.** The statement of cash flows shows how the Cash account changed during the period. It shows the amount of cash at the beginning of the period, the sources and uses of cash during the period, and the $15,200 of cash at the end of the period. The ending amount of cash shown on the statement of cash flows must agree with the amount of cash on the balance sheet.

Study these interrelationships carefully. **To prepare financial statements, you must understand the sequence in which these amounts are determined and how each statement impacts the next.**

ILLUSTRATION 1.10

Sierra Corporation's financial statements

HELPFUL HINT

Note that final sums are double-underlined.

HELPFUL HINT

The arrows in this illustration show the interrelationships of the four financial statements.

HELPFUL HINT

Negative amounts are presented in parentheses.

Sierra Corporation
Income Statement
For the Month Ended October 31, 2027

Revenues		
Service revenue		$10,600
Expenses		
Salaries and wages expense	$5,200	
Supplies expense	1,500	
Rent expense	900	
Interest expense	50	
Insurance expense	50	
Depreciation expense	40	
Total expenses		7,740
Net income		$ 2,860

Sierra Corporation
Retained Earnings Statement
For the Month Ended October 31, 2027

Retained earnings, October 1	$ 0
Add: Net income	2,860
	2,860
Less: Dividends	500
Retained earnings, October 31	$2,360

Sierra Corporation
Balance Sheet
October 31, 2027

Assets		
Cash		$15,200
Accounts receivable		200
Supplies		1,000
Prepaid insurance		550
Equipment, net		4,960
Total assets		$21,910
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$ 5,000	
Accounts payable	2,500	
Unearned service revenue	800	
Salaries and wages payable	1,200	
Interest payable	50	
Total liabilities		$ 9,550
Stockholders' equity		
Common stock	10,000	
Retained earnings	2,360	
Total stockholders' equity		12,360
Total liabilities and stockholders' equity		$21,910

Sierra Corporation
Statement of Cash Flows
For the Month Ended October 31, 2027

Cash flows from operating activities		
Cash receipts from operating activities	$11,200	
Cash payments for operating activities	(5,500)	
Net cash provided by operating activities		$ 5,700
Cash flows from investing activities		
Purchased office equipment	(5,000)	
Net cash used by investing activities		(5,000)
Cash flows from financing activities		
Issuance of common stock	10,000	
Issuance of note payable	5,000	
Payment of dividend	(500)	
Net cash provided by financing activities		14,500
Net increase in cash		15,200
Cash at beginning of period		0
Cash at end of period		$15,200

DO IT! 3a | Financial Statements

Part 4: BRB Corporation began operations on January 1, 2027. The following information is available for BRB on December 31, 2027.

Accounts receivable	$ 1,600	Retained earnings	$ 0	Supplies expense	$ 300
Accounts payable	3,000	Equipment	21,000	Cash	2,400
Rent expense	7,000	Insurance expense	2,000	Dividends	700
Notes payable	4,000	Service revenue	21,000		
Common stock	12,000	Supplies	5,000		

Prepare an income statement, a retained earnings statement, and a balance sheet.

ACTION PLAN

- **Report the revenues and expenses for a period of time in an income statement.**
- **Show the amounts and causes (net income and dividends) of changes in retained earnings during the period in the retained earnings statement.**
- **Present the assets and claims to those assets (liabilities and stockholders' equity) at a specific point in time in the balance sheet.**

Solution

BRB Corporation
Income Statement
For the Year Ended December 31, 2027

Revenues		
Service revenue		$21,000
Expenses		
Rent expense	$7,000	
Insurance expense	2,000	
Supplies expense	300	
Total expenses		9,300
Net income		$11,700

BRB Corporation
Retained Earnings Statement
For the Year Ended December 31, 2027

Retained earnings, January 1	$ 0
Add: Net income	11,700
	11,700
Less: Dividends	700
Retained earnings, December 31	$11,000

BRB Corporation
Balance Sheet
December 31, 2027

Assets		
Cash		$ 2,400
Accounts receivable		1,600
Supplies		5,000
Equipment		21,000
Total assets		$30,000
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$ 4,000	
Accounts payable	3,000	
Total liabilities		$ 7,000
Stockholders' equity		
Common stock	12,000	
Retained earnings	11,000	
Total stockholders' equity		23,000
Total liabilities and stockholders' equity		$30,000

Related exercise material: BE1.6, BE1.7, BE1.10, DO IT! 1.3a, E1.10, E1.11, E1.12, E1.13, E1.14, E1.15, E1.16, E1.17, E1.18, E1.19, E1.20, and E1.23.

Elements of an Annual Report

Publicly traded U.S. companies must provide shareholders with an **annual report**. The annual report always includes the financial statements introduced in this chapter. The annual report also includes other important information such as a management discussion and analysis section, notes to the financial statements, and an independent auditor's report. No analysis of a company's financial situation and performance is complete without a review of these items.

Management Discussion and Analysis

The **management discussion and analysis (MD&A)** section presents management's views on the company's:

- Ability to pay near-term obligations.
- Ability to fund operations and expansion.
- Results of operations.

Management must highlight favorable or unfavorable trends and identify significant events and uncertainties that affect these three factors. This discussion obviously involves a number of subjective estimates and opinions. A brief excerpt from the MD&A section of a recent **Columbia Sportswear** annual report, which addresses its liquidity requirements, is presented in **Illustration 1.11**.

ILLUSTRATION 1.11
Columbia Sportswear's management discussion and analysis

Real World

Columbia Sportswear Company Management's Discussion and Analysis of Seasonality and Variability of Business
Our business is affected by the general seasonal trends common to the industry, including discretionary consumer shopping and spending patterns, as well as seasonal weather. Our products are marketed on a seasonal basis, and our sales are weighted substantially toward the third and fourth quarters, while our operating costs are more equally distributed throughout the year.

Notes to the Financial Statements

Explanatory notes and supporting schedules accompany every set of financial statements and are an integral part of the statements. The **notes to the financial statements** clarify the financial statements and provide additional detail. Information in the notes does not have to be quantifiable (numeric). Examples of notes are:

- Descriptions of the significant accounting policies and methods used in preparing the statements.
- Explanations of uncertainties and contingencies.
- Various statistics and details too voluminous to be included in the statements.

The notes are essential to understanding a company's operating performance and financial position.

Illustration 1.12 is an excerpt from the notes to recent **Columbia Sportswear** financial statements. It describes the methods that the company uses to account for revenues.

ILLUSTRATION 1.12
Notes to Columbia Sportswear's financial statements
Real World

Columbia Sportswear Company
Notes to Financial Statements
Revenue Recognition

Revenues are recognized when our performance obligations are satisfied as evidenced by transfer of control of promised goods to our customers, in an amount that reflects the consideration we expect to be entitled to receive in exchanges for those goods or services. Within our wholesale channel, control generally transfers to the customer upon shipment to, or upon receipt by, the customer depending on the terms of sale with the customer. Within our DTC channel, control generally transfers to the customer at the time of sale within our retail stores and concession-based arrangements and upon shipment to the customer with respect to e-commerce transactions.

Auditor's Report

An **auditor's report** is prepared by an independent outside auditor. It states the auditor's opinion as to the fairness of the presentation of the financial position and results of operations and their conformance with generally accepted accounting principles.

An **auditor** is an accounting professional who conducts an independent examination of a company's financial statements. Only accountants who meet certain criteria and thereby attain the designation **certified public accountant (CPA)** may certify audits.

- If the auditor is satisfied that the financial statements provide a fair representation of the company's financial position and results of operations in accordance with generally accepted accounting principles, then the auditor expresses an **unqualified opinion**.
- If the auditor expresses anything other than an unqualified opinion, then readers should only use the financial statements with caution.
- That is, without an unqualified opinion, we cannot have complete confidence that the financial statements give a fair picture of the company's financial health.
- A new auditing standard requires the auditor to report any **critical audit matters**. These are items that are material in size that involve challenging, subjective, or complex auditor judgment.

For example, **Blockbuster** once dominated movie rentals in the United States with over 9,000 stores. But it faltered when the upstart **Netflix** rapidly took over the movie-rental business. Blockbuster's auditor then stated that its financial situation raised "substantial doubt about the Company's ability to continue as a going concern." Shortly after that, the company filed for bankruptcy.

Illustration 1.13 is an excerpt from the auditor's report from Columbia Sportswear's annual report. Columbia received an unqualified opinion from its auditor, **Deloitte & Touche**.

ILLUSTRATION 1.13
Excerpt from auditor's report on Columbia Sportswear's financial statements
Real World

Columbia Sportswear Company
Excerpt from Auditor's Report

We have audited the accompanying consolidated balance sheets of Columbia Sportswear Company and subsidiaries (the "Company") as of December 31, 2020 and 2019, the related consolidated statements of operations, comprehensive income, equity, and cash flows for each of the three years in the period ended December 31, 2020, and the related notes and schedule listed in the Index at Item 15 (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2020 and 2019, and the results of its operations and its cash flows for each of the three years ended December 31, 2020, in conformity with accounting principles generally accepted in the United States of America.

Accounting Across the Organization

Prostock-studio/Adobe Stock

Spinning the Career Wheel

How will the study of accounting help you? A working knowledge of accounting is desirable for virtually every field of business. Some examples of how accounting is used in business careers include the following.

General management: Managers of **Harley-Davidson**, a **Qdoba** franchise, and a **Trek** bike shop all need to understand accounting data in order to make wise business decisions.

Marketing: Marketing specialists at **Hulu** must be sensitive to costs and benefits to ensure that marketing efforts increase company profits.

Finance: Do you want to work for **Robinhood**, **E-Trade**, or **Goldman Sachs**? Financial fields rely heavily on accounting knowledge to analyze financial statements. In fact, it is difficult to get a good job in a finance function without two or three courses in accounting.

Real estate: Because a third party—the bank—is almost always involved in financing a real estate transaction, brokers at **Prudential Real Estate** must understand the numbers involved.

Accounting: Certified public accountants (CPAs) examine (audit) the financial statements and issue opinions on the accuracy of the financial presentation. Some CPAs offer tax advice and planning. Others work for for-profit companies such as **Starbucks** or **Google**, or for non-profit entities such as the **Red Cross**, where they manage the accounting information systems and prepare financial statements. Opportunities also exist in government, including the **Federal Bureau of Investigation (FBI)**. Finally, forensic accountants conduct investigations into theft and fraud.

How might accounting help you? (Answer is available at the end of the chapter.)

ACTION PLAN

- **Realize that financial statements provide information about a company's performance and financial position.**
- **Be familiar with the other elements of the annual report in order to gain a fuller understanding of a company.**

DO IT! 3b | Components of Annual Reports

State whether each of the following items is most closely associated with the management discussion and analysis (MD&A), the notes to the financial statements, or the auditor's report.

