

EFFECTS OF THESE BUSINESS TRANSACTIONS ON THE ACCOUNTING EQUATION

As we learned earlier, the statement of financial position, or balance sheet, is a detailed expression of the accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

As we have progressed through a series of business transactions, we have illustrated the effects of Overnight's January transactions on the statement of financial position.

To review, Overnight's transactions during January were as follows, with the resulting balance sheet indicated in parentheses:

- Jan. 20** Michael McBryan started the business by depositing \$80,000 received from the sale of capital stock in a company bank account (Exhibit 2-2).
- Jan. 21** Purchased land for \$52,000, paying cash (Exhibit 2-3).
- Jan. 22** Purchased a building for \$36,000, paying \$6,000 in cash and issuing a note payable for the remaining \$30,000 (Exhibit 2-4).
- Jan. 23** Purchased tools and equipment on account, \$13,800 (Exhibit 2-5).
- Jan. 24** Sold some of the tools at a price equal to their cost, \$1,800, collectible within 45 days (Exhibit 2-6).
- Jan. 26** Received \$600 in partial collection of the account receivable from the sale of tools (Exhibit 2-7).
- Jan. 27** Paid \$6,800 in partial payment of an account payable (Exhibit 2-8).
- Jan. 31** Received \$2,200 of sales revenue in cash (Exhibit 2-9).
- Jan. 31** Paid \$1,400 of operating expenses in cash—\$200 for utilities and \$1,200 for wages (Exhibit 2-10).

The expanded accounting equation in Exhibit 2-11 shows the effects of these transactions on the accounting equation. The effect of each transaction is shown in red. Notice that the "balances," shown in black, are the amounts appearing in Overnight's balance sheets in Exhibits 2-2 through 2-10. Notice also that the accounting equation is in balance after each transaction.

While this table represents the impact of Overnight's transactions on the accounting equation, and on its financial position as shown in its balance sheet, we can now learn how the income statement and statement of cash flows enter the picture. Specifically, the income statement is a separate financial statement that shows how the statement of financial position changed as a result of its revenue and expense transactions. The statement of cash flows shows how the company's cash increased and decreased during the period.

Income Statement

The income statement is a summarization of the company's revenue and expense transactions for a period of time. The income statement is particularly important for the company's owners, creditors, and other interested parties to understand. Ultimately the company will succeed or fail based on its ability to earn revenues in excess of its expenses. Once the company's assets are acquired and business commences, revenues and expenses are important dimensions of the company's operations. **Revenues** are increases in the company's assets from its profit-directed activities, and they result in positive cash flows. **Expenses** are decreases in the company's assets from its profit-directed activities, and they result in negative cash flows. *Net income* is the difference between the revenues and expenses for a specified period of time. Should a company find itself in the undesirable situation of having expenses greater than revenues, we call the difference a *net loss*.

Overnight's income statement for January 20-31 is relatively simple because the company did not have a large number of complex revenue and expense transactions.⁵ Taking information directly from the Retained Earnings column in Exhibit 2-11, and separating the total

⁵ In this illustration, only revenue and expense transactions change the amount of owners' equity from the original \$80,000 investment of the owner. Examples of other events and transactions that affect the amount of owners' equity, but that are not included in net income, are the sale of additional shares of capital stock and the payment of dividends to shareholders. These subjects are covered in later chapters.

A=L+LOE

Multiple transactions significantly change the enterprise's financial position

LO2-5

LEARNING OBJECTIVE

Explain how the income statement reports an enterprise's financial performance for a period of time in terms of the relationship of revenues and expenses.

EXHIBIT 2-11 Income Statement

OVERNIGHT AUTO SERVICE
EXPANDED ACCOUNTING EQUATION
JANUARY 20-31, 2018

	Assets				Liabilities			Owners' Equity	
	Cash	Accounts Receivable	Tools and Equipment	Building	Land	Notes Payable	Accounts Payable	Capital Stock	Retained Earnings
Jan. 20 Balances	\$80,000							\$80,000	
Jan. 21 Balances	\$80,000				+\$52,000			\$80,000	
Jan. 22 Balances	\$28,000				\$52,000			\$80,000	
Jan. 23 Balances	\$22,000			+\$36,000	\$52,000	+\$30,000		\$80,000	
Jan. 24 Balances	\$22,000		+\$13,800	\$36,000	\$52,000	\$30,000	+\$13,800	\$80,000	
Jan. 26 Balances	\$22,000	\$1,800	\$13,800	\$36,000	\$52,000	\$30,000	\$13,800	\$80,000	
Jan. 27 Balances	\$22,600	-\$600	\$12,000	\$36,000	\$52,000	\$30,000	\$13,800	\$80,000	
Jan. 27 Balances	\$15,800	\$1,200	\$12,000	\$36,000	\$52,000	\$30,000	-\$6,800	\$80,000	
Jan. 31 Balances	\$16,600	\$1,200	\$12,000	\$36,000	\$52,000	\$30,000	\$7,000	\$80,000	+\$2,200
Jan. 31 Balances	\$16,600	\$1,200	\$12,000	\$36,000	\$52,000	\$30,000	\$7,000	\$80,000	-\$1,400
Jan. 31 Balances	\$16,600	\$1,200	\$12,000	\$36,000	\$52,000	\$30,000	\$7,000	\$80,000	\$ 800

