Survey of Accounting

Carl S. Warren | 8e

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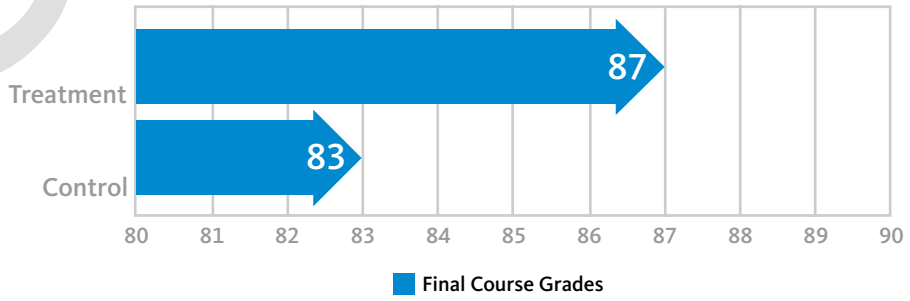

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University of Utah

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Jennifer Loughren
Student, Northeast Iowa Community College

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Survey of Accounting 8e

Carl S. Warren*
Professor Emeritus of Accounting
University of Georgia, Athens

* A special thanks to Amanda Farmer, Andrea Meyer, and Mark Sears for their contributions to this edition.

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Survey of Accounting, Eighth Edition

Carl S. Warren

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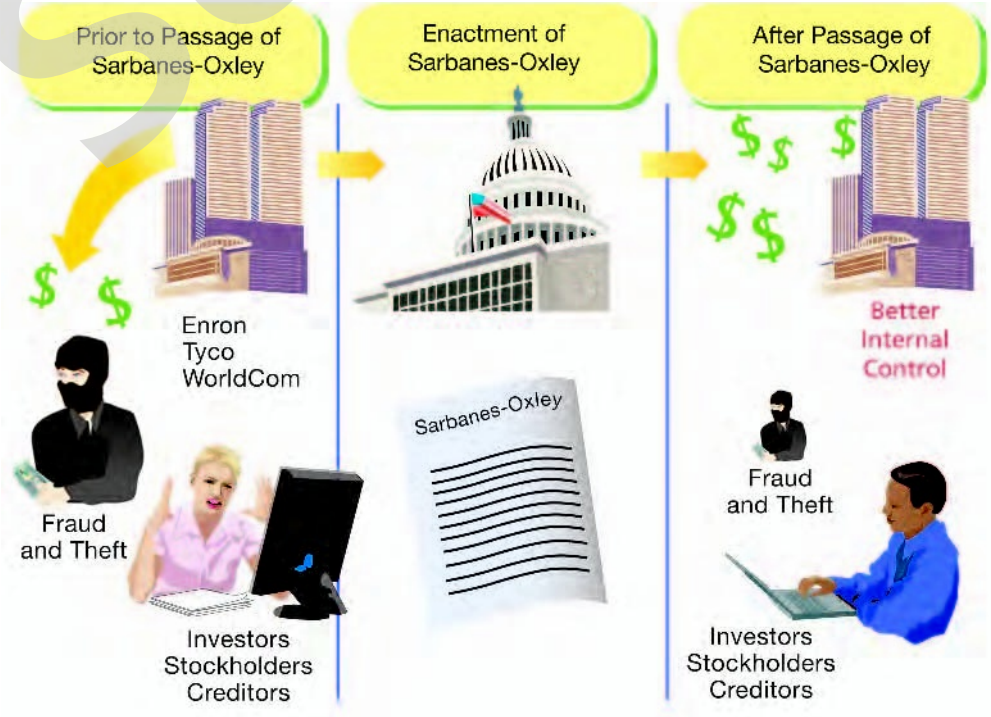
Preface

Survey of Accounting, Eighth Edition, is designed for a one-term introductory accounting course. Written for students who have no prior knowledge of accounting, this text emphasizes how managers, investors, and other business stakeholders use accounting reports. It provides an overview of the basic topics in financial and managerial accounting.

Hallmark Features

The Eighth Edition of this text continues to emphasize elements designed to help instructors and enhance the learning experience of students. These features include the following:

- **Integrated Financial Statement Framework** shows how transactions impact each of the three primary financial statements and stresses the integrated nature of accounting.
- **Infographic art** examples help students visualize important accounting concepts within the chapter.



- **Illustrative Problems** help students apply what they learn by walking them through problems that cover the most important concepts addressed within the chapter.

Illustrative Problem

McCollum Company, a furniture wholesaler, acquired new equipment at a cost of $150,000 at the beginning of the fiscal year. The equipment has an estimated life of five years and an estimated residual value of $12,000. Ellen McCollum, the president, has requested information regarding alternative depreciation methods.

Instructions

Determine the annual depreciation for each of the five years of estimated useful life of the equipment, the accumulated depreciation at the end of each year, and the book value of the equipment at the end of each year by (a) the straight-line method and (b) the double-declining-balance method.

Solution

	Year	Depreciation Expense	Accumulated Depreciation, End of Year	Book Value, End of Year
a.	1	$27,600*	$ 27,600	$122,400
	2	27,600	55,200	94,800
	3	27,600	82,800	67,200
	4	27,600	110,400	39,600
	5	27,600	138,000	12,000

*$27,600 = ($150,000 − $12,000) ÷ 5

b.	1	$60,000**	$ 60,000	$ 90,000
	2	36,000	96,000	54,000
	3	21,600	117,600	32,400
	4	12,960	130,560	19,440
	5	7,440***	138,000	12,000

**$60,000 = $150,000 × 40%.
***The asset is not depreciated below the estimated residual value of $12,000.

- **"Integrity, Objectivity, and Ethics in Business"** features describe real-world dilemmas, helping students apply accounting concepts within an ethical context, using integrity and objectivity.

Integrity, Objectivity, and Ethics in Business

Tips on Preventing Employee Fraud in Small Companies

- Do not have the same employee write company checks and keep the books. Look for payments to vendors you don't know or payments to vendors whose names appear to be misspelled.
- If your business has a computer system, restrict access to accounting files as much as possible. Also, keep a backup copy of your accounting files and store it at an off-site location.
- Be wary of anybody working in finance that declines to take vacations. They may be afraid that a replacement will uncover fraud.
- Require and monitor supporting documentation (such as vendor invoices) before signing checks.
- Track the number of credit card bills you sign monthly.
- Limit and monitor access to important documents and supplies, such as blank checks and signature stamps.
- Check W-2 forms against your payroll annually to make sure you're not carrying any fictitious employees.
- Rely on yourself, not on your accountant, to spot fraud.

Source: Steve Kaufman, "Embezzlement Common at Small Companies," Knight-Ridder Newspapers, reported in *Athens Daily News/Athens Banner-Herald,* March 10, 1996, p. 4D.

- **"Business Insight Make Money"** vignettes emphasize practical ways in which businesses apply accounting concepts when generating profit strategies.

Business Insight

Got the Flu? Why Not Chew Some Gum?

Facing a slumping market for sugared chewing gum—such as Juicy Fruit™ and Doublemint™—**Wm. Wrigley Jr. Company**, a subsidiary of **Mars Incorporated**, is reinventing itself by expanding its product lines and introducing new chewing gum applications. Wrigley's new products include sugarless breath mints and more powerful fl vored mint chewing gum, like Extra Polar Ice™. In addition, Wrigley is experimenting with health-care applications of chewing gum. For example, the company founded the Wrigley Science Institute™ with the objective of promoting scientific research on the benefits of chewing gum. Specificall , the Institute sponsors research in such areas as weight reduction, management and stress relief, and cognitive focus. The Institute provides grants to leading researchers who investigate the role of chewing gum in health and wellness.

Source: Wrigley.com and *USA Today*, "Wrigley Wants Science to Prove Gum-Chewing Benefit ," by Dave Carpenter, The Associated Press, March 28, 2006.

- The **"International Connections"** feature, in select chapters, highlights key differences between international accounting standards and U.S. GAAP.

International Connection

Adoption or Convergence?

The largest public accounting firms, known as the Big Four, have pushed for the "adoption" of IFRS in the United States within a relatively short period of time. Such a strategy of adoption would generate millions of dollars of consulting and accounting work within the U.S. for the Big Four: Deloitte Touche Tohmatsu, PwC (PriceWaterhouseCoopers), Ernst & Young, and KPMG.

In contrast, others have argued for a strategy of gradual "convergence" to IFRS over time. Currently, it appears that regulators within the United States and the FASB are favoring convergence rather than adoption. For example, since November 2010, the FASB and IASB have completed several projects to converge U.S. and IFRS standards.[1]

1. FASB.org, "Progress Report on IASB-FASB Convergence Work," April 21, 2011.

- **An attractive design** engages students and clearly presents the material. The Integrated Financial Statement Framework benefits from this pedagogically sound use of color, as each statement within the framework is shaded to reinforce the integrated nature of accounting.

Integrated Financial Statement (IFS) Approach

This framework clearly demonstrates the impact of transactions on the balance sheet, income statement, and the statement of cash flows and the corresponding relationship among these financial statements. The IFS framework moves the student from the simple to the complex and explains the how and why of financial statements.

Chapter 1 introduces students to this integration in the form of actual company financials from **The Hershey Company**, a well-known manufacturer of chocolates.

Exhibit 10 Integrated Financial Statements

The Hershey Company
Balance Sheet
December 31

Assets		Liabilities	+	Stockholders' Equity	
Cash $ 728					
.		.		.	
.		.		$5,028	Retained Earnings
.		.		360	Common Stock
$4,754	=	$3,706	+	$1,048	

$4,754
Total Liabilities + Stockholders' Equity

The Hershey Company
Statement of Cash Flows
for the Year Ended Dec. 31

Operating act.	$1,095
Investing act.	(473)
Financing act.	(587)
Increase in cash	$ 35
Cash, Jan. 1	693
Cash, Dec. 31	$ 728

The Hershey Company
Income Statement
for the Year Ended Dec. 31

Revenues	$6,644
Expenses	(5,983)
Net income	$ 661

The Hershey Company
Statement of Stockholders' Equity
for the Year Ended Dec. 31

	Common Stock	Retained Earnings	Other Items	Total
Bal. Jan. 1	$360	$4,798	$(4,188)	$ 880
Net income		661		661
Dividends		(341)		(341)
Other items			(152)	(152)
Bal. Dec. 31	$360	$5,028	$(4,340)	$1,048

Chapter 2 begins with an example format of the integrated framework used throughout the financial chapters. Early in the course, students will gain a greater understanding of how important trends or events can impact a company's financial statements, which add valuable insight into the financial condition and performance of a business.

Exhibit 1 Integrated Financial Statement Framework

Integrated Financial Statement Framework

BALANCE SHEET

	Assets	=	Liabilities	+	Stockholders' Equity	
	Assets	=	Liabilities	+	Capital Stock +	Retained Earnings
Transaction	XXX		XXX		XXX	XXX
	XXX					
	XXX		XXX		XXX	XXX

STATEMENT OF CASH FLOWS

+/– Operating activities	XXX
+/– Investing activities	XXX
+/– Financing activities	XXX
Increase or decrease in cash	XXX
Beginning cash	XXX
Ending cash	XXX

INCOME STATEMENT

Revenues	XXX
Expenses	XXX
Net income or loss	XXX

The primary focus in Chapter 2 is on cash transactions, which helps eliminate confusion for students who may have difficulty determining whether an event or transaction should be recorded.

Transaction (d)

During the first month of operations, Family Health Care earned patient fees of $5,500, receiving the fees in cash.

The effects of this transaction on Family Health Care's financial statements are recorded as follows:

1. Under the Statement of Cash Flows column, Cash from Operating activities is increased by $5,500.
2. Under the Balance Sheet column, Cash under Assets is increased by $5,500. To balance the accounting equation, Retained Earnings under Stockholders' Equity is also increased by $5,500.
3. Under the Income Statement column, Fees earned is increased by $5,500.

This transaction illustrates an inflow of cash from operating activities by earning revenues (fees earned) of $5,500. Retained Earnings is increased under Stockholders' Equity by $5,500 because fees earned contribute to net income and net income increases stockholders' equity. Since fees earned are a type of revenue, Fees earned of $5,500 is also entered under the Income Statement column.