1. Descriptions of significant accounting policies.
2. Unqualified opinion.
3. Explanations of uncertainties and contingencies.
4. Description of ability to fund operations and expansion.
5. Description of results of operations.
6. Certified public accountant (CPA).

Solution

1. Descriptions of significant accounting policies: Notes.
2. Unqualified opinion: Auditor's report.
3. Explanations of uncertainties and contingencies: Notes.
4. Description of ability to fund operations and expansion: MD&A.
5. Description of results of operations: MD&A.
6. Certified public accountant (CPA): Auditor's report.

Related exercise material: BE1.12, DO IT! 1.3b, and E1.26.

USING THE DECISION TOOLS | Under Armour, Inc.

Using the Decision Tools comprehensive exercises ask you to apply business information and the decision tools presented in the chapter. Most of these exercises are based on the companies highlighted in the Feature Story.

There is a good chance that you are wearing one of **Under Armour, Inc.**'s products right now. Under Armour is a competitor to **Columbia Sportswear**. Suppose that you are considering investing in shares of Under Armour's common stock.

Instructions

Answer these questions related to your decision whether to invest.

a. What financial statements should you evaluate?

b. What should these financial statements tell you?

c. Do you care if the financial statements have been audited? Explain.

d. Appendix B contains financial statements for Columbia, and Appendix C contains those for Under Armour. You can make many comparisons between Columbia and Under Armour in terms of their respective results from operations and financial position. Compare their respective total assets, total revenues, and net cash provided by operating activities for 2020.

Solution

a. Before you invest, you should evaluate the income statement, retained earnings statement, balance sheet, and statement of cash flows.

b. You would probably be most interested in the income statement because it summarizes past performance and thus gives an indication of future performance. The retained earnings statement provides a record of the company's dividend history. The balance sheet reveals the relationship between assets and liabilities. The statement of cash flows reveals where the company is getting and spending its cash. This is especially important for a company that wants to grow.

c. You would want audited financial statements. These statements indicate that a CPA (certified public accountant) has examined and expressed an opinion whether the statements present fairly the financial position and results of operations of the company. Investors and creditors should not make decisions without studying audited financial statements.

d. Many interesting comparisons can be made between the two companies (all numbers are in thousands). Columbia is smaller, with total assets of $2,836,571 versus $5,030,628 for Under Armour, and it has lower revenue—$2,501,554 versus $4,474,667 for Under Armour. However, Columbia's net cash provided by operating activities of $276,077 is greater than Under Armour's $212,864. However, while useful, these basic measures are not enough to determine whether one company is a better investment than the other. In later chapters, you will learn tools that will allow you to compare the relative profitability and financial health of these and other companies.

Appendix 1A Career Opportunities in Accounting

LEARNING OBJECTIVE *4

Explain the career opportunities in accounting.

Why is accounting such a popular major and career choice?

1. **There are a lot of jobs.** In many cities in recent years, the demand for accountants exceeded the supply. Not only are there a lot of jobs, but there are a wide array of opportunities. As one accounting organization observed, "accounting is one degree with 360 degrees of opportunity."
2. **Accounting matters.** Interest in accounting has increased, ironically, because of the attention caused by the accounting failures of companies such as **Enron** and **WorldCom**. These widely publicized scandals revealed the important role that accounting plays in society. Most people want to make a difference, and an accounting career provides many opportunities to contribute to society.
3. **The Sarbanes-Oxley Act (SOX) significantly increased the accounting and internal control requirements for corporations.** This dramatically increased demand for professionals with accounting training.
4. **Emerging technologies such as automation, blockchain, and data analytics are changing the way accountants work.** With those skills, accountants add value to business decision-making.

Accountants are in such demand that it is not uncommon for accounting students to have accepted a job offer a year before graduation. As **Illustration 1A.1** reveals, the job options of people with accounting degrees are virtually unlimited.

ILLUSTRATION 1A.1 **Career options in accounting**

Areas of Accounting Careers	Type of Work	Examples of Employers	Certification Opportunities
Public accounting	• In **auditing**, accountants examine (audit) the financial statements and issue opinions on the fairness of the financial presentation. • In **taxation**, CPAs offer tax advice and planning. • In **management consulting**, accountants design and install accounting software and enterprise resource planning systems and support mergers and acquisitions.	**Deloitte**, **EY**, **KPMG**, **PwC**, **Grant Thornton**, **BDO**, **Baker Tilly**	Certified public accountants (CPAs), enrolled agent (EA), certified information systems auditor (CISA)
Private accounting	• Financial accountants manage the accounting information system and prepare financial statements. • Managerial accountants manage costs and budgets. • Internal auditors ensure compliance with policies and regulations.	For-profit: **Starbucks**, **Google**, **Under Armour** Non-profit: **Salvation Army**, **Red Cross**	Certified management accountant (CMA), certified internal auditor (CIA)
Governmental accounting	• There are opportunities in government at the local, state, and federal levels.	**Internal Revenue Service (IRS)**, **Federal Bureau of Investigation (FBI)**	Certified government financial manager (CGFM)
Forensic accounting	• In **forensic accounting**, accountants conduct **investigations** into theft and fraud.	Insurance companies, law firms, **FBI**	Certified fraud examiner (CFE)

"Show Me the Money"

How much can a new accountant make? Take a look at the average salaries for college graduates in public and private accounting shown in **Illustration 1A.2**.[1] Keep in mind if you also have a CPA license, you'll make 10–15% more when you start out.

ILLUSTRATION 1A.2
Salary estimates for jobs in public and corporate accounting

Employer	Jr. Level (0–3 yrs.)	Sr. Level (4–6 yrs.)
Public accounting (large firm)	$63,250–$83,250	$78,500–$106,500
Public accounting (medium firm)	$56,500–$67,750	$70,500–$96,000
Public accounting (small company)	$51,500–$60,500	$63,750–$81,500
Corporate accounting (large company)	$53,750–$69,500	$68,750–$87,750

Illustration 1A.3 lists some examples of upper-level salaries for managers in corporate accounting. Note that geographic region, experience, education, CPA certification, and company size each play a role in determining salary.

ILLUSTRATION 1A.3
Upper-level management salaries in corporate accounting

Position	Large Company	Small to Medium Company
Chief financial officer	$207,000–$465,750	$105,250–$208,750
Corporate controller	$140,000–$224,750	$92,000–$161,250
Tax manager	$112,000–$158,250	$88,000–$124,750

[1]See the AICPA-sponsored *startheregoplaces* website for more information regarding accounting careers and salaries.

The **Review and Practice** section provides opportunities for students to review key concepts and terms as well as complete multiple-choice questions, brief exercises, exercises, and a comprehensive problem. Detailed solutions are also included.

Review and Practice

Learning Objectives Review

1 Identify the forms of business organization and the uses of accounting information.

A sole proprietorship is a business owned by one person. A partnership is a business owned by two or more people associated as partners. A corporation is a separate legal entity for which evidence of ownership is provided by shares of stock.

Internal users are managers who need accounting information to plan, organize, and run business operations. The primary external users are investors and creditors. Investors (stockholders) use accounting information to decide whether to buy, hold, or sell shares of a company's stock. Creditors (suppliers and bankers) use accounting information to assess the risk of granting credit or loaning money to a business. Other groups who have an indirect interest in a business are taxing authorities, customers, labor unions, and regulatory agencies.

2 Explain the three principal types of business activity.

Financing activities involve collecting the necessary funds to support the business. Investing activities involve acquiring the resources necessary to run the business. Operating activities involve putting the resources of the business into action to generate a profit.

3 Describe the four financial statements and how they are prepared.

An income statement presents the revenues and expenses of a company for a specific period of time. A retained earnings statement summarizes the changes in retained earnings that have occurred for a specific period of time. A balance sheet reports the assets, liabilities, and stockholders' equity of a business at a specific date. A statement of cash flows summarizes information concerning the cash inflows (receipts) and outflows (payments) for a specific period of time.

Assets are resources owned by a business. Liabilities are the debts and obligations of the business. Liabilities represent claims of creditors on the assets of the business. Stockholders' equity represents the claims of owners on the assets of the business. Stockholders' equity is subdivided into two parts: common stock and retained earnings. The basic accounting equation is Assets = Liabilities + Stockholders' Equity.

Within the annual report, the management discussion and analysis provides management's interpretation of the company's results and financial position as well as a discussion of plans for the future. Notes to the financial statements provide additional explanation or detail to make the financial statements more informative. The auditor's report expresses an opinion as to whether the financial statements present fairly the company's results of operations and financial position.

*4 Explain the career opportunities in accounting.

Accounting offers many different jobs in fields such as public and private accounting, governmental, and forensic accounting. Accounting is a popular major because there are many different types of jobs, with unlimited potential for career advancement.

Decision Tools Review

Decision Checkpoints	Info Needed for Decision	Tool to Use for Decision	How to Evaluate Results
Are the company's operations profitable?	Income statement	The income statement reports a company's revenues and expenses and resulting net income or loss for a period of time.	If the company's revenues exceed its expenses, it will report net income; otherwise, it will report a net loss.
What is the company's policy toward dividends and growth?	Retained earnings statement	The retained earnings statement reports how much of this year's income the company paid out in dividends to shareholders.	A company striving for rapid growth will pay a low (or no) dividend.

(continues)

(continued)

Decision Checkpoints	Info Needed for Decision	Tool to Use for Decision	How to Evaluate Results
Does the company rely primarily on debt or stockholders' equity to finance its assets?	Balance sheet	The balance sheet reports the company's resources and claims to those resources; there are two types of claims: liabilities and stockholders' equity.	Compare the amount of debt versus the amount of stockholders' equity to determine whether the company relies more on creditors or owners for its financing.
Does the company generate sufficient cash from operations to fund its investing activities?	Statement of cash flows	The statement of cash flows shows the amount of net cash provided or used by operating activities, investing activities, and financing activities.	Compare the amount of net cash provided by operating activities with the amount of net cash used by investing activities. Any deficiency in cash from operating activities must be made up with cash from financing activities.

Glossary Review

Accounting The information system that identifies, records, and communicates the economic events of an organization to interested users. (p. 1-4).

Annual report A report prepared by corporate management that presents financial information including financial statements, a management discussion and analysis section, notes, and an independent auditor's report. (p. 1-20).

Assets Resources owned by a business. (p. 1-9).

***Auditing** The examination of financial statements by a certified public accountant in order ro express an opinion as to the fairness of presentation. (p. 1-24).

Auditor's report A report prepared by an independent outside auditor stating the auditor's opinion as to the fairness of the presentation of the financial position and results of operations and their conformance with generally accepted accounting principles. (p. 1-21).

