



# Introduction to Financial Statements

## Chapter Preview

How do you start a business? How do you determine whether your business 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 and 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 of a heart attack. 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.

Columbia doesn’t 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 issues including forced labor, child labor, harassment, wages and benefits, health and safety, and the environment.

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

<b>LO 1</b> Identify the forms of business organization and the uses of accounting information.	<ul style="list-style-type: none"><li>• Forms of business organization</li><li>• Users and uses of financial information</li><li>• Ethics in financial reporting</li></ul>	<b>DO IT! 1</b> Business Organization Forms
<b>LO 2</b> Explain the three principal types of business activity.	<ul style="list-style-type: none"><li>• Financing activities</li><li>• Investing activities</li><li>• Operating activities</li></ul>	<b>DO IT! 2</b> Business Activities
<b>LO 3</b> Describe the four financial statements and how they are prepared.	<ul style="list-style-type: none"><li>• Income statement</li><li>• Retained earnings statement</li><li>• Balance sheet</li><li>• Statement of cash flows</li><li>• Interrelationships of statements</li><li>• Other annual report elements</li></ul>	<b>DO IT! 3a</b> Financial Statements <b>DO IT! 3b</b> 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. Visit WileyPLUS for additional tutorials and practice opportunities.		

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 also spend most of your free time outdoors, kayaking, backpacking, skiing, rock

climbing, and mountain biking. You think you might be successful in opening an outdoor guide service where you grew up, in the Sierra Nevada mountains.

## Forms of Business Organization

Your next decision is to determine the organizational form of 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** to initiate or expand the business. Sometimes **partners bring unique skills or resources** to the partnership. 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**. 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**. If you choose a sole proprietorship or partnership, you generally receive more favorable tax treatment than a corporation. 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.

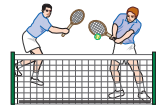
Finally, while sole proprietorships, partnerships, and corporations represent the main types of business organizations, hybrid forms are now allowed in all states. These hybrid business forms combine the tax advantages of partnerships with the limited liability of corporations. Probably the most common among these hybrids 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, **Coca-Cola**, **ExxonMobil**, **General Motors**, **Citigroup**, 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.*

## 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.



**HELPFUL HINT**

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

*Helpful Hints further clarify concepts being discussed.*




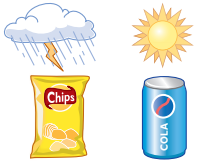
Accounting software systems collect vast amounts of data about the economic events experienced by a company and about the parties with whom the company engages, such as suppliers and customers. Business decision-makers take advantage of this wealth of data by using data analytics to make more informed business decisions. 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**).

**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

Questions Asked by Internal Users			
 <p><b>Finance</b></p> <p>Is cash sufficient to pay dividends to <b>Microsoft</b> stockholders?</p>	 <p><b>Marketing</b></p> <p>What price should <b>Apple</b> charge for an iPhone to maximize the company's net income?</p>	 <p><b>Human Resources</b></p> <p>Can <b>General Motors</b> afford to give its employees pay raises this year?</p>	 <p><b>Management</b></p> <p>Which <b>PepsiCo</b> product line is the most profitable? Should any product lines be eliminated?</p>

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

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 Clif Bar & Company



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### Owning a Piece of the Bar

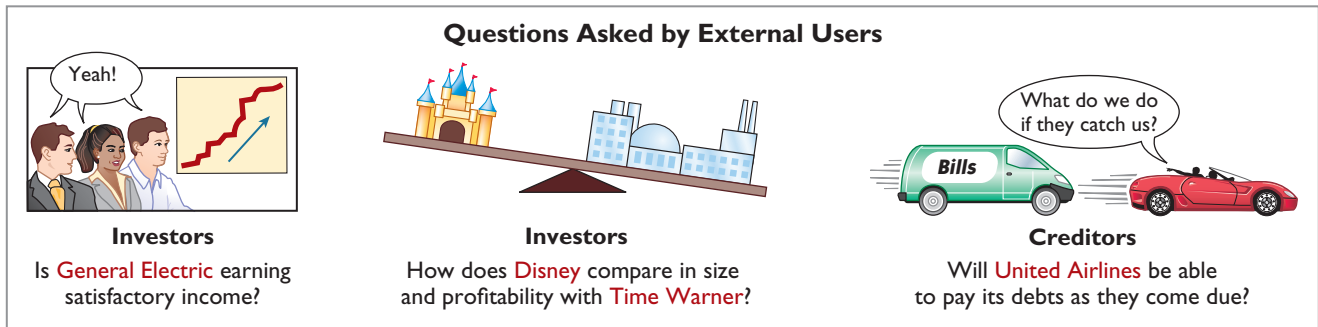
The original Clif Bar® energy bar was created in 1990 after six months of experimentation by Gary Erickson and his mother in her kitchen. The company has approximately 1,000 employees and was named one of Landor's Breakaway Brands®. One of **Clif Bar & Company's** proudest moments was the creation of 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? (Go to WileyPLUS for this answer and additional questions.)**

## 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 **General Motors** will continue 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.

## Accounting Across the Organization



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### 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 **Ford Motors**, Massachusetts General Hospital, California State University–Fullerton, a **McDonald's** franchise, and a **Trek** bike shop all need to understand accounting data in order to make wise business decisions.

**Marketing:** Marketing specialists at **Procter & Gamble** must be sensitive to costs and benefits, which accounting helps them quantify and understand. Making a sale is meaningless unless it is a profitable sale.

**Finance:** Do you want to be a banker for **Citicorp**, an investment analyst for **Goldman Sachs**, or a stock broker for **Merrill Lynch**? These 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:** Are you interested in being a real estate broker for **Prudential Real Estate**? Because a third party—the bank—is almost always involved in financing a real estate transaction, brokers must understand the numbers involved: Can the buyer afford to make the payments to the bank? Does the cash flow from an industrial property justify the purchase price? What are the tax benefits of the purchase?