The effects of this transaction on Family Health Care's financial statements are shown below.

Financial Statement Effects

BALANCE SHEET

	Assets			=	Liabilities	+	Stockholders' Equity		
	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings
Balances	4,000		12,000		10,000		6,000		
d. Fees earned	5,500								5,500
Balances	9,500		12,000		10,000		6,000		5,500

STATEMENT OF CASH FLOWS

d. Operating	5,500

INCOME STATEMENT

d. Fees earned	5,500

Transaction Metric Effects

The effects of receiving $5,500 of patient fees on Family Health Care's liquidity and profitability metrics are as follows:

LIQUIDITY

Cash	$5,500

PROFITABILITY

Net Income – Cash Basis	$5,500

Eighth Edition: Changes and Enhancements

NEW! Warren's Metric Analyses

As illustrated above, the Eighth Edition of Survey of Accounting introduces and incorporates Warren's Metric Analyses throughout. It uses common business metrics to assess

a company's financial condition and performance. Metrics are assessed at three levels: the Transaction Level, Financial Statement level, and Managerial Decision-Making Level.

To accompany the addition of Warren's Metric Analyses, end-of-chapter problems have been added to test the students knowledge and understanding of the concepts.

Metric Analyses are clearly identified wtih a separate screen of color. This allows for quick identification of the analyses through the chapters and text. This separate screen of color also identifies the end-of-chapter section for assigning homework.

MBA 2-4 Common-Sized Statements **Obj. 6**

Southwest Airlines Co. (LUV) provides passenger services throughout the United States, Mexico, Jamaica, The Bahamas, Aruba, and the Dominican Republic. The following operating data (in millions) were adapted from recent financial statements of Southwest.

	Year 1	Year 2
Revenue	$ 17,699	$ 18,605
Operating expenses:		
Fuel	$(5,763)	$(5,293)
Aircraft-related	(3,411)	(3,322)
Selling and general	(5,035)	(5,434)
Other expenses	(2,212)	(2,331)
Total operating expenses	$(16,421)	$(16,380)
Operating income	$ 1,278	$ 2,225

1. Prepare common-sized statements for Years 2 and 1. Round to one decimal place.
2. Using (1), analyze and comment on the performance of Southwest in Year 2.

Other Enhancements

- Retained Earnings Statement is REPLACED with Statement of Stockholders Equity throughout the book. This will reflect what students will see in business and also allows for real-world examples of statements of stockholder's equity for in-class illustrations or homework.
- Each Financial Accounting Chapter now includes one financial statement metric at the end of each chapter. In addition, each financial chapter transaction is analyzed using a liquidity and profitability metric. Depending upon chapter content, a variety of liquidity and profitability metrics are used throughout the financial accounting chapters.
- Each Managerial Accounting Chapter now includes one metric used by managers in operating a business. Many of these metrics are operational in nature and include margin of safety, cost per unit, process yield, and utilization rate.
- This edition includes updated or replaced chapter openers to feature recent, intriguing developments in accounting. The author has woven connections to the opening company highlighted in each chapter throughout each chapter. This now promotes a stronger connection for students, allowing them to gain additional insight into the opening company and its relationship to the chapter content.
- For this edition, when Real Publicly Traded Companies appear through out the book, their (TICKERS) symbol is also represented. This allows students to easily look up company's financial data on the internet.

Technology

CENGAGENOWv2

What is CengageNOWv2?

CengageNOWv2 is a powerful course management and online homework tool that provides robust intructor control and customization to optimize the student learning experience and meet desired outcomes.

CengageNOWv2 includes

- Integrated eBook
- End-of-Chapter homework with static and algorithmic version
- Adaptive Study Plan with quizzing and multimedia study tools
- Test Bank
- Course management tools and flexible assignment options
- Reporting and grade book options
- Mastery Problems
- Tell Me More eLectures
- Show Me How Demonstration Videos
- Animated Activities

CengageNOWv2 for Warren's *Survey of Accounting, 8e* is designed to help students learn more effectively by providing engaging resources at unique points in the learning process:

When to use it?	What to use?	How will it help?
Preparing for Class	Lecture Activities Animated Activities	Recall Understand
Completing Homework	Solutions Videos Enhanced Feedback	Apply
Going Further	Mastery Assignments Conceptual Conversions	Analyze Evaluate

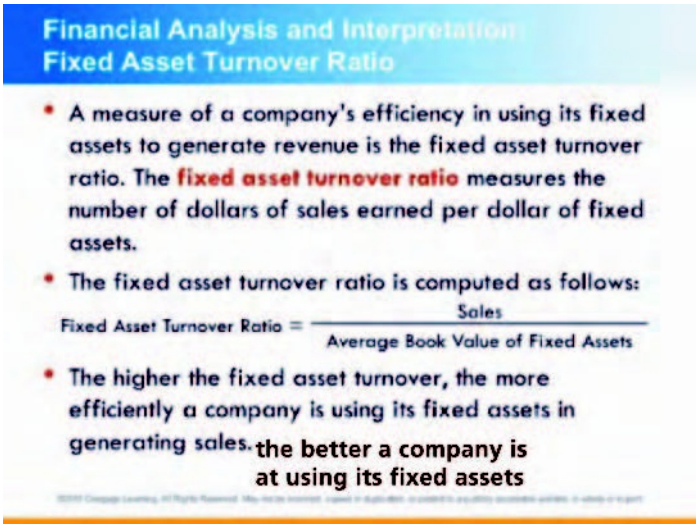
Preparing for Class

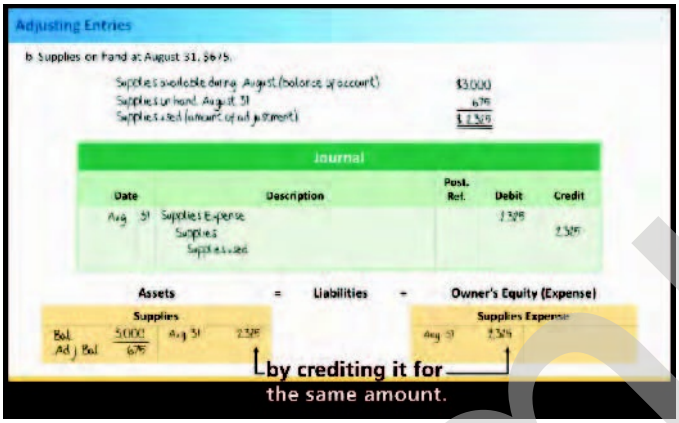
CengageNOWv2 helps you motivate students and prepare them for class with a host of resources. These resources were developed with visual learners and those that don't like to read textbooks in mind. Available in the Study Tools tab in CengageNOWv2, students may access these resources on demand. Each resource is fully assignable and gradable!

Tell Me More Lecture Activities are available and correlate to each Learning Objective (LO). These Lecture Assignments review the material covered in each LO, giving students a way to review what is covered in each objective in a digestible video activity format so they come to class more prepared and ready to participate.

Animated Activities are available on a chapter-by-chapter basis. Animated Activities are assignable/gradable illustrations that visually explain and guide students through selected core topics. Each activity uses a realistic company example to illustrate how the concepts relate to the everyday activities of a business. After finishing the video, a student is expected to answer questions based on what they've seen. These activities offer excellent resources for students prior to coming to lecture and will especially appeal to visual learners.

By using these resources, you have a powerful suite of content to help you ensure students can familiarize themselves with content prior to coming to class, which is an excellent way to help you flip the classroom!





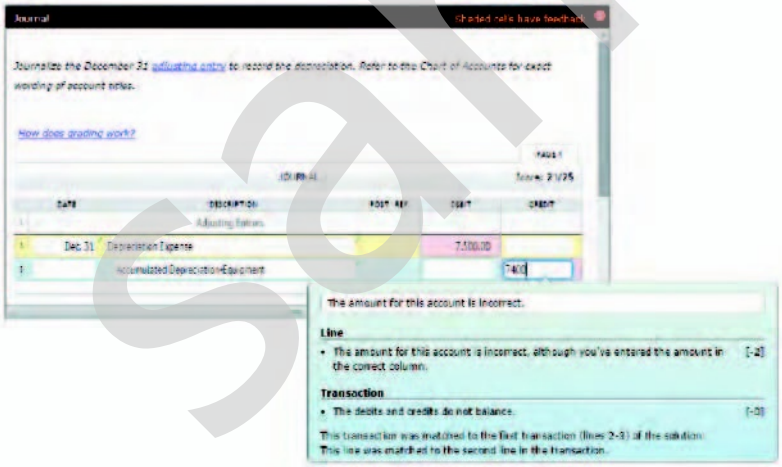
Completing Homework

Students sometimes struggle with accounting homework. By using CengageNOWv2's powerful instructor tools you can fine-tune the amount of help that your students receive as they work on their homework. Help your students succeed by making the right amount of assistance available at the right time!

Show Me How Videos are available for the most commonly assigned end-of-chapter assignments. *Linked only to algorithms*, these Videos provide students with both a detailed walk-through of a similar problem and problem-solving strategies.

Made without giving away the answer.

CengageNOWv2 provides multiple layers of guidance to keep students on track and progressing.



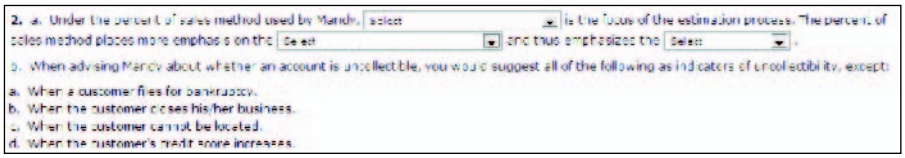
- Check My Work Feedback provides general guidance and hints as students work through homework assignments.
- Check My Work Feedback in CengageNOWv2 only reports on what students have attempted, which prevents them from "guessing" their way through assignments.
- Explanations are available after the assignment has been submitted and provide a detailed description of how the student should have arrived at the solution.

Going Further

Mastering accounting includes making connections between concepts and asking students to apply what they've learned to different scenarios. CengageNOWv2 has the tools that help you assess your students' abilities in these key skill areas!

In CengageNOWv2, all of the special activities in Warren, *Survey of Accounting, 8th Edition* are available for you to assign to your students. These **Mastery Assignments** do more than test your students' ability to recall, understand and apply. These assignments challenge your students to go further by demonstrating their ability to analyze and evaluate accounting information.

Conceptual Conversions are open-ended requirements from the end-of-chapter homework that have been converted into automatically gradable formats in CengageNOWv2. Now you can assess your students' understanding of more conceptual, open-ended questions previously not available to assign in an online environment.



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- **Instructor Excel® Templates** This resource provides the solutions for the problems and exercises that have enhanced Excel® templates for students.
- **Instructor's Manual** Each chapter contains a number of resources designed to aid instructors as they prepare lectures, assign homework, and teach in the classroom.
- **Solutions Manual** The Solutions Manual contains answers to all exercises, problems, and cases that appear in the text. As always, the solutions are author-written and verified multiple times for numerical accuracy and consistency with the core text.

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Many people deserve thanks for their contributions to this text. For the Eighth edition Amanda Farmer and Mark Sears provided a thorough technical review and verification of the end-of-chapter materials. Robin Browning and Tomeika Williams did a thorough review of the CNOWv2 content. Andrea Meyer, the Content Developer from Cengage who helped to manage the timeline and development process for this edition. The comments from the following reviewers also influenced recent edition of the text as well as the current edition:

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Your comments and suggestions as you use this text are sincerely appreciated.

Carl S. Warren

About the Author

Carl S. Warren

Dr. Carl S. Warren is Professor Emeritus of Accounting at the University of Georgia, Athens. For over twenty-five years, Professor Warren has taught all levels of accounting classes. In recent years, Professor Warren has focused his teaching efforts on principles of accounting and auditing courses. Professor Warren has taught classes at the University of Iowa, Michigan State University, and University of Chicago. Professor Warren received his doctorate degree (PhD) from Michigan State University and his undergraduate (BBA) and master's (MA) degrees from the University of Iowa. During his career, Professor Warren published numerous articles in professional journals, including *The Accounting Review, Journal of Accounting Research, Journal of Accountancy, The CPA Journal,* and *Auditing: A Journal of Practice & Theory*. Professor Warren's outside interests include handball, skiing, hiking, fly-fishing, and golf. Professor Warren also spends time backpacking U.S. national parks (Yellowstone and the Grand Canyon), playing with his grandchildren, and riding ATVs and motorcycles.

