

CHAPTER 1: INTRODUCTION TO FINANCIAL STATEMENTS



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The Navigator

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LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- [1 Describe the primary forms of business organization.](#)
- [2 Identify the users and uses of accounting information.](#)
- [3 Explain the three principal types of business activity.](#)
- [4 Describe the content and purpose of each of the financial statements.](#)
- [5 Explain the meaning of assets, liabilities, and stockholders' equity, and state the basic accounting equation.](#)
- [6 Describe the components that supplement the financial statements in an annual report.](#)



The Navigator is a learning system designed to prompt you to use the learning aids in the chapter and to set priorities as you study.



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.

Many businesses agree with this view. They see the value of their employees being able to read financial statements and understand how their actions affect the company’s financial results. For example, consider **Clif Bar & Company**. The original Clif Bar[®] energy bar was created in 1990 after six months of experimentation by Gary Erickson and his mother in her kitchen. Today, the company has almost 300 employees and is considered one of the leading Landor’s Breakaway Brands[®].

Clif Bar is guided by what it calls its Five Aspirations—Sustaining Our Business, Our Brands, Our People, Our Community, and the Planet. Its website documents its efforts and accomplishments in these five areas. Just a few examples include the company’s use of organic products to protect soil, water, and biodiversity; the “smart” solar array (the largest in North America), which provides nearly all the electrical needs for its 115,000-square-foot building; and the incentives Clif Bar provides to employees to reduce their personal environmental impact, such as \$6,500 toward the purchase of an efficient car or \$1,000 per year for eco-friendly improvements toward their homes.

One of the company's proudest moments was the creation of an employee stock ownership plan (ESOP) in 2010. This plan gives its employees 20% ownership of the company (Gary and his wife Kit own the other 80%). 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 this basic financial knowledge, employees are more aware of the financial impact of their actions, which leads to better decisions.

Even in companies that do not practice open-book management, today's employers generally assume that managers in all areas of the company are "financially literate." To help prepare you for that, in this textbook you will learn how to read and prepare financial statements, and how to use basic tools to evaluate financial results. In this first chapter, we will introduce you to the financial statements of a real company whose products you are probably familiar with—**Tootsie Roll**. Tootsie Roll's presentation of its financial results is complete, yet also relatively easy to understand.



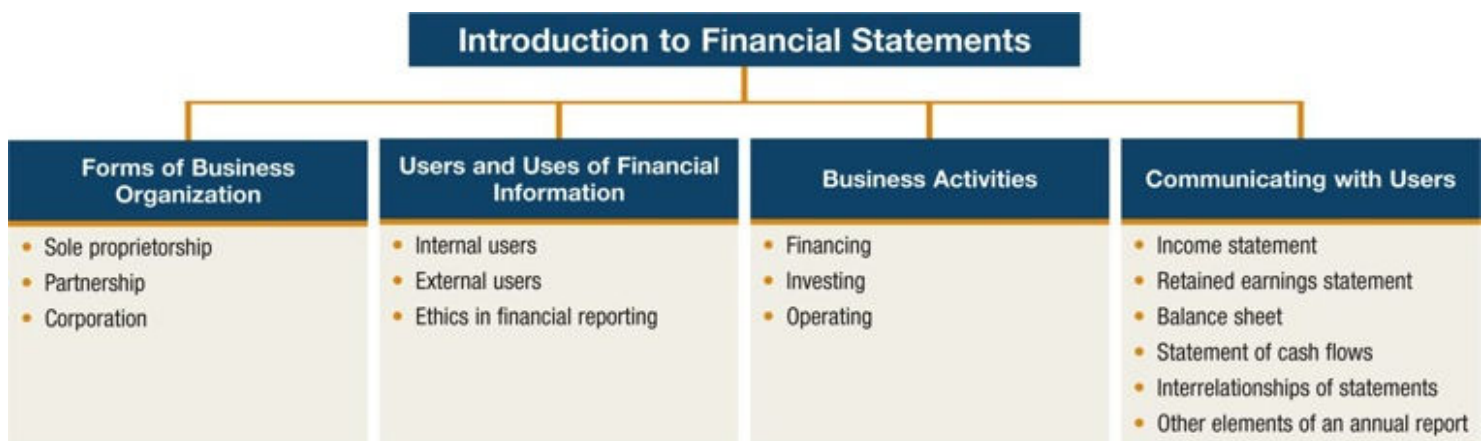
INSIDE CHAPTER 1...

- **The Scoop on Accounting** ([p. 6](#))
- **Spinning the Career Wheel** ([p. 7](#))
- **The Numbers Behind Not-for-Profit Organizations** ([p. 9](#))
- **Beyond Financial Statements** ([p. 16](#))

PREVIEW OF CHAPTER 1

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 content and organization of the chapter are as follows.





Forms of Business Organization

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.

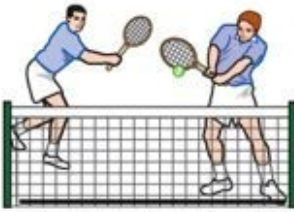
LEARNING OBJECTIVE 1

Describe the primary forms of business 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

Your next decision is to determine the organizational form of your business. You have three choices—sole proprietorship, partnership, or corporation.

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.

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

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. 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. For example, in 1896 Leo Hirshfield started **Tootsie Roll** as a sole proprietorship, and by 1919 the company had incorporated.

Alternative Terminology

Stockholders are sometimes called *shareholders*.

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

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 is more than five times the number of corporations. However, the revenue produced by corporations is eight 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 textbook is on the corporate form of organization.



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

Do it! exercises prompt you to stop and review the key points you have just studied.

Action Plans give you tips about how to approach the problem.

Action Plan

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  [1-1](#).

Users and Uses of Financial Information

The purpose of financial information is to provide inputs for decision-making. [Accounting](#) is the information system that identifies, records, and communicates the economic events of an organization to interested users. **Users** of accounting information can be divided broadly into two groups: internal users and external users.

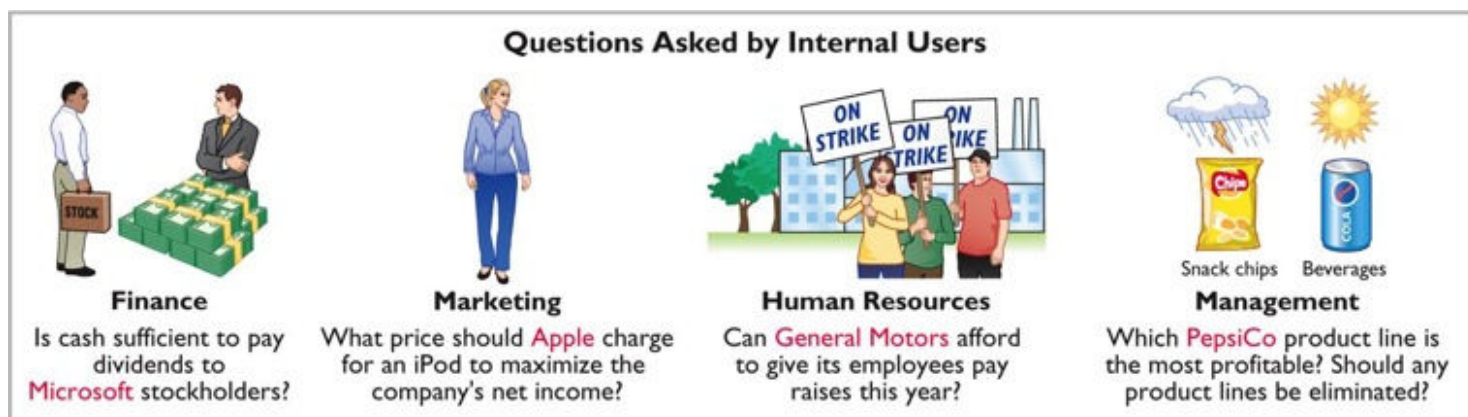
LEARNING OBJECTIVE 2

Identify the users and uses of accounting information.

INTERNAL USERS

Internal users of accounting information are managers who plan, organize, and run a business. These include **marketing managers, production supervisors, finance directors, and company officers**. In running a business, managers must answer many important questions, as shown in [Illustration 1-1](#).

Illustration 1-1: Questions that internal users ask



To answer these and other questions, you need detailed information on a timely basis. For internal users, accounting provides internal reports, such as financial comparisons of operating alternatives, projections of income from new

Illustrations help you visualize and apply the ideas as you study.