**How might accounting help you? (Go to WileyPLUS for this answer and additional questions.)**

## 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, the financial press was full of articles about financial scandals at **Enron**, **WorldCom**, **HealthSouth**, and **AIG**. As more scandals came to light, a mistrust of financial reporting in general seemed to be developing. One article in the *Wall Street Journal* 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. There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

**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.*

United States 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 accuracy 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. To sensitize you to ethical situations and to give you practice at solving ethical dilemmas, we address ethics in a number of ways in this text. (1) A number of the *Feature Stories* and other parts of the text discuss the central importance of ethical behavior to financial reporting. (2) *Ethics Insight boxes* and marginal *Ethics Notes* highlight ethics situations and issues in actual business settings. (3) Many of the *People, Planet, and Profit Insight boxes* focus on ethical issues that companies face in measuring and reporting social and environmental issues. (4) At the end of each chapter, an *Ethics Case* simulates a business situation and asks you to put yourself in the position of a decision-maker in that case.

When analyzing these various ethics cases and your own ethical experiences, you should apply the three steps outlined in **Illustration 1.3**.

**ILLUSTRATION 1.3** 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.

*Insight boxes provide examples of business situations from various perspectives—ethics, investor, international, and corporate social responsibility. Guideline answers to the critical thinking questions, as well as additional questions, are available in **WileyPLUS**.*

**Ethics Insight** Dewey & LeBoeuf LLP

Alliance/Shutterstock

**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 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:** 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? (Go to WileyPLUS for this answer and additional questions.)**

**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.

### DO IT! 1 | 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.

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

#### 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** and **DO IT! 1.1**.

#### ACTION PLAN

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

## The Three Types of Business Activity

### LEARNING OBJECTIVE 2

Explain the three principal types of business activity.

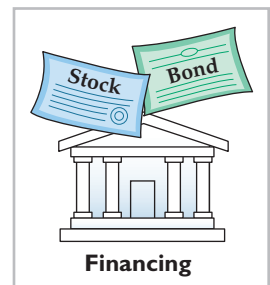
All businesses are involved in three types of activity—financing, investing, and operating. For example, Gert Boyle’s parents, the founders of **Columbia Sportswear**, obtained cash through financing to start and grow their business. Some of this **financing** came from personal savings, and some likely came from outside sources like banks. The family then **invested** the cash in equipment to run the business, such as sewing equipment and delivery vehicles. Once this equipment was in place, they could begin 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. 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**. 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. A growing company purchases many resources, such as computers, delivery trucks, furniture, and buildings. Resources owned by a business are called **assets**. Different types of assets are given different names. For example, 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. **Investments** are another example of an investing activity.

### ALTERNATIVE TERMINOLOGY

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



## Operating Activities

Once a business has the assets it needs to get started, it begins operations. Columbia Sportswear is in the business of selling outdoor clothing and footwear. It sells TurboDown jackets, Millenium snowboard pants, Sorel® snow boots, Bugaboos™, rainwear, and anything else you might need to protect you from the elements. We call amounts earned on 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. For example, 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. For instance, Columbia's primary source of revenue is the sale of sportswear. However, 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. For example, **supplies** are assets used in day-to-day operations. Goods available for future sales to customers are assets called **inventory**. Also, 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. This right to receive money in the future is called an **account receivable**.

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, it 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. | 4. Issuance of ownership shares.          |
| 2. Truck purchased.          | 5. Amount earned from performing service. |
| 3. Notes payable.            | 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 earned from performing service: Revenue.
6. Amounts owed to suppliers: Liability.

Related exercise material: BE1.3, DO IT! 1.2, and E1.4.

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

# 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 (see **International Note**):

- To show how successfully your business performed during a period of time, you report its revenues and expenses in an **income statement**.
- To indicate how much of previous income was distributed to you and the other owners of your business in the form of dividends, and how much was retained in the business to allow for future growth, you present a **retained earnings statement**.
- To present a picture at a point in time of what your business owns (its assets) and what it owes (its liabilities), you prepare a **balance sheet**.

### 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. Neither IFRS nor GAAP is very specific regarding format requirements for the primary financial statements. However, in practice, some format differences do exist in presentations commonly employed by IFRS companies as compared to GAAP companies.

- To show where your business obtained cash during a period of time and how that cash was used, you present a **statement of cash flows**.

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. To summarize, you officially started your business in Truckee, California, on October 1, 2022. 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, at this point the company has limited outdoor equipment for customer use. Instead, 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.

*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.*

Decision Tools

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

ILLUSTRATION 1.4

Sierra Corporation's income statement

HELPFUL HINT

The financial statement heading identifies the company, the type of statement, and the time period covered. Sometimes, another line indicates the unit of measure, e.g., "in thousands" or "in millions."

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.

Income Statement

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, 2022." 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 1.4** (see **Helpful Hint**). Congratulations, you are already showing a profit!

Sierra Corporation			
Income Statement			
For the Month Ended October 31, 2022			
Revenues			
Service revenue			\$10,600
Expenses			
Salaries and wages expense	\$5,200		
Rent expense	900		
Supplies expense	1,500		
Depreciation expense	40		
Interest expense	50		
Insurance expense	50		
Total expenses			<u>7,740</u>
Net income			<u>\$ 2,860</u>

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 also 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. 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 1.7), nor does it regard as a business expense the \$500 of dividends paid (see Illustration 1.5) (see **Ethics Note**).

## 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 **Facebook**, 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 1.5** 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.

### ILLUSTRATION 1.5

Sierra Corporation's retained earnings statement

### HELPFUL HINT

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

Sierra Corporation Retained Earnings Statement For the Month Ended October 31, 2022	
Retained earnings, October 1	\$ 0
Add: Net income	2,860
	2,860
Less: Dividends	500
Retained earnings, October 31	<u>\$2,360</u>

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.