Brief Contents

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Chapter 1

The Role of Accounting in Business

What's Covered:

Topics: The Role of Accounting in Business

Nature of Business
- Types of Business (Obj. 1)
- Forms of Business (Obj. 1)
- Business Strategies (Obj. 1)
- Business Stakeholders (Obj. 1)
- Business Activities (Obj. 2)

Role of Accounting
- Financial and Managerial Accounting (Obj. 3)
- Income Statement (Obj. 4)
- Statement of Changes in Stockholders' Equity (Obj. 4)
- Balance Sheet (Obj. 4)
- Statement of Cash Flows (Obj. 4)
- Accounting Concepts (Obj. 5)

Metric-Based Analysis
- Types of Analyses (Obj. 6)
- Return on Assets (Obj. 6)

Learning Objectives

Obj.1 Describe the types and forms of businesses, how businesses make money, and business stakeholders.

Obj.2 Describe the three business activities of financin , investing, and operating.

Obj.3 Define a counting and describe its role in business.

Obj.4 Describe and illustrate the basic financial statements and how they interrelate.

Obj.5 Describe eight accounting concepts underlying financial eporting.

Obj.6 Describe types of metrics and analyze a company's performance using return on assets.

Chapter Metrics

Use the following metrics to analyze transactions and financial st tements

TRANSACTIONS*

Liquidity: N/A

Profitability: N/A

FINANCIAL STATEMENTS

Return on Assets

* There are no transactions in this chapter.

LinkedIn

Evan Lorne/ Shutterstock.com

How much are you willing to pay for stock of a company that has never been traded on a public market? Investors must come up with an answer to this question for companies that offer stock to the public for the first time, which is called an *initial public offerin* .

In the United States, before such companies can offer stock for sale, they must file a prospectus (Form S-1) with the Securities and Exchange Commission. The prospectus includes background information on the company, including its business strategy and the range of prices that the stock is expected to sell for in the market. Also included in the prospectus are the company's financial st tements for the past three years.

LinkedIn Corporation (LNKD) offered its stock for sale to the public in May 2011. At that time, LinkedIn was the world's largest professional network on the Internet with more than 100 million members in over 200 countries. Members join the network free of cost and are able to create and manage their professional identity online. LinkedIn generates its revenues by offering premium services to its members and by selling services such as hiring and marketing solutions to businesses and professional organizations.

In its prospectus filed with the Securities and Exchange Commission in 2011, LinkedIn indicated that it anticipated a price for its stock of between $42.00 and $45.00 per share. On the first day the stock was publicly traded, LinkedIn's stock rose to a high of $122.70, more than two and a half times its highest anticipated price of $45.00. LinkedIn recently traded on the New York Exhange for over $135.

Is LinkedIn's stock really worth over $100 per share? To answer this question, investors analyze LinkedIn's financial condition and performance using public information, including its financial st tements.*

In this chapter, the nature, types, and activities of businesses, such as LinkedIn, are described and illustrated. In addition, the role of accounting in business, including financial statements, basic accounting concepts, and how to use metrics to evaluate a business's performance, are also described and illustrated.

* In June 2016 Microsoft and LinkedIn entered into an agreement in which Microsoft (MSFT) would acquire LinkedIn for $196 per share.

Objective 1
Describe the types and forms of businesses, how businesses make money, and business stakeholders.

Nature of Business and Accounting

A **business**[1] is an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers. Businesses come in all sizes, from a local coffee house to **Starbucks**, which sells over $19 billion of coffee and related products each year.

The objective of most businesses is to earn a profit. **Profit** is the difference between the amounts received from customers for goods or services and the amounts paid for the inputs used to provide the goods or services. In this text, we focus on businesses operating to earn a profit. However, many of the same concepts and principles also apply to not-for-profit organizations such as hospitals, churches, and government agencies.

Types of Businesses

Three types of businesses operated for profit include service, merchandising, and manufacturing businesses. Each type of business and some examples are described below.

Service businesses provide services rather than products to customers.

Delta Air Lines (transportation services)
The Walt Disney Company (entertainment services)

Merchandising businesses sell products they purchase from other businesses to customers.

Wal-Mart (general merchandise)
Amazon.com (books, music, videos)

1. A complete glossary of terms appears at the end of the text.

Manufacturing businesses change basic inputs into products that are sold to customers.
General Motors Corporation (cars, trucks, vans)
Dell Inc. (personal computers)

LinkedIn is a service business that provides value to its members by connecting them to people, knowledge, and opportunities to advance their careers.

LinkedIn Connection

Forms of Business

A business is normally organized in one of the following four forms:

- proprietorship
- partnership
- corporation
- limited liability company

A **proprietorship** is owned by one individual. More than 70% of the businesses in the United States are organized as proprietorships. The frequency of this form is due to the ease and low cost of organizing. The primary disadvantage of proprietorships is that the financial resources are limited to the individual owner's resources. In addition, the owner has unlimited liability to creditors for the debts of the company.

A **partnership** is owned by two or more individuals. About 10% of the businesses in the United States are organized as partnerships. Like a proprietorship, a partnership may outgrow the financial resources of its owners. Also, the partners have unlimited liability to creditors for the debts of the company.

A **corporation** is organized under state or federal statutes as a separate legal entity. The ownership of a corporation is divided into shares of stock. A corporation issues the stock to individuals or other companies, who then become owners or stockholders of the corporation. A primary advantage of the corporate form is the ability to obtain large amounts of resources by issuing shares of stock. In addition, the stockholders' liability to creditors for the debts of the company is limited to their investment in the corporation.

LinkedIn is organized as a corporation in Delaware even though its offices are in Mountain View, California. Many companies incorporate in Delaware because of its favorable legal and business environment.

LinkedIn Connection

A **limited liability company (LLC)** combines attributes of a partnership and a corporation. The primary advantage of the limited liability company form is that it operates similar to a partnership, but its owners' (or members') liability for the debts of the company is limited to their investment. Many professional practices such as, lawyers, doctors, and accountants are organized as limited liability companies.

In addition to the ease of formation, ability to raise capital, and liability for the debts of the business, other factors such as taxes and legal life of the business should be considered when forming a business. For example, corporations are taxed as separate legal entities, while the income of sole proprietorships, partnerships, and limited liability companies is passed through to the owners and taxed on the owners' tax returns. As separate legal entities, corporations also continue on, regardless of the lives of the individual owners. In contrast, sole proprietorships, partnerships, and limited liability companies may terminate their existence with the death of an individual owner.

The characteristics of sole proprietorships, partnerships, corporations, and limited liability companies are summarized below.

Organizational Form	Ease of Formation	Legal Liability	Taxation	Limitation on Life of Entity	Access to Capital
Proprietorship	Simple	No limitation	Nontaxable (pass-through) entity	Yes	Limited
Partnership	Simple	No limitation	Nontaxable (pass-through) entity	Yes	Average
Corporation	Complex	Limited liability	Taxable entity	No	Extensive
Limited Liability Company	Moderate	Limited liability	Nontaxable (pass-through) entity by election	Yes	Average

The three types of businesses we discussed earlier—manufacturing, merchandising, and service—may be proprietorships, partnerships, corporations, or limited liability companies. However, businesses that require a large amount of resources, such as many manufacturing businesses, are corporations. Likewise, most large retailers such as **Wal-Mart**, **Target**, and **Macy's** are corporations.

Because most large businesses are corporations, they tend to dominate the economic activity in the United States. For this reason, this text focuses on the corporate form of organization. However, many of the concepts and principles discussed also apply to proprietorships, partnerships, and limited liability companies.

How Do Businesses Make Money?

The objective of a business is to earn a profit by providing goods or services to customers. How does a company decide which products or services to offer its customers? Many factors influence this decision. Ultimately, however, the decision is based on how the company plans to gain an advantage over its competitors and, in doing so, maximize its profits.

Companies try to maximize their profits by generating high revenues while maintaining low costs, which results in high profits. However, a company's competitors are also trying to do the same, and thus, a company can only maximize its profits by gaining an advantage over its competitors.

Generally, companies gain an advantage over their competitors by using one of the following strategies:

- A **low-cost strategy**, where a company designs and produces products or services at a lower cost than its competitors. Such companies often sell no-frills, standardized products and services.
- A **premium-price strategy**, where a company tries to design and produce products or services that serve unique market needs, allowing it to charge premium prices. Such companies often design and market their products so that customers perceive their products or services as having a unique quality, reliability, or image.

Wal-Mart and **Southwest Airlines** are examples of companies using a low-cost strategy. **John Deere**, **Tommy Hilfiger**, and **BMW** are examples of companies using a premium-price strategy.

Since business is highly competitive, it is difficult for a company to sustain a competitive advantage over time. For example, a competitor of a company using a low-cost strategy may copy the company's low-cost methods or develop new methods that achieve even lower costs. Likewise, a competitor of a company using a premium-price strategy may develop products that are perceived as more desirable by customers.

Examples of companies utilizing low-cost and premium-price strategies include:

- Local pharmacies who develop personalized relationships with their customers. By doing so, they are able to charge premium (higher) prices. In contrast, Wal-Mart's pharmacies use the low-cost emphasis and compete on cost.
- Grocery stores such as **Kroger** and **Safeway** develop relationships with their customers by issuing preferred customer cards. These cards allow the stores to track consumer preferences and buying habits for use in purchasing and advertising campaigns.

- **Honda** promotes the reliability and quality ratings of its automobiles and thus charges premium prices. Similarly, **Volvo** promotes the safety characteristics of its automobiles. In contrast, **Kia** uses a low-cost strategy.
- **Harley-Davidson** emphasizes that its motorcycles are "Made in America" and promotes its "rebel" image as a means of charging higher prices than its competitors **Honda**, **Yamaha**, or **Suzuki**.

Companies sometimes struggle to find a competitive advantage. For example, **JCPenney** and **Macy's** have difficulty competing on low costs against **Wal-Mart**, **Kohl's**, **T.J. Maxx**, and **Target**. At the same time, JCPenney and Sears have difficulty charging premium prices against competitors such as **The Gap**, **Eddie Bauer**, and **Talbot's**. Likewise, **Delta Air Lines** and **United Airlines** have difficulty competing against low-cost airlines such as **Southwest**. At the same time, Delta and United don't offer any unique services for which their passengers are willing to pay a premium price.

Exhibit 1 summarizes low-cost and premium-price strategies with common examples of companies that employ each strategy.

Exhibit 1
Business Strategies and Industries

	Industry					
Business Strategy	**Airline**	**Freight**	**Automotive**	**Retail**	**Financial Services**	**Hotel**
Low cost	Southwest	Union Pacifi	Hyundai	Sam's Club	Ameritrade	Super 8
Premium price	Virgin Atlantic	FedEx	BMW	Talbot's	Morgan Stanley	Ritz-Carlton

LinkedIn Connection

LinkedIn's strategy is to be the premier online professional network that allows its members to be more productive and successful. It provides a free platform for members to manage their professional identify and engage in professional networks. To make money (monetize itself), it provides recruiting and marketing services to organizations and enterprises for a fee.

Business Stakeholders

A **business stakeholder** is a person or entity with an interest in the economic performance and well-being of a company. For example, owners, suppliers, customers, and employees are all stakeholders in a company.

Business stakeholders can be classified into one of the four categories illustrated in Exhibit 2.

Exhibit 2
Business Stakeholders

Business Stakeholder	Interest in the Business	Examples
Capital market stakeholders	Providers of major financing for the business	Banks, owners, stockholders
Product or service market stakeholders	Buyers of products or services and vendors to the business	Customers and suppliers
Government stakeholders	Collect taxes and fees from the business and its employees	Federal, state, and city governments
Internal stakeholders	Individuals employed by the business	Employees and managers

Capital market stakeholders provide the financing for a company to begin and continue its operations. Banks and other long-term creditors have an economic interest in receiving the amount loaned plus interest. Owners want to maximize the economic value of their investments.