Income Statement ←

← Statement of Cash Flows

Statement of Cash Flows

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**OVERNIGHT AUTO SERVICE
INCOME STATEMENT
FOR THE PERIOD JANUARY 20–31, 2018**

Sales Revenues		\$2,200
Operating expenses:		
Wages	\$1,200	
Utilities	200	1,400
Net Income		<u>\$ 800</u>

EXHIBIT 2–12
Income Statement

A=L+LOE
An income statement displays revenues and expenses for a period of time

expenses of \$1,400 into wages of \$1,200 and utilities of \$200, we can prepare the company's income statement as shown in Exhibit 2–12.

Notice that the heading for the income statement refers to a *period* of time rather than a *point* in time, as was the case with the balance sheet. The income statement reports on the financial performance of the company in terms of earning revenue and incurring expenses *over a period of time* and explains, in part, how the company's financial position changed between the beginning and ending of that period.

Statement of Cash Flows

In Chapter 1, we established the importance of cash flows to investors and creditors and that the cash flows of the company are an important consideration in investors' and creditors' assessments of cash flows to them. As a result, a second set of information that is particularly important concerning how a company's financial position changed between two points in time is cash flow information.

We can use the entire Cash column of the analysis in Exhibit 2–11 to create a statement of cash flows for Overnight Auto Service. The statement classifies the various cash flows into three categories—operating, investing, and financing—and relates these categories to the beginning and ending cash balances. Cash flows from **operating activities** are the cash effects of revenue and expense transactions that are included in the income statement.⁶ Cash flows from **investing activities** are the cash effects of purchasing and selling assets, such as land and buildings. Cash flows from **financing activities** are the cash effects of the owners investing in the company and creditors loaning money to the company and the repayment of either or both.

The statement of cash flows for Overnight Auto Service for the period January 20–31 is presented in Exhibit 2–13.

Notice that the operating, investing, and financing categories include both positive and negative cash flows. (The negative cash flows are in parentheses.) Also notice that the combined total of the three categories of the statement (increase of \$16,600) explains the total change in cash from the beginning to the end of the period. On January 20, the beginning balance was zero because the company was started on that day. Several transactions and parts of transactions had no cash effects and, therefore, are not included in the statement of cash flows. For example, on January 22, Overnight purchased a building for \$36,000, only \$6,000 of which was paid in cash. The remaining \$30,000 is not included in the statement of cash flows because it did not affect the amount of cash at the time the building was purchased. Similarly, on January 23, Overnight purchased tools and equipment for \$13,800, paying no cash at that time. That transaction has no cash effect on January 23, although the cash payment of \$6,800 on January 27, which is a continuation of that transaction, did affect cash and is included in the statement of cash flows. Transactions that did not affect cash are called

⁶ In this illustration, net cash amounts provided by operating activities and net income are equal. This is because all of Overnight Auto Service's revenues and expenses were cash transactions. This will not always be the case. As we learn more about the accrual method of accounting, you will see that revenues and expenses may be recorded in a different accounting period than the period when cash is received or paid. This will cause net income and net cash from operating activities to be different amounts.

LO2-6

LEARNING OBJECTIVE
Explain how the statement of cash flows presents the change in cash for a period of time in terms of the company's operating, investing, and financing activities.

EXHIBIT 2-13
Statement of Cash Flows

OVERNIGHT AUTO SERVICE
STATEMENT OF CASH FLOWS
FOR THE PERIOD JANUARY 20-31, 2018

Cash flows from operating activities:		
Cash received from revenue transactions	\$ 2,200	
Cash paid for expenses	(1,400)	
Net cash provided by operating activities		\$ 800
Cash flows from investing activities:		
Purchase of land	\$(52,000)	
Purchase of building	(6,000)	
Purchase of tools	(6,800)	
Sale of tools	600	
Net cash used by investing activities		(64,200)
Cash flows from financing activities:		
Sale of capital stock	80,000	
Increase in cash for the period		\$16,600
Beginning cash balance, January 20, 2018		-0-
Ending cash balance, January 31, 2018		<u>\$16,600</u>