Accounting Across the Organization: The Scoop on Accounting

Accounting can serve as a useful recruiting tool even for the human resources department. **Rhino Foods**, located in Burlington, Vermont, is a manufacturer of specialty ice cream. Its corporate website includes the following:



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“Wouldn’t it be great to work where you were part of a team? Where your input and hard work made a difference? Where you weren’t kept in the dark about what management was thinking? ... Well—it’s not a dream! It’s the way we do business ... Rhino Foods believes in family, honesty and open communication—we really care about and appreciate our employees—and it shows. Operating results are posted and monthly group meetings inform all employees about what’s happening in the Company. Employees also share in the Company’s profits, in addition to having an excellent comprehensive *benefits* package.”

Source: www.rhinofoods.com/workforus/workforus.html.

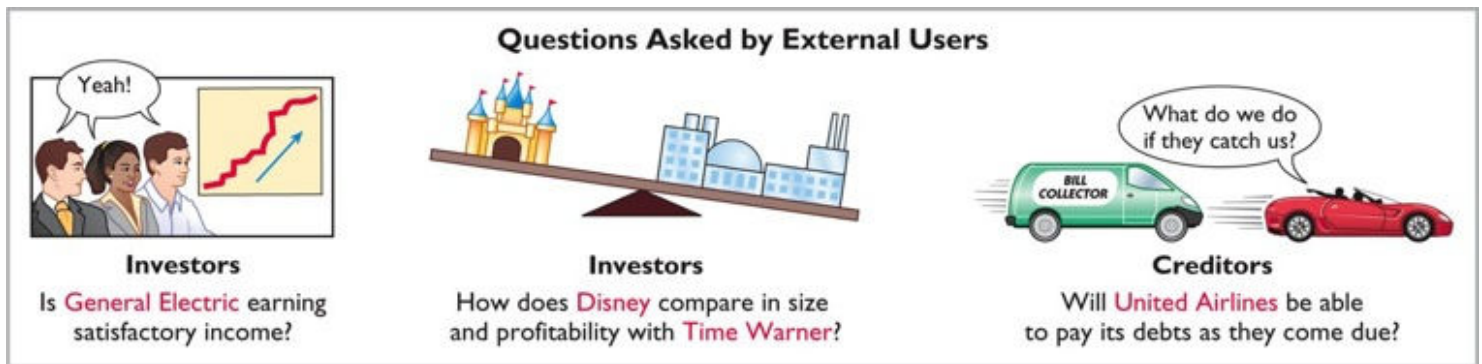


Accounting Across the Organization stories show applications of accounting information in various business functions.

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: 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:



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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: A marketing specialist 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?



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."¹ 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.

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. 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 the independence of the outside auditors who review the accuracy of corporate financial statements, and increased the oversight role of boards of directors.

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.

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 textbook. (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 the 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.



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Ethics Insight: The Numbers Behind Not-for-Profit Organizations

Accounting plays an important role for a wide range of business organizations worldwide. Just as the integrity of the numbers matters for business, it matters at least as much at not-for-profit organizations. Proper control and reporting help ensure that money is used the way donors intended. Donors are less inclined to give to an organization if they think the organization is subject to waste or theft. The accounting challenges of some large international not-for-profits rival those of the world's largest businesses. For example, after the Haitian earthquake, the Haitian-born musician Wyclef Jean was criticized for the poor accounting controls in a relief fund that he founded. In response, he hired a new accountant and improved the transparency regarding funds raised and spent.



Gemunu Amarasinghe/AP Photo



What benefits does a sound accounting system provide to a not-for-profit organization? (See [page 43](#).)

Insights provide examples of business situations from various perspectives—ethics, investor, international, and corporate social responsibility.

Business Activities

All businesses are involved in three types of activity—financing, investing, and operating. For example, Leo Hirshfield, the founder of **Tootsie Roll**, obtained cash through financing to start and grow his business. Some of this **financing** came from personal savings, and some likely came from outside sources like banks. Hirshfield then

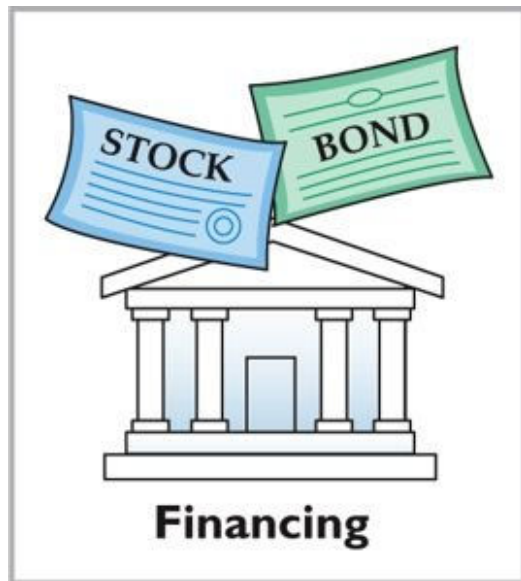
LEARNING OBJECTIVE 3

Explain the three principal types of business activity.

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).



Tootsie Roll 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 Tootsie Roll 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. Tootsie Roll 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**.

Essential terms are printed in blue. They are defined again in the **glossary** at the end of the chapter.

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. However, many corporations make payments to

INVESTING ACTIVITIES

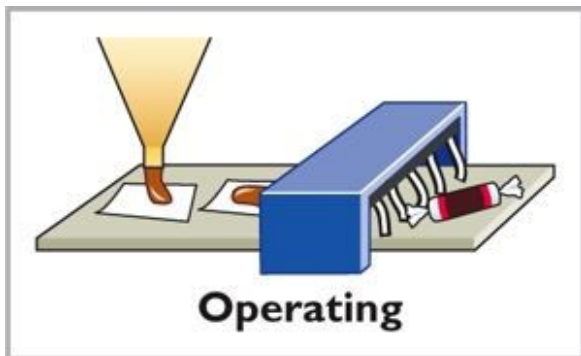
Once the company has raised cash through financing activities, it uses that cash in investing activities. Investing activities involve the purchase of the resources a company needs in order to operate. A growing company purchases many resources, such as computers, delivery trucks, furniture, and buildings. Resources owned by a business are called [assets](#). Different types of assets are given different names. For example, Tootsie Roll's mixing equipment is a type of asset referred to as **property, plant, and equipment**.



Cash is one of the more important assets owned by Tootsie Roll 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. Tootsie Roll is in the business of selling all things that taste, look, or smell like candy. It sells Tootsie Rolls, Tootsie Pops, Blow Pops, Caramel Apple Pops, Mason Dots, Mason Crows, Sugar Daddy, and Sugar Babies. 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

Revenues arise from different sources and are identified by various names depending on the nature of the business. For instance, Tootsie Roll's primary source of revenue is the sale of candy products. 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 Tootsie Roll 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 Tootsie Roll can sell a single Tootsie Roll, Tootsie Pop, or Blow Pop, it must purchase sugar, corn syrup, and other ingredients, mix these ingredients, process the mix, and 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, Tootsie Roll keeps track of these types of expenses: **cost of goods sold** (such as the cost of ingredients); **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 taxes** (corporate taxes paid to the government).

Tootsie Roll 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, Tootsie Roll 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.

Tootsie Roll 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.

BUSINESS ACTIVITIES

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

- 1. Cost of renting property.
- 2. Truck purchased.
- 3. Notes payable.
- 4. Issuance of ownership shares.
- 5. Amount earned from performing service.
- 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: Liabilities.
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- 4. Issuance of ownership shares: Common stock.
- 5. Amount earned from performing service: Revenue.
- 6. Amounts owed to suppliers: Liabilities.

Related exercise material: [BE1-3](#),  [1-2](#), and [E1-3](#).



Communicating with Users

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:

LEARNING OBJECTIVE 4

Describe the content and purpose of each of the financial statements.

- • 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**.
- • 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**.

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 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, 2014. 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.

INCOME STATEMENT

The [income statement](#) reports a company's revenues and expenses and resulting net income or loss for a period of time. To indicate that its income statement reports the results of operations for a **specific period of time**, Sierra dates

the income statement “For the Month Ended October 31, 2014.” 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 Corporation’s income statement is shown in [Illustration 1-4](#). Congratulations, you are already showing a profit!