Product or service market stakeholders purchase the company's products or services or sell their products or services to the company. Customers have an economic interest

in the continued success of the company. For example, customers who purchase advance tickets on **Delta Air Lines** are depending on Delta continuing in business. Likewise, suppliers depend on continued success of their customers. For example, if a customer fails or cuts back on purchases, the supplier's business will also decline.

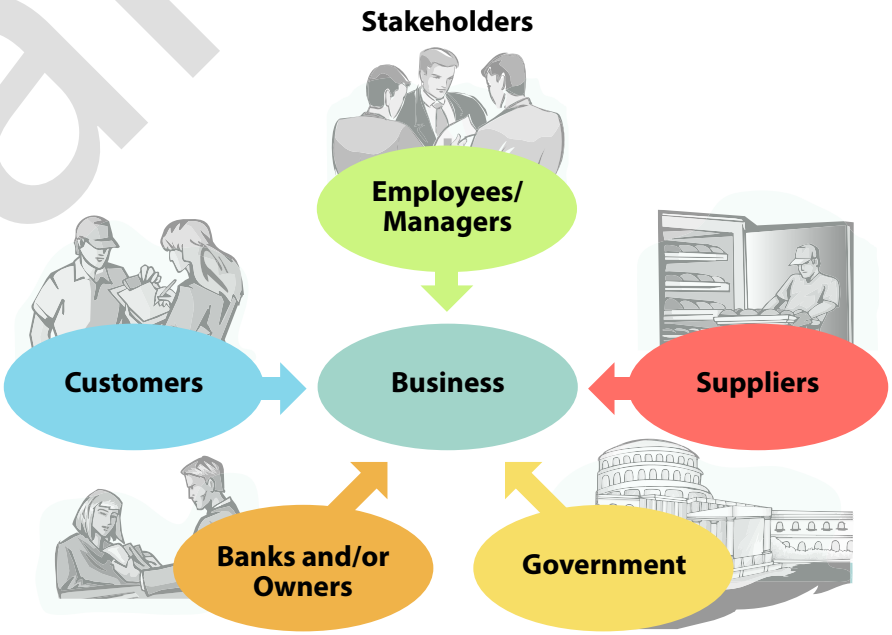
Government stakeholders, such as federal, state, county, and city governments, collect taxes from companies. The better a company does, the more taxes the government collects. In addition, workers who are laid off by a company can file claims for unemployment compensation, which results in a financial burden for the state and federal governments.

Internal stakeholders, such as managers and employees, depend upon the continued success of the company for keeping their jobs. Managers of companies that perform poorly are often fired by the owners. Likewise, during economic downturns companies often lay off workers. Stakeholders are illustrated in Exhibit 3.

LinkedIn Connection

LinkedIn's stakeholders include common stockholders, bondholders, network members, employees, and U.S. and state governments who receives taxes.

Exhibit 3
Business Stakeholders



Integrity, Objectivity, and Ethics in Business

The Hershey Trust Company

Milton Snavely Hershey founded **The Hershey Company** after serving as a candy apprentice in Philadelphia, running a failing candy shop, and finally succeeding at caramel making. Milton started The Hershey Company in the early 1900s after selling his caramel company.

Milton and his wife, Catherine, couldn't have children, and in 1909, they created the Milton Hershey School. After Catherine's death, Milton willed virtually his entire fortune, including his interest in The Hershey Company, to the School. Today, the School provides free education, meals, clothing, health care, and a home to almost 2,000 children in financial and social need. The School is run by The Hershey Trust Company, which is the largest shareholder of The Hershey Company.

Finnbarr Webster/Alamy Stock Photo

A public uproar was created in 2002 when the trustees of The Hershey Trust Company tried to sell their controlling stock interest in The Hershey Company. As a result of the public outcry, the majority of the trustees were forced to resign.

Source: Adapted from www.thehersheycompany.com.

Business Activities

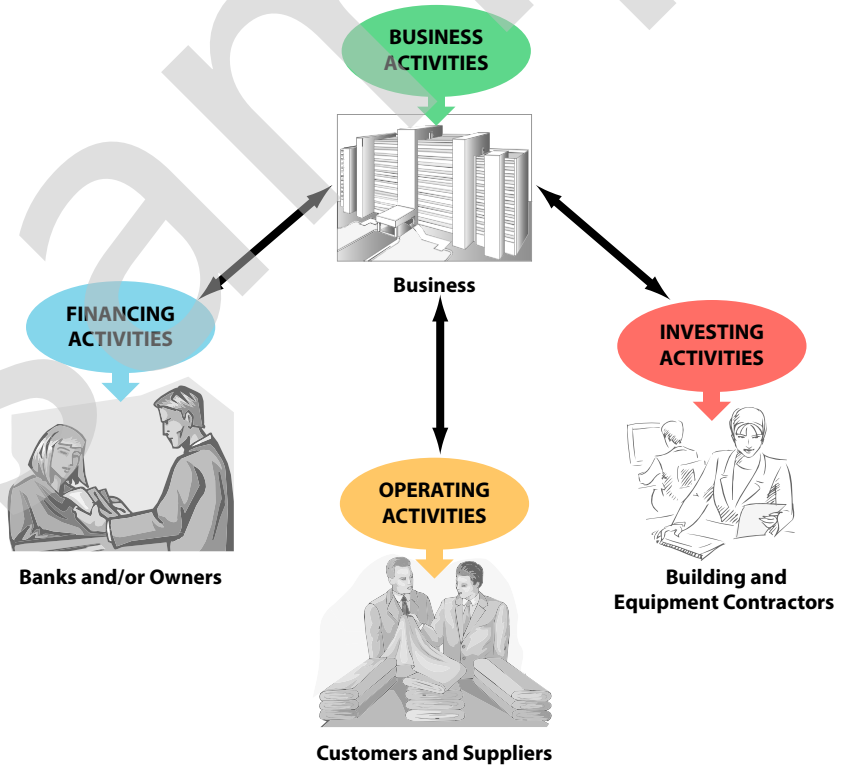
Objective 2
Describe the three business activities of financing, investing, and operating.

All companies engage in the following three business activities:

- **Financing activities** to obtain the necessary funds (monies) to organize and operate the company
- **Investing activities** to obtain assets such as buildings and equipment to begin and operate the company
- **Operating activities** to earn revenues and profits

The preceding business activities are illustrated in Exhibit 4.

Exhibit 4
Business Activities



Financing Activities

Financing activities involve obtaining funds to begin and operate a business. Companies obtain financing through the use of capital markets by:

- borrowing
- issuing shares of ownership

When a company borrows money, it incurs a liability. A **liability** is a legal obligation to repay the amount borrowed according to the terms of the borrowing agreement. When a company borrows from a vendor or supplier, the liability is called an **account payable**. In such cases, the company promises to pay according to the terms set by the vendor or supplier. Most vendors and suppliers require payment within a relatively short time, such as 30 days.

On a recent balance sheet, LinkedIn reported $100.3 million of accounts payable.

LinkedIn Connection

A company may also borrow money by issuing bonds. *Bonds* are sold to investors and require repayment normally with interest. The amount of the bonds, called the *face value*, usually requires repayment several years in the future. Thus, bonds are a form of long-term financing. The interest on the bonds, however, is normally paid semiannually. Bond obligations are reported as **bonds payable**, and any interest that is due is reported as **interest payable**.

Many companies borrow by issuing notes payable. A **note payable** requires payment of the amount borrowed plus interest. Notes payable are similar to bonds except that they may be issued on either a short-term or a long-term basis.

A company may finance its operations by issuing shares of ownership. For a corporation, shares of ownership are issued in the form of shares of stock. Although corporations may issue a variety of different types of stock, the basic type of stock issued to owners is called **common stock**.[2] Investors who purchase the stock are referred to as **stockholders**.

The claims of creditors and stockholders on the assets of a corporation are different. **Assets** are the resources owned by a corporation (company). Creditors have first claim on the company's assets. Only after the creditors' claims are satisfied do the stockholders have a right to the corporate assets.

Creditors normally receive timely payments, which may include interest. In contrast, stockholders are not entitled to regular payments. However, many corporations distribute earnings to stockholders on a regular basis. These distributions of earnings to stockholders are called **dividends**.

LinkedIn Connection

In a recent year, LinkedIn engaged in the financing a tivities of issuing bonds and stock.

Investing Activities

Investing activities involve using the company's assets to obtain additional assets to start and operate the business. Depending upon the nature of the business, a variety of different assets must be acquired.

Most businesses need assets such as machinery, buildings, computers, office furnishings, trucks, and automobiles. These assets have physical characteristics and as such are **tangible assets**. Long-term tangible assets such as machinery, buildings, and land are reported separately as property, plant, and equipment. Short-term tangible assets such as cash and inventories are reported separately.

A business may also need **intangible assets**. For example, a business may obtain patent rights to use in manufacturing a product. Long-term assets such as patents, goodwill, and copyrights are reported separately as intangible assets.

A company may also prepay for items such as insurance or rent. Such items, which are assets until they are consumed, are reported as **prepaid expenses**. In addition, rights to payments from customers who purchase merchandise or services on credit are reported as **accounts receivable**.

LinkedIn Connection

For a recent year, LinkedIn engaged in the investing activities of purchasing property and equipment as well as acquiring other companies, including Bizo, Inc. and Bright Media Corporation.

Operating Activities

Operating activities involve using assets to earn revenues and profits. The management of a company does this by implementing one of the business strategies discussed earlier.

2. Other types of stock are discussed in Chapter 8, "Liabilities and Stockholders' Equity."

Revenue is the increase in assets from selling products or services. Revenues are normally identified according to their source. For example, revenues received from selling products are called **sales**. Revenues received from providing services are called **fees earned**.

In a recent year, LinkedIn reported $2.2 billiion of revenue.

LinkedIn Connection

To earn revenue, a business incurs costs, such as wages of employees, salaries of managers, rent, insurance, advertising, freight, and utilities. Costs used to earn revenue are called **expenses** and are identified and reported in a variety of ways. For example, the cost of products sold is referred to as the **cost of goods sold, cost of merchandise sold, or cost of sales**. Other expenses are normally classified as either selling expenses or administrative expenses. **Selling expenses** include those costs directly related to the selling of a product or service. For example, selling expenses include such costs as sales salaries, sales commissions, freight, and advertising costs. **Administrative expenses** include other costs not directly related to the selling such as officer salaries and other costs of the corporate office.

By comparing the revenues for a period to the related expenses, it can be determined whether the company has earned net income or incurred a net loss. **Net income** results when revenues exceed expenses. A **net loss** results when expenses exceed revenues.

In a recent year, LinkedIn reported income from operations of $36.1 million and a net loss of $15.3 million after taxes.

LinkedIn Connection

As discussed next, the major role of accounting is to provide stakeholders with information on the financing, investing, and operating activities of businesses. Financial statements are one source of such information.

What Is Accounting and Its Role in Business?

Objective 3
Define accounting and describe its role in business.

The *role of accounting* is to provide information about the financing, investing, and operating activities of a company to its stakeholders. For example, accounting provides information for managers to use in operating the business. In addition, accounting provides information to other stakeholders, such as creditors, for assessing the economic performance and condition of the company.

Accounting is often called the "language of business." In a general sense, **accounting** is defined as an information system that provides reports to stakeholders about the economic activities and condition of a business. This text focuses on accounting and its role in business. However, many of the concepts discussed also apply to individuals, governments, and not-for-profit organizations. For example, individuals must account for their hours worked, checks written, and bills paid. Stakeholders for individuals include creditors, dependents, and the government.

A primary purpose of accounting is to summarize the financial performance of a business for external stakeholders, such as banks and governmental agencies. The branch of accounting that is associated with preparing reports for users external to the business is called **financial accounting**. Accounting also can be used to guide management in making financing, investing, and operations decisions for the company. This branch of accounting is called **managerial accounting**. Financial and managerial accounting may overlap. For example, financial reports for external stakeholders are often used by managers in assessing

the potential impact of their decisions on the company. The head of the accounting department in a company is called **comptroller** or **chief financial officer** (CFO).