A=L+LOE

A statement of cash flows shows how cash changed during the period

CASE IN POINT

It is not unusual for a company to report an increase in cash from operating activities, but a decrease in the total amount of cash. This outcome results when more cash is used for investing and financing activities than is generated from operations. For example, in 2014 Carnival Corporation, which owns and operates cruise lines, reported cash provided by operating activities of over \$3.4 billion but a decrease in total cash of \$131 million. This was due primarily to large expenditures for property and equipment, such as cruise ships, which are presented as investing activities in the company's statement of cash flows. In addition, Carnival used a large amount of cash to reduce its debt, and made a substantial dividend payment.

noncash investing and financing transactions. In a formal statement of cash flows, these transactions are required to be noted as we explain later in this text, even though they do not affect the actual flow of cash into and out of the company.

Relationships among Financial Statements

As our discussion of Overnight Auto Service indicates, the statement of financial position (balance sheet), the income statement, and the statement of cash flows are all based on the same transactions, but they present different "views" of the company. They should not be thought of as alternatives to each other; rather, all are important in terms of presenting key financial information about the company.

The diagram in Exhibit 2-14 explains how the three financial statements relate to the period of time they cover. The horizontal line represents time (for example, a month or a year). At the beginning and ending points in time, the company prepares a statement of financial position (balance sheet) that gives a static look in financial terms of where the company stands. The other two financial statements—the income statement and the statement of cash flows—cover the intervening *period of time* between the two balance sheets and help explain important changes that occurred during the period.

L02-7

LEARNING OBJECTIVE

Explain how the statement of financial position (balance sheet), income statement, and statement of cash flows relate to each other.

Relationships among Financial Statements

57

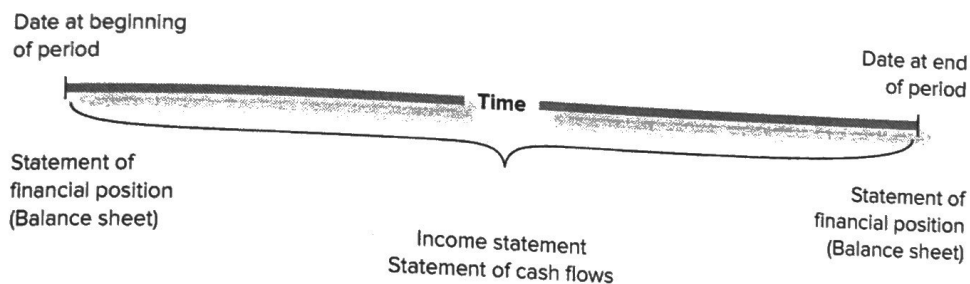


EXHIBIT 2-14
Financial Reporting Time Line

If we understand where a company stands financially at two points in time, and if we understand the changes that occurred during the intervening period in terms of the company's profit-seeking activities (income statement) and its cash activities (statement of cash flows), we know a great deal about the company that is valuable in assessing its future cash flows—information that is useful to investors, creditors, management, and others.

Because the balance sheet, income statement, and statement of cash flows are derived from the same underlying financial information, they are said to “articulate,” meaning that they relate closely to each other. The diagram in Exhibit 2-15 indicates relationships that we have discussed in this chapter as we have introduced these three important financial statements. The dollar amounts are taken from the Overnight Auto Service example presented earlier in this chapter. In the balance sheet, the property, plant, and equipment amount of \$100,000 represents the total of land (\$52,000), building (\$36,000), and tools and equipment (\$12,000).