Balance sheet A financial statement that reports the assets and claims to those assets at a specific point in time. (p. 1-14).

Basic accounting equation Assets = Liabilities + Stockholders' Equity. (p. 1-14).

Certified public accountant (CPA) An individual who has met certain criteria and is thus allowed to perform audits of corporations. (p. 1-21).

Common stock Term used to describe the total amount paid in by stockholders for the shares they purchase. (p. 1-9).

Corporation A business organized as a separate legal entity owned by stockholders. (p. 1-3).

Data analytics The evaluation of data, often employing both software and statistics, to draw inferences. (p. 1-6).

Dividends Payments of cash from a corporation to its stockholders. (p. 1-9).

ESG reporting Reports prepared by a company to highlight its performance regarding environmental, social, and governance (ESG) issues. (p. 1-17).

Expenses The cost of assets consumed or services used in the process of generating revenues. (p. 1-10).

***Forensic accounting** An area of accounting that uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. (p. 1-24).

Income statement A financial statement that reports a company's revenues and expenses and resulting net income or net loss for a specific period of time. (p. 1-12).

Liabilities Amounts owed to creditors in the form of debts and other obligations. (p. 1-9).

***Management consulting** An area of public accounting ranging from development of accounting and computer systems to support services for marketing projects and merger and acquisition activities. (p. 1-24).

Management discussion and analysis (MD&A) A section of the annual report that presents management's views on the company's ability to pay near-term obligations, its ability to fund operations and expansion, and its results of operations. (p. 1-20).

Net income The amount by which revenues exceed expenses. (p. 1-10).

Net loss The amount by which expenses exceed revenues. (p. 1-10).

Notes to the financial statements Notes that clarify information presented in the financial statements and provide additional detail. (p. 1-20).

Partnership A business owned by two or more persons associated as partners. (p. 1-3).

Retained earnings The amount of net income retained in the corporation. (p. 1-13).

Retained earnings statement A financial statement that summarizes the amounts and causes of changes in retained earnings for a specific time period. (p. 1-13).

Revenue The increase in assets or decrease in liabilities resulting from the sale of goods or the performance of services in the normal course of business. (p. 1-10).

Sarbanes-Oxley Act (SOX) Regulations passed by Congress to reduce unethical corporate behavior. (p. 1-7).

Sole proprietorship A business owned by one person. (p. 1-3).

Statement of cash flows A financial statement that provides financial information about the cash receipts and cash payments of a business for a specific period of time. (p. 1-16).

Stockholders' equity The owners' claim to assets. (p. 1-14).

***Taxation** An area of public accounting involving tax advice, tax planning, preparing tax returns, and representing clients before governmental agencies. (p. 1-24).

Practice Multiple-Choice Questions

1. **(LO 1)** Which is **not** one of the three forms of business organization?

   a. Sole proprietorship. **c.** Partnership.
   b. Creditorship. **d.** Corporation.

2. **(LO 1)** Which is an advantage of corporations relative to partnerships and sole proprietorships?

   a. Lower taxes.
   b. Harder to transfer ownership.
   c. Reduced legal liability for investors.
   d. Most common form of organization.

3. **(LO 1)** Which statement about users of accounting information is **incorrect**?

   a. Management is considered an internal user.
   b. Taxing authorities are considered external users.
   c. Present creditors are considered external users.
   d. Regulatory authorities are considered internal users.

4. **(LO 1)** Which of the following did **not** result from the Sarbanes-Oxley Act?

   a. Top management must now certify the accuracy of financial information.
   b. Penalties for fraudulent activity increased.
   c. Independence of auditors increased.
   d. Tax rates on corporations increased.

5. **(LO 2)** Which is **not** one of the three primary business activities?

   a. Financing. **c.** Advertising.
   b. Operating. **d.** Investing.

6. **(LO 2)** Which of the following is an example of a financing activity?

   a. Issuing shares of common stock.
   b. Selling goods on account.
   c. Buying delivery equipment.
   d. Buying inventory.

7. **(LO 2)** Net income will result during a time period when:

   a. assets exceed liabilities.
   b. assets exceed revenues.
   c. expenses exceed revenues.
   d. revenues exceed expenses.

8. **(LO 3)** The financial statements for Macias Corporation contained the following information.

Accounts receivable	$ 5,000
Sales revenue	75,000
Cash	15,000
Salaries and wages expense	20,000
Rent expense	10,000

What was Macias Corporation's net income?

   a. $60,000. **c.** $65,000.
   b. $15,000. **d.** $45,000.

9. **(LO 3)** What section of a statement of cash flows indicates the cash spent on new equipment during the past accounting period?

   a. The investing activities section.
   b. The operating activities section.
   c. The financing activities section.
   d. The statement of cash flows does not give this information.

10. **(LO 3)** Which statement presents information as of a specific point in time?

   a. Income statement.
   b. Balance sheet.
   c. Statement of cash flows.
   d. Retained earnings statement.

11. **(LO 3)** Which financial statement reports assets, liabilities, and stockholders' equity?

   a. Income statement.
   b. Retained earnings statement.
   c. Balance sheet.
   d. Statement of cash flows.

12. **(LO 3)** Stockholders' equity represents:

   a. claims of creditors.
   b. claims of employees.
   c. the difference between revenues and expenses.
   d. claims of owners.

13. **(LO 3)** As of December 31, 2027, Rockford Corporation has assets of $3,500 and stockholders' equity of $1,500. What are the liabilities for Rockford as of December 31, 2027?

   a. $1,500. **c.** $2,500.
   b. $1,000. **d.** $2,000.

14. **(LO 3)** The element of a corporation's annual report that describes the corporation's accounting methods is/are the:

   a. notes to the financial statements.
   b. management discussion and analysis.
   c. auditor's report.
   d. income statement.

15. **(LO 3)** The element of the annual report that presents an opinion regarding the fairness of the presentation of the financial position and results of operations is/are the:

   a. income statement.
   b. auditor's opinion.
   c. balance sheet.
   d. comparative statements.

Solutions

1. b. Creditorship is not a form of business organization. The other choices are incorrect because (a) sole proprietorship, (c) partnership, and (d) corporation are all forms of business organization.

2. c. An advantage of corporations is that investors are not personally liable for debts of the business. The other choices are incorrect because (a) lower taxes, (b) harder to transfer ownership, and (d) most common form of organization are not true of corporations.

3. d. Regulatory authorities are considered external, not internal, users. The other choices are true statements.

4. d. The Sarbanes-Oxley Act (SOX) was created to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals, not to address tax rates. The other choices are incorrect because (a) top management must now certify the accuracy of financial information, (b) penalties for fraudulent activity increased, and (c) increased independence of auditors all resulted from SOX.

5. c. Advertising is a type of operating activity. The other choices are incorrect because (a) financing, (b) operating, and (d) investing are the three primary business activities.

6. a. Issuing shares of common stock is a financing activity. The other choices are incorrect because (b) selling goods on account is an operating activity, (c) buying delivery equipment is an investing activity, and (d) buying inventory is an operating activity.

7. d. When a company earns more revenues than expenses, it will report net income during a time period. The other choices are incorrect because (a) assets and liabilities are on the balance sheet, not the income statement; (b) assets are on the balance sheet, not the income statement; and (c) net income results when revenues exceed expenses, not when expenses exceed revenues.

8. d. Net income = Sales revenue ($75,000) − Salaries and wages expense ($20,000) − Rent expense ($10,000) = $45,000. The other choices are therefore incorrect.

9. a. The investing activities section of the statement of cash flows provides information about property, plant, and equipment accounts, not (b) the operating activities section or (c) the financing activities section. Choice (d) is incorrect as the statement of cash flows does provide this information.

10. b. The balance sheet presents information as of a specific point in time. The other choices are incorrect because the (a) income statement, (c) statement of cash flows, and (d) retained earnings statement all cover a period of time.

11. c. The balance sheet is a formal presentation of the accounting equation, such that Assets = Liabilities + Stockholders' Equity, not the (a) income statement, (b) retained earnings statement, or (d) statement of cash flows.

12. d. Stockholders' equity represents claims of owners. The other choices are incorrect because (a) claims of creditors and (b) claims of employees are liabilities. Choice (c) is incorrect because the difference between revenues and expenses is net income.

13. d. Using the accounting equation, liabilities can be computed by subtracting stockholders' equity from assets, or $3,500 − $1,500 = $2,000, not (a) $1,500, (b) $1,000, or (c) $2,500.

14. a. The corporation's accounting methods are described in the notes to the financial statements, not in the (b) management discussion and analysis, (c) auditor's report, or (d) income statement.

15. b. The element of the annual report that presents an opinion regarding the fairness of the presentation of the financial position and results of operations is the auditor's opinion, not the (a) income statement, (c) balance sheet, or (d) comparative statements.

Practice Brief Exercises

Use basic accounting equation.

1. (LO 3) At the beginning of the year, Ortiz Company had total assets of $900,000 and total liabilities of $440,000. Answer the following questions.

a. If total assets decreased $100,000 during the year and total liabilities increased $80,000 during the year, what is the amount of stockholders' equity at the end of the year?

b. During the year, total liabilities decreased $100,000 during the year and stockholders' equity increased $200,000. What is the amount of total assets at the end of the year?

c. If total assets increased $50,000 during the year and stockholders' equity increased $60,000 during the year, what is the amount of total liabilities at the end of the year?

Solution

1. a.	Assets	−	Liabilities	=	Stockholders' Equity
	($900,000 – $100,000)	–	($440,000 + $80,000)	=	$280,000
b.	Liabilities	+	Stockholders' Equity	=	Assets
	($440,000 – $100,000)	+	($900,000 – $440,000 + $200,000)	=	$1,000,000
c.	Assets	–	Stockholders' Equity	=	Liabilities
	($900,000 + $50,000)	–	($900,000 – $440,000 + $60,000)	=	$430,000

Determine where items appear on financial statements.

2. (LO 3) Indicate whether the following items would appear on the income statement (IS), balance sheet (BS), or retained earnings statement (RES).

a. _____ Common stock.

b. _____ Cash.

c. _____ Salaries and wages expense.

d. _____ Service revenue.

e. _____ Accounts payable.

Solution

2. **a.** BS Common stock.
   b. BS Cash.
   c. IS Salaries and wages expense.
   d. IS Service revenue.
   e. BS Accounts payable.

3. **(LO 3)** Presented below in alphabetical order are balance sheet items for Feagler Company at December 31, 2027. Prepare a balance sheet following the format of Illustration 1.8.

Prepare a balance sheet.

Accounts receivable	$12,500
Cash	38,000
Common stock	5,000
Notes payable	40,000
Retained earnings	5,500

Solution

3.