LinkedIn Connection

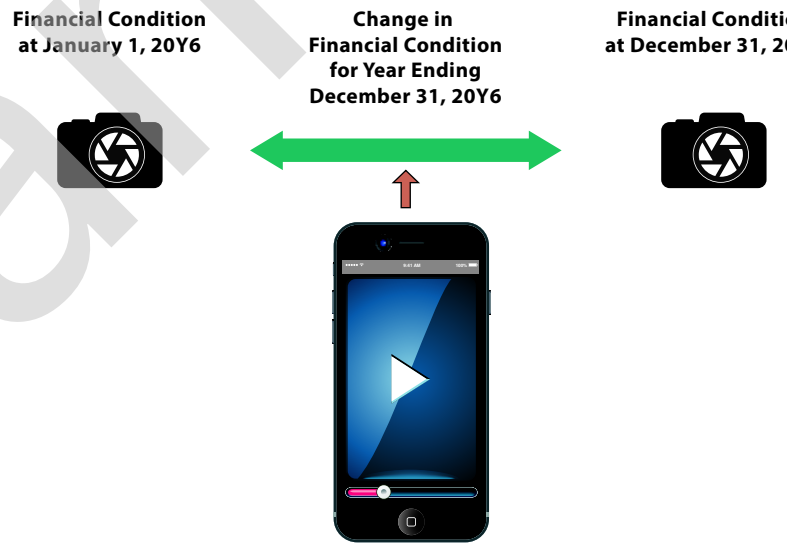
The chief financial officer (CFO) of LinkedIn is Steven J. Sordello (age 46), who earns a salary of $1 million.

The two major objectives of financial accounting are:

- To report the financial condition of a business at a point in time
- To report changes in the financial condition of a business over a period of time

The relationship between these two financial accounting objectives is shown in Exhibit 5.

Exhibit 5
Objectives of Financial Accounting



The first objective can be thought of as a still photograph (snapshot) of the company's financial (economic) condition as of a point in time. The second objective can be thought of as a moving picture (video) of the company's financial (economic) performance over time.

The objectives of accounting are achieved by (1) recording the economic events affecting a business and then (2) summarizing the impact of these events on the business in financial reports, called **financial statements**.

Objective 4
Describe and illustrate the basic financial statements and how they are integrated.

Financial Statements

Financial statements report the financial condition of a business at a point in time and changes in the financial condition over a period of time. The four basic financial statements and their relationship to the objectives of financial accounting are listed below.

Financial Statement	Financial Accounting Objective
Income Statement	Reports change in financial ondition
Statement of Stockholders' Equity	Reports change in financial ondition
Balance Sheet	Reports financial ondition
Statement of Cash Flows	Reports change in financial ondition

The order in which each financial statement is prepared and the nature of each statement is described below.

Order Prepared	Financial Statement	Description of Statement
1	Income Statement	A summary of the revenue and expenses for a specific pe iod of time, such as a month or a year.
2	Statement of Stockholders' Equity	A summary of the changes in the stockholders' equity in the corporation for a specific pe iod of time, such as a month or a year.
3	Balance Sheet	A list of the assets, liabilities, and stockholders' equity as of a specific d te, usually at the close of the last day of a month or a year.
4	Statement of Cash Flows	A summary of the cash receipts and cash payments for a specific pe iod of time, such as a month or a year.

The preceding four financial statements are described and illustrated in Exhibits 6 through 9 using **The Hershey Company (HSY)**. These illustrations will introduce you to the financial statements that you will be studying throughout this text. The data for the statements are adapted from a recent annual report of The Hershey Company.[3]

Income Statement

The **income statement** reports the change in financial condition due to the operations of the company. The time period covered by the income statement may vary depending upon the needs of stakeholders. Public corporations are required to file quarterly and annual income statements with the Securities and Exchange Commission (SEC). The income statement for a year ending December 31 for The Hershey Company is shown in Exhibit 6.

Since the objective of business operations is to generate revenues, the income statement begins by listing the revenues for the period. During the year, Hershey generated sales of $6,644 million. These sales are listed under "Revenues." The numbers shown in Exhibit 6 are expressed in millions of dollars. It is common for large companies to express their financial statements in thousands or millions of dollars.

Exhibit 6 Income Statement: The Hershey Company

The Hershey Company
Income Statement
For the Year Ended December 31 (in millions)

Revenues:		
Sales		$6,644
Expenses:		
Cost of sales	$3,784	
Selling and administrative expenses	1,704	
Interest expense	96	
Income taxes expense	354	
Other expenses	45	(5,983)
Net income		$ 661

3. The financial statements for Hershey shown in Exhibits 6–9 are for the year ended December 31, 2015. The most up to date statements may be found at http://www.sec.gov/edgar/searchedgar/companysearch.html, enter Hershey's stock market symbol HSY in the Fast Search box, enter 10-K in the Filing Type box, and click on the latest 10-K.

Following the revenues, the expenses used in generating the revenues are listed. For Hershey, these expenses include cost of sales, selling and administrative, interest, income taxes, and other expenses. By reporting the expenses and the related revenues for a period, the expenses are said to be matched against the revenues. This is known in accounting as the *matching concept*, which is discussed later in this chapter.

When revenues exceed expenses for a period, the company has *net income*. If expenses exceed revenues, the company has a *net loss*. Net income means that the business increased its net assets through its operations. That is, the assets created by the revenues exceeded the assets used in generating those revenues.

The objective of most companies is to maximize net income or profit. A net loss means that the business decreased its net assets through its operations. While a business might survive in the short run by reporting net losses, in the long run a business must earn net income to survive.

Exhibit 6 shows that Hershey earned net income of $661 million. Is this good or bad? Certainly, net income is better than a net loss. However, the stakeholders must assess net income according to their objectives. For example, a creditor might be satisfied that the net income is sufficient to ensure that it will be repaid. In contrast, a stockholder might assess the corporation's profitability as less than its competitors' profits and thus be disappointed. Throughout this text, various methods of assessing corporate performance will be described and illustrated.

Statement of Stockholders' Equity

The **statement of stockholders' equity** reports the changes in financial condition due to changes in stockholders' equity for a period. Changes to stockholders' equity normally involve common stock and retained earnings. **Retained earnings** are the portion of a corporation's net income retained in the business. A corporation may retain all of its net income for expanding operations, or it may pay a portion or all of its net income as dividends. For example, high-growth companies often do not distribute dividends but instead retain profits for future expansion. In contrast, more mature corporations normally pay a regular dividend.

LinkedIn Connection

LinkedIn has never paid a dividend and doesn't intend to in the foreseeable future. Instead, it retains all its income to use in the development of its operations.

Since retained earnings depend upon net income, the period covered by the statement of stockholders' equity is the same period as the income statement. The statement of stockholders' equity for Hershey for the year ended December 31 is shown in Exhibit 7.

Exhibit 7 Statement of Stockholders' Equity

The Hershey Company
Statement of Stockholders' Equity
For the Year Ended December 31 (in millions)

	Common Stock	Retained Earnings	Other Items	Total
Balances, January 1	$360	$4,708	$(4,188)	$ 880
Net income		661		661
Dividends		(341)		(341)
Other items			(152)	(152)
Balances, December 31	$360	$5,028	$(4,340)	$1,048

There was no change in common stock during the year. During the year, Hershey earned net income of $661 million and distributed (declared) dividends of $341 million. Thus, Hershey's retained earnings increased from $4,188 million to $4,340 million during the year. Dividends are reported in the statement of stockholders' equity rather than the income statement. This is because dividends are not an expense but a distribution of net income to stockholders.

Exhibit 7 includes a column for other equity items. Items in this category include paid-in capital (amounts contributed in excess of the par value of stock) and Treasury stock (repurchased common stock) that will be discussed in a later chapter.

Balance Sheet

The balance sheet reports the financial condition *as of a point in time*. This is in contrast to the income statement, statement of stockholders' equity, and statement of cash flows, which report changes in financial condition *for a period of time*. The financial condition of a business as of a point in time is measured by its total assets and claims or rights to those assets.

The claims on a company's assets consist of rights of creditors and stockholders. The rights of creditors are *liabilities*. The rights of stockholders are referred to as **stockholders' equity** or **owners' equity**. Thus, the financial condition of a business can be expressed in equation form as:

Assets = Liabilities + Stockholders' Equity

This equation is called the **accounting equation**. This equation is the foundation of accounting information systems, which are discussed in later chapters.

The **balance sheet**, sometimes called the **statement of financial condition**, is prepared using the accounting equation. The balance sheet is prepared by listing the accounting equation in vertical rather than horizontal form as follows:

Step 1. Each *asset* is listed and added to arrive at *total assets.*

Step 2. Each *liability* is listed and added to arrive at *total liabilities.*

Step 3. Each *stockholders' equity* item is listed and added to arrive at *total stockholders' equity.*

Step 4. Total liabilities and total stockholders' equity is added to arrive at *total liabilities and stockholders' equity.*

Step 5. Total assets must equal total liabilities and stockholders' equity.

The accounting equation must balance in Step 5; hence, the name balance sheet. The balance sheet for The Hershey Company as of December 31 is shown in Exhibit 8.

Exhibit 8 reports total assets of $4,754 million equal its total liabilities of $3,706 million plus its total stockholders' equity of $1,048 million.

Statement of Cash Flows

The **statement of cash flows** reports the change in financial condition due to the changes in cash during a period. The statement of cash flows is organized around the three business activities of financing, investing, and operating. Any changes in cash must be related to one or more of these activities.

The *net cash flows from operating activities* is reported first. This is because cash flows from operating activities is a primary focus of the company's stakeholders. In the short term, creditors use cash flows from operating activities to assess whether the company's operating activities are generating enough cash to repay them. In the long term, a company cannot survive unless it generates positive cash flows from operating activities. Thus, cash flows from operating activities is also a focus of employees, managers, suppliers, customers, and other stakeholders who are interested in the long-term success of the company.

The *net cash flows from investing activities* is reported second. This is because investing activities directly impact the operations of the company. Cash receipts from

Exhibit 8 Balance Sheet: The Hershey Company

The Hershey Company Balance Sheet December 31 (in millions)	
Assets	
Cash	$ 728
Accounts receivable	461
Inventories	633
Prepaid expenses	168
Property, plant, and equipment	1,674
Intangibles	803
Other assets	287
Total assets	$4,754
Liabilities	
Accounts payable	$ 442
Accrued liabilities	651
Notes and other debt	2,611
Income taxes payable	2
Total liabilities	$3,706
Stockholders' Equity	
Capital stock	$ 579
Retained earnings	5,028
Repurchased capital stock and other equity items	(4,559)
Total stockholders' equity	$1,048
Total liabilities and stockholders' equity	$4,754

selling property, plant, and equipment are reported in this section. Likewise, any purchases of property, plant, and equipment are reported as cash payments. Companies that are expanding rapidly, such as start-up companies, normally report negative net cash flows from investing activities. In contrast, companies that are downsizing or selling segments of the business may report positive net cash flows from investing activities.

The *net cash flows from financing activities* is reported third. Any cash receipts from issuing debt or stock are reported in this section as cash receipts. Likewise, cash payments of debt and dividends are reported in this section.

The statement of cash flows is completed by adding the net cash flows from operating, investing, and financing activities to determine the *net increase or decrease in cash* for the period. This net increase or decrease in cash is then added to the *cash at the beginning of the period* to arrive at the *cash at the end of the period.*

The statement of cash flows for The Hershey Company for the year ended December 31 is shown in Exhibit 9.

During the year, Hershey's *operating activities* generated a positive net cash flow of $1,095 million. Hershey's *investing activities* used $473 million of cash primarily to purchase property, plant, equipment, and other long-term assets. Hershey's *financing activities* used $587 million of cash. This cash was used to pay dividends of $341 million, pay debt of $115 million, and purchase $511 million of its own stock. A company may purchase its own common stock if the corporate management believes its stock is undervalued or for providing stock to employees or managers as part of an incentive (stock option) plan.[4] Hershey received cash of $380 million primarily by borrowing from creditors.