A=L+LOE Financial statements are closely tied to time periods

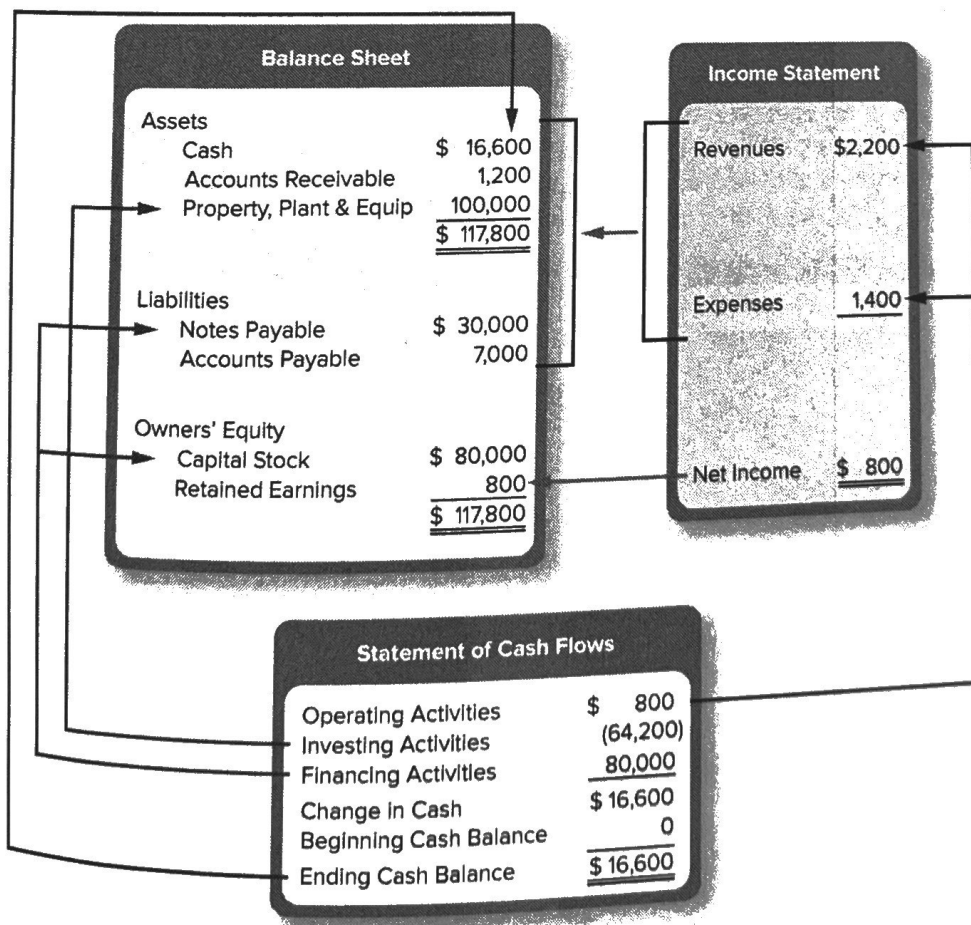


EXHIBIT 2-15
Financial Statement Articulation

The balance sheet represents an expansion of the accounting equation and explains the various categories of assets, liabilities, and owners' equity. The income statement explains changes in financial position that result from profit-generating transactions in terms of revenue and expense transactions. The resulting number, net income, represents an addition to

A=L+LOE Financial statements are based on the same underlying transactions

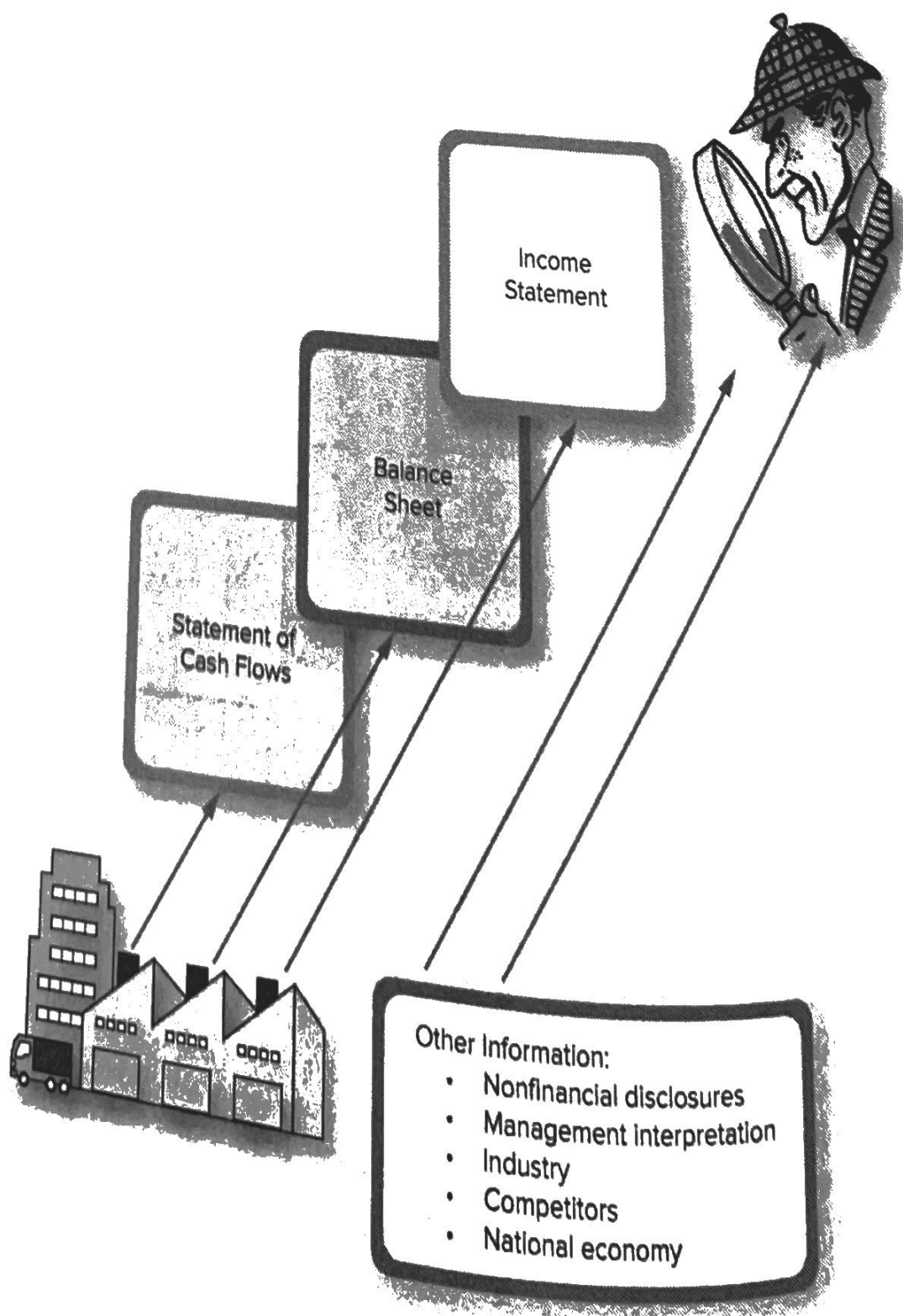
the owners' equity in the enterprise. The statement of cash flows explains the ways cash increased and decreased during the period in terms of the enterprise's operating, investing, and financing activities.