Illustration 1-4: Sierra Corporation’s income statement



SIERRA CORPORATION

Income Statement

For the Month Ended October 31, 2014

Revenues

Service revenue	\$10,600
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Expenses

Salaries and wages expense	\$5,200
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Rent expense	900
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Supplies expense	1,500
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Depreciation expense	40
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Interest expense	50
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Insurance expense	<u>50</u>
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Total expenses	<u>7,740</u>
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Net income	\$ 2,860
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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.”

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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.

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.

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](#)).



DECISION TOOLKIT

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
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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 revenue exceeds its expenses, it will report net income; otherwise, it will report a net loss.
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Decision Toolkits summarize the financial decision-making process.

RETAINED EARNINGS STATEMENT

If Sierra 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. 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 Corporation's retained earnings statement.

Illustration 1-5: Sierra Corporation's retained earnings statement



SIERRA CORPORATION

Retained Earnings Statement

For the Month Ended October 31, 2014

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

Helpful Hint

The heading of this statement identifies the company, the type of statement, and the time period covered by the statement.
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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](https://www.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.



DECISION TOOLKIT

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
What is the company's policy toward dividends and growth?	Retained earnings statement	How much of this year's income did the company pay out in dividends to shareholders?	A company striving for rapid growth will pay a low (or no) dividend.

BALANCE SHEET

The [balance sheet](#) reports assets and claims to assets at a specific **point** in time. 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](#).

LEARNING OBJECTIVE 5

Explain the meaning of assets, liabilities, and stockholders' equity, and state the basic accounting equation.
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[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](#).

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’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, 2014. It lists assets first, followed by liabilities and stockholders’ equity. Stockholders’ equity is comprised of two parts: (1) common stock and (2) retained earnings. As noted earlier, common stock results when the company sells new shares of stock; retained earnings is the net income retained in the corporation. Sierra has common stock of \$10,000 and retained earnings of \$2,360, for total stockholders’ equity of \$12,360.

Alternative Terminology

Liabilities are also referred to as *debt*.

Illustration 1-7: Sierra Corporation’s balance sheet



SIERRA CORPORATION

Balance Sheet

October 31, 2014

Assets

Cash	\$15,200
Accounts receivable	200
Supplies	1,000
Prepaid insurance	550
Equipment, net	<u>4,960</u>
Total assets	\$21,910



SIERRA CORPORATION

Balance Sheet

October 31, 2014

Liabilities and Stockholders' Equity

Liabilities

Notes payable	\$ 5,000
Accounts payable	2,500
Unearned service revenue	800
Salaries and wages payable	1,200
Interest payable	<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	\$21,910

Helpful Hint

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

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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 the Sierra Corporation 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.



DECISION TOOLKIT

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
Does the company rely primarily on debt or stockholders' equity to finance its assets?	Balance sheet	The balance sheet reports the company's resources and claims to those resources. There are two types of claims: liabilities and stockholders' equity.	Compare the amount of debt versus the amount of stockholders' equity to determine whether the company relies more on creditors or owners for its financing.

STATEMENT OF CASH FLOWS

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. 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.

- 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?

Illustration 1-8: Sierra Corporation's statement of cash flows



SIERRA CORPORATION

Statement of Cash Flows

For the Month Ended October 31, 2014

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	14,500

Net increase in cash	15,200
----------------------	--------

Cash at end of period	\$15,200
-----------------------	----------

Helpful Hint

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

The statement of cash flows for Sierra, in [Illustration 1-8](#), shows that cash increased \$15,200 during the month. 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.



People, Planet, and Profit Insight: Beyond Financial Statements

Should we expand our corporate reports 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.



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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 textbook, 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? (See [page 43](#).)



DECISION TOOLKIT

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
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 cash provided or used by operating activities, investing activities, and financing activities.	Compare the amount of cash provided by operating activities with the amount of cash used by investing activities. Any deficiency in cash from operating activities must be made up with cash from financing activities.

INTERRELATIONSHIPS OF STATEMENTS

[Illustration 1-9](#) shows simplified financial statements of **Tootsie Roll Industries, Inc.** (We have simplified the financial statements to assist your learning.) Tootsie Roll's **actual financial statements** are presented in [Appendix A](#), at the end of the textbook. Note that the numbers in Tootsie Roll's statements are presented in thousands—that is, the last three 000s are omitted. Thus, Tootsie Roll's net income in 2011 is \$43,938,000, not \$43,938. Because the results on some financial statements become inputs to other statements, the statements are interrelated. These interrelationships can be seen in Tootsie Roll's financial statements, as follows.

- 1. The retained earnings statement uses the results of the income statement. Tootsie Roll reported net income of \$43,938,000 for the period. Net income is added to the beginning amount of retained earnings to determine ending retained earnings.

Illustration 1-9: Tootsie Roll's financial statements



TOOTSIE ROLL INDUSTRIES, INC.
Income Statement
For the Year Ended December 31, 2011 (in thousands)

Revenues		\$532,505
Expenses		
Cost of goods sold	\$365,225	
Selling, marketing, and administrative expense and other	106,368	
Income tax expense	16,974	
Total expenses		<u>488,567</u>
Net income		<u>\$ 43,938</u>

Helpful Hint Note that final sums are double-underlined.



TOOTSIE ROLL INDUSTRIES, INC.
Retained Earnings Statement
For the Year Ended December 31, 2011 (in thousands)

Retained earnings, January 1, 2011	\$135,866
Add: Net income	<u>43,938</u>
	179,804
Less: Dividends and other (net)	<u>65,535</u>
Retained earnings, December 31, 2011	<u>\$114,269</u>

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



TOOTSIE ROLL INDUSTRIES, INC.
Balance Sheet
December 31, 2011 (in thousands)

<u>Assets</u>		
Cash		\$ 78,612
Investments		10,895
Accounts receivable		41,895
Inventories		71,760
Prepaid expenses		5,070
Property, plant and equipment, net		212,162
Other assets		<u>437,462</u>
Total assets		<u>\$857,856</u>
<u>Liabilities and Stockholders' Equity</u>		
Liabilities		
Accounts payable	\$ 10,683	
Dividends payable	4,603	
Accrued liabilities	43,069	
Deferred income taxes payable	43,521	
Bonds payable	7,500	
Employee benefits payable and other	<u>82,545</u>	\$191,921
Stockholders' equity		
Common stock	551,666	
Retained earnings	<u>114,269</u>	<u>665,935</u>
Total liabilities and stockholders' equity		<u>\$857,856</u>



TOOTSIE ROLL INDUSTRIES, INC.
Statement of Cash Flows
For the Year Ended December 31, 2011 (in thousands)

Cash flows from operating activities		
Cash receipts from operating activities	\$528,004	
Cash payments for operating activities	<u>(477,614)</u>	
Net cash provided by operating activities		\$ 50,390
Cash flows from investing activities		
Capital expenditures and acquisitions	(16,351)	
Net purchases/sales of investment securities and other	<u>(34,806)</u>	
Net cash used by investing activities		(51,157)
Cash flows from financing activities		
Repurchase of common stock	(18,190)	
Dividends paid in cash	<u>(18,407)</u>	
Net cash used by financing activities		<u>(36,597)</u>
Net increase (decrease) in cash		<u>(37,364)</u>
Cash at beginning of year		115,976
Cash at end of year		<u>\$ 78,612</u>

Helpful Hint Negative amounts in the statement of cash flows are presented in parentheses.

- 2. The balance sheet and retained earnings statement are also interrelated. Tootsie Roll reports the ending amount of \$114,269,000 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 \$78,612,000 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.**

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FINANCIAL STATEMENTS

CSU Corporation began operations on January 1, 2014. The following information is available for CSU Corporation on December 31, 2014:

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, 2014

Revenues

Service revenue	\$17,000
-----------------	----------

Expenses

Rent expense	\$9,000
--------------	---------

CSU CORPORATION

Income Statement

For the Year Ended December 31, 2014

Insurance expense	1,000
Supplies expense	<u>200</u>
Total expenses	<u>10,200</u>
Net income	\$ 6,800

CSU CORPORATION

Retained Earnings Statement

For the Year Ended December 31, 2014

Retained earnings, January 1	\$ 0
Add: Net income	<u>6,800</u>
	6,800
Less: Dividends	<u>600</u>
Retained earnings, December 31	\$6,200

CSU CORPORATION

Balance Sheet

December 31, 2014

Assets

Cash	\$ 1,400
------	----------

CSU CORPORATION

Balance Sheet

December 31, 2014

Accounts receivable	1,800
Supplies	4,000
Equipment	<u>16,000</u>
Total assets	\$23,200

Liabilities and Stockholders' Equity

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	\$23,200



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.