Feagler Company
Balance Sheet
December 31, 2027

Assets		
Cash		$38,000
Accounts receivable		12,500
Total assets		$50,500
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$40,000	
Total liabilities		$40,000
Stockholders' equity		
Common stock	5,000	
Retained earnings	5,500	
Total stockholders' equity		10,500
Total liabilities and stockholders' equity		$50,500

4. **(LO 3)** Identify whether the following items would appear on the balance sheet (BS) or income statement (IS) of a corporation.

Determine where items appear on financial statements.

a. _____ Income taxes payable.
b. _____ Cost of goods sold.
c. _____ Supplies.
d. _____ Notes payable.
e. _____ Salaries and wages expense.
f. _____ Service revenue.
g. _____ Depreciation expense.
h. _____ Prepaid insurance.
i. _____ Interest payable.

Solution

4. **a.** BS Income taxes payable.
   b. IS Cost of goods sold.
   c. BS Supplies.
   d. BS Notes payable.
   e. IS Salaries and wages expense.
   f. IS Service revenue.
   g. IS Depreciation expense.
   h. BS Prepaid insurance.
   i. BS Interest payable.

Practice Exercises

Prepare an income statement.

1. (LO 3) The following items and amounts were taken from Ricardo Inc.'s 2027 income statement and balance sheet.

Cash	$ 84,700	Inventory	$ 64,618
Retained earnings	123,192	Accounts receivable	88,419
Cost of goods sold	483,854	Sales revenue	693,485
Salaries and wages expense	125,000	Income taxes payable	6,499
Prepaid insurance	7,818	Accounts payable	49,384
Interest expense	994	Service revenue	8,998

Instructions

Prepare an income statement for Ricardo Inc. for the year ended December 31, 2027.

Solution

1.

Ricardo Inc.
Income Statement
For the Year Ended December 31, 2027

Revenues		
Sales revenue	$693,485	
Service revenue	8,998	
Total revenues		$702,483
Expenses		
Cost of goods sold	483,854	
Salaries and wages expense	125,000	
Interest expense	994	
Total expenses		609,848
Net income		$ 92,635

Compute net income and prepare a balance sheet.

2. (LO 3) Cozy Bear is a private camping ground near the Mountain Home Recreation Area. It has compiled the following financial information as of December 31, 2027.

Service revenue (from camping fees)	$148,000	Dividends	$ 9,000
Sales revenue (from general store)	35,000	Bonds payable	50,000
Accounts payable	16,000	Expenses during 2027	135,000
Cash	18,500	Supplies	12,500
Equipment	129,000	Common stock	40,000
		Retained earnings (1/1/2027)	15,000

Instructions

a. Determine net income from Cozy Bear for 2027.

b. Prepare a retained earnings statement and a balance sheet for Cozy Bear as of December 31, 2027.

Solution

2. a.

Service revenue	$148,000
Sales revenue	35,000
Total revenues	183,000
Expenses	135,000
Net income	$ 48,000

b.

Cozy Bear Retained Earnings Statement For the Year Ended December 31, 2027	
Retained earnings, January 1	$15,000
Add: Net income	48,000
	63,000
Less: Dividends	9,000
Retained earnings, December 31	$54,000

Cozy Bear Balance Sheet December 31, 2027		
Assets		
Cash		$ 18,500
Supplies		12,500
Equipment		129,000
Total assets		$160,000
Liabilities and Stockholders' Equity		
Liabilities		
Accounts payable	$16,000	
Bonds payable	50,000	
Total liabilities		$ 66,000
Stockholders' equity		
Common stock	40,000	
Retained earnings	54,000	
Total stockholders' equity		94,000
Total liabilities and stockholders' equity		$160,000

Practice Problem

(LO 3) Jeff Andringa, a former college hockey player, quit his job and started Ice Camp, a hockey camp for kids ages 8 to 18. Eventually, he would like to open hockey camps nationwide. Jeff has asked you to help him prepare financial statements at the end of 2027, his first year of operations. He relates the following facts about his business activities.

Prepare financial statements.

In order to get the business off the ground, Jeff decided to incorporate. He sold shares of common stock to a few close friends, as well as bought some of the shares himself. He initially raised $25,000 through the sale of these shares. In addition, the company took out a $10,000 loan at a local bank.

Ice Camp purchased, for $12,000 cash, a bus for transporting kids. The company also bought hockey goals and other miscellaneous equipment with $1,500 cash. The company earned camp tuition of $100,000 during the year but had collected only $80,000 of this amount. Thus, at the end of the year, its customers still owed $20,000. The company rents time at a local rink for $50 per hour. Total rink rental costs during the year were $8,000, insurance was $10,000, salary expense was $20,000, and supplies used totaled $9,000, all of which were paid in cash. The company incurred $800 in interest expense on the bank loan, which it still owed at the end of the year.

The company paid dividends during the year of $5,000 cash. The balance in the corporate bank account at December 31, 2027, was $49,500.

Instructions

Using the format of the Sierra Corporation statements in this chapter, prepare an income statement, retained earnings statement, balance sheet, and statement of cash flows. (*Hint:* Prepare the statements in the order stated to take advantage of the flow of information from one statement to the next, as shown in Illustration 1.10.)

Solution

Ice Camp
Income Statement
For the Year Ended December 31, 2027

Revenues		
Service revenue		$100,000
Expenses		
Salaries and wages expense	$20,000	
Insurance expense	10,000	
Supplies expense	9,000	
Rent expense	8,000	
Interest expense	800	
Total expenses		47,800
Net income		$ 52,200

Ice Camp
Retained Earnings Statement
For the Year Ended December 31, 2027

Retained earnings, January 1, 2027	$ 0
Add: Net income	52,200
	52,200
Less: Dividends	5,000
Retained earnings, December 31, 2027	$47,200

Ice Camp
Balance Sheet
December 31, 2027

Assets		
Cash		$49,500
Accounts receivable		20,000
Equipment ($12,000 + $1,500)		13,500
Total assets		$83,000
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$10,000	
Interest payable	800	
Total liabilities		$10,800
Stockholders' equity		
Common stock	25,000	
Retained earnings	47,200	
Total stockholders' equity		72,200
Total liabilities and stockholders' equity		$83,000

Ice Camp
Statement of Cash Flows
For the Year Ended December 31, 2027

Cash flows from operating activities		
Cash receipts from operating activities	$80,000	
Cash payments for operating activities	(47,000)	
Net cash provided by operating activities		$33,000
Cash flows from investing activities		
Purchase of equipment	(13,500)	
Net cash used by investing activities		(13,500)
Cash flows from financing activities		
Issuance of common stock	25,000	
Issuance of notes payable	10,000	
Dividends paid	(5,000)	
Net cash provided by financing activities		30,000
Net increase in cash		49,500
Cash at beginning of period		0
Cash at end of period		$49,500

Brief Exercises, DO IT! Exercises, Exercises, Problems, Data Analytics Activities, and many additional resources are available for practice in the Wiley online course.

Questions

1. What are the three basic forms of business organizations?

2. What are the advantages to a business of being formed as a corporation? What are the disadvantages?

3. What are the advantages to a business of being formed as a partnership or sole proprietorship? What are the disadvantages?

4. Is it possible to create a company using an organizational form that has the advantages of both a partnership and a corporation? Explain.

5. "Accounting is ingrained in our society and is vital to our economic system." Do you agree? Explain.

6. Who are the internal users of accounting data? How does accounting provide relevant data to the internal users?

7. Who are the external users of accounting data? Give examples.

8. What are the four most common types of data analytics, and what basic question does each address?

9. What are the three main types of business activity? Give examples of each activity.

10. Listed here are some items found in the financial statements of Finzelberg. Indicate in which financial statement(s) each item would appear.

a. Service revenue.
b. Equipment.
c. Advertising expense.
d. Accounts receivable.
e. Common stock.
f. Interest payable.

11. Why would a bank want to monitor the dividend payment practices of the corporations to which it lends money?

12. "A company's net income appears directly on the income statement and the retained earnings statement, and it is included indirectly in the company's balance sheet." Do you agree? Explain.

13. What is the primary purpose of the statement of cash flows?

14. What are the three main categories of the statement of cash flows? Why do you think these categories were chosen?

15. What is retained earnings? What items increase the balance in retained earnings? What items decrease the balance in retained earnings?

16. What is the basic accounting equation?

17. **a.** Define the terms assets, liabilities, and stockholders' equity.
b. What items affect stockholders' equity?

18. Which of these items are liabilities of White Glove Cleaning Service?

a. Cash.
b. Accounts payable.
c. Dividends.
d. Accounts receivable.
e. Supplies.
f. Equipment.
g. Salaries and wages payable.
h. Service revenue.
i. Rent expense.

19. How are each of the following financial statements interrelated?

a. Retained earnings statement and income statement.
b. Retained earnings statement and balance sheet.
c. Balance sheet and statement of cash flows.

20. What is the purpose of the management discussion and analysis section (MD&A)?

21. Why is it important for financial statements to receive an unqualified auditor's opinion?

22. What types of information are presented in the notes to the financial statements?

23. The accounting equation is Assets = Liabilities + Stockholders' Equity. Appendix A reproduces **Apple**'s financial statements. Replacing words in the equation with dollar amounts, what is Apple's accounting equation at September 26, 2020?

24. What are the characteristics of a "critical audit matter"?

Brief Exercises

Describe forms of business organization.

BE1.1 (LO 1), K Match each of the following forms of business organization with a set of characteristics: sole proprietorship (SP), partnership (P), and corporation (C).

a. _____ Shared control, tax advantages, increased skills and resources.

b. _____ Simple to set up and maintains control with owner.

c. _____ Easier to transfer ownership and raise funds, no personal liability.

Identify users of accounting information.

BE1.2 (LO 1), K The following lists situations that require the use of accounting information.

1. Trying to determine whether the company complied with tax laws.

2. Trying to determine whether the company can pay its obligations.

3. Trying to determine whether an advertising proposal will be cost-effective.

4. Trying to determine whether the company's net income will result in a stock price increase.

5. Trying to determine whether the company should employ debt or equity financing.

Match each of the situations with the following users of accounting information.

a. _____ Investors in common stock.

b. _____ Marketing managers.

c. _____ Creditors.

d. _____ Chief financial officer.

e. _____ Internal Revenue Service.

Identify the four types of data analytics.

BE1.3 (LO 1), K For each of the following types of data analytics, state whether it relates to the past or future, and rank each in terms of the value to a business (1 is the lowest, 4 is the highest).

	Past or Future	Rank
a. Diagnostic		
b. Prescriptive		
c. Descriptive		
d. Predictive		

Classify items by activity.