## Balance Sheet

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 1.6** shows the relationship among the categories on the balance sheet in equation form. This equation is referred to as the **basic accounting equation**.

### Decision Tools

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

### ILLUSTRATION 1.6

Basic accounting equation

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

This relationship is where the name "balance sheet" comes from. Assets must balance with the claims to assets.

As you can see from looking at Sierra Corporation's balance sheet in **Illustration 1.7**, the balance sheet presents the company's financial position as of a specific date—in this case, October 31, 2022 (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

### ALTERNATIVE TERMINOLOGY

Liabilities are also referred to as *debt*.

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 1.7****Sierra Corporation's balance sheet****HELPFUL HINT**

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

Sierra Corporation Balance Sheet October 31, 2022		
<u>Assets</u>		
Cash		\$15,200
Accounts receivable		200
Supplies		1,000
Prepaid insurance		550
Equipment, net		<u>4,960</u>
Total assets		<u>\$21,910</u>
<u>Liabilities and Stockholders' Equity</u>		
Liabilities		
Notes payable	\$ 5,000	
Accounts payable	2,500	
Unearned service revenue	800	
Salaries and wages payable	1,200	
Interest payable	<u>50</u>	
Total liabilities		\$ 9,550
Stockholders' equity		
Common stock	10,000	
Retained earnings	<u>2,360</u>	
Total stockholders' equity		<u>12,360</u>
Total liabilities and stockholders' equity		<u>\$21,910</u>

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

## 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?

The statement of cash flows for Sierra Corporation, in **Illustration 1.8**, 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.



**Sierra Corporation**  
**Statement of Cash Flows**  
**For the Month Ended October 31, 2022**

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

**ILLUSTRATION 1.8**

**Sierra Corporation's statement of cash flows**

**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.

## People, Planet, and Profit Insight



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### Beyond Financial Statements

Should we expand our financial statements beyond the income statement, retained earnings statement, balance sheet, and statement of cash flows? Some believe we should take into account ecological and social performance, in addition to financial

results, in evaluating a company. The argument 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. Granted, measurement of these factors is difficult. How to report this information is also controversial. But many interesting and useful efforts are underway. Throughout this text, we provide additional insights into how companies are attempting to meet the challenge of measuring and reporting their contributions to society, as well as their financial results, to stockholders.

**Why might a company's stockholders be interested in its environmental and social performance? (Go to WileyPLUS for this answer and additional questions.)**

## Interrelationships of Statements

**Illustration 1.9** 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. Finally, 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 1.9**

Sierra Corporation's financial statements

**HELPFUL HINT**

Note that final sums are double-underlined.

**HELPFUL HINT**

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

### Sierra Corporation

#### Income Statement

For the Month Ended October 31, 2022

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

### Sierra Corporation

#### Retained Earnings Statement

For the Month Ended October 31, 2022

Retained earnings, October 1	\$ 0
Add: Net income	<u>2,860</u>
	2,860
Less: Dividends	<u>500</u>
Retained earnings, October 31	<u><u>\$2,360</u></u>

### Sierra Corporation

#### Balance Sheet

October 31, 2022

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

### Sierra Corporation

#### Statement of Cash Flows

For the Month Ended October 31, 2022

Cash flows from operating activities		
Cash receipts from operating activities	\$11,200	
Cash payments for operating activities	<u>(5,500)</u>	
Net cash provided by operating activities		\$ 5,700
Cash flows from investing activities		
Purchased office equipment	<u>(5,000)</u>	
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	<u>(500)</u>	
Net cash provided by financing activities		<u>14,500</u>
Net increase in cash		15,200
Cash at beginning of period		<u>0</u>
Cash at end of period		<u><u>\$15,200</u></u>

**HELPFUL HINT**

Negative amounts are presented in parentheses.

**DO IT! 3a | Financial Statements**

CSU Corporation began operations on January 1, 2022. The following information is available for CSU on December 31, 2022:

Accounts receivable	1,800	Retained earnings	?	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, 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 equity) at a specific point in time in the balance sheet.

**Solution**

CSU Corporation Income Statement For the Year Ended December 31, 2022		
Revenues		
Service revenue		\$17,000
Expenses	\$9,000	
Rent expense	1,000	
Insurance expense	200	
Supplies expense		
Total expenses		10,200
Net income		<u>\$ 6,800</u>

CSU Corporation Retained Earnings Statement For the Year Ended December 31, 2022	
Retained earnings, January 1	\$ 0
Add: Net income	<u>6,800</u>
	6,800
Less: Dividends	<u>600</u>
Retained earnings, December 31	<u>\$6,200</u>

CSU Corporation Balance Sheet December 31, 2022		
<u>Assets</u>		
Cash		\$ 1,400
Accounts receivable		1,800
Supplies		4,000
Equipment		<u>16,000</u>
Total assets		<u>\$23,200</u>
<u>Liabilities and Stockholders' Equity</u>		
Liabilities		
Notes payable	\$ 5,000	
Accounts payable	<u>2,000</u>	
Total liabilities		\$ 7,000
Stockholders' equity		
Common stock	10,000	
Retained earnings	<u>6,200</u>	
Total stockholders' equity		<u>16,200</u>
Total liabilities and stockholders' equity		<u>\$23,200</u>

Related exercise material: BE1.5, BE1.6, BE1.7, BE1.8, BE1.9, BE1.10, DO IT! 1.3a, E1.5, E1.6, E1.7, E1.8, E1.9, E1.10, E1.11, E1.12, E1.13, E1.14, E1.15, and E1.18.

## Other 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, its ability to fund operations and expansion, and its 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 **Columbia Sportswear’s** annual report, which addresses its liquidity requirements, is presented in **Illustration 1.10**.