While these three key financial statements present important information, they do not include all possible information that might be presented about a company. For example, look again at Overnight's activities during the latter part of January. We could have prepared a separate financial statement on how liabilities changed or how the Tools and Equipment asset account changed. There is also important nonfinancial information that underlies the statement of financial position, the income statement, and the statement of cash flows that could be presented and that would benefit users of the statements. Accountants have developed methods of dealing with these other types of information, which we will learn about later in this text. At this point, we have focused our attention on the three primary financial statements that companies most often use to describe the activities that are capable of being captured in financial terms.

Financial reporting, and financial statements in particular, can be thought of as a lens through which you can view a business. (See Exhibit 2-16.) A lens allows you to see things from a distance that you would not otherwise be able to see; it also allows you to focus in greater detail on certain aspects of what you are looking at. Financial information, and particularly financial statements, allows you to do just that—focus in on certain financial aspects of the enterprise that are of particular interest to you in making important investing and credit decisions. Financial reporting encompasses financial statements, but it is not limited to financial statements.

EXHIBIT 2-16

Financial Reporting and Financial Statements





PATHWAYS CONNECTION

Relationships among the three primary financial statements provide the opportunity to learn a great deal about a company by bringing information together in a meaningful way. In fact, some people believe that relationships in the financial statements are as important as the actual dollar figures in those statements.

For example, take another look at the balance sheet in Exhibit 2–10. Notice that the company has \$16,600 of cash and \$1,200 of accounts receivable, a total of \$17,800 in what are sometimes referred to as *current* assets, denoting that they either are cash or will soon become cash. Now look at the liabilities in the balance sheet and notice that the company has notes payable of \$30,000 and accounts payable of \$7,000 for a total of \$37,000 of liabilities. Because both types of liabilities are current liabilities, meaning that they will be due in the near future and can be expected to require the use of current assets, Overnight Auto Service will have difficulty paying them because it does not have enough liquid assets to cover its liabilities. Comparing current assets with current liabilities provides useful information in analyzing a business' liquidity position. To address inadequate liquidity, the company may decide to seek additional capital or long-term financing of the \$30,000 note payable on the building. The relationship of current assets to current liabilities is called the *current ratio*. For Overnight Auto Service it is a low .48 (\$17,800 divided by \$37,000). This means that Overnight Auto Service has only 48 cents available for every \$1 of liabilities that will come due in the near future.

On the other hand, if the \$30,000 notes payable resulting from the building purchase is not due in the near future, the company's liquidity is much stronger and the company may have sufficient time to bring in enough cash through its operations to pay the note when it is due. The above analysis illustrates the Pathways approach (introduced in Chapter 1) to thinking about accounting information—that is, how accounting can provide useful information leading to good decisions.