LEARNING OBJECTIVE 6

Describe the components that supplement the financial statements in an annual report.

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 **Tootsie Roll's** annual report is presented in [Illustration 1-10](#).

Illustration 1-10: Tootsie Roll's management discussion and analysis



TOOTSIE ROLL INDUSTRIES, INC.

Management's Discussion and Analysis of Financial Condition and Results of Operations

The Company has a relatively straightforward financial structure and has historically maintained a conservative financial position. Except for an immaterial amount of operating leases, the Company has no special financing arrangements or "off-balance sheet" special purpose entities. Cash flows from operations plus maturities of short-term investments are expected to be adequate to meet the Company's overall financing needs, including capital expenditures, in 2012.

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 **Tootsie Roll's** financial statements. It describes the methods that Tootsie Roll uses to account for revenues.

Illustration 1-11: Notes to Tootsie Roll's financial statements No part of this book may be reproduced or transmitted without publisher's prior permission. Violators will be prosecuted.



TOOTSIE ROLL INDUSTRIES, INC.

Notes to Financial Statements

Revenue recognition

Revenue, net of applicable provisions for discounts, returns, allowances, and certain advertising and promotional costs, is recognized when products are delivered to customers based on a customer purchase order, and collectibility is reasonably assured.

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, recently **Blockbuster, Inc.**'s auditor 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 Tootsie Roll's 2011 annual report. Tootsie Roll received an unqualified opinion from its auditor, **PricewaterhouseCoopers**.

Illustration 1-12: Excerpt from auditor's report on Tootsie Roll's financial statements



TOOTSIE ROLL INDUSTRIES, INC.

Excerpt from Auditor's Report

To the Board of Directors and Shareholders of Tootsie Roll Industries, Inc.

In our opinion, the accompanying consolidated statements of financial position and the related consolidated statements of earnings, comprehensive earnings and retained earnings, and of cash flows present fairly, in all material respects, the financial position of Tootsie Roll Industries, Inc. and its subsidiaries at December 31, 2011 and December 31, 2010, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2011 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

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).

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.

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](#),  [1-4](#), and [E1-17](#).





USING

THE DECISION TOOLKIT

The Hershey Company, located in Hershey, Pennsylvania, is the leading North American manufacturer of chocolate. Its products include Hershey's Kisses, Reese's Peanut Butter Cups, Kit Kat, and Take 5 bars. Imagine that you are considering the purchase of shares of Hershey's common stock.

Instructions

Answer these questions related to your decision whether to invest.

- (a) What financial statements should you evaluate?
- (b) What should these financial statements tell you?
- (c) Do you care if the financial statements have been audited? Explain.
- (d) [Appendix B](#) at the end of this textbook contains financial statements for Hershey. What comparisons can you make between Tootsie Roll and Hershey in terms of their respective results from operations and financial position?

Using the Decision Toolkit exercises ask you to use information from financial statements to make financial decisions.

Solution

- (a) Before you invest, you should evaluate the income statement, retained earnings statement, balance sheet, and statement of cash flows.
- (b) You would probably be most interested in the income statement because it 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.
- (c) 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

- (d) Many interesting comparisons can be made between the two companies. Tootsie Roll is smaller, with total assets of \$857,856,000 versus \$4,412,199,000 for Hershey, and it has lower revenue—\$532,505,000 versus \$6,080,788,000 for Hershey. In addition, Tootsie Roll's cash provided by operating activities of \$50,390,000 is less than Hershey's \$580,867,000.

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 of tools that will allow you to compare the relative profitability and financial health of these and other companies.



Summary of Learning Objectives

- **1 Describe the primary forms of business organization.** 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.
- **2 Identify the users and uses of accounting information.** 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 help them 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.
- **3 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.
- **4 Describe the content and purpose of each of the financial statements.** 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.
- **5 Explain the meaning of assets, liabilities, and stockholders' equity, and state the basic accounting equation.** 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 $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$.
- **6 Describe the components that supplement the financial statements in an 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 TOOLKIT *A SUMMARY*

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 revenue exceeds 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	How much of this year's income did the company pay 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.

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
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 cash provided or used by operating activities, investing activities, and financing activities.	Compare the amount of cash provided by operating activities with the amount of cash used by investing activities. Any deficiency in cash from operating activities must be made up with cash from financing activities.

Glossary

Accounting

(p. 6) The information system that identifies, records, and communicates the economic events of an organization to interested users.

Annual report

(p. 19) 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.

Assets

(p. 10) Resources owned by a business.

Auditor's report

(p. 20) 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.

Balance sheet

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

Basic accounting equation

(p. 14) $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$.

Certified public accountant (CPA)

(p. 20) An individual who has met certain criteria and is thus allowed to perform audits of corporations.

Common stock

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

Corporation

(p. 4) A business organized as a separate legal entity owned by stockholders.

(p. 10) Payments of cash from a corporation to its stockholders.

Expenses

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

Income statement

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

Liabilities

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

Management discussion and analysis (MD&A)

(p. 19) 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.

Net income

(p. 11) The amount by which revenues exceed expenses.

Net loss

(p. 11) The amount by which expenses exceed revenues.

Notes to the financial statements

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

Partnership

(p. 4) A business owned by two or more persons associated as partners.

Retained earnings

(p. 13) The amount of net income retained in the corporation.

Retained earnings statement

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

Revenue

(p. 10) 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.

Sarbanes-Oxley Act (SOX)

(p. 8) Regulations passed by Congress to reduce unethical corporate behavior.

Sole proprietorship

(p. 15) A financial statement that provides financial information about the cash receipts and cash payments of a business for a specific period of time.

Stockholders' equity

(p. 14) The owners' claim to assets.

Comprehensive

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.

The Comprehensive Do it! is a final review before you begin homework.

In order to get the business off the ground, he decided to incorporate. He sold shares of common stock to a few close friends, as well as buying 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, 2014, 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](#) on [page 17](#).)

Action Plan

- On the income statement: Show revenues and expenses for a period of time.
- On the retained earnings statement: Show the changes in retained earnings for a period of time.
- On the balance sheet: Report assets, liabilities, and stockholders' equity at a specific date.
- On the statement of cash flows: Report sources and uses of cash from operating, investing, and financing activities for a period of time.

Solution to Comprehensive

ICE CAMP

Income Statement

For the Year Ended December 31, 2014

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	<u>800</u>
------------------	------------

Total expenses	<u>47,800</u>
----------------	---------------

Net income	\$ 52,200
------------	-----------

ICE CAMP

Retained Earnings Statement

For the Year Ended December 31, 2014

Retained earnings, January 1, 2014	\$	0
------------------------------------	----	---

Add: Net income	<u>52,200</u>
-----------------	---------------

52,200

ICE CAMP

Retained Earnings Statement

For the Year Ended December 31, 2014

Less: Dividends	<u>5,000</u>
Retained earnings, December 31, 2014	\$47,200

ICE CAMP

Balance Sheet

December 31, 2014

Assets

Cash	\$49,500
Accounts receivable	20,000
Equipment	<u>13,500</u>
Total assets	\$83,000

Liabilities and Stockholders' Equity

Liabilities

Notes payable	\$10,000
Interest payable	<u>800</u>
Total liabilities	\$10,800

Stockholders' equity

ICE CAMP

Balance Sheet

December 31, 2014

Common stock	25,000
Retained earnings	<u>47,200</u>
Total stockholders' equity	<u>72,200</u>
Total liabilities and stockholders' equity	\$83,000

ICE CAMP

Statement of Cash Flows

For the Year Ended December 31, 2014

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
--------------------------	--------

ICE CAMP

Statement of Cash Flows

For the Year Ended December 31, 2014

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	\$49,500



WileyPLUS

Self-Test, Brief Exercises, Exercises, Problem Set A, and many more resources are available for practice in WileyPLUS.

This would be a good time to look at the Preface to this textbook. Knowing the purpose of the different types of homework will help you understand what each contributes to your accounting skills and competencies.

Self-Test Questions

Answers are on [page 43](#).

1.

Which is **not** one of the three forms of business organization?

(LO 1)

- (a) Sole proprietorship.
- (b) Creditorship.

2.

Which is an advantage of corporations relative to partnerships and sole proprietorships?