**ILLUSTRATION 1.10**

Columbia Sportswear’s management discussion and analysis



### Columbia Sportswear Company

Management’s Discussion and Analysis of  
Seasonality and Variability of Business

Our operations are affected by seasonal trends typical in the outdoor apparel and footwear industry and have historically resulted in higher sales and profits in the third and fourth calendar quarters. This pattern has resulted primarily from the timing of shipments of fall season products to wholesale customers in the third and fourth quarters and proportionally higher sales in our direct-to-consumer channels in the fourth quarter, combined with an expense base that is spread more consistent throughout the year. We believe that our liquidity requirements for at least the next 12 months will be adequately covered by existing cash, cash provided by operations and existing short-term borrowing arrangements.


### 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, and 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 1.11** is an excerpt from the notes to **Columbia Sportswear’s** financial statements. It describes the methods that the company uses to account for revenues.

**ILLUSTRATION 1.11**

Notes to Columbia Sportswear’s financial statements



### Columbia Sportswear Company

Notes to Financial Statements  
Revenue Recognition

We record wholesale, distributor, e-commerce and licensed product revenues when title passes and the risks and rewards of ownership have passed to the customer. Title generally passes upon shipment to or upon receipt by the customer depending on the terms of sale with the customer. Retail store revenues are recorded at the time of sale.



## 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 perform 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 an accurate picture of the company's financial health. For example, **Blockbuster, Inc.**'s auditor at one time stated that its financial situation raised "substantial doubt about the Company's ability to continue as a going concern."

**Illustration 1.12** is an excerpt from the auditor's report from Columbia Sportswear's 2016 annual report. Columbia received an unqualified opinion from its auditor, **Deloitte & Touche**.



### Columbia Sportswear Company Excerpt from Auditor's Report

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Columbia Sportswear Company and subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

#### ILLUSTRATION 1.12

Excerpt from auditor's report  
on Columbia Sportswear's  
financial statements

### 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: **BE1.11**, **DO IT! 1.3b**, and **E1.21**.

#### 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.

*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.*

## USING THE DECISION TOOLS | VF Corporation

There is a good chance that you may have never heard of **VF Corporation**. There is also a very good chance that you are wearing one of VF's products right now. VF owns North Face, Lee, Vans, Nautica, Wrangler, Timberland, and numerous other brands. VF is a direct competitor to **Columbia Sportswear**. Suppose that you are considering investing in shares of VF's common stock.

### Instructions

Answer these questions related to your decision whether to invest.

- What financial statements should you evaluate?
- What should these financial statements tell you?
- Do you care if the financial statements have been audited? Explain.
- Appendix B contains financial statements for Columbia, and Appendix C contains those for VF. You can make many comparisons between Columbia and VF 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 2016.

### Solution

- Before you invest, you should evaluate the income statement, retained earnings statement, balance sheet, and statement of cash flows.
- You would probably be most interested in the income statement because it tells about 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.
- You would want audited financial statements. These statements indicate that a CPA (certified public accountant) has examined and expressed an opinion that 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.
- Many interesting comparisons can be made between the two companies (all numbers are in thousands). Columbia is smaller, with total assets of \$2,013,894 versus \$9,739,287 for VF, and it has lower revenue—\$2,377,045 versus \$12,019,003 for VF. In addition, Columbia's net cash provided by operating activities of \$275,167 is less than VF's \$1,477,919. 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.

*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  $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$ .

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.

## 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.
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. 1-3).

**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. 1-16).

**Assets** Resources owned by a business. (p. 1-8).

**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. 1-17).

**Balance sheet** A financial statement that reports the assets and claims to those assets at a specific point in time. (p. 1-11).

**Basic accounting equation** Assets = Liabilities + Stockholders' Equity. (p. 1-11).

**Certified public accountant (CPA)** An individual who has met certain criteria and is thus allowed to perform audits of corporations. (p. 1-17).

**Common stock** Term used to describe the total amount paid in by stockholders for the shares they purchase. (p. 1-8).

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

**Dividends** Payments of cash from a corporation to its stockholders. (p. 1-8).

**Expenses** The cost of assets consumed or services used in the process of generating revenues. (p. 1-8).

**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. 1-10).

**Liabilities** Amounts owed to creditors in the form of debts and other obligations. (p. 1-7).

**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. 1-16).

**Net income** The amount by which revenues exceed expenses. (p. 1-9).

**Net loss** The amount by which expenses exceed revenues. (p. 1-9).

**Notes to the financial statements** Notes clarify information presented in the financial statements and provide additional detail. (p. 1-16).

**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. 1-11).

**Retained earnings statement** A financial statement that summarizes the amounts and causes of changes in retained earnings for a specific time period. (p. 1-11).

**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. 1-8).

**Sarbanes-Oxley Act (SOX)** Regulations passed by Congress to reduce unethical corporate behavior. (p. 1-6).

**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. 1-12).

**Stockholders' equity** The owners' claim to assets. (p. 1-11).

## Practice Multiple-Choice Questions

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

- a. Sole proprietorship.
- b. Partnership.
- c. 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.
- b. Advertising.
- c. 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.
- b. \$15,000.
- c. \$65,000.
- 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, 2022, Rockford Corporation has assets of \$3,500 and stockholders' equity of \$1,500. What are the liabilities for Rockford as of December 31, 2022?

- a. \$1,500.
- b. \$1,000.
- c. \$2,500.
- 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.
- 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?
  - 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?
  - 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.  $(\$900,000 - \$440,000) - \$100,000 - \$80,000 = \$280,000$  stockholders' equity  
 b.  $\$900,000 - \$100,000 + \$200,000 = \$1,000,000$  total assets  
 c.  $\$440,000 - \$60,000 + \$50,000 = \$430,000$  total liabilities

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).
- Common stock.
  - Cash.
  - Salaries and wages expense.
  - Service revenue.
  - 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.