BE1.4 (LO 2), K Indicate to which business activity, operating activity (O), investing activity (I), or financing activity (F), each item relates.

a. _____ Cash received from customers.

b. _____ Cash paid to stockholders (dividends).

c. _____ Cash received from issuing new common stock.

d. _____ Cash paid to suppliers.

e. _____ Cash paid to purchase a new office building.

Determine effect of transactions on stockholders' equity.

BE1.5 (LO 3), C Presented below are a number of transactions. Determine whether each transaction affects common stock (C), dividends (D), revenues (R), expenses (E), or does not affect stockholders' equity (NSE). Provide titles for the revenues and expenses.

a. _____ Costs incurred for advertising.

b. _____ Cash received for services performed.

c. _____ Costs incurred for insurance.

d. _____ Amounts paid to employees.

e. _____ Cash distributed to stockholders.

f. _____ Cash received in exchange for allowing the use of the company's building.

g. _____ Costs incurred for utilities used.

h. _____ Cash purchase of equipment.

i. _____ Cash received from investors.

BE1.6 (LO 3), AP In alphabetical order below are balance sheet items for Karol Company at December 31, 2027. Prepare a balance sheet following the format of Illustration 1.8.

Prepare a balance sheet.

Accounts payable	$65,000
Accounts receivable	71,000
Cash	22,000
Common stock	18,000
Retained earnings	10,000

BE1.7 (LO 3), K Eskimo Pie Corporation markets a broad range of frozen treats, including its famous Eskimo Pie ice cream bars. The following items were taken from a recent income statement and balance sheet. In each case, identify whether the item would appear on the balance sheet (BS) or income statement (IS).

Determine where items appear on financial statements.

a. _____ Income tax expense.
b. _____ Inventory.
c. _____ Accounts payable.
d. _____ Retained earnings.
e. _____ Equipment.
f. _____ Sales revenue.
g. _____ Cost of goods sold.
h. _____ Common stock.
i. _____ Accounts receivable.
j. _____ Interest expense.

BE1.8 (LO 3), K Indicate which statement you would examine to find each of the following items: income statement (IS), balance sheet (BS), retained earnings statement (RES), or statement of cash flows (SCF).

Determine proper financial statement.

a. _____ Revenue during the period.
b. _____ Supplies on hand at the end of the year.
c. _____ Cash received from issuing new bonds during the period.
d. _____ Total debts outstanding at the end of the period.

BE1.9 (LO 3), AP Use the basic accounting equation to answer these questions.

Use basic accounting equation.

a. The liabilities of Lantz Company are $90,000 and the stockholders' equity is $230,000. What is the amount of Lantz's total assets?
b. The total assets of Salley Company are $170,000 and its stockholders' equity is $80,000. What is the amount of its total liabilities?
c. The total assets of Brandon Co. are $800,000 and its liabilities are equal to one-fourth of its total assets. What is the amount of Brandon's stockholders' equity?

BE1.10 (LO 3), AP At the beginning of the year, Morales Company had total assets of $800,000 and total liabilities of $500,000. (Treat each item independently.)

Use basic accounting equation.

a. If total assets increased $150,000 during the year and total liabilities decreased $80,000, what is the amount of stockholders' equity at the end of the year?
b. During the year, total liabilities increased $100,000 and stockholders' equity decreased $70,000. What is the amount of total assets at the end of the year?
c. If total assets decreased $80,000 and stockholders' equity increased $110,000 during the year, what is the amount of total liabilities at the end of the year?

BE1.11 (LO 3), K Indicate whether each of these items is an asset (A), a liability (L), or part of stockholders' equity (SE).

Identify assets, liabilities, and stockholders' equity.

a. _____ Accounts receivable.
b. _____ Salaries and wages payable.
c. _____ Equipment.
d. _____ Supplies.
e. _____ Common stock.
f. _____ Notes payable.

BE1.12 (LO 3), K Which is **not** a required part of an annual report of a publicly traded company?

Determine required parts of annual report.

a. Statement of cash flows.
b. Notes to the financial statements.
c. Management discussion and analysis.
d. All of these are required.

DO IT! Exercises

DO IT! 1.1a (LO 1), C Identify each of the following organizational characteristics with the business organizational form or forms with which it is associated.

Identify benefits of business organization forms.

a. Easier to transfer ownership.
b. Easier to raise funds.
c. More owner control.
d. Tax advantages.
e. No personal legal liability.

Identify accounting terms.

DO IT 1.1b (LO 1), C Match each of the following terms with its definition, classification type, or associated phrase.

a. _____ Accounting.
b. _____ Internal users of financial information.
c. _____ Element of Sarbanes-Oxley Act.
d. _____ External users of financial information.
e. _____ Steps in solving an ethical dilemma.

1. Creditors, regulatory authorities.
2. Increased independence of outside auditors.
3. Information system that identifies, records, and communicates the economic events of an organization to interested users.
4. Identify the stakeholders.
5. Production supervisors, company officers.

Classify financial statement elements.

DO IT! 1.2 (LO 2), K Classify each item as an asset, liability, common stock, revenue, or expense.

a. Issuance of ownership shares.
b. Land purchased.
c. Amounts owed to suppliers.
d. Bonds payable.
e. Amount recorded from selling a product.
f. Cost of advertising.

Prepare financial statements.

DO IT! 1.3a (LO 3), AP Gray Corporation began operations on January 1, 2027. The following information is available for Gray on December 31, 2027.

Accounts payable	$ 5,000	Notes payable	$ 7,000
Accounts receivable	2,000	Rent expense	10,000
Advertising expense	4,000	Retained earnings	?
Cash	3,100	Service revenue	25,000
Common stock	15,000	Supplies	1,900
Dividends	2,500	Supplies expense	1,700
Equipment	26,800		

Prepare an income statement, a retained earnings statement, and a balance sheet for Gray Corporation.

Identify components of annual reports.

DO IT! 1.3b (LO 3), K Indicate whether each of the following items is most closely associated with the management discussion and analysis (MD&A), the notes to the financial statements, or the auditor's report.

a. Description of ability to pay near-term obligations.
b. Unqualified opinion.
c. Details concerning liabilities, too voluminous to be included in the statements.
d. Description of favorable and unfavorable trends.
e. Certified public accountant (CPA).
f. Descriptions of significant accounting policies.

Exercises

Match items with descriptions.

E1.1 (LO 1, 2, 3), K Here is a list of words or phrases discussed in this chapter:

1. Corporation.
2. Creditor.
3. Accounts receivable.
4. Partnership.
5. Stockholder.
6. Common stock.
7. Accounts payable.
8. Auditor's opinion.
9. Hybrid organizational forms.

Instructions

Match each word or phrase above with the best description of it.

_____ **a.** An expression about whether financial statements conform with generally accepted accounting principles.
_____ **b.** A business that raises money by issuing shares of stock.
_____ **c.** The portion of stockholders' equity that results from receiving cash from investors.
_____ **d.** Obligations to suppliers of goods.
_____ **e.** Amounts due from customers.
_____ **f.** A party to whom a business owes money.
_____ **g.** Combines tax advantages with limited liability.
_____ **h.** A party that invests in common stock.
_____ **i.** A business that is owned jointly by two or more individuals but does not issue stock.

E1.2 (LO 1), C Consider the following statements. *Identify forms of business organization.*

	Sole Proprietorship	Partnership	Corporation
1. No personal liability.			
2. Owners pay personal income tax on company income.			
3. Generally the easiest form of organization to raise capital.			
4. Ownership indicated by shares.			
5. Owned by one person.			
6. Limited life.			
7. Usually the easiest form of organization to set up.			

Instructions

Complete the above by indicating if each of the statements is normally true (T) or false (F) for each type of business organization: sole proprietorship, partnership, and corporation.

E1.3 (LO 1), C The following list presents different types of evaluations made by various users of accounting information. *Identify users of accounting information.*

1. Determining if the company can pay for purchases made on account.
2. Determining if the company has complied with income tax regulations.
3. Determining if the company might afford a 1% hourly wage increase.
4. Determining if an advertising campaign was cost-effective.
5. Determining if the company's net income might result in a share price increase.
6. Determining if the company should use debt or equity financing.

Instructions

Complete the following by indicating (a) the number of the evaluation (1 to 6) that the user would most likely make, and (b) if the user is internal or external.

	(a) Type of Evaluation	(b) Type of User
Investor		
Marketing manager		
Creditor		
Chief financial officer		
Internal Revenue Service		
Labor union		

E1.4 (LO 1), K The types of data analytics includes the following. *Describe forms of data analytics.*

1. Descriptive. **2.** Diagnostic. **3.** Predictive. **4.** Prescriptive.

Instructions

Match each type of data analytics to its description below.

a. Explains what future actions the company should take.
b. Explains what happened in the past.
c. Explains what will probably happen in the future.
d. Explains why past events occurred.

E1.5 (LO 1, 2, 3), K The following terms or phrases are discussed in this chapter. *Match items with descriptions.*

1. Certified public accountant (CPA).
2. Management discussion and analysis (MD&A).
3. Revenue.
4. Dividends.
5. Stockholders' equity.
6. Net loss.
7. Sole proprietorship.
8. Basic accounting equation.
9. Expenses.
10. Liabilities.
11. Sarbanes-Oxley Act (SOX).

Instructions

Match each term or phrase to its description below.

a. _____ Assets = Liabilities + Stockholders' Equity.

b. _____ An individual who has met certain criteria and is thus allowed to perform audits of corporations.

c. _____ Payments of cash from a corporation to its stockholders.

d. _____ The cost of assets consumed or services used in the process of generating revenues.

e. _____ Amounts owed to creditors in the form of debts and other obligations.

f. _____ A section of the annual report that presents management's views on the company's ability to pay near-term obligations, its ability to fund operations and expansion, and its results of operations.

g. _____ The amount by which expenses exceed revenues.

h. _____ The increase in assets or decrease in liabilities resulting from the sale of goods or the performance of services in the normal course of business.

i. _____ Regulations passed by Congress to reduce unethical corporate behavior.

j. _____ A business owned by one person.

k. _____ The owners' claim to assets.

Identify business activities.

E1.6 (LO 2), C All businesses are involved in three types of activities—financing, investing, and operating. Listed below are the names and descriptions of companies in several different industries.

Abitibi-Consolidated Inc.—manufacturer and marketer of newsprint
California State University—Northridge Student Union—university student union
Oracle Corporation—computer software developer and retailer
Aquilini Investment Group—owner of the Vancouver Canucks ice hockey team
Grant Thornton LLP—professional accounting and business advisory firm
Southwest Airlines—low-cost airline

Instructions

a. For each of the above companies, provide examples of (1) a financing activity, (2) an investing activity, and (3) an operating activity that the company likely engages in.

b. Which of the activities that you identified in (a) are common to most businesses? Which activities are not?