(LO 1)

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

3.

Which statement about users of accounting information is **incorrect**?

(LO 2)

- (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.

Which of the following did **not** result from the Sarbanes-Oxley Act?

(LO 2)

- (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.

Which is **not** one of the three primary business activities?

(LO 3)

- (a) Financing.
- (b) Operating.
- (c) Advertising.
- (d) Investing.

6.

Which of the following is an example of a financing activity?

(LO 3)

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

7. PRINTED BY: jromero0950@email.phoenix.edu. Printing is for personal, private use only. No part of this book may be reproduced or transmitted without publisher's prior permission. Violators will be prosecuted.
Net income will result during a time period when:

(LO 4)

- (a) assets exceed liabilities.
- (b) assets exceed revenues.
- (c) expenses exceed revenues.
- (d) revenues exceed expenses.

8.

The financial statements for Joseph Corporation contained the following information.

(LO 4)

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

What was Joseph Corporation's net income?

- (a) \$60,000.
- (b) \$15,000.
- (c) \$65,000.
- (d) \$45,000.

9.



What section of a statement of cash flows indicates the cash spent on new equipment during the past accounting period?

(LO 4, 5)

- (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.

Which statement presents information as of a specific point in time?

(LO 4, 5)

11.

Which financial statement reports assets, liabilities, and stockholders' equity?

(LO 5)

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

12.

Stockholders' equity represents:

(LO 5)

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

13.

As of December 31, 2014, Stoneland Corporation has assets of \$3,500 and stockholders' equity of \$1,500. What are the liabilities for Stoneland Corporation as of December 31, 2014?

(LO 5)

- (a) \$1,500.
- (b) \$1,000.
- (c) \$2,500.
- (d) \$2,000.

14.

The element of a corporation's annual report that describes the corporation's accounting methods is/are the:

(LO 6)

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

15.

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:

(LO 6)

- (a) income statement.

Go to the book's companion website, www.wiley.com/college/kimmel, to access additional Self-Test Questions.



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.

 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](#), at the end of this textbook, reproduces **Tootsie Roll**'s financial statements. Replacing words in the equation with dollar amounts, what is Tootsie Roll's accounting equation at December 31, 2011?

The tool icon  indicates that an activity employs one of the decision tools presented in the chapter. The



indicates that an activity relates to a business function beyond accounting. The pencil icon



indicates that an activity requires written communication.

Brief Exercises

BE1-1 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.

(LO 1), K

- (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 Match each of the following types of evaluation with one of the listed users of accounting information.

Identify users of accounting information.

(LO 2), K



- 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 a 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.

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- (a) _____ Investors in common stock.
- (b) _____ Marketing managers.
- (c) _____ Creditors.
- (d) _____ Chief Financial Officer.
- (e) _____ Internal Revenue Service.

BE1-3 Indicate in which part of the statement of cash flows each item would appear: operating activities (O), investing activities (I), or financing activities (F).

Classify items by activity.

(LO 3), K

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

Determine effect of transactions on stockholders' equity.

(LO 4), C

- (a) Costs incurred for advertising.
- (b) Assets received for services performed.
- (c) Costs incurred for insurance.
- (d) Amounts paid to employees.
- (e) Cash distributed to stockholders.
- (f) Assets received in exchange for allowing the use of the company's building.
- (g) Costs incurred for utilities used.
- (h) Cash purchase of equipment.
- (i) Cash received from investors.

BE1-5 In alphabetical order below are balance sheet items for Burnett Company at December 31, 2014. Prepare a balance sheet following the format of [Illustration 1-7 \(page 14\)](#).

Prepare a balance sheet.

(LO 4, 5), AP

Accounts payable \$65,000

Accounts receivable 71,000

Cash 22,000

Common stock 18,000

BE1-6 Eskimo Pie Corporation markets a broad range of frozen treats, including its famous Eskimo Pie ice cream bars. The following items were taken from a recent income statement and balance sheet. In each case, identify whether the item would appear on the balance sheet (BS) or income statement (IS).

Determine where items appear on financial statements.

(LO 4, 5), K

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

BE1-7 Indicate which statement you would examine to find each of the following items: income statement (IS), balance sheet (BS), retained earnings statement (RES), or statement of cash flows (SCF).

Determine proper financial statement.

(LO 4), K



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

BE1-8 Use the basic accounting equation to answer these questions.

Use basic accounting equation.

(LO 5), AP

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

BE1-9 At the beginning of the year, Goren Company had total assets of \$800,000 and total liabilities of \$500,000. (Treat each item independently.)

Use basic accounting equation.

(LO 5), AP

- PRINTED BY: jromer00950@email.phoenix.edu. Printing is for personal, private use only. No part of this book may be reproduced or transmitted without publisher's prior permission. Violators will be prosecuted.
- (a) If total assets increased \$150,000 during the year and total liabilities decreased \$80,000, what is the amount of stockholders' equity at the end of the year?
 - (b) During the year, total liabilities increased \$100,000 and stockholders' equity decreased \$70,000. What is the amount of total assets at the end of the year?
 - (c) If total assets decreased \$80,000 and stockholders' equity increased \$110,000 during the year, what is the amount of total liabilities at the end of the year?

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

Identify assets, liabilities, and stockholders' equity.

(LO 5), K

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

BE1-11 Which is **not** a required part of an annual report of a publicly traded company?

Determine required parts of annual report.

(LO 6), K



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

Do it! Review

Do it! **1-1** Identify each of the following organizational characteristics with the organizational form or forms with which it is associated.

Identify benefits of business organization forms.

(LO 1), C

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

Classify business activities.

(LO 3), K

- (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.



1-3 Marsh Corporation began operations on January 1, 2014. The following information is available for Marsh Corporation on December 31, 2014.

Prepare financial statements.

(LO 4, 5), AP

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 Marsh Corporation.



1-4 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.

(LO 6), C

- (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 Here is a list of words or phrases discussed in this chapter:

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Match items with descriptions.

(LO 1, 2, 4, 6), K

- 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.

E1-2 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.

Identify business activities.

(LO 3), C

- **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**—discount 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?

E1-3 The Clear View Golf & Country Club details the following accounts in its financial statements.

Classify accounts.

(LO 3, 4), C

(a) (b)

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

Instructions

- (a) Classify each of the above accounts as an asset (A), liability (L), stockholders' equity (SE), revenue (R), or expense (E) item.
- (b) Classify each of the above accounts as a financing activity (F), investing activity (I), or operating activity (O). If you believe a particular account doesn't fit in any of these activities, explain why.

E1-4 This information relates to Molina Co. for the year 2014.

Prepare income statement and retained earnings statement.

(LO 4), AP

Retained earnings, January 1, 2014	\$67,000
Advertising expense	1,800
Dividends	6,000

Service revenue 58,000

Utilities expense 2,400

Salaries and wages expense 30,000

Instructions

After analyzing the data, prepare an income statement and a retained earnings statement for the year ending December 31, 2014.

E1-5 Suppose the following information was taken from the 2014 financial statements of pharmaceutical giant **Merck and Co.** (All dollar amounts are in millions.)

Prepare income statement and retained earnings statement.

(LO 4), AP



Retained earnings, January 1, 2014 \$43,698.8

Cost of goods sold 9,018.9

Selling and administrative expenses 8,543.2

Dividends 3,597.7

Sales revenue 38,576.0

Research and development expense 5,845.0

Income tax expense 2,267.6

Instructions

- (a) After analyzing the data, prepare an income statement and a retained earnings statement for the year ending December 31, 2014.
- (b) Suppose that Merck decided to reduce its research and development expense by 50%. What would be the short-term implications? What would be the long-term implications? How do you think the stock market would

Prepare a retained earnings statement.

(LO 4), AP

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

Instructions

Prepare the 2014 retained earnings statement for DeVito Inc.

E1-7 Consider each of the following independent situations.

Interpret financial facts.

(LO 4), AP



- (a) The retained earnings statement of Grant Corporation shows dividends of \$68,000, while net income for the year was \$75,000.
- (b) The statement of cash flows for Remington 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.

E1-8 The following items and amounts were taken from Motte Inc.'s 2014 income statement and balance sheet.

Identify financial statement components and prepare income statement.

(LO 4, 5), C

_____ Cash	\$ 84,700	_____ Accounts receivable	\$ 88,419
_____ Retained earnings	123,192	_____ Sales revenue	584,951

_____	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), stockholder's equity (SE), revenue (R), or expense (E) item.
- (b) Prepare an income statement for Motte Inc. for the year ended December 31, 2014.