Prepare a balance sheet.

3. (LO 3) Presented below in alphabetical order are balance sheet items for Feagler Company at December 31, 2022. Prepare a balance sheet following the format of Illustration 1.7.

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, 2022		
<u>Assets</u>		
Cash		\$38,000
Accounts receivable		<u>12,500</u>
Total assets		<u>\$50,500</u>
<u>Liabilities and Stockholders' Equity</u>		
Liabilities		
Notes payable	\$40,000	
Total liabilities		\$40,000
Stockholders' equity		
Common stock	5,000	
Retained earnings	<u>5,500</u>	
Total stockholders' equity		<u>10,500</u>
Total liabilities and stockholders' equity		<u>\$50,500</u>

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

### 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

1. (LO 3) The following items and amounts were taken from Ricardo Inc.'s 2022 income statement and balance sheet.

*Prepare an income statement.*

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, 2022.

### Solution

1.

Ricardo Inc. Income Statement For the Year Ended December 31, 2022			
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			<u>\$ 92,635</u>

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, 2022.

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 2022	135,000
Cash	18,500	Supplies	12,500
Equipment	129,000	Common stock	40,000
		Retained earnings (1/1/2022)	15,000

### Instructions

- Determine net income from Cozy Bear for 2022.
- Prepare a retained earnings statement and a balance sheet for Cozy Bear as of December 31, 2022.

### Solution

2. a. Service revenue	\$148,000
Sales revenue	<u>35,000</u>
Total revenue	183,000
Expenses	<u>135,000</u>
Net income	<u>\$ 48,000</u>

b.

Cozy Bear Retained Earnings Statement For the Year Ended December 31, 2022	
Retained earnings, January 1	\$15,000
Add: Net income	<u>48,000</u>
	63,000
Less: Dividends	<u>9,000</u>
Retained earnings, December 31	<u>\$54,000</u>

Cozy Bear Balance Sheet December 31, 2022	
<u>Assets</u>	
Cash	\$ 18,500
Supplies	12,500
Equipment	<u>129,000</u>
Total assets	<u>\$160,000</u>
<u>Liabilities and Stockholders' Equity</u>	
Liabilities	
Bonds payable	\$50,000
Accounts payable	<u>16,000</u>
Total liabilities	\$ 66,000
Stockholders' equity	
Common stock	40,000
Retained earnings	<u>54,000</u>
Total stockholders' equity	<u>94,000</u>
Total liabilities and stockholders' equity	<u>\$160,000</u>

## 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 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 during the year of \$100,000 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, 2022, 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 1.9.)

### Solution

Ice Camp Income Statement For the Year Ended December 31, 2022		
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		<u>47,800</u>
Net income		<u>\$ 52,200</u>

Ice Camp Retained Earnings Statement For the Year Ended December 31, 2022	
Retained earnings, January 1, 2022	\$ 0
Add: Net income	<u>52,200</u>
	52,200
Less: Dividends	<u>5,000</u>
Retained earnings, December 31, 2022	<u>\$47,200</u>



Ice Camp Balance Sheet December 31, 2022		
<u>Assets</u>		
Cash		\$49,500
Accounts receivable		20,000
Equipment (\$12,000 + \$1,500)		<u>13,500</u>
Total assets		<u>\$83,000</u>
<u>Liabilities and Stockholders' Equity</u>		
Liabilities		
Notes payable	\$10,000	
Interest payable	<u>800</u>	
Total liabilities		\$10,800
Stockholders' equity		
Common stock	25,000	
Retained earnings	<u>47,200</u>	
Total stockholders' equity		<u>72,200</u>
Total liabilities and stockholders' equity		<u>\$83,000</u>

Ice Camp Statement of Cash Flows For the Year Ended December 31, 2022		
Cash flows from operating activities		
Cash receipts from operating activities	\$80,000	
Cash payments for operating activities	<u>(47,000)</u>	
Net cash provided by operating activities		\$33,000
Cash flows from investing activities		
Purchase of equipment	<u>(13,500)</u>	
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	<u>(5,000)</u>	
Net cash provided by financing activities		<u>30,000</u>
Net increase in cash		49,500
Cash at beginning of period		<u>0</u>
Cash at end of period		<u>\$49,500</u>

## WileyPLUS

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## 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. "Accounting is ingrained in our society and is vital to our economic system." Do you agree? Explain.
5. Who are the internal users of accounting data? How does accounting provide relevant data to the internal users?
6. Who are the external users of accounting data? Give examples.

7. What are the three main types of business activity? Give examples of each activity.
8. 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.
9. Why would a bank want to monitor the dividend payment practices of the corporations to which it lends money?
10. "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.
11. What is the primary purpose of the statement of cash flows?
12. What are the three main categories of the statement of cash flows? Why do you think these categories were chosen?
13. What is retained earnings? What items increase the balance in retained earnings? What items decrease the balance in retained earnings?
14. What is the basic accounting equation?
15. a. Define the terms assets, liabilities, and stockholders' equity.  
b. What items affect stockholders' equity?
16. 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.
17. 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.
18. What is the purpose of the management discussion and analysis section (MD&A)?
19. Why is it important for financial statements to receive an unqualified auditor's opinion?
20. What types of information are presented in the notes to the financial statements?
21. The accounting equation is  $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$ . Appendix A reproduces **Apple's** financial statements. Replacing words in the equation with dollar amounts, what is Apple's accounting equation at September 30, 2017?

## Brief Exercises

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

*Describe forms of business organization.*

- 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.

**BE1.2 (LO 1), K** Match each of the following types of evaluation with one of the listed users of accounting information.