While this refers exclusively to information found in the balance sheet, key information from one financial statement often is combined with information from another financial statement. For example, we may be interested in knowing the amount of cash provided by operations (cash flow statement) relative to the amount of a company's currently maturing liabilities (balance sheet). Or we might want to compare a company's net income (income statement) with the investment in assets (balance sheet) that were used to generate that income.

Many of the chapters in this text introduce you to how accounting can provide useful information, leading to good decisions, with the ultimate goal being to increase societal welfare. We build more explicitly on the Pathways approach in Chapter 14, Financial Statement Analysis, in which we provide a comprehensive treatment of how financial statements are used to inform investors and creditors.



YOUR TURN

You as a Creditor

Assume that you are a financial analyst for a potential supplier to Overnight Auto Service. Overnight wants to buy goods from your company on credit. What factors might you consider in deciding whether to extend credit to Overnight?

(See our comments in Connect.)

Forms of Business Organization

In the United States, most business enterprises are organized as *sole proprietorships*, *partnerships*, or *corporations*. Generally accepted accounting principles can be applied to the financial statements of all three forms of organization.

SOLE PROPRIETORSHIPS

An unincorporated business owned by one person is called a *sole proprietorship*. Often the owner also acts as the manager. This form of business organization is common for small retail stores, farms, service businesses, and professional practices in law, medicine, and accounting. In fact, the sole proprietorship is the most common form of business organization in our economy.

L02-8

LEARNING OBJECTIVE
Explain common forms of business ownership—sole proprietorship, partnership, and corporation—and demonstrate how they differ in terms of their statements of financial position.



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LO2-8

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From an accounting viewpoint, a sole proprietorship is regarded as a business entity separate from the other financial activities of its owner. From a legal viewpoint, however, the business and its owner are not regarded as separate entities. Thus, the owner is personally liable for the debts of the business. If the business encounters financial difficulties, creditors can force the owner to sell his or her personal assets to pay the business debts. While an advantage of the sole proprietorship form of organization is its simplicity, this *unlimited liability* feature is a disadvantage to the owner.

PARTNERSHIPS

An unincorporated business owned by two or more persons voluntarily acting as partners (co-owners) is called a **partnership**. Partnerships, like sole proprietorships, are widely used for small businesses. In addition, some large professional practices, including CPA firms and law firms, are organized as partnerships. As in the case of the sole proprietorship, the owners of a partnership are personally responsible for all debts of the business. From an accounting standpoint, a partnership is viewed as a business entity separate from the personal affairs of its owners.⁷ A benefit of the partnership form over the sole proprietorship form is the ability to bring together larger amounts of capital investment from multiple owners.

CORPORATIONS

A **corporation** is a type of business organization that is recognized under the law as an entity separate from its owners. Therefore, the owners of a corporation are *not* personally liable for the debts of the business. These owners can lose no more than the amounts they have invested in the business—a concept known as *limited liability*. This concept is one of the principal reasons that corporations are an attractive form of business organization to many investors. Overnight Auto Service, the company used in our illustrations, is a corporation.

Ownership of a corporation is divided into transferable shares of capital stock, and the owners are called **stockholders** or shareholders. Stock certificates are issued by the corporation to each stockholder showing the number of shares that he or she owns. The stockholders are generally free to sell some or all of these shares to other investors at any time. This transferability of ownership adds to the attractiveness of the corporate form of organization, because investors can more easily get their money out of the business. Corporations offer an even greater opportunity than partnerships to bring together large amounts of capital from multiple owners.

There are many more sole proprietorships and partnerships than corporations, but most large businesses are organized as corporations. Thus, corporations are the dominant form of business organization in terms of the dollar volume of business activity. Of the three types of business, corporations are most likely to distribute financial statements to investors and other outsiders.

REPORTING OWNERSHIP EQUITY IN THE STATEMENT OF FINANCIAL POSITION

Assets and liabilities are presented in the same manner in the statement of financial position of all three types of business organization. Some differences arise, however, in the presentation of the ownership equity.

Sole Proprietorships A sole proprietorship is owned by only one person. Therefore, the owner's equity section of the balance sheet includes only one item—the equity of the owner. If Overnight Auto Service had been organized as a sole proprietorship with Michael McBryan as the owner, owner's equity in the January 31 balance sheet would appear as follows:

Owner's equity:	
Michael McBryan, Capital	\$80,800

⁷ Creditors of an unincorporated business often ask to see the *personal* financial statements of the business owners, as these owners ultimately are responsible for paying the debts of the business.