4. The accounting for a company's purchase of its own stock, termed treasury stock, is discussed in a later chapter.

Exhibit 9 Statement of Cash Flows: The Hershey Company

The Hershey Company
Statement of Cash Flows
For the Year Ended December 31 (in millions)

Net cash flows from operating activities		$1,095
Cash flows used in investing activities:		
Investments in property, plant, equipment, and other long-term assets	$ (473)	
Net cash flows used in investing activities		(473)
Cash flows from financing activities:		
Cash receipts from financing activities, including debt	$ 380	
Dividends paid to stockholders	(341)	
Repurchase of stock	(511)	
Other, including repayment of debt	(115)	
Net cash flows used in financing activities		(587)
Net increase in cash during year		$ 35
Cash as of January 1		693
Cash as of December 31		$ 728

During the year Hershey increased its cash by $35 million. This increase is added to the cash at the beginning of the period of $693 million to arrive at net cash at the end of the period of $728 million.

Overall, Hershey's statement of cash flows indicates that Hershey generated over $1,095 million in cash flows from its operations. It used this cash to expand its operations and pay dividends to stockholders. Thus, Hershey appears to be in a strong operating position.

Integrated Financial Statements

The financial statements are prepared in the following order:

1. income statement
2. statement of stockholders' equity
3. balance sheet
4. statement of cash flows

Preparing the financial statements in the preceding order is important because the financial statements are integrated as follows:[5]

1. The income statement and statement of stockholders' equity are integrated. The net income or net loss reported on the income statement also appears on the statement of stockholders' equity as either an addition (net income) to or deduction (net loss) from the beginning retained earnings.
2. The statement of stockholders' equity and the balance sheet are integrated. The common stock and retained earnings at the end of the period on the statement of stockholders' equity also appear on the balance sheet.
3. The balance sheet and statement of cash flows are integrated. The cash on the balance sheet also appears as the end-of-period cash on the statement of cash flows.

5. Depending upon the method of preparing cash flows from operating activities, net income may also appear on the statement of cash flows. This method of preparing the statement of cash flows is called the indirect method. This method is illustrated in a later chapter. In addition, Chapter 2 illustrates how cash flows from operating activities may equal net income.

To illustrate, The Hershey Company's financial statements in Exhibits 6 through 9 are integrated as follows:

1. *Net income* of $661 million is also reported on the statement of stockholders' equity as an addition to the beginning retained earnings.
2. *Retained earnings* of $5,028 million and common stock of $360 as of December 31 are also reported on the balance sheet.
3. *Cash* of $728 million on the December 31 balance sheet is also reported as the end-of-period cash on the statement of cash flows.

The preceding integrations are shown in Exhibit 10. These integrations are important in analyzing (1) financial statements and (2) the impact of transactions on the financial statements. In addition, these integrations serve as a check on whether the financial statements have been prepared correctly. For example, if the ending cash on the statement of cash flows doesn't agree with the balance sheet cash, then an error has occurred.

Exhibit 10 Integrated Financial Statements

The Hershey Company
Balance Sheet
December 31

Assets		=	Liabilities	+	Stockholders' Equity	
Cash	$ 728					
	•		•		•	
	•		•		$5,028	Retained Earnings
	•		•		360	Common Stock
	$4,754	=	$3,706	+	$1,048	

$4,754
Total Liabilities + Stockholders' Equity

The Hershey Company
Statement of Cash Flows
For the Year Ended Dec. 31

Operating act.	$1,095
Investing act.	(473)
Financing act.	(587)
Increase in cash	$ 35
Cash, Jan. 1	693
Cash, Dec. 31	$ 728

The Hershey Company
Income Statement
For the Year Ended Dec. 31

Revenues	$6,644
Expenses	(5,983)
Net income	$ 661

The Hershey Company
Statement of Stockholders' Equity
For the Year Ended Dec. 31

	Common Stock	Retained Earnings	Other Items	Total
Bal. Jan. 1	$360	$4,798	$(4,188)	$ 880
Net income		661		661
Dividends		(341)		(341)
Other items			(152)	(152)
Bal. Dec. 31	$360	$5,028	$(4,340)	$1,048

Objective 5
Describe eight accounting concepts underlying financial reporting.

Accounting Concepts

The four corporate financial statements described and illustrated in the preceding section were prepared using accounting "rules," called **generally accepted accounting principles (GAAP)**. Generally accepted accounting principles (GAAP) are necessary so

that stakeholders can compare companies across time. If the management of a company could prepare financial statements as they saw fit, the comparability between companies and across time would be impossible.

Accounting principles and concepts develop from research, accepted accounting practices, and pronouncements of regulators. Within the United States, the **Financial Accounting Standards Board (FASB)** has the primary responsibility for developing accounting principles. The FASB publishes *Statements of Financial Accounting Standards* as well as interpretations of these *Standards*.

The **Securities and Exchange Commission (SEC)**, an agency of the U.S. government, also has authority over the accounting and financial disclosures for corporations whose stock is traded and sold to the public. The SEC normally accepts the accounting principles set forth by the FASB. However, the SEC may issue *Staff Accounting Bulletins* on accounting matters that may not have been addressed by the FASB.

Many countries outside the United States use generally accepted accounting principles adopted by the **International Accounting Standards Board (IASB)**. The IASB issues *International Financial Reporting Standards (IFRS)*. Significant differences currently exist between FASB and IASB accounting principles. However, the FASB and IASB are working together to reduce and eliminate these differences towards the goal of developing a single set of accounting principles. Such a set of worldwide accounting principles would help facilitate investment and business in an increasingly global economy.

Generally accepted accounting principles (GAAP) rely upon eight supporting accounting concepts, as shown in Exhibit 11. Throughout this text, emphasis is on accounting principles and concepts. In this way, you will gain an understanding of "why" as well as "how" accounting is applied in business. Such an understanding is essential for analyzing and interpreting financial statements.

Business Entity Concept

The **business entity concept** limits the economic data recorded in an accounting system to data related to the activities of that company. In other words, the company is viewed as an entity separate from its owners, creditors, or other companies. For example, a company with one owner records the activities of only that company and does not record the personal activities, property, or debts of the owner. A business entity may take the form of a proprietorship, partnership, corporation, or limited liability company (LLC).

To illustrate, the accounting for The Hershey Company, a corporation, is separate from the accounting of its stakeholders. In other words, the accounting for transactions and events of individual stockholders, creditors, or other Hershey stakeholders is not included in The Hershey Company's financial statements. Only the transactions and events of the corporation are included.

International Connection

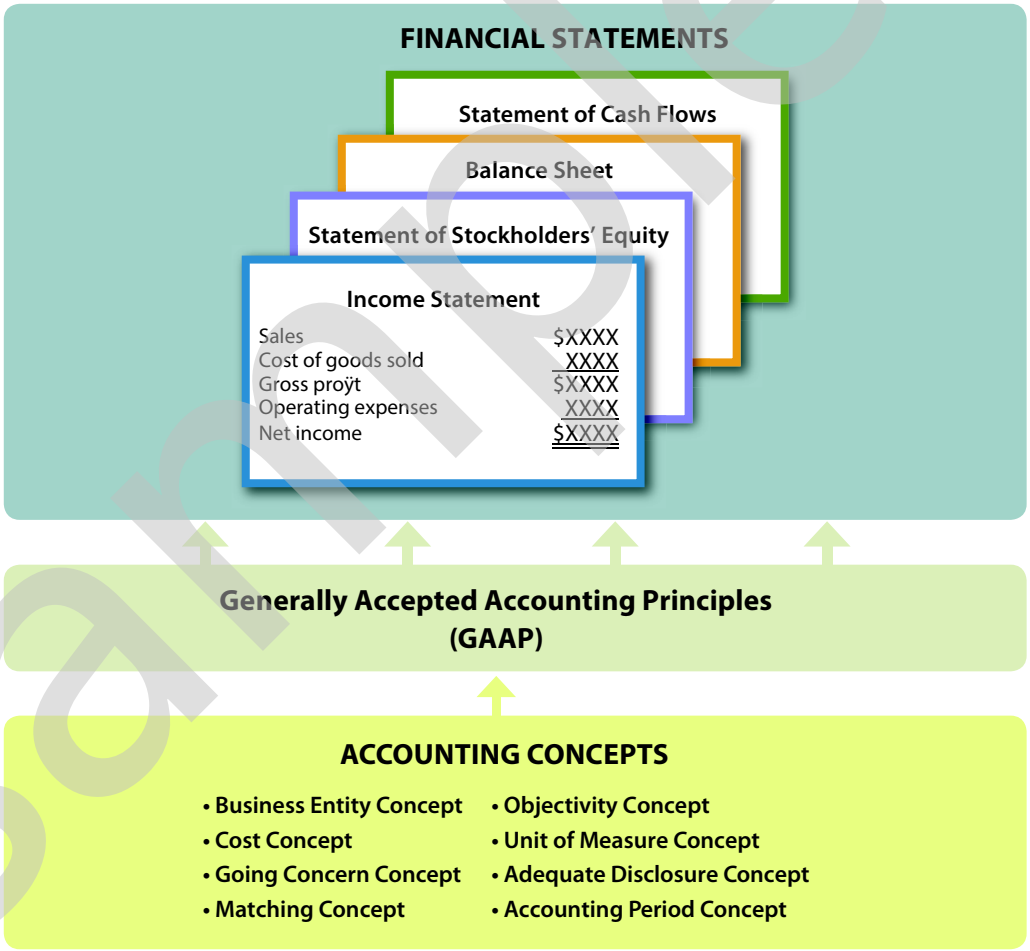
Adoption or Convergence?

The largest public accounting firms, known as the Big Four, have pushed for the "adoption" of IFRS in the United States within a relatively short period of time. Such a strategy of adoption would generate millions of dollars of consulting and accounting work within the U.S. for the Big Four: Deloitte Touche Tohmatsu, PwC (PriceWaterhouseCoopers), Ernst & Young, and KPMG.

In contrast, others have argued for a strategy of gradual "convergence" to IFRS over time. Currently, it appears that regulators within the United States and the FASB are favoring convergence rather than adoption. For example, the FASB and IASB have completed several projects to converge U.S. and IFRS standards.[1]

1. FASB.org, "Progress Report on IASB-FASB Convergence Work," April 21, 2011.

Exhibit 11
Accounting Principles and Concepts



Cost Concept

The **cost concept** initially records assets in the accounting records at their cost or purchase price. To illustrate, assume that Aaron Publishers purchased the following land on August 3, 20Y4, for $150,000:

Price listed by seller on March 1, 20Y4	$160,000
Aaron Publishers' initial offer to buy on January 31, 20Y4	140,000
Estimated selling price on December 31, 20Y8	220,000
Assessed value for property taxes, December 31, 20Y8	190,000

Under the cost concept, Aaron Publishers records the purchase of the land on August 3, 20Y4, at the purchase price of $150,000. The other amounts listed above have no effect on the accounting records.

The fact that the land has an estimated selling price of $220,000 on December 31, 20Y8, indicates that the land has increased in value. However, to use the $220,000 in the accounting records would be to record an illusory or unrealized profit. If Aaron Publishers sells the land on January 9, 20Y9, for $240,000, a profit of $90,000 ($240,000 − $150,000) is then realized and recorded. The new owner would record $240,000 as its cost of the land.

Going Concern Concept

The **going concern concept** assumes that a company will continue in business indefinitely. This assumption is made because the amount of time that a company will continue in business is not known.

The going concern concept justifies the use of the cost concept for recording purchases, such as land. For example, in the preceding illustration Aaron Publishers plans to build a plant on the land. Since Aaron Publishers does not plan to sell the land, reporting changes in the market value of the land is irrelevant. That is, the amount Aaron Publishers could sell the land for if it went out of business is not important. This is because Aaron Publishers plans to continue its operations.

If, however, there is strong evidence that a company is planning on discontinuing its operations, then the accounting records are revised. To illustrate, the assets and liabilities of businesses in receivership or bankruptcy are valued from a quitting concern or liquidation point of view, rather than from the going concern point of view.

Matching Concept

The **matching concept** reports the revenues earned by a company for a period with the expenses incurred in generating the revenues. That is, expenses are *matched* against the revenues they generated.

Revenues are normally recorded at the time a product is sold or a service is rendered, which is referred to as the **revenue recognition principle**. At the point of sale, the sale price has been agreed upon, the buyer acquires ownership of the product or acquires the service, and the seller has a legal claim against the buyer for payment.

The expenses incurred in generating revenue should be reported in the same period as the related revenue. This is called the **expense recognition principle**. By matching revenues and expenses, net income or loss for the period can properly be determined and reported.