*Identify users 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.
- a. \_\_\_\_ Investors in common stock.
  - b. \_\_\_\_ Marketing managers.
  - c. \_\_\_\_ Creditors.
  - d. \_\_\_\_ Chief Financial Officer.
  - e. \_\_\_\_ Internal Revenue Service.

**BE1.3 (LO 2), K** Indicate to which business activity, operating activity (O), investing activity (I), or financing activity (F), each item relates.

*Classify items by activity.*

- 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.

**BE1.4 (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.

*Determine effect of transactions on stockholders' equity.*

- 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.

Prepare a balance sheet.

**BE1.5 (LO 3), AP** In alphabetical order below are balance sheet items for Karol Company at December 31, 2022. Prepare a balance sheet following the format of Illustration 1.7.

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

Determine where items appear on financial statements.

**BE1.6 (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).

- 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.

Determine proper financial statement.

**BE1.7 (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).

- 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.

Use basic accounting equation.

**BE1.8 (LO 3), AP** Use the basic accounting equation to answer these questions.

- 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?

Use basic accounting equation.

**BE1.9 (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.)

- 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?

Identify assets, liabilities, and stockholders' equity.

**BE1.10 (LO 3), K** Indicate whether each of these items is an asset (A), a liability (L), or part of stockholders' equity (SE).

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

**BE1.11 (LO 3), K** Which is **not** a required part of an annual report of a publicly traded company?

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

*Determine required parts of annual report.*

## DO IT! Exercises

**DO IT! 1.1 (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.

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

*Classify financial statement elements.*

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

**DO IT! 1.3a (LO 3), AP** Gray Corporation began operations on January 1, 2022. The following information is available for Gray on December 31, 2022.

*Prepare financial statements.*

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.

**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.

*Identify components of annual reports.*

- 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

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

*Match items with descriptions.*

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

### Instructions

Match each word or phrase 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. A party that invests in common stock.
- \_\_\_\_\_ h. A business that is owned jointly by two or more individuals but does not issue stock.

Match items with descriptions.

E1.2 (LO 1, 2, 3), K The following list of terms or phrases are discussed in this chapter.

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.

E1.3 (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
- Cal State–Northridge Std't Union**—university student union
- Oracle Corporation**—computer software developer and retailer
- Sportsco Investments**—owner of the Vancouver Canucks hockey club
- 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 accounts.

E1.4 (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.

**E1.5 (LO 3), AP** This information relates to Benser Co. for the year 2022.

*Prepare income statement and retained earnings statement.*

Retained earnings, January 1, 2022	\$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, 2022.

**E1.6 (LO 3), AP** Suppose the following information was taken from the 2022 financial statements of pharmaceutical giant **Merck and Co.** (All dollar amounts are in millions.)

*Prepare income statement and retained earnings statement.*

Retained earnings, January 1, 2022	\$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**

- After analyzing the data, prepare an income statement and a retained earnings statement for the year ending December 31, 2022.
- 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?

**E1.7 (LO 3), AP** Presented here is information for Zheng Inc. for 2022.

*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 2022 retained earnings statement for Zheng Inc.

**E1.8 (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	Service revenue	40,920
Notes payable	31,500	Salaries and wages payable	745
Common stock	50,700	Depreciation expense	670
Inventory	2,840	Equipment (net)	108,200

**Instructions**

Using the information above, prepare a balance sheet as of December 31, 2022. (*Hint: Solve for the missing retained earnings amount.*)

**E1.9 (LO 3), AP** Consider each of the following independent situations.

*Interpret financial facts.*

- 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 facts. For example, you might discuss the company's financial health or its apparent growth philosophy.

Identify financial statement components and prepare income statement.

**E1.10 (LO 3), C** The following items and amounts were taken from Lonyear Inc.'s 2022 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, 2022.

Identify financial statement components and prepare income statement.

**E1.11 (LO 3), AP** The following items and amounts were taken from Familia Inc.'s 2022 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, 2022.

Calculate missing amounts.

**E1.12 (LO 3), AN** Here are incomplete financial statements for Donovan, Inc.

Donovan, 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	
Total assets	<u>\$62,000</u>	Common stock	(a)
		Retained earnings	(b)
		Total liabilities and stockholders' equity	<u>\$62,000</u>
Income Statement			
Revenues		\$85,000	
Cost of goods sold		(c)	
Salaries and wages expense		10,000	
Net income		<u>\$ (d)</u>	
Retained Earnings Statement			
Beginning retained earnings		\$12,000	
Add: Net income		(e)	
Less: Dividends		5,000	
Ending retained earnings		<u>\$27,000</u>	

### Instructions

Calculate the missing amounts.

**E1.13 (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.

**E1.14 (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, 2022.

Compute net income and prepare a 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 2022	126,000
Cash	8,500	Supplies	5,500
Equipment	114,000	Common stock	40,000
		Retained earnings (1/1/2022)	5,000

### Instructions

- Determine Otay Lakes Park's net income for 2022.
- Prepare a retained earnings statement and a balance sheet for Otay Lakes Park as of December 31, 2022.
- 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?

**E1.15 (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 2022 income statement and balance sheet. (All dollars are in millions.)

Identify financial statement components and prepare an income statement.

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

- In each case, identify whether the item is an asset (A), liability (L), stockholders' equity (SE), revenue (R), or expense (E).
- Prepare an income statement for Kellogg Company for the year ended December 31, 2022.

Prepare a statement of cash flows.

**E1.16 (LO 3), AP** This information is for Williams Corporation for the year ended December 31, 2022.

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 1/1/22	12,000

### Instructions

- Prepare the 2022 statement of cash flows for Williams Corporation.
- 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.

**E1.17 (LO 3), AP** Suppose the following data are derived from the 2022 financial statements of **Southwest Airlines**. (All dollars are in millions.) Southwest has a December 31 year-end.