Classify business activities.

E1.7 (LO 2), K Consider the following business activities that occur at a Colorado ski area.

1. _____ Cash receipts from customers paying for daily ski passes.

2. _____ Payments made to purchase additional snow-making equipment.

3. _____ Payments made to repair the snow-grooming machines.

4. _____ Receipt of funds from the bank to finance the purchase of additional snow-making equipment.

5. _____ Issue of shares to raise funds for a planned expansion.

6. _____ Repayment of a portion of the bank loan (see item 4).

7. _____ Payment of salaries to the ski-lift operators.

8. _____ Payment of dividend to shareholders.

Instructions

Classify each of the above items by type of business activity: operating (O), investing (I), or financing (F).

Classify accounts.

E1.8 (LO 2, 3), C The Bonita Vista Golf & Country Club details the following accounts in its financial statements.

Accounts payable	_____
Accounts receivable	_____
Equipment	_____
Sales revenue	_____
Service revenue	_____
Inventory	_____
Mortgage payable	_____
Supplies expense	_____
Rent expense	_____
Salaries and wages expense	_____

Instructions

Classify each of the accounts as an asset (A), liability (L), stockholders' equity (SE), revenue (R), or expense (E) item.

E1.9 (LO 3), K Consider the following typical accounts and statement items. *Identify financial statements.*

1. _____ Interest income.
2. _____ Cash.
3. _____ Cash provided by operating activities.
4. _____ Service revenue.
5. _____ Common stock.
6. _____ Dividends.
7. _____ Retained earnings, beginning of period.
8. _____ Accounts receivable.
9. _____ Inventory.
10. _____ Income tax expense.
11. _____ Interest expense.
12. _____ Net cash used by investing activities.
13. _____ Equipment.
14. _____ Total stockholders' equity.
15. _____ Bank loan payable.

Instructions

Indicate on which statement—income statement (IS), balance sheet (BS), retained earning statement (RE), and/or statement of cash flows (SCF)—you would find each of the above accounts or items.

E1.10 (LO 3), AP This information relates to Benser Co. for the year 2027. *Prepare income statement and retained earnings statement.*

Retained earnings, January 1, 2027	$67,000
Advertising expense	1,800
Dividends	6,000
Rent expense	10,400
Service revenue	58,000
Utilities expense	2,400
Salaries and wages expense	30,000

Instructions

Prepare an income statement and a retained earnings statement for the year ending December 31, 2027.

E1.11 (LO 3), AP Suppose the following information was taken from the 2027 financial statements of pharmaceutical giant **Merck & Co.** (All dollar amounts are in millions.) *Prepare income statement and retained earnings statement.*

Retained earnings, January 1, 2027	$43,698.8
Cost of goods sold	9,018.9
Selling and administrative expenses	8,543.2
Dividends	3,597.7
Sales revenue	38,576.0
Research and development expense	5,845.0
Income tax expense	2,267.6

Instructions

a. After analyzing the data, prepare an income statement and a retained earnings statement for the year ending December 31, 2027.

b. Suppose that Merck decided to reduce its research and development expense by 50%. What would be the short-term implications? What would be the long-term implications? How do you think the stock market would react?

E1.12 (LO 3), AP Presented here is information for Zheng Inc. for 2027. *Prepare a retained earnings statement.*

Retained earnings, January 1	$130,000
Service revenue	400,000
Total expenses	175,000
Dividends	65,000

Instructions

Prepare the 2027 retained earnings statement for Zheng Inc.

E1.13 (LO 3), AP The following information is available for Randall Inc. *Prepare a balance sheet.*

Accounts receivable	$ 2,400	Cash	$ 6,250
Accounts payable	3,700	Supplies	3,760
Interest payable	580	Unearned service revenue	850
Salaries and wages expense	4,500	Salaries and wages payable	745
Notes payable	31,500	Depreciation expense	670
Common stock	50,700	Equipment (net)	108,200
Inventory	2,840		

Instructions

Using the information above, prepare a balance sheet as of December 31, 2027. (*Hint:* Solve for the missing retained earnings amount after first determining total assets and total liabilities.)

Interpret financial data.

E1.14 (LO 3), AN Consider each of the following independent situations.

a. The retained earnings statement of Lee Corporation shows dividends of $68,000, while net income for the year was $75,000.

b. The statement of cash flows for Steele Corporation shows that cash provided by operating activities was $10,000, cash used in investing activities was $110,000, and cash provided by financing activities was $130,000.

Instructions

For each company, provide a brief discussion interpreting these financial data. For example, you might discuss the company's financial health or its apparent growth philosophy.

Identify financial statement components and prepare income statement.

E1.15 (LO 3), AP The following items and amounts were taken from Lonyear Inc.'s 2027 income statement and balance sheet.

_____	Cash	$ 84,700	_____	Accounts receivable	$ 88,419
_____	Retained earnings	123,192	_____	Sales revenue	584,951
_____	Cost of goods sold	438,458	_____	Notes payable	6,499
_____	Salaries and wages expense	115,131	_____	Accounts payable	49,384
_____	Prepaid insurance	7,818	_____	Service revenue	4,806
_____	Inventory	64,618	_____	Interest expense	1,882

Instructions

a. In each, case, identify on the blank line whether the item is an asset (A), liability (L), stockholders' equity (SE), revenue (R), or expense (E) item.

b. Prepare an income statement for Lonyear Inc. for the year ended December 31, 2027.

Identify financial statement components and prepare income statement.

E1.16 (LO 3), AP The following items and amounts were taken from Familia Inc.'s 2027 income statement and balance sheet, the end of its first year of operations.

_____	Interest expense	$ 2,200	_____	Equipment, net	$54,700
_____	Interest payable	700	_____	Depreciation expense	3,200
_____	Notes payable	11,800	_____	Supplies	4,100
_____	Sales revenue	44,300	_____	Common stock	26,800
_____	Cash	2,900	_____	Supplies expense	900
_____	Salaries and wages expense	15,600			

Instructions

a. In each case, identify on the blank line whether the item is an asset (A), liability (L), stockholders' equity (SE), revenue (R), or expense (E) item.

b. Prepare an income statement for Familia Inc. for December 31, 2027.

Calculate missing amounts.

E1.17 (LO 3), AN Here are incomplete financial statements for Donavan, Inc.

Donavan, Inc.
Balance Sheet

Assets		Liabilities and Stockholders' Equity	
Cash	$ 7,000	Liabilities	
Inventory	10,000	Accounts payable	$ 5,000
Buildings (net)	45,000	Stockholders' equity	
		Common stock	(a)
Total assets	$62,000	Retained earnings	(b)
		Total liabilities and stockholders' equity	$62,000

Income Statement	
Revenues	$85,000
Cost of goods sold	(c)
Salaries and wages expense	10,000
Net income	$ (d)

Retained Earnings Statement	
Beginning retained earnings	$12,000
Add: Net income	(e)
Less: Dividends	5,000
Ending retained earnings	$27,000

Instructions

Calculate the missing amounts.

E1.18 (LO 3), AN Here are incomplete financial statements for Oway Corporation.

Calculate missing amounts.

Oway Corporation
Balance Sheet

Assets		Liabilities and Stockholders' Equity	
Cash	$ 29,000	Liabilities	
Supplies	(a)	Notes payable	$22,000
Equipment (net)	65,000	Stockholders' equity	
Total assets	$ (b)	Common stock	38,000
		Retained earnings	(c)
		Total liabilities and stockholders' equity	$ (d)

Income Statement	
Revenues	$53,000
Depreciation expense	(e)
Salaries and wages expense	10,000
Interest expense	1,000
Net income	$25,000

Retained Earnings Statement	
Beginning retained earnings	$ (f)
Add: Net income	(g)
Less: Dividends	6,000
Ending retained earnings	$37,000

Instructions

Calculate the missing amounts.

E1.19 (LO 3), AP Otay Lakes Park is a private camping ground near the Mount Miguel Recreation Area. It has compiled the following financial information as of December 31, 2027.

Compute net income and prepare a retained earnings statement and balance sheet.

Service revenue (from camping fees)	$132,000	Dividends	$ 9,000
Sales revenue (from general store)	25,000	Notes payable	50,000
Accounts payable	11,000	Expenses during 2027	126,000
Cash	8,500	Supplies	5,500
Equipment	114,000	Common stock	40,000
		Retained earnings (1/1/2027)	5,000

Instructions

a. Determine Otay Lakes Park's net income for 2027.

b. Prepare a retained earnings statement and a balance sheet for Otay Lakes Park as of December 31, 2027.

c. Upon seeing this income statement, Walt Jones, the campground manager, immediately concluded, "The general store is more trouble than it is worth—let's get rid of it." The marketing director isn't so sure this is a good idea. What do you think?

Identify financial statement components and prepare an income statement.

E1.20 (LO 3), AP **Kellogg Company** is the world's leading producer of ready-to-eat cereal and a leading producer of grain-based convenience foods such as frozen waffles and cereal bars. Suppose the following items were taken from its 2027 income statement and balance sheet. (All dollars are in millions.)

____ Retained earnings	$5,481	____ Bonds payable	$ 4,835
____ Cost of goods sold	7,184	____ Inventory	910
____ Selling and administrative expenses	3,390	____ Sales revenue	12,575
____ Cash	334	____ Accounts payable	1,077
____ Notes payable	44	____ Common stock	105
____ Interest expense	295	____ Income tax expense	498

Instructions

a. In each case, identify whether the item is an asset (A), liability (L), stockholders' equity (SE), revenue (R), or expense (E).

b. Prepare an income statement for Kellogg Company for the year ended December 31, 2027.

Prepare a statement of cash flows.

E1.21 (LO 3), AP This information is for Williams Corporation for the year ended December 31, 2027.

Cash received from lenders	$20,000
Cash received from customers	50,000
Cash paid for new equipment	28,000
Cash dividends paid	8,000
Cash paid to suppliers	16,000
Cash balance, January 1, 2027	12,000

Instructions

a. Prepare the 2027 statement of cash flows for Williams Corporation.

b. Suppose you are one of Williams' creditors. Referring to the statement of cash flows, evaluate Williams' ability to repay its creditors.

Prepare a statement of cash flows.

E1.22 (LO 3), AP Suppose the following data are derived from the 2027 financial statements of **Southwest Airlines**. (All dollars are in millions.) Southwest has a December 31 year-end.

Cash balance, January 1, 2027	$1,390
Cash paid for repayment of debt	122
Cash received from issuance of common stock	144
Cash received from issuance of long-term debt	500
Cash received from customers	9,823
Cash paid for property and equipment	1,529
Cash paid for dividends	14
Cash paid for repurchase of common stock	1,001
Cash paid for goods and services	6,978

Instructions

a. After analyzing the data, prepare a statement of cash flows for Southwest Airlines for the year ended December 31, 2027.

b. Discuss whether the company's net cash provided by operating activities was sufficient to finance its investing activities. If it was not, how did the company finance its investing activities?