LinkedIn recognizes (records) revenue when (1) evidence of a contract exists, (2) delivery of a product or services has been provided to the customer, (3) the fee is fi ed or determinable, and (4) the fee is reasonably collectible.

LinkedIn Connection

Objectivity Concept

The **objectivity concept** requires that entries in the accounting records and the data reported on financial statements be based on verifiable or objective evidence. For example, invoices, bank statements, and a physical count of supplies on hand are all objective and verifiable. Thus, they can be used for entering amounts in the accounting system. In some cases, judgments, estimates, and other subjective factors may have to be used in preparing financial statements. In such situations, the most objective evidence available is used.

Unit of Measure Concept

In the United States, the **unit of measure concept** requires that all economic data be recorded in dollars. Other relevant, nonfinancial information may also be recorded, such as terms of contracts. However, it is only through using dollar amounts that the various transactions and activities of a business can be measured, summarized, reported, and compared. Money is common to all business transactions and thus is the unit of measurement for financial reporting.

Adequate Disclosure Concept

The **adequate disclosure concept** requires that the financial statements, including related notes, contain all relevant data a stakeholder needs to understand the financial condition and performance of the company. Nonessential data are excluded to avoid clutter.

Accounting Period Concept

The **accounting period concept** requires that accounting data be recorded and summarized in financial statements for periods of time. For example, transactions are recorded for a period of time such as a month or a year. The accounting records are then summarized and updated before preparing the financial statements.

The financial history of a company may be shown by a series of balance sheets and income statements. If the life of a company is expressed by a line moving from left to right, the financial history of the company may be graphed as shown in Exhibit 12.

Exhibit 12 Financial History of a Company

Responsible Reporting

The reliability of the financial reporting system is important to the economy and for the ability of businesses to raise money from investors. That is, stockholders and creditors require accurate financial reporting before they will invest their money. Scandals and financial reporting frauds threaten the confidence of investors. Exhibit 13 is a list of some financial reporting frauds and abuses.

The companies listed in Exhibit 13 were caught in the midst of ethical lapses that led to fines, firings, and criminal or civil prosecution. The second column of Exhibit 13 identifies the accounting concept that was violated in committing these unethical business practices. For example, the **WorldCom** fraud involved reporting various expense items as though they were assets. This is a violation of the matching concept and resulted in overstating income and assets. The third column of the exhibit identifies some of the results of these events. In most cases, senior and mid-level executives lost their jobs and were sued by upset stakeholders. In some cases, the executives also were criminally prosecuted and are serving prison terms.

Integrity, Objectivity, and Ethics in Business

Doing the Right Thing

Time magazine named three women as "Persons of the Year 2002." Each of these not-so-ordinary women had the courage, determination, and integrity to do the right thing. Each risked their personal careers to expose shortcomings in their organizations. Sherron Watkins, an **Enron** vice president, wrote a letter to Enron's chairman, Kenneth Lay, warning him of improper accounting that eventually led to Enron's collapse. Cynthia Cooper, an internal accountant, informed **WorldCom**'s Board of Directors of phony accounting that allowed WorldCom to cover up over $3 billion in losses and forced WorldCom into bankruptcy. Coleen Rowley, an FBI staff attorney, wrote a memo to FBI Director Robert Mueller, exposing how the Bureau brushed off her pleas to investigate Zacarias Moussaoui, who was indicted as a co-conspirator in the September 11 terrorist attacks.

Exhibit 13 Accounting Frauds

Company	Concept Violated	Result
Adelphia	*Business Entity Concept:* Rigas family treated the company assets as their own.	Bankruptcy. Rigas family members convicted of fraud and lost their investment in the company.
AIG	*Business Entity Concept:* Compensation transactions with an off-sho e company that should have been disclosed on AIG's books.	CEO (Chief Executive Officer) resigned. AIG paid out $126 million in fine .
AOL and PurchasePro	*Matching Concept:* Back-dated contracts to infl te revenues.	Civil charges filed against senior xecutives of both companies. Fined $500 million.
Computer Associates	*Matching Concept:* Fraudulently infl ting revenues.	CEO and senior executives indicted. Five executives pled guilty. Fined $225 million.
Enron	*Business Entity Concept:* Treated transactions as revenue, when they should have been treated as debt.	Bankruptcy. Criminal charges against senior executives. Over $60 billion in stock market losses.
Fannie Mae	*Accounting Period Concept:* Managing earnings by shifting expenses between periods.	CEO and CFO fi ed. $9 billion in restated earnings.
HealthSouth	*Matching Concept:* $4 billion in false entries to overstate revenues.	Senior executives faced regulatory and civil charges.
Quest	*Matching Concept:* Improper recognition of $3 billion in revenue.	CEO and six other executives charged with "massive financial f aud." Fined $250 million by SEC.
Tyco	*Adequate Disclosure Concept:* Failure to disclose secret loans to executives that were subsequently forgiven.	CEO forced to resign and was convicted in criminal proceedings.
WorldCom	*Matching Concept:* Improperly treated expenses as assets.	Bankruptcy. Criminal conviction of CEO and CFO. Over $100 billion in stock market losses. Directors fined $18 million
Xerox	*Matching Concept:* Recognized $3 billion in revenue in periods earlier than should have been recognized.	Fined $10 million by SEC. Six executives fined $22 million.

What went wrong for the managers and companies listed in Exhibit 13? The answer normally involved one or both of the following factors:

- *Failure of Individual Character*. Ethical managers and accountants are honest and fair. However, managers and accountants often face pressures from supervisors to meet company and investor expectations. In many of the cases in Exhibit 13, managers and accountants justified small ethical violations to avoid such pressures. However, these small violations became big violations as the company's financial problems became worse.
- *Culture of Greed and Ethical Indifference*. By their behavior and attitude, senior managers set the company culture. In most of the companies listed in Exhibit 13, the senior managers created a culture of greed and indifference to the truth.

Ponzi Schemes

Business Insight

A Ponzi scheme is a scam or fraudulent operation where to attract investors an individual or entity promises high returns with little or no risk. To meet their claims, the perpetrators (fraudsters) pay early investors with monies obtained from attracting new investors. To succeed, a Ponzi scheme requires a constant stream of money from new investors. Eventually, Ponzi schemes become so large that they collapse. One of the most recent Ponzi schemes was perpetrated by Bernard Madoff, who admitted to defrauding clients of up to $50 billion over a number of years. He is serving a sentence of 150 years in prison.

As a result of accounting and business frauds, the United States Congress passed laws to monitor the behavior of accounting and business. For example, the Sarbanes-Oxley Act of 2002 (SOX) was enacted. SOX established a new oversight body for the accounting profession called the Public Company Accounting Oversight Board (PCAOB). In addition, SOX established standards for independence, corporate responsibility, and disclosure.

How does one behave ethically when faced with financial or other types of pressure? Guidelines for behaving ethically are shown in Exhibit 14.

Exhibit 14
Guidelines for Ethical Conduct

1. Identify an ethical decision by using your personal ethical standards of honesty and fairness.
2. Identify the consequences of the decision and its effect on others.
3. Consider your obligations and responsibilities to those that will be affected by your decision.
4. Make a decision that is ethical and fair to those affected by it.

Many companies have ethical standards of conduct for managers and employees. In addition, the Institute of Management Accountants and the American Institute of Certified Public Accountants have professional codes of conduct.

Objective 6
Describe types of metrics and analyze a company's performance using return on assets.

Metric-Based Analysis: Return on Assets

In analyzing and assessing a company's financial condition and performance, a variety of quantitative measures may be used. Quantitative measures are referred to as **metrics**. Throughout this text, we use a variety of metrics to assess a company's financial condition and performance. In addition, the effects of management's decisions on metrics are also described and illustrated. We call this use of metrics to assess financial condition, performance, and decisions **metric-based analysis**.

Types of Metrics

The two basic types of metrics used in this text are ratios and amounts. For example, the return on assets ratio is described and illustrated in this chapter. An example of a metric amount is passenger miles flown by an airline or grade point average of a student.

LinkedIn Connection

Some ratio metrics that LinkedIn uses to assess its performance include its price to earnings ratio (common stock price divided by earnings per share) and net revenue growth rate. Some of its amount metrics include number of registered members and number of member page views.

Level of Application

We apply metric analysis at the following three levels:

1. Financial statement level
2. Transaction level
3. Managerial decision level

Financial statement level. Metric-based analysis is commonly applied at the financial statement level. At this level, various financial ratios are computed and analyzed. In the next section, we apply metric-based analysis at the financial statement level using the ratio return on assets (net income divided by average total assets).

Transaction level. We also apply metric-based analysis at the transaction level. When a company enters into a transaction, it changes the company's assets, liabilities, and stockholders' equity. Since we assume companies operate to maximize their profits, we assess the effects of a transaction on one or more of a company's profitability metrics.

Companies also attempt to maintain a minimum degree of liquidity so they can pay their liabilities and respond quickly to new opportunities to expand or enhance their operations. **Liquidity** refers to the degree to which a company has cash or assets that can be readily converted to cash. For example, investments in marketable securities can readily be converted to cash. In contrast, property, plant, and equipment are less liquid and could take months or years to convert to cash.

Liquidity differs from solvency. **Solvency** refers to the ability of a company to pay its long-term debts. Companies that cannot pay their debts are said to be insolvent, which usually involves filing for bankruptcy. Liquidity affects a company's ability to pay its debts. However, a company may have a large portion of assets that cannot be readily converted to cash but still be profitable and solvent.

In addition to assessing the effects of a transaction on one or more of a company's profitability metrics, we also assess the effects on one or more of a company's liquidity metrics. In Chapter 2, we begin our metric-based analysis of transactions by assessing the effects of each transaction on cash and net income. In later chapters, we expand this analysis to include a variety of profitability and liquidity metrics.

Managerial decision level. In the managerial chapters of this text, metric-basis analysis assesses the effects of decisions on a variety of operating metrics. For example, a managerial decision to increase selling prices (assuming no decrease in units sold) would decrease its break-even point, which is the level at which operations may neither profit nor experience a loss. In this case, the metric being assessed is the break-even point.

Return on Assets

In the remainder of this chapter, we describe and illustrate metric-based analysis at the financial statement level using return on assets. The return on assets is a profitability metric often used to compare a company's performance over time and with competitors.

Return on assets is normally expressed as a percent such as 12%. However, it may also be expressed as an amount per dollar invested. For example, a 12% return on assets could also be expressed as $0.12 return per $1 invested. In other words, the company is earning 12 cents per dollar invested.

The **return on assets** percentage is computed as follows:

$$\textbf{Return on Assets} = \frac{\textbf{Net Income}}{\textbf{Average Total Assets}}$$

To illustrate, return on assets is computed for **Apple Inc. (AAPL)** and **HP Inc. (HPQ)** (formerly **Hewlett-Packard)**. The computations use data (in millions) from recent financial statements.

	Apple Inc.	HP Inc.
Net income	$ 53,394	$ 5,013
Total assets at beginning of year	$231,839	$105,676
Total assets at end of year	$290,479	$103,206
Average total assets:		
Apple Inc. [($231,839 + $290,479) ÷ 2]	$261,159	
HP Inc. [($105,676 + $103,206) ÷ 2]		$104,441
Return on assets:*		
Apple Inc. ($53,394 ÷ $261,159)	20.4%	
HP Inc. ($5,013 ÷ $104,441)		4.8%

* Rounded to one decimal place.

As shown above, Apple is over 4 (20.4% ÷ 4.8%) times more profitable, as measured by return on assets, than is HP Inc. Apple's profitability is largely due to its innovative technology, including its iPad, iPhone, iPod, and Mac computers.

Comparing rates of return among companies that use different tax strategies or different methods of financing their operations may be misleading. In the case of companies using different tax strategies, tax expense may be added to net income to reduce the impact of taxes. Likewise, some companies finance their operations primarily by debt, while other companies finance their operations primarily by equity. In this case, interest expense may be added to net income to reduce the impact of differences in financing.