Partnerships A partnership has two or more owners. Accountants use the term *partners' equity* instead of owners' equity and usually list separately the amount of each partner's equity in the business. If, for example, Michael McBryan had been in partnership with his sister, Rebecca McBryan, in Overnight Auto Service, and if each had contributed an equal amount of cash (\$40,000) and had shared equally in the net income (\$400), the partners' equity section of the balance sheet would have been presented as follows:

Partners' equity:	
Michael McBryan, Capital	\$40,400
Rebecca McBryan, Capital	40,400
Total partners' equity	<u>\$80,800</u>

A-L-LOE
... in a partnership

Corporations In a business organized as a corporation, it is *not* customary to show separately the equity of each stockholder. In the case of large corporations, this clearly would be impractical because these businesses may have several million individual stockholders (owners).

We return to our original assumption that Overnight Auto Service is organized as a corporation. Owners' equity (also referred to as **stockholders' equity** or shareholders' equity) is presented in two amounts—capital stock and retained earnings. This section of the balance sheet appears as follows:

Owners' equity:	
Capital Stock	\$80,000
Retained Earnings	800
Total stockholders' equity	<u>\$80,800</u>

A-L-LOE
... and in a corporation

Capital stock represents the amount that the stockholders originally invested in the business in exchange for shares of the company's stock. **Retained earnings**, in contrast, represents the increase in owners' equity that has accumulated over the years as a result of profitable operations.

The Use of Financial Statements by External Parties

As we learned in Chapter 1, investors and creditors use financial statements in making *financial decisions*—that is, in selecting those companies in which they will invest resources or to which they will extend credit. For this reason, financial statements are designed primarily to meet the needs of creditors and investors. Two factors of particular concern to creditors and investors are the *liquidity* and *profitability* of a business organization.

Creditors are interested in **liquidity**—the ability of the business to pay its debts as they come due. Liquidity is critical to the very survival of a business organization—a business that is not liquid may be forced into bankruptcy by its creditors. Once bankrupt, a business may be forced by the courts to stop its operations, sell its assets (for the purpose of paying its creditors), and eventually cease to exist.

Investors also are interested in the liquidity of a business organization, but often they are even more interested in its profitability. Profitable operations increase the value of the owners' equity in the business. A company that continually operates unprofitably will eventually exhaust its resources and be forced out of existence. Therefore, most users of financial statements study these statements carefully for clues to the company's liquidity and future profitability.

The Short Run versus the Long Run In the short run, liquidity and profitability may be independent of each other. A business may be operating profitably but nevertheless run out of cash needed to meet its obligations. On the other hand, a company may operate unprofitably during a given year yet still have enough cash from previous periods to pay its bills and remain liquid.

Over a longer term, however, liquidity and profitability go hand in hand. If a business is to survive, it must remain liquid and, in the long run, must operate profitably.

Evaluating Short-Term Liquidity As discussed earlier in this chapter, one key indicator of short-term liquidity is the relationship between an entity's liquid assets and the liabilities requiring payment in the near future. By studying the nature of a company's assets, and the amounts and due dates of its liabilities, users of financial statements often may anticipate whether the company is likely to have difficulty in meeting its upcoming obligations. This simple type of analysis meets the needs of many short-term creditors. Evaluating long-term debt-paying ability is a more difficult matter and is discussed in later chapters.

In studying financial statements, users should always read the accompanying notes and the auditors' report.

THE NEED FOR ADEQUATE DISCLOSURE

The concept of adequate **disclosure** is an important generally accepted accounting principle. Adequate disclosure means that users of financial statements are informed of all information necessary for the proper interpretation of the statements. Adequate disclosure is made in the body of the financial statements and in notes accompanying these statements. It is common for the notes to the financial statements to be longer than the statements themselves.

Among the events that may require disclosure in notes to the financial statements are occurrences after the date of the financial statements. For example, assume that Overnight Auto Service's building is destroyed by fire on February 2, and that Michael McBryan is using the financial statements to acquire additional financing for the business after that date. Assume also that McBryan has less insurance on the building than will be needed to replace it. Users of the financial statements, such as bankers who might be considering lending money to Overnight, must be informed of this important "subsequent event." This disclosure usually would be done with a note like the following:

Note 7: Events occurring after the financial statement date

The building included in the December 31, 2018 statement of financial position at \$36,000 was destroyed by fire on February 2, 2019. While the company has insurance on this facility, management expects to recover only approximately \$30,000 of the loss.

In addition to important subsequent events, many other situations may require disclosure in notes to the financial statements. Examples include unsettled lawsuits against the company, due dates of major liabilities, assets pledged as collateral to secure loans, amounts receivable from officers or other "insiders," and contractual commitments requiring large future cash outlays.

There is no single comprehensive list of the items and events that may require disclosure. As a general rule, a company should disclose all financial information that a reasonably informed person would consider necessary for the proper interpretation of the financial statements. Events that clearly are unimportant do not require disclosure. Determining information that should be disclosed in financial statements is another situation that requires significant judgment on the part of the accountant.