Correct an incorrectly prepared balance sheet.

E1.23 (LO 3), AP Wayne Holtz is the bookkeeper for Beeson Company. Wayne has been trying to get the balance sheet of Beeson Company to balance. It finally balanced, but now he's not sure it is correct.

Beeson Company
Balance Sheet
December 31, 2027

Assets		Liabilities and Stockholders' Equity	
Cash	$18,000	Accounts payable	$16,000
Supplies	9,500	Accounts receivable	(12,000)
Equipment	40,000	Common stock	40,000
Dividends	8,000	Retained earnings	31,500
Total assets	$75,500	Total liabilities and stockholders' equity	$75,500

Instructions

Prepare a correct balance sheet.

E1.24 (LO 3), AP Suppose the following items were taken from the balance sheet of **Nike, Inc.** (All dollars are in millions.)

Classify items as assets, liabilities, and stockholders' equity, and prepare accounting equation.

Excel

1.	____ Cash	$2,291.1	**7.**	____ Inventory	$2,357.0
2.	____ Accounts receivable	2,883.9	**8.**	____ Income taxes payable	86.3
3.	____ Common stock	2,874.2	**9.**	____ Equipment	1,957.7
4.	____ Notes payable	342.9	**10.**	____ Retained earnings	5,818.9
5.	____ Buildings	3,759.9	**11.**	____ Accounts payable	2,815.8
6.	____ Mortgage payable	1,311.5			

Instructions

Perform each of the following.

a. Classify each of these items as an asset (A), liability (L), or stockholders' equity (SE) item.

b. Determine Nike's accounting equation by calculating the value of total assets, total liabilities, and total stockholders' equity.

c. To what extent does Nike rely on debt versus equity financing?

E1.25 (LO 3), AN The summaries of data from the balance sheet, income statement, and retained earnings statement for two corporations, Walco Corporation and Gunther Enterprises, are presented as follows for 2027.

Use financial statement relationships to determine missing amounts.

	Walco Corporation	Gunther Enterprises
Beginning of year		
Total assets	$110,000	$150,000
Total liabilities	70,000	(d)
Total stockholders' equity	(a)	70,000
End of year		
Total assets	(b)	180,000
Total liabilities	120,000	55,000
Total stockholders' equity	60,000	(e)
Changes during year in retained earnings		
Dividends	(c)	5,000
Total revenues	215,000	(f)
Total expenses	165,000	80,000

Instructions

Determine the missing amounts. Assume all changes in stockholders' equity are due to changes in retained earnings.

E1.26 (LO 3), K The annual report provides financial information in a variety of formats, including the following.

Classify various items in an annual report.

Management discussion and analysis (MD&A)
Financial statements
Notes to the financial statements
Auditor's opinion

Instructions

For each of the following, state in what area of the annual report the item would be presented. If the item would probably not be found in an annual report, state "Not disclosed."

a. The total cumulative amount received from stockholders in exchange for common stock.

b. An independent assessment concerning whether the financial statements present a fair depiction of the company's results and financial position.

c. The interest rate that the company is being charged on all outstanding debts.

d. Total revenue from operating activities.

e. Management's assessment of the company's results.

f. The names and positions of all employees hired in the last year.

Classify accounts and prepare balance sheet.

E1.27 (LO 3), AP The following list of accounts, in alphabetical order, is for Aventura Inc. at November 30, 2027.

____ Accounts payable	$ 26,200	____ Inventory	$18,000
____ Accounts receivable	19,500	____ Land	44,000
____ Buildings	100,000	____ Mortgage payable	97,500
____ Cash	20,000	____ Notes payable	34,000
____ Common stock	20,000	____ Retained earnings	48,500
____ Equipment, net	30,000	____ Supplies	700
____ Income taxes payable	6,000		

Instructions

a. For each of the above accounts, identify whether it is an asset (A), liability (L), or stockholders' equity (SE) item.

b. Prepare a balance sheet at November 30, 2027.

Problems

Determine forms of business organization.

P1.1 (LO 1), C **Writing** Presented below are five independent situations.

a. Three physics professors at MIT have formed a business to improve the speed of information transfer over the Internet for stock exchange transactions. Each has contributed an equal amount of cash and knowledge to the venture. Although their approach looks promising, they are concerned about the legal liability that their business might confront.

b. Bob Colt, a college student looking for summer employment, opened a bait shop in a small shed at a local marina.

c. Alma Ortiz and Jaime Falco each owned separate shoe manufacturing businesses. They have decided to combine their businesses. They expect that within the coming year they will need significant funds to expand their operations.

d. Alice, Donna, and Sam recently graduated with marketing degrees. They have been friends since childhood. They have decided to start a consulting business focused on marketing sporting goods over the Internet.

e. Don Rolls has developed a low-cost GPS device that can be implanted into pets so that they can be easily located when lost. He would like to build a small manufacturing facility to make the devices and then sell them to veterinarians across the country. Don has no savings or personal assets. He wants to maintain control over the business.

Instructions

In each case, explain what form of organization the business is likely to take—sole proprietorship, partnership, or corporation. Give reasons for your choice.

Identify users and uses of financial statements.

P1.2 (LO 3), C **Writing** Financial decisions often place heavier emphasis on one type of financial statement over the others. Consider each of the following hypothetical situations independently.

a. **The North Face** is considering extending credit to a new customer. The terms of the credit would require the customer to pay within 30 days of receipt of goods.

b. An investor is considering purchasing common stock of **Amazon.com**. The investor plans to hold the investment for at least 5 years.

c. **JPMorgan Chase** is considering extending a loan to a small company. The company would be required to make interest payments at the end of each year for 5 years, and to repay the loan at the end of the fifth year.

d. The president of **Campbell Soup** is trying to determine whether the company is generating enough cash to increase the amount of dividends paid to investors in this and future years, and still have enough cash to buy equipment as it is needed.

Instructions

In each situation, state whether the decision-maker would be most likely to place primary emphasis on information provided by the income statement, balance sheet, or statement of cash flows. In each case provide a brief justification for your choice. Choose only one financial statement in each case.

P1.3 (LO 3), AP On June 1, 2027, Elite Service Co. was started with an initial investment in the company of $22,100 cash. Here are the assets, liabilities, and common stock of the company at June 30, 2027, and the revenues and expenses for the month of June, its first month of operations:

Prepare an income statement, retained earnings statement, and balance sheet; discuss results.

Excel

Cash	$ 4,600	Notes payable	$12,000
Accounts receivable	4,000	Accounts payable	500
Service revenue	7,500	Supplies expense	1,000
Supplies	2,400	Maintenance and repairs expense	600
Advertising expense	400	Utilities expense	300
Equipment	26,000	Salaries and wages expense	1,400
Common stock	22,100		

During June, the company issued no additional stock but paid dividends of $1,400.

Check figures provide a key number to let you know you are on the right track.

a. Net income $ 3,800
Ret. earnings $ 2,400
Tot. assets $37,000

Instructions

a. Prepare an income statement and a retained earnings statement for the month of June and a balance sheet at June 30, 2027.

b. Briefly discuss whether the company's first month of operations was a success.

c. Discuss the company's decision to distribute a dividend.

P1.4 (LO 3), AP Reese Inc., a provider of consulting services, was founded on October 1, 2027. At the end of the first month of operations, the company decided to prepare an income statement, retained earnings statement, and balance sheet using the following information.

Prepare an income statement, retained earnings statement, and balance sheet.

Accounts payable	$ 3,300	Supplies	$ 2,460
Interest expense	410	Supplies expense	380
Equipment (net)	48,200	Depreciation expense	270
Salaries and wages expense	2,500	Service revenue	20,920
Bonds payable	21,500	Salaries and wages payable	445
Unearned service revenue	4,065	Common stock	9,100
Accounts receivable	1,300	Interest payable	140
Cash	3,950		

Instructions

Using the information, prepare an income statement and retained earnings statement for the month of October 2027 and a balance sheet as of October 31, 2027.

End. retained earnings $17,360

P1.5 (LO 3), AP Presented below is selected financial information for Rojo Corporation for December 31, 2027.

Determine items included in a statement of cash flows, prepare the statement, and comment.

Inventory	$ 25,000	Cash paid to purchase equipment	$ 12,000
Cash paid to suppliers	104,000	Equipment	40,000
Buildings	200,000	Service revenue	100,000
Common stock	50,000	Cash received from customers	132,000
Cash dividends paid	7,000	Cash received from issuing common stock	22,000
Cash at beginning of period	9,000		

Instructions

a. Prepare the statement of cash flows for Rojo Corporation.

b. Comment on the adequacy of net cash provided by operating activities to fund the company's investing activities and dividend payments.

a. Net cash increase $31,000

Comment on proper accounting treatment and prepare a corrected balance sheet.

P1.6 (LO 3), AN **Writing** Micado Corporation was formed on January 1, 2027. At December 31, 2027, Miko Liu, the president and sole stockholder, decided to prepare a balance sheet, which appeared as follows.

Micado Corporation
Balance Sheet
December 31, 2027

Assets		Liabilities and Stockholders' Equity	
Cash	$20,000	Accounts payable	$30,000
Accounts receivable	50,000	Notes payable	15,000
Inventory	36,000	Boat loan	22,000
Boat	24,000	Stockholders' equity	63,000

Miko willingly admits that she is not an accountant by training. She is concerned that her balance sheet might not be correct. She has provided you with the following additional information.

1. The boat actually belongs to Miko, not to Micado Corporation. However, because she thinks she might take customers out on the boat occasionally, she decided to list it as an asset of the company. To be consistent, she also listed as a liability of the corporation her personal loan that she took out at the bank to buy the boat.
2. The inventory was originally purchased for $25,000, but due to a surge in demand Miko now thinks she could sell it for $36,000. She thought it would be best to record it at $36,000.
3. Included in the accounts receivable balance is $10,000 that Miko loaned to her brother 5 years ago. Miko included this in the receivables of Micado Corporation so she wouldn't forget that her brother owes her money.

Instructions

a. Comment on the proper accounting treatment of the three items above.

b. Tot. assets $85,000

b. Provide a corrected balance sheet for Micado Corporation. (*Hint:* To get the balance sheet to balance, adjust stockholders' equity.)

Expand Your Critical Thinking

Financial Reporting Problem: Apple Inc.

CT1.1 The financial statements of **Apple Inc.** are presented in Appendix A.