Cash balance, January 1, 2022	\$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

- After analyzing the data, prepare a statement of cash flows for Southwest Airlines for the year ended December 31, 2022.
- 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.

**E1.18 (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, 2022			
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	<u>\$75,500</u>	Total liabilities and stockholders' equity	<u>\$75,500</u>

### Instructions

Prepare a correct balance sheet.

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



**E1.19 (LO 3), AP** Suppose the following items were taken from the balance sheet of **Nike, Inc.** (All dollars are in millions.)

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.

- Classify each of these items as an asset, liability, or stockholders' equity, and determine the total dollar amount for each classification.

- 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?

**E1.20 (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 2022.

*Use financial statement relationships to determine missing amounts.*

	<u>Walco Corporation</u>	<u>Gunther Enterprises</u>
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.

**E1.21 (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.

## Problems: Set A

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

*Determine forms of business organization.*

- 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 liabilities 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.

**P1.2A (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 Bank** 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.

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



**P1.3A (LO 3), AP** On June 1, 2022, 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, 2022, and the revenues and expenses for the month of June, its first month of operations:

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.

### Instructions

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

- a. Prepare an income statement and a retained earnings statement for the month of June and a balance sheet at June 30, 2022.
- b. Briefly discuss whether the company's first month of operations was a success.
- c. Discuss the company's decision to distribute a dividend.

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

**P1.4A (LO 3), AP** Reese Inc., a provider of consulting services, was founded on October 1, 2022. 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.

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 2022 and a balance sheet as of October 31, 2022.

End. retained earnings \$17,360

**P1.5A (LO 3), AP** Presented below is selected financial information for Rojo Corporation for December 31, 2022.

*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	
Cash at beginning of period	9,000	common stock	22,000

**Instructions**

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

**P1.6A (LO 3), AN Writing** Micado Corporation was formed on January 1, 2022. At December 31, 2022, Miko Liu, the president and sole stockholder, decided to prepare a balance sheet, which appeared as follows.

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

Micado Corporation Balance Sheet December 31, 2022			
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.

- 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.
- 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.
- 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**

- Comment on the proper accounting treatment of the three items above.
- Provide a corrected balance sheet for Micado Corporation. (*Hint:* To get the balance sheet to balance, adjust stockholders' equity.)

b. Tot. assets \$85,000

**Continuing Case**

*The **Cookie Creations** case starts in Chapter 1 and continues in every chapter. Complete case details and instructions are available in WileyPLUS.*

**Cookie Creations**

**CC1** Natalie Koebel spent much of her childhood learning the art of cookie-making from her grandmother. They spent many happy hours mastering every type of cookie imaginable and later devised new recipes that were both healthy and delicious. Now at the start of her second year in college, Natalie is investigating possibilities for starting her own business as part of the entrepreneurship program in which she is enrolled.

A long-time friend insists that Natalie has to include cookies in her business plan. After a series of brainstorming sessions, Natalie settles on the idea of operating a cookie-making school. She will start on



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a part-time basis and offer her services in people's homes. Now that she has started thinking about it, the possibilities seem endless. During the fall, she will concentrate on holiday cookies. She will offer group sessions (which will probably be more entertainment than education) and individual lessons. Natalie also decides to include children in her target market. The first difficult decision is coming up with the perfect name for her business. She settles on "Cookie Creations," and then moves on to more important issues.

### Instructions

- What form of business organization—proprietorship, partnership, or corporation—do you recommend that Natalie use for her business? Discuss the benefits and weaknesses of each form that Natalie might consider.
- Will Natalie need accounting information? If yes, what information will she need and why? How often will she need this information?
- Identify specific asset, liability, revenue, and expense accounts that Cookie Creations will likely use to record its business transactions.
- Should Natalie open a separate bank account for the business? Why or why not?
- Natalie expects she will have to use her car to drive to people's homes and to pick up supplies, but she also needs to use her car for personal reasons. She recalls from her first-year accounting course something about keeping business and personal assets separate. She wonders what she should do for accounting purposes. What do you recommend?

## 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.

- What were Apple's total assets at September 30, 2017? At September 24, 2016?
- How much cash (and cash equivalents) did Apple have on September 30, 2017?
- What amount of accounts payable did Apple report on September 30, 2017? On September 24, 2016?
- What were Apple's net sales in the year ending September 30, 2017? In the year ending September 24, 2016? In the year ending September 26, 2015?
- What is the amount of the change in Apple's net income from 2016 to 2017?

### Comparative Analysis Problem: Columbia Sportswear Company vs. VF Corporation

**CT1.2** **Columbia Sportswear Company's** financial statements are presented in Appendix B. Financial statements of **VF Corporation** are presented in Appendix C.

### Instructions

- Based on the information in these financial statements, determine the following for each company.
  - Total liabilities at December 31, 2016.
  - Net property, plant, and equipment at December 31, 2016.
  - Net cash provided or (used) in investing activities for 2016.
  - Net income for 2016.
- What conclusions concerning the two companies can you draw from these data?

### Comparative Analysis Problem: Amazon.com, Inc. vs. Wal-Mart Stores, Inc.

**CT1.3** **Amazon.com, Inc.'s** financial statements are presented in Appendix D. Financial statements of **Wal-Mart Stores, Inc.** are presented in Appendix E.

### Instructions

- Based on the information contained in these financial statements, determine the following for each company.
  - Total assets at December 31, 2016, for Amazon and for Wal-Mart at January 31, 2017.

2. Receivables (net) at December 31, 2016, for Amazon and for Wal-Mart at January 31, 2017.
  3. Net sales (product only) for the year ended in 2016 (2017 for Wal-Mart).
  4. Net income for year ended in 2016 (2017 for Wal-Mart).
- b. What conclusions concerning these two companies can be drawn from these data?