MANAGEMENT'S INTEREST IN FINANCIAL STATEMENTS
While we have emphasized the importance of financial statements to investors and creditors, the management of a business organization is vitally concerned with the financial position of the business and with its profitability and cash flows. Therefore, management is anxious to receive financial statements as frequently and as quickly as possible so that it may take action to improve areas of weak performance. Most large organizations provide managers with financial statements on at least a monthly basis. With modern technology, financial statements prepared on a weekly, daily, or even hourly basis are possible.

A-1-LOE

Notes to the statements
contain vital information

LO2-9

LEARNING OBJECTIVE

Discuss the importance of financial statements to a company and its investors and creditors and why management may take steps to improve the appearance of the company in its financial statements.

The Use of Financial Statements by External Parties

Managers have a special interest in the *annual* financial statements, because these statements are used by decision makers outside of the organization. For example, if creditors view the annual financial statements as strong, they will be more willing to extend credit to the business than if they regard the company's financial statements as weak. Management is concerned with its ability to obtain the funds it needs to meet its objectives, so it is particularly interested in how investors and creditors react to the company's financial statements.

A strong statement of financial position is one that shows relatively little debt and adequate amounts of liquid assets relative to the liabilities due in the near future. A strong income statement is one that shows large revenues relative to the expenses required to earn the revenues. A strong statement of cash flows is one that not only shows a strong cash balance but also indicates that cash is being generated by operations. Demonstrating that these positive characteristics of the company are ongoing and can be seen in a series of financial statements is particularly helpful in creating confidence in the company on the part of investors and creditors. Because of the importance of the financial statements, management may take steps that are specifically intended to improve the company's financial position and financial performance. For example, cash purchases of assets may be delayed until the beginning of the next accounting period so that large amounts of cash will be included in the statement of financial position and the statement of cash flows. On the other hand, if the company is in a particularly strong cash position, liabilities due in the near future may be paid early.

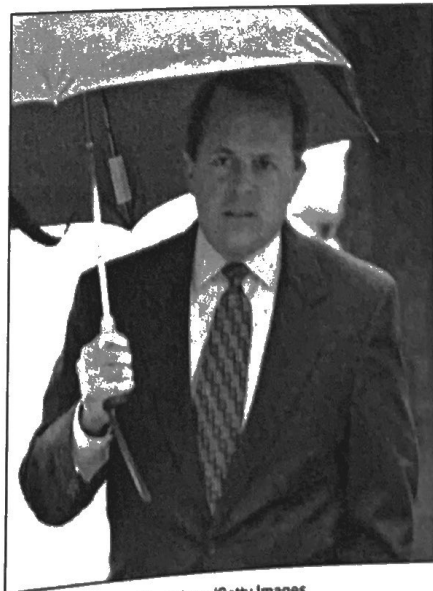
These actions are sometimes called **window dressing**—measures taken by management to make the company appear as strong as possible in its financial statements. Users of financial statements should realize that while the financial statements are fair representations of the financial position at the end of the period and financial performance during the period, they may not necessarily describe the typical financial situation of the business throughout the entire financial reporting period. In its annual financial statements, in particular, management tries to make the company appear as strong as is reasonably possible. As a result, many creditors regard more frequent financial statements (for example, quarterly or even monthly) as providing important additional information beyond that in the annual financial statements. The more frequently financial statements are presented, the less able management is to window-dress and make a company look financially stronger than it actually is.



ETHICS, FRAUD, & CORPORATE GOVERNANCE

A major outgrowth from the business failures amid allegations of fraudulent financial reporting discussed in the last chapter was the passage of the Sarbanes-Oxley Act of 2002. This Act was signed into law by President George W. Bush on July 30, 2002. The Sarbanes-Oxley Act (hereafter SOX or the Act) is generally viewed as the most far-reaching piece of securities legislation since the original Securities Acts were passed in the 1930s.

One of the major requirements of this legislation is for CEOs and CFOs to certify the accuracy of their company's financial statements. The CEOs and CFOs of all public companies must certify on an annual and quarterly basis that they (1) have reviewed their company's financial statements, (2) are not aware of any error or omission that would make the financial statements misleading, and (3) believe that the financial statements fairly present in all material respects the company's financial condition (balance sheet) and results of operations (income statement). There is some evidence that this certification requirement is affecting corporate behavior. For example, a former CFO of HealthSouth (Weston Smith, shown in photo) contacted federal authorities about the massive (alleged) accounting fraud at that company because



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he was not willing to certify that HealthSouth's financial statements were materially accurate.