E1-9 Here are incomplete financial statements for Riedy, Inc.

Calculate missing amounts.

(LO 4, 5), AP

RIEDY, INC.

Balance Sheet

Assets

Liabilities and Stockholders' Equity

Cash	\$ 7,000	Liabilities	
Inventory	10,000	Accounts payable	\$ 5,000
Buildings	<u>45,000</u>	Stockholders' equity	
Total assets	\$62,000	Common stock	(a)
		Retained earnings	<u>(b)</u>
		Total liabilities and stockholders' equity	\$62,000

Income Statement

Revenues	\$85,000
----------	----------

Income Statement

Cost of goods sold	(c)
Salaries and wages expense	<u>10,000</u>
Net income	\$ (d)

Retained Earnings Statement

Beginning retained earnings	\$12,000
Add: Net income	(e)
Less: Dividends	<u>5,000</u>
Ending retained earnings	\$27,000

Instructions

Calculate the missing amounts.

E1-10 Flint Hills Park is a private camping ground near the Lathom Peak Recreation Area. It has compiled the following financial information as of December 31, 2014.

Compute net income and prepare a balance sheet.

(LO 4, 5), AP



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 2014	126,000

Equipment	114,000	Common stock	40,000
		Retained earnings (1/1/2014)	5,000

Instructions

- (a) Determine Flint Hills Park's net income for 2014.
- (b) Prepare a retained earnings statement and a balance sheet for Flint Hills Park as of December 31, 2014.
- (c) Upon seeing this income statement, Joe Winsor, 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?

E1-11 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 2014 income statement and balance sheet. (All dollars are in millions.)

Identify financial statement components and prepare an income statement.

(LO 4, 5), AP

____ 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
		____ Accounts payable	1,077
____ Cash	334	____ Common stock	105
____ Notes payable	44	____ Income tax expense	498
____ Interest expense	295		

Instructions

Perform each of the following.

- (a) In each case, identify whether the item is an asset (A), liability (L), stockholders' equity (SE), revenue (R), or expense (E).
- (b) Prepare an income statement for Kellogg Company for the year ended December 31, 2014.

E1-12 This information is for Dyckman Corporation for the year ended December 31, 2014.



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 1/1/14	12,000

Instructions

- (a) Prepare the 2014 statement of cash flows for Dyckman Corporation.
- (b) Suppose you are one of Dyckman's creditors. Referring to the statement of cash flows, evaluate Dyckman's ability to repay its creditors.

E1-13 Suppose the following data are derived from the 2014 financial statements of **Southwest Airlines**. (All dollars are in millions.) Southwest has a December 31 year-end.

Prepare a statement of cash flows.

(LO 5), AP

Cash balance, January 1, 2014	\$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 dividends	14
Cash paid for repurchase of common stock	1,001
Cash paid for goods and services	6,978

Instructions

- (a) After analyzing the data, prepare a statement of cash flows for Southwest Airlines for the year ended December 31, 2014.
- (b) Discuss whether the company's net cash provided by operating activities was sufficient to finance its investing activities. If it was not, how did the company finance its investing activities?

E1-14 Edward Waltz is the bookkeeper for Edminson Company. Edward has been trying to get the balance sheet of Edminson Company to balance. It finally balanced, but now he's not sure it is correct.

Correct an incorrectly prepared balance sheet.

(LO 5), AP

EDMINSON COMPANY

Balance Sheet

December 31, 2014

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

Instructions

Prepare a correct balance sheet.

E1-15 Suppose the following items were taken from the balance sheet of **Nike, Inc.** (All dollars are in millions.)



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

Instructions

Perform each of the following.

- (a) 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?

E1-16 The summaries of data from the balance sheet, income statement, and retained earnings statement for two corporations, Colaw Corporation and Hunter Enterprises, are presented on the next page for 2014.

Colaw Corporation

Hunter Enterprises

Beginning of year

Total assets	\$110,000	\$150,000
Total liabilities	70,000	(d)
Total stockholders' equity	(a)	70,000

End of year

Total assets	(b)	180,000
Total liabilities	120,000	55,000

Colaw Corporation

Hunter Enterprises

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.

E1-17 The annual report provides financial information in a variety of formats, including the following.

Classify various items in an annual report.



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.

Exercises: Set B and Challenge Exercises

Visit the book's companion website, at www.wiley.com/college/kimmel, and choose the Student Companion site to access Exercise Set B and Challenge Exercises.

Problems: Set A

P1-1A Presented below are five independent situations.

Determine forms of business organization.

(LO 1), C

- (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) Al Bolt, a college student looking for summer employment, opened a bait shop in a small shed at a local marina.
- (c) Rita Benedict and Joe Freeze 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) Andrea, Diane, and Steve 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) Jack Yaeger 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. Jack 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.

P1-2A Financial decisions often place heavier emphasis on one type of financial statement over the others. Consider each of the following hypothetical situations independently.

Identify users and uses of financial statements.

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- (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](https://www.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.

P1-3A On June 1, Hightower 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, and the revenues and expenses for the month of June, its first month of operations:

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

(LO 4, 5), AP



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		

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

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- (a) Prepare an income statement and a retained earnings statement for the month of June and a balance sheet at June 30, 2014.

Marginal check figures (in blue) 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

- (b) Briefly discuss whether the company's first month of operations was a success.
- (c) Discuss the company's decision to distribute a dividend.

P1-4A Presented below is selected financial information for Wenger Corporation for December 31, 2014.

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

(LO 5), AP



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

Instructions

- (a) Determine which items should be included in a statement of cash flows and then prepare the statement for Wenger Corporation.

(a) Net increase \$31,000

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

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

(LO 5), AP

MERANDO CORPORATION

Balance Sheet

December 31, 2014

<u>Assets</u>		<u>Liabilities and Stockholders' Equity</u>	
Cash	\$20,000	Accounts payable	\$30,000
Accounts receivable	50,000	Notes payable	15,000
Inventory	36,000	Boat loan	22,000

MERANDO CORPORATION

Boat	24,000	Stockholders' equity	64,000
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Balance Sheet

December 31, 2014

Bill willingly admits that he is not an accountant by training. He is concerned that his balance sheet might not be correct. He has provided you with the following additional information.

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

Instructions



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

(b) Tot. assets \$85,000

Problems: Set B

P1-1B Presented below are five independent situations.

Determine forms of business organization.

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- (a) Randy Gentry, a college student looking for summer employment, opened a produce stand along a busy local highway. Each morning he buys produce from local farmers, then sells it in the afternoon as people return home from work.
- (b) Dave Boyce and Davey Lopez each owned separate swing-set manufacturing businesses. They have decided to combine their businesses and try to expand their reach beyond their local market. They expect that within the coming year they will need significant funds to expand their operations.
- (c) Three chemistry professors at LU have formed a business to employ enzymes to clean up toxic waste sites. Each has contributed an equal amount of cash and knowledge to the venture. The use of enzymes in this situation is experimental, and legal obligations could result.
- (d) Marty Wells has run a successful, but small cooperative vitamin store for over 20 years. The increased sales of her store have made her believe that the time is right to open a national chain of vitamin stores across the country. Of course, this will require a substantial investment in stores, inventory, and employees in each store. Marty has no savings or personal assets. She wants to maintain control over the business.
- (e) Charles Kuehl and Peg Lambing recently graduated with masters degrees in business. They have decided to start a consulting business focused on teaching the basics of exporting to small business owners interested in exporting.

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.

P1-2B Financial decisions often place heavier emphasis on one type of financial statement over the others. Consider each of the following hypothetical situations independently.

Identify users and uses of financial statements.

(LO 2, 4, 5), K

- (a) An investor is considering purchasing common stock of the **24/7 Fitness** company. The investor plans to hold the investment for at least 3 years.
- (b) **Xerox** is considering extending credit to a new customer. The terms of the credit would require the customer to pay within 60 days of receipt of goods.
- (c) The president of **American Airlines** 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 new flight equipment as it is needed.
- (d) **PNC 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.

Instructions



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

P1-3B Shaw's Garden was started on May 1 with an investment of \$45,000 cash. Following are the assets, liabilities, and common stock of the company on May 31, 2014, and the revenues and expenses for the month of May, its first month of operations.