## Interpreting Financial Statements

**CT1.4 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 data below 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	<u>3,498</u>	
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

**CT1.5** 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?

**CT1.6** The June 1, 2017, issue of the *Wall Street Journal* includes 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 answer the following questions.

- a. What does the current auditor's report primarily focus on?
- b. What will the new report provide beyond the current report? what are some examples of items that might be discussed?
- c. How would the requirements of the new report compare to the requirements of auditor reports in other countries?
- d. What criteria must be met in order for an item to be disclosed in the new report?

## Decision-Making Across the Organization

**CT1.7** 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

Use Johnson & Johnson's 10-K report dated January 1, 2017, 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 in 2016?
- c. What are the company's net sales in foreign countries in 2016?
- d. What were net sales in 2014?
- e. How many shares of common stock have been authorized?
- f. How much cash was spent on capital expenditures in 2016?
- g. Over what life does the company depreciate its buildings?
- h. What was the value of inventory in 2015?

### Communication Activity

**CT1.8** 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, 2022			
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	<u>\$24,000</u>	Retained earnings	<u>10,000</u>
		Total liabilities and stockholders' equity	<u>\$24,000</u>

### Instructions

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

### Ethics Case

**CT1.9** 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** 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 PricewaterhouseCoopers took such extreme steps in response to the SEC investigation?

## 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?

## FASB Codification Activity

**CT1.11** The FASB has developed the Financial Accounting Standards Board Accounting Standards Codification (or more simply "the Codification"). The FASB's primary goal in developing the Codification is to provide in one place all the authoritative literature related to a particular topic. To provide easy access to the Codification, the FASB also developed the Financial Accounting Standards Board Codification Research System (CRS). CRS is an online, real-time database that provides easy access to the Codification. The Codification and the related CRS provide a topically organized structure, subdivided into topic, subtopics, sections, and paragraphs, using a numerical index system.

You may find this system useful in your present and future studies, and so we have provided an opportunity to use this online system as part of the *Expand Your Critical Thinking* section.

### Instructions

Academic access to the FASB Codification is available through university subscriptions, obtained from the **American Accounting Association**. This subscription covers an unlimited number of students within a single institution. Once this access has been obtained by your school, you should log in and familiarize yourself with the resources that are accessible at the FASB Codification site.

## Considering People, Planet, and Profit

**CT1.12** 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 identify the company’s five aspirations.

## A Look at IFRS

### LEARNING OBJECTIVE 4

Describe the impact of international accounting standards on U.S. financial reporting.

Many people feel that there is a need for one set of international accounting standards. Here is why:

**Multinational corporations.** Today’s companies view the entire world as their market. For example, **Coca-Cola**, **Intel**, and **McDonald’s** generate more than 50% of their sales outside the United States. Many foreign companies, such as **Toyota**, **Nestlé**, and **Sony**, find their largest market to be the United States.

**Mergers and acquisitions.** The mergers between **Fiat/Chrysler** and **Vodafone/Mannesmann** suggest that we will see even more such business combinations of companies from different countries in the future.

**Information technology.** As communication barriers continue to topple through advances in technology, companies and individuals in different countries and markets are becoming more comfortable buying and selling goods and services from one another.

**Financial markets.** Financial markets are of international significance today. Whether it is currency, equity securities (stocks), bonds, or derivatives, there are active markets throughout the world trading these types of instruments.

### Key Points

Following are the key similarities and differences between GAAP and IFRS as related to accounting fundamentals.

#### Similarities

- The basic techniques for recording business transactions are the same for U.S. and international companies.
- Both international and U.S. accounting standards emphasize transparency in financial reporting. Both sets of standards are primarily driven by meeting the needs of investors and creditors.
- The three most common forms of business organizations, proprietorships, partnerships, and corporations, are also found in countries that use international accounting standards.

#### Differences

- International standards are referred to as International Financial Reporting Standards (IFRS), developed by the International Accounting Standards Board. Accounting standards in the United States are referred to as generally accepted accounting principles (GAAP) and are developed by the Financial Accounting Standards Board.
- IFRS tends to be simpler in its accounting and disclosure requirements; some people say it is more “principles-based.” GAAP is more detailed; some people say it is more “rules-based.”
- The internal control standards applicable to Sarbanes-Oxley (SOX) apply only to large public companies listed on U.S. exchanges. There is continuing debate as to whether non-U.S. companies should have to comply with this extra layer of regulation.

## IFRS Practice

### IFRS Self-Test Questions

1. Which of the following is **not** a reason why a single set of high-quality international accounting standards would be beneficial?
  - a. Mergers and acquisition activity.
  - b. Financial markets.
  - c. Multinational corporations.
  - d. GAAP is widely considered to be a superior reporting system.
2. The Sarbanes-Oxley Act determines:
  - a. international tax regulations.
  - b. internal control standards as enforced by the IASB.
  - c. internal control standards of U.S. publicly traded companies.
  - d. U.S. tax regulations.
3. IFRS is considered to be more:
  - a. principles-based and less rules-based than GAAP.
  - b. rules-based and less principles-based than GAAP.
  - c. detailed than GAAP.
  - d. None of the above.

## IFRS Exercises

**IFRS1.1** Who are the two key international players in the development of international accounting standards? Explain their role.

**IFRS1.2** What is the benefit of a single set of high-quality accounting standards?

### International Financial Reporting Problem: Louis Vuitton

**IFRS1.3** The financial statements of **Louis Vuitton** are presented in Appendix F. The complete annual report, including the notes to its financial statements, is available at the company's website.

#### Instructions

Answer the following questions from the company's 2016 annual report.

- a. What accounting firm performed the audit of Louis Vuitton's financial statements?
- b. What is the address of the company's corporate headquarters?
- c. What is the company's reporting currency?

### Answers to IFRS Self-Test Questions

1. d   2. c   3. a