Instructions

Refer to Apple's financial statements and answer the following questions.

a. What were Apple's total assets at September 26, 2020? At September 28, 2019?

b. How much cash (and cash equivalents) did Apple have on September 26, 2020?

c. What amount of accounts payable did Apple report on September 26, 2020? On September 28, 2019?

d. What were Apple's net sales in the year ending September 26, 2020? In the year ending September 28, 2019? In the year ending September 29, 2018?

e. What is the amount of the change in Apple's net income from 2019 to 2020?

Comparative Analysis Problem: Columbia Sportswear Company vs. Under Armour, Inc.

CT1.2 **Columbia Sportswear Company**'s financial statements are presented in Appendix B. Financial statements of **Under Armour, Inc.** are presented in Appendix C.

Instructions

a. Based on the information in these financial statements, determine the following for each company.

1. Total liabilities at December 31, 2020.
2. Net property, plant, and equipment at December 31, 2020.

3. Net cash provided or (used) in investing activities for 2020.
4. Net income for 2020.

b. What conclusions concerning the two companies can you draw from these data?

Interpreting Financial Statements

CT1.3 **Xerox** was not having a particularly pleasant year. The company's stock price had already fallen in the previous year from $60 per share to $30. Just when it seemed things couldn't get worse, Xerox's stock fell to $4 per share. The following data were taken from the statement of cash flows of Xerox. (All dollars are in millions.)

Cash used in operating activities		$ (663)
Cash used in investing activities		(644)
Financing activities		
Dividends paid	$ (587)	
Net cash received from issuing debt	3,498	
Cash provided by financing activities		2,911

Instructions

Analyze the information and then answer the following questions.

a. If you were a creditor of Xerox, what reaction might you have to the above information?

b. If you were an investor in Xerox, what reaction might you have to the above information?

c. If you were evaluating the company as either a creditor or a stockholder, what other information would you be interested in seeing?

d. Xerox decided to pay a cash dividend. This dividend was approximately equal to the amount paid in the previous year. Discuss the issues that were probably considered in making this decision.

Real-World Focus

CT1.4 You can easily search the Internet to find summary information about companies. This information includes basic descriptions of the company's location, activities, industry, financial health, and financial performance.

Instructions

Go to the **Yahoo! Finance** website, type in a company name, and then use the links (such as Financials) to locate the information necessary to answer the following questions.

a. What is the company's net income? Over what period was this measured?

b. What is the company's total sales? Over what period was this measured?

c. What is the company's industry?

d. What are the names of four companies in this industry?

e. Choose one of the competitors. What is this competitor's name? What is its total sales? What is its net income?

CT1.5 The *Wall Street Journal* published an article by Michael Rapoport entitled "Coming Soon: What Auditors Really Think About Company Numbers." It provides a discussion about changes to be made to the auditor's report.

Instructions

Read the article and then answer the following questions.

a. What did the old auditor's report primarily focus on?

b. What does the new report provide beyond the old report? What are some examples of items that might be discussed?

c. How do the requirements of the new report compare to the requirements of auditor reports in other countries?

d. What criteria must be met in other for an item to be disclosed in the new report?

Decision-Making Across the Organization

CT1.6 Sylvia Ayala recently accepted a job in the production department at **Johnson & Johnson**. Before she starts work, she decides to review the company's annual report to better understand its operations.

The content and organization of corporate annual reports have become fairly standardized. Excluding the public relations part of the report (pictures, products, etc.), the following are the traditional financial portions of the annual report.

- Financial Highlights
- Letter to the Stockholders
- Management's Discussion and Analysis
- Financial Statements
- Notes to the Financial Statements
- Management's Responsibility for Financial Reporting
- Management's Report on Internal Control over Financial Reporting
- Report of Independent Registered Public Accounting Firm
- Selected Financial Data

The official SEC filing of the annual report is called a **Form 10-K**, which often omits the public relations pieces found in most standard annual reports.

Instructions

Search the Internet to find Johnson & Johnson's 10-K report dated for the year ended January 3, 2021, to answer the following questions.

a. What CPA firm performed the audit of Johnson & Johnson's financial statements?

b. What was the amount of Johnson & Johnson's basic earnings per share for the year ended January 3, 2021?

c. What are the company's net sales in foreign countries during the year ended January 3, 2021?

d. What were net sales during the year ended December 30, 2018?

e. How many shares of common stock have been authorized?

f. How much cash was spent on capital expenditures during the year ended January 3, 2021?

g. Over what life does the company depreciate its buildings?

h. What was the value of inventory on December 29, 2019?

Communication Activity

CT1.7 Marci Ling is the bookkeeper for Samco Company, Inc. Marci has been trying to get the company's balance sheet to balance. She finally got it to balance, but she still isn't sure that it is correct.

Samco Company, Inc.
Balance Sheet
For the Month Ended December 31, 2027

Assets		Liabilities and Stockholders' Equity	
Equipment	$18,000	Common stock	$12,000
Cash	9,000	Accounts receivable	(6,000)
Supplies	1,000	Dividends	(2,000)
Accounts payable	(4,000)	Notes payable	10,000
Total assets	$24,000	Retained earnings	10,000
		Total liabilities and stockholders' equity	$24,000

Instructions

Explain to Marci Ling in an email (a) the purpose of a balance sheet, and (b) why this balance sheet is incorrect and what Marci should do to correct it.

Ethics Cases

CT1.8 Rules governing the investment practices of individual certified public accountants prohibit them from investing in the stock of a company that their firm audits. The Securities and Exchange Commission (SEC) became concerned that some accountants were violating this rule. In response to an SEC investigation, **PricewaterhouseCoopers (PwC)** fired 10 people and spent $25 million educating employees about the investment rules and installing an investment tracking system.

Instructions

Answer the following questions.

a. Why do you think rules exist that restrict auditors from investing in companies that are audited by their firms?

b. Some accountants argue that they should be allowed to invest in a company's stock as long as they themselves aren't involved in working on the company's audit or consulting. What do you think of this idea?

c. Today, a very high percentage of publicly traded companies are audited by only four very large public accounting firms. These firms also do a high percentage of the consulting work that is done for publicly traded companies. How does this fact complicate the decision regarding whether CPAs should be allowed to invest in companies audited by their firm?

d. Suppose you were a CPA and you had invested in **IBM** when IBM was not one of your firm's clients. Two years later, after IBM's stock price had fallen considerably, your firm won the IBM audit contract. You will be involved in working with the IBM audit. You know that your firm's rules require that you sell your shares immediately. If you do sell immediately, you will sustain a large loss. Do you think this is fair? What would you do?

e. Why do you think PwC took such extreme steps in response to the SEC investigation?

CT1.9 Ethical behavior is fundamental to communications between investors and companies. However, it is difficult for company founders to control their enthusiasm in discussions related to their company, such that sometimes new companies overstate their potential for future success, either intentionally or unintentionally, in order to generate investor interest.

For example, **Nikola Corporation**, a pioneer in electric semi-trucks, was investigated by U.S. securities regulators because critics claimed that the company's chairperson made false claims about the company's progress in his efforts to make Nikola "the Tesla of semi-trucks." Shortly after its stock began trading publicly, the company was estimated to be worth $30 billion, even though it had yet to produce its first electric truck. Similarly, **Tesla**'s founder and CEO, Elon Musk, has been investigated by the Securities and Exchange Commission a number of times regarding the accuracy of his communications, including Tweets.

Instructions

In groups, discuss the following topics.

a. Should companies be held accountable for the fairness of their communications, or instead should it be the responsibility of investors to determine whether company statements are true and fair?

b. Suppose that you founded a new company. What steps would you take to ensure that your communications were accurate, while still generating enthusiasm with investors?

c. Search the Internet to find information about the allegations and any results of regulatory investigations regarding the accuracy of Elon Musk's communications about Tesla. What are the allegations, and did investigations uncover any wrongdoing?

d. What are the potential costs to society of inaccurate company communications to investors?

All About You

CT1.10 Some people are tempted to make their finances look worse to get financial aid. Companies sometimes also manage their financial numbers in order to accomplish certain goals. Earnings management is the planned timing of revenues, expenses, gains, and losses to smooth out bumps in net income. In managing earnings, companies' actions vary from being within the range of ethical activity, to being both unethical and illegal attempts to mislead investors and creditors.

Instructions

Provide responses for each of the following questions.

a. Discuss whether you think each of the following actions (adapted from the **FinAid** website) to increase the chances of receiving financial aid is ethical.

1. Spend down the student's assets and income first, before spending parents' assets and income.
2. Accelerate necessary expenses to reduce available cash. For example, if you need a new car, buy it before applying for financial aid.
3. State that a truly financially dependent child is independent.
4. Have a parent take an unpaid leave of absence for long enough to get below the "threshold" level of income.

b. What are some reasons why a **company** might want to overstate its earnings?

c. What are some reasons why a **company** might want to understate its earnings?

d. Under what circumstances might an otherwise ethical person decide to illegally overstate or understate earnings?

Considering Environmental, Social, and Governance Reporting

CT1.11 Although **Clif Bar & Company** is not a public company, it does share its financial information with its employees as part of its open-book management approach. Further, although it does not publicly share its financial information, it does provide a different form of an annual report to external users. In this report, the company provides information regarding its sustainability efforts.

Instructions

Go to the "Who We Are" page at the Clif Bar website and then identify the company's five aspirations.

Answers to Insight and Accounting Across the Organization Questions

Owning a Piece of the Bar **Q:** What are the benefits to the company and to the employees of making the financial statements available to all employees? **A:** If employees can read and use financial reports, a company will benefit in the following ways. The **marketing department** will make better decisions about products to offer and prices to charge. The **finance department** will make better decisions about debt and equity financing and how much to distribute in dividends. The **production department** will make better decisions about when to buy new equipment and how much inventory to produce. The **human resources department** will be better able to determine whether employees can be given raises. Finally, **all employees** will be better informed about the basis on which they are evaluated, which will increase employee morale.

Using Data Science to Create Art **Q:** How can "big data" improve decision-making? **A:** Companies analyze the large amounts of data now available to improve cost estimation for future projects as well as identify bottlenecks and opportunities to increase the efficiency of production processes.

I Felt the Pressure—Would You? **Q:** Why did these employees lie, and what do you believe should be their penalty for these lies? **A:** They felt pressured by their supervisors to make the company's financial statements look better than warranted. They should be prosecuted for fraudulent activities under the Sarbanes-Oxley Act, as they knowingly misstated financial statement data.

Spinning the Career Wheel **Q:** How might accounting help you? **A:** You will need to understand financial reports in any enterprise with which you are associated. Whether you become a manager, a doctor, a lawyer, a social worker, a teacher, an engineer, an architect, or an entrepreneur, a working knowledge of accounting is relevant.