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

(LO 4, 5), AP

Accounts receivable	\$ 8,400	Notes payable	\$26,000
---------------------	----------	---------------	----------

Service revenue	10,400	Salaries and wages expense	1,900
Advertising expense	1,800	Equipment	58,800
Accounts payable	4,400	Maintenance and repairs expense	2,100
Cash	10,800	Insurance expense	400
Common stock	45,000		

No additional common stock was issued in May, but a dividend of \$1,600 in cash was paid.

Instructions

- (a) Prepare an income statement and a retained earnings statement for the month of May and a balance sheet at May 31, 2014.

(a) Net income \$ 4,200

Ret. earnings \$ 2,600

Tot. assets \$78,000

- (b) Briefly discuss whether the company's first month of operations was a success.
- (c) Discuss the company's decision to distribute a dividend.

P1-4B Presented below are selected financial statement items for Preacher Corporation for December 31, 2014.

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

(LO 5), AP



Inventory	\$ 55,000	Cash paid to purchase equipment	\$ 20,000
Cash paid to suppliers	154,000	Equipment	40,000
Buildings	400,000	Service revenue	200,000
Common stock	20,000	Cash received from customers	162,000

Cash dividends paid	2,000	Cash received from issuing	
Cash at beginning of period	11,000	bonds payable	40,000

Instructions

- (a) Determine which items should be included in a statement of cash flows, and then prepare the statement for Preacher Corporation.

(a) Net increase \$26,000

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

P1-5B Walters Corporation was formed during 2013 by John Walters. John is the president and sole stockholder. At December 31, 2014, John prepared an income statement for Walters Corporation. John is not an accountant, but he thinks he did a reasonable job preparing the income statement by looking at the financial statements of other companies. He has asked you for advice. John's income statement appears as follows.

Comment on proper accounting treatment and prepare a corrected income statement.

(LO 4, 5), AP

WALTERS CORPORATION

Income Statement

For the Year Ended December 31, 2014

Accounts receivable	\$17,000
Service revenue	40,000
Rent expense	10,000
Insurance expense	7,000
Vacation expense	<u>6,000</u>
Net income	\$34,000

John has also provided you with these facts.

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1. Included in the service revenue account is \$3,000 of revenue that the company provided service for and received payment for in 2013. He forgot to include it in the 2013 income statement, so he put it in this year's statement.

- 2. John operates his business out of the basement of his parents' home. They do not charge him anything, but he thinks that if he paid rent it would cost him about \$10,000 per year. He, therefore, included \$10,000 of rent expense in the income statement.
- 3. To reward himself for a year of hard work, John went to Turkey. He did not use company funds to pay for the trip, but he reported it as an expense on the income statement since it was his job that made him need the vacation.

Instructions



- (a) Comment on the proper accounting treatment of the three items above.
- (b) Prepare a corrected income statement for Walters Corporation.

(b) Net income \$30,000

Problems: Set C

Visit the book's companion website, at www.wiley.com/college/kimmel, and choose the Student Companion site to access Problem Set C.

Continuing Cookie Chronicle

CCC1 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 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.



This serial problem starts in Chapter 1 and continues in every chapter. You can also find this problem at the book's companion website, www.wiley.com/college/kimmel.

Instructions

- (a) 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.
- (b) Will Natalie need accounting information? If yes, what information will she need and why? How often will she need this information?
- (c) Identify specific asset, liability, revenue, and expense accounts that Cookie Creations will likely use to record its business transactions.
- (d) Should Natalie open a separate bank account for the business? Why or why not?
- (e) 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?

Broadening Your Perspective

Financial Reporting and Analysis

FINANCIAL REPORTING PROBLEM: *Tootsie Roll Industries, Inc.*

BYP1-1 The 2011 financial statements of *Tootsie Roll Industries, Inc.* are provided in [Appendix A](#).



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Instructions

Refer to Tootsie Roll's financial statements to answer the following questions.

- (a) What were Tootsie Roll's total assets at December 31, 2011? At December 31, 2010?
- (b) How much cash did Tootsie Roll have on December 31, 2011?
- (c) What amount of accounts payable did Tootsie Roll report on December 31, 2011? On December 31, 2010?
- (d) What were Tootsie Roll's total revenues in 2011? In 2010?
- (e) What is the amount of the change in Tootsie Roll's net income from 2010 to 2011?

COMPARATIVE ANALYSIS PROBLEM: *Tootsie Roll vs. Hershey*

BYP1-2 Tootsie Roll's financial statements are presented in [Appendix A](#). The financial statements of **The Hershey Company** are presented in [Appendix B](#).



Instructions

- (a) Based on the information in these financial statements, determine the following for each company.
 - (1) Total assets at December 31, 2011.
 - (2) Net property, plant, and equipment at December 31, 2011.
 - (3) Total revenue for 2011.
 - (4) Net income for 2011.
- (b) What conclusions concerning the two companies can you draw from these data?

RESEARCH CASE

BYP1-3 The June 22, 2011, issue of the *Wall Street Journal Online* includes an article by Michael Rapoport entitled "Auditors Urged to Tell More." It provides an interesting discussion of the possible expanding role of CPAs.

Instructions

Read the article and answer the following questions.

- (a) What are some of the ideas that the Public Company Accounting Oversight Board proposed for expanding the role of auditors in "passing judgment on more of what a company does and says?"
- (b) How might the financial crisis influence the public's opinion regarding the need for more information from auditors?
- (c) Describe the proposed "Auditor's Discussion and Analysis."
- (d) Discuss whether you think that auditors will view these proposals positively or negatively.

INTERPRETING FINANCIAL STATEMENTS

BYP1-4 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 3,498

Cash provided by financing activities 2,911

Instructions

Analyze the information, and then answer the following questions.

- (a) If you were a creditor of Xerox, what reaction might you have to the above information?
- (b) If you were an investor in Xerox, what reaction might you have to the above information?
- (c) If you were evaluating the company as either a creditor or a stockholder, what other information would you be interested in seeing?
- (d) Xerox decided to pay a cash dividend. This dividend was approximately equal to the amount paid in the previous year. Discuss the issues that were probably considered in making this decision.

REAL-WORLD FOCUS

BYP1-5 Purpose: Identify summary information about companies. This information includes basic descriptions of the company's location, activities, industry, financial health, and financial performance.

Address: <http://biz.yahoo.com/i>, or go to www.wiley.com/college/kimmel

Steps

- 1. Type in a company name, or use the index to find company name.
- 2. Choose **Quote**, then choose **Profile**, then choose **Income Statement**. Perform instructions (a) and (b) below.
- 3. Choose **Industry** to identify others in this industry. Perform instructions (c)–(e) below.

Instructions

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?

Critical Thinking

DECISION-MAKING ACROSS THE ORGANIZATION

Instructions

Use the annual report provided in [Appendix A](#) to answer the following questions.

- (a) What CPA firm performed the audit of Tootsie Roll's financial statements?
- (b) What was the amount of Tootsie Roll's earnings per share in 2011?
- (c) What are the company's net sales in foreign countries in 2011?
- (d) What did management suggest as the cause of the decrease in the earnings from operations in 2011?
- (e) What were net sales in 2007?
- (f) How many shares of Class B common stock have been authorized?
- (g) How much cash was spent on capital expenditures in 2011?
- (h) Over what life does the company depreciate its buildings?
- (i) What was the value of raw material and supplies inventory in 2010?

COMMUNICATION ACTIVITY

BYP1-7 Lori Milner is the bookkeeper for Philco Company, Inc. Lori 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.

PHILCO COMPANY, INC.

Balance Sheet

For the Month Ended December 31, 2014

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

Instructions

Explain to Lori Milner 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

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BYP1-8 Rules governing the investment practices of individual certified public accountants prohibit them from investing in the stock of a company that their firm audits. The Securities and Exchange Commission (SEC) became concerned that some accountants were violating this rule. In response to an SEC investigation, **PricewaterhouseCoopers** 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

BYP1-9 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 www.finaid.org/fafsa/maximize.phtml) to increase the chances of receiving financial aid is ethical.
 - (i) Spend down the student's assets and income first, before spending parents' assets and income.
 - (ii) Accelerate necessary expenses to reduce available cash. For example, if you need a new car, buy it before applying for financial aid.
 - (iii) State that a truly financially dependent child is independent.
 - (iv) 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

BYP1-10 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-

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 *Broadening Your Perspective* section.

Instructions

Academic access to the FASB Codification is available through university subscriptions, obtained from the American Accounting Association (at <http://aaahq.org/FASB/Access.cfm>), for an annual fee of \$150. 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 (at <http://aaahq.org/ascLogin.cfm>) and familiarize yourself with the resources that are accessible at the FASB Codification site.

CONSIDERING PEOPLE, PLANET, AND PROFIT

BYP1-11 This chapter's Feature Story discusses the fact that 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.

Address: www.clifbar.com/uploads/default/ClifBar_AA2010.pdf

Instructions

Access the 2010 annual report of Clif Bar & Company at the site shown above and then answer the following questions.

- (a) What are the Five Aspirations?
- (b) How does this annual report differ from the annual report discussed in the chapter (see [pages 17](#) and [19](#))? Are there any similarities?
- (c) What are the four key goals of the company's sustainability efforts related to the planet? Give one example of a recent initiative, and a measurable outcome for that initiative, that the company has taken related to each goal.

Answers to Insight and Accounting Across the Organization Questions

p. 6 The Scoop on Accounting Q: What are the benefits to the company and to the employees of making the financial statements available to all employees? **A:** If employees can read and use financial reports, a company will benefit in the following ways. The **marketing department** will make better decisions about products to offer and prices to charge. The **finance department** will make better decisions about debt and equity financing and how much to distribute in dividends. The **production department** will make better decisions about when to buy new equipment and how much inventory to produce. The **human resources department** will be better able to determine whether employees can be given raises. Finally, **all employees** will be better informed about the basis on which they are evaluated, which will increase employee morale.

p. 7 Spinning the Career Wheel Q: How might accounting help you? **A:** You will need to understand financial reports in any business with which you are associated. Whether you become a manager, a doctor, a lawyer, a social worker, a teacher, an engineer, an architect, or an entrepreneur, a working knowledge of accounting is relevant.

p. 9 The Numbers Behind Not-for-Profit Organizations Q: What benefits does a sound accounting system provide to a not-for-profit organization? **A:** Accounting provides at least two benefits to not-for-profit organizations. First, it helps to ensure that money is used in the way that donors intended. Second, it assures donors that their money is not going to waste and thus increases the likelihood of future donations.

P. 16 Beyond Financial Statements Q: Why might a company's stockholders be interested in its environmental and social performance? **A:** Many companies now recognize that being a socially responsible organization is not only the right thing to do, but it also is good for business. Many investment professionals understand, for example, that environmental, social, and proper corporate governance of companies affects the performance of their investment portfolios. For example, **British Petroleum's** oil spill disaster is a classic example of the problems that can occur for a company and its stockholders. BP's stock price was slashed, its dividend reduced, its executives replaced, and its reputation badly damaged. It is interesting that socially responsible investment funds are now gaining momentum in the marketplace such that companies now recognize this segment as an important investment group.

Answers to Self-Test Questions

1. b 2. c 3. d 4. d 5. c 6. a 7. d 8. d 9. a 10. b 11. c 12. d 13. d 14. a 15. b



A Look at IFRS

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

LEARNING OBJECTIVE 7

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

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, and 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 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.

KEY POINTS

- International standards are referred to as **International Financial Reporting Standards (IFRS)**, developed by the International Accounting Standards Board (IASB). Over 115 countries require or permit use of IFRS.
- Recent events in the global capital markets underscore the importance of financial disclosure and transparency not only in the United States but in markets around the world. As a result, many are examining which accounting and financial disclosure rules should be followed.
- U.S. standards, referred to as generally accepted accounting principles (GAAP), are developed by the Financial Accounting Standards Board (FASB). The fact that there are differences between what is in this textbook (which is based on U.S. standards) and IFRS should not be surprising because the FASB and IASB have responded to different user needs. In some countries, the primary users of financial statements are private investors. In others, the primary users are tax authorities or central government planners. It appears that the United States and the international standard-setting environment are primarily driven by meeting the needs of investors and creditors.
- The internal control standards applicable to Sarbanes-Oxley (SOX) apply only to large public companies listed on U.S. exchanges. There is a continuing debate as to whether non-U.S. companies should have to comply with this extra layer of regulation. Debate about international companies (non-U.S.) adopting SOX-type standards centers on whether the benefits exceed the costs. The concern is that the higher costs of SOX compliance are making the U.S. securities markets less competitive.
- The textbook mentions a number of ethics violations, such as **Enron**, **WorldCom**, and **AIG**. These problems have also occurred internationally, for example, at **Satyam Computer Services** (India), **Parmalat** (Italy), and **Royal Ahold** (the Netherlands).
- 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.” This difference in approach has resulted in a debate about the merits of “principles-based” versus “rules-based” standards.
- U.S. regulators have recently eliminated the need for foreign companies that trade shares in U.S. markets to reconcile their accounting with GAAP.
- The three most common forms of business organization, proprietorships, partnerships, and corporations, are also found in countries that use IFRS. Because the choice of business organization is influenced by factors such as legal environment, tax rates and regulations, and degree of entrepreneurship, the relative use of each form will vary across countries.
- The conceptual framework that underlies IFRS is very similar to that used to develop GAAP. The basic definitions provided in this textbook for the key elements of financial statements, that is, assets, liabilities, equity, revenues, and expenses, are simplified versions of the official definitions provided by the FASB. The more substantive definitions, using the IASB definitional structure, are as follows.
 - **Assets.** A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. **Liabilities.** A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Liabilities may be legally enforceable via a contract or law, but need not be; i.e., they can arise due to normal business practice or customs. **Equity.** A residual interest in the assets of the entity after deducting all its liabilities. **Income.** Increases in economic benefits that result in increases in equity (other than those related to contributions from shareholders). Income includes both revenues (resulting from ordinary activities) and gains. **Expenses.** Decreases in economic benefits that result in decreases in equity (other than those related to distributions to shareholders). Expenses includes losses that are not the result of ordinary activities.

LOOKING TO THE FUTURE

Both the IASB and the FASB are hard at work developing standards that will lead to the elimination of major differences in the way certain transactions are accounted for and reported. In fact, at one time the IASB stated that no new major standards would be issued for a period of time. The reason for this policy was to provide companies the

time to translate and implement IFRS into practice, as much had happened in a very short period of time. Consider, for example, that as a result of a joint project on the conceptual framework, the definitions of the most fundamental elements (assets, liabilities, equity, revenues, and expenses) may actually change. However, whether the IASB adopts internal control provisions similar to those in SOX remains to be seen.

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.

4.

Which of the following statements is **false**?

- (a) IFRS is based on a conceptual framework that is similar to that used to develop GAAP.
- (b) Assets are defined by the IASB as resources controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- (c) Non-U.S. companies that trade shares in U.S. markets must reconcile their accounting with GAAP.
- (d) Proprietorships, partnerships, and corporations are also found in countries that use IFRS.

5.

Which of the following statements is **true**?

- (a) Under IFRS, the term *income* refers to what would be called revenues and gains under GAAP.
- (b) The term *income* is not used under IFRS.
- (c) The term *income* refers only to gains on investments.
- (d) Under IFRS, expenses include distributions to owners.

IFRS CONCEPTS AND APPLICATION

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

IFRS1-2 What might explain the fact that different accounting standard-setters have developed accounting standards that are sometimes quite different in nature?

IFRS1-3 What is the benefit of a single set of high-quality accounting standards?

IFRS1-4 Discuss the potential advantages and disadvantages that countries outside the United States should consider before adopting regulations, such as those in the Sarbanes-Oxley Act, that increase corporate internal control requirements.

INTERNATIONAL FINANCIAL REPORTING PROBLEM: *Zetar plc*

IFRS1-5 The financial statements of *Zetar plc* are presented in [Appendix C](#). The company's complete annual report, including the notes to its financial statements, is available in the Investors section at www.zetarplc.com.

Instructions

Visit Zetar's corporate website and answer the following questions from Zetar's 2011 annual report.

- (a) What accounting firm performed the audit of Zetar's financial statements?
- (b) Over what life does the company depreciate its buildings?
- (c) What is the address of the company's corporate headquarters?
- (d) What is the company's reporting currency?
- (e) What two segments does the company operate in, and what were the sales for each segment in the year ended April 30, 2011?

Answers to IFRS Self-Test Questions

1. d 2. c 3. a 4. c 5. a



Remember to go back to The Navigator box on the chapter opening page and check off your completed work.

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