Key Points

1. Describe the types and forms of businesses, how businesses make money, and business stakeholders.

The three types of businesses operated for profit include manufacturing, merchandising, and service businesses. Such businesses may be organized as proprietorships, partnerships, corporations, and limited liability companies. A business may make money (profits) by gaining an advantage over its competitors using a low-cost or a premium-price emphasis. Under a *low-cost emphasis*, a business designs and produces products or services at a lower cost than its competitors. Under a *premium-price emphasis*, a business tries to design products or services that possess unique attributes or characteristics for which customers are willing to pay more. A business' economic performance is of interest to its stakeholders. Business stakeholders include four categories: capital market stakeholders, product or service market stakeholders, government stakeholders, and internal stakeholders.

2. Describe the three business activities of financing, investing, and operating.

All businesses engage in financing, investing, and operating activities. Financing activities involve obtaining funds to begin and operate a business. Investing activities involve obtaining the necessary resources to start and operate the business. Operating activities involve using the business's resources according to its business emphasis.

3. Define accounting and describe its role in business.

Accounting is an information system that provides reports to stakeholders about the economic activities and condition of a business. Accounting is the "language of business."

4. Describe and illustrate the basic financial statements and how they interrelate.

The principal financial statements of a corporation are the income statement, the statement of stockholders' equity, the balance sheet, and the statement of cash flows. The income statement reports a period's net income or net loss, which also appears on the statement of stockholders' equity. The ending reported on the statement of stockholders' equity is also reported on the balance sheet. The ending cash balance is reported on the balance sheet and the statement of cash flows.

5. Describe eight accounting concepts underlying financial reporting.

The eight accounting concepts discussed in this chapter include the business entity, cost, going concern, matching, objectivity, unit of measure, adequate disclosure, and accounting period concepts.

6. Describe types of metrics and analyze a company's performance using return on assets.

A metric is any quantitative measure. Metric analysis may be performed at the financial statement, transaction, or managerial decision level. At the financial statement level, return on assets is computed by dividing net income by average total assets. Return on assets is useful in assessing the percentage (rate) that a company is earnings on its invested assets. Return on assets can also be expressed as dollars earned for each dollar invested.

Key Terms

Accounting (9)
Accounting equation (13)
Accounting period concept (20)
Accounts payable (7)
Accounts receivable (8)
Adequate disclosure concept (19)
Administrative expenses (9)
Assets (8)
Balance sheet (13)
Bonds payable (8)
Business (2)
Business entity concept (17)
Business stakeholder (5)
Chief financial officer (10)
Common stock (8)
Comptroller (10)
Corporation (3)
Cost concept (18)
Cost of goods sold (9)
Cost of merchandise sold (9)
Cost of sales (9)
Dividends (8)
Expenses (9)
Expense recognition principle (19)
Fees earned (9)
Financial accounting (9)
Financial Accounting Standards Board (FASB) (17)
Financial statements (10)
Financing activities (7)
Generally accepted accounting principles (GAAP) (16)
Going concern concept (18)
Income statement (11)
Intangible assets (8)
Interest payable (8)
International Accounting Standards Board (IASB) (17)
Investing activities (7)
Liabilities (7)
Limited liability company (LLC) (3)
Liquidity (23)
Low-cost strategy (4)
Managerial accounting (9)
Manufacturing business (3)
Matching concept (19)
Merchandising business (2)
Metric (22)
Metric-based analysis (22)
Net income (9)
Net loss (9)
Note payable (8)
Objectivity concept (19)
Operating activities (7)
Owner's equity (13)
Partnership (3)
Premium-price strategy (4)
Prepaid expenses (8)
Profit (2)
Proprietorship (3)
Retained earnings (12)
Return on assets (23)
Revenue (9)
Revenue recognition principle (19)
Sales (9)
Securities and Exchange Commission (SEC) (17)
Selling expenses (9)
Service business (2)
Solvency (23)
Statement of cash flows (13)
Statement of financial condition (13)
Statement of stockholders' equity (12)
Stockholders (8)
Stockholders' equity (13)
Tangible assets (8)
Unit of measure concept (19)

Illustrative Problem

The financial statements at the end of Spratlin Consulting's first month of operations follow.

SPRATLIN CONSULTING
Income Statement
For the Month Ended June 30, 20Y8

Fees earned		$ 36,000
Operating expenses:		
Wages expense	$12,000	
Rent expense	7,640	
Utilities expense	(a)	
Miscellaneous expense	1,320	
Total operating expenses		(23,120)
Net income		$ (b)

SPRATLIN CONSULTING
Statement of Stockholders' Equity
For the Month Ended June 30, 20Y8

	Common Stock	Retained Earnings
Balances, June 1, 20Y8	$ 0	$ 0
Issued common stock	48,000	
Net income		(c)
Dividends		(d)
Balances, June 30, 20Y8	$48,000	$(e)

SPRATLIN CONSULTING
Balance Sheet
June 30, 20Y8

Assets	
Cash	$ 5,600
Land	50,000
Total assets	$ (f)
Liabilities	
Accounts payable	$ 1,920
Stockholders' Equity	
Common stock	$ (g)
Retained earnings	(h)
Total stockholders' equity	$ (i)
Total liabilities and stockholders' equity	$ (j)

SPRATLIN CONSULTING
Statement of Cash Flows
For the Month Ended June 30, 20Y8

Cash flows from operating activities:		
Cash received from customers	$36,000	
Cash paid for operating expenses	(k)	
Net cash flows from operating activities		$14,800
Cash flows from investing activities:		
Cash paid for acquisition of land		(l)
Cash flows from financing activities:		
Cash received from issuing common stock	$48,000	
Dividends paid to stockholders	(7,200)	
Net cash flows from financing activities		(m)
Net increase in cash during month		$ (n)
Cash as of June 1		0
Cash as of June 30		$ (n)

Instructions

By analyzing how the four financial statements are integrated, determine the proper amounts for (a) through (n).

Solution

a. Utilities expense, $2,160 ($23,120 − $12,000 − $7,640 − $1,320)
b. Net income, $12,880 ($36,000 − $23,120)
c. Net income, $12,880 [same as (b)]
d. Dividends, $(7,200) (from statement of cash flows)
e. Retained earnings, $5,680 ($12,880 − $7,200)
f. Total assets, $55,600 ($5,600 + $50,000)
g. Common stock, $48,000 (from the statement of stockholders' equity or statement of cash flows)
h. Retained earnings, $5,680 [same as (e)]
i. Total stockholders' equity, $53,680 ($48,000 + $5,680)
j. Total liabilities and stockholders' equity, $55,600 ($1,920 + $53,680) [same as (f)]

k. Cash payments for operating expenses, $21,200 ($36,000 − $14,800)
l. Cash payments for acquisition of land, $50,000 (from balance sheet)
m. Net cash flows from financing activities, $40,800 ($48,000 − $7,200)
n. Net increase in cash and June 30, 20Y8, cash balance, $5,600 ($14,800 − $50,000 + $40,800)

Self-Examination Questions

(Answers appear at the end of chapter.)

1. A profit-making business operating as a separate legal entity and in which ownership is divided into shares of stock is known as a:
   A. proprietorship.
   B. service business.
   C. partnership.
   D. corporation.
2. The resources owned by a business are called:
   A. assets.
   B. liabilities.
   C. the accounting equation.
   D. stockholders' equity.
3. A listing of a business entity's assets, liabilities, and stockholders' equity as of a specific date is:
   A. a balance sheet.
   B. an income statement.
   C. a statement of changes in stockholders' equity.
   D. a statement of cash flows.
4. If total assets are $20,000 and total liabilities are $12,000, the amount of stockholders' equity is:
   A. $32,000.
   B. $(32,000).
   C. $(8,000).
   D. $8,000.
5. If revenue was $45,000, expenses were $37,500, and dividends were $10,000, the amount of net income or net loss would be:
   A. $45,000 net income.
   B. $7,500 net income.
   C. $37,500 net loss.
   D. $2,500 net loss.

Class Discussion Questions

1. What is the objective of most businesses?
2. What is the difference between a manufacturing business and a merchandising business? Give an example of each type of business.
3. What is the difference between a manufacturing business and a service business? Is a restaurant a manufacturing business, a service business, or both?
4. Why are most large companies like **Apple**, **Pepsi**, **General Electric**, and **Intel** organized as corporations?
5. Both **KIA** and **BMW** produce and sell automobiles. Describe and contrast the business emphasis of KIA and BMW.
6. Assume that a friend of yours operates a family-owned pharmacy. A super **Wal-Mart**, scheduled to open in the next several months, will also offer pharmacy services. What business emphasis would your friend use to compete with the Super Walmart pharmacy?
7. What services does **eBay** offer its customers?
8. A business's stakeholders can be classified into capital market, product or service market, government, and internal stakeholders. Will the interests of all the stakeholders within a classification be the same? Use bankers and stockholders of the capital market as an example in answering this question.

9. The three business activities are financing, investing, and operating. Using **Southwest Airlines**, give an example of each type of activity.
10. What is the role of accounting in business?
11. Briefly describe the nature of the information provided by each of the following financial statements: the income statement, the statement of stockholders' equity, the balance sheet, and the statement of cash flows. In your descriptions, indicate whether each of the financial statements covers a period of time or is for a specific date.
12. For a recent year ending January 31, **Target Corporation** had revenues of $72,618 million and total expenses of $74,254 million. Did Target Corporation report a net loss or a net income?
13. What particular item of financial or operating data appears on both the income statement and the statement of stockholders' equity? What items appear on both the balance sheet and the statement of stockholders' equity? What item appears on both the balance sheet and statement of cash flows?
14. Billy Jessop is the owner of Valley Delivery Service. Recently, Billy paid interest of $6,000 on a personal loan of $75,000 that he used to begin the business. Should Valley Delivery Service record the interest payment? Explain.
15. On October 1, Wok Repair Service extended an offer of $100,000 for land that had been priced for sale at $150,000. On December 19, Wok Repair Service accepted the seller's counteroffer of $110,000. Describe how Wok Repair Service should record the land.
16. Land with an assessed value of $500,000 for property tax purposes is acquired by a business for $600,000. Four years later, the plot of land has an assessed value of $750,000 and the business receives an offer of $975,000 for it. Should the monetary amount assigned to the land in the business records now be increased?

Exercises

Obj. 1

E1-1 Types of businesses

Indicate whether each of the following companies is primarily a service, merchandise, or manufacturing business. If you are unfamiliar with the company, you may use the Internet to locate the company's home page or use the finance Web site of Yahoo.com.

1. AFLAC
2. Best Buy
3. Boeing
4. Caterpillar
5. Citigroup
6. CVS Caremark
7. Dow Chemical
8. Exxon Mobil
9. Facebook
10. Ford Motor
11. General Electric
12. Hilton Hotels
13. H&R Block Inc.
14. Oracle
15. Target

Obj. 1

E1-2 Business emphasis

Identify the primary business emphasis of each of the following companies as (a) a low-cost emphasis or (b) a premium-price emphasis. If you are unfamiliar with the company, you may use the Internet to locate the company's home page or use the finance Web site of Yahoo.com.

1. Allegiant Travel Services
2. Best Buy
3. BMW
4. Dollar Tree
5. E*TRADE
6. Goldman Sachs Group
7. Lowe's
8. Nike
9. Pepsi
10. Staples
11. Sub-Zero
12. Mercedes-Benz

E1-3 Accounting equation

Obj. 4

The total assets and total liabilities for a recent year of Best Buy (BBY) and Gamestop (GME) are shown below.

✔ Best Buy, $4,995

	Best Buy (in millions)	Gamestop (in millions)
Assets	$15,256	$4,246
Liabilities	10,261	2,179

Determine the stockholders' equity of each company.

E1-4 Accounting equation

Obj. 4

The total assets and total liabilities for a recent year of Apple (AAPL) and HP (HPQ) formerly Hewlett-Packard are shown here.

✔ Apple, $119,355

	Apple (in millions)	HP (in millions)
Assets	$290,479	$103,206
Liabilities	171,124	76,475

Determine the stockholders' equity of each company.

E1-5 Accounting equation

Obj. 4

Determine the missing amount for each of the following:

✔ a. $475,000

	Assets	=	Liabilities	+	Stockholders' Equity
a.	X	=	$ 175,000	+	$300,000
b.	$ 880,000	=	X	+	$525,000
c.	$2,100,000	=	$600,000	+	X

E1-6 Accounting equation

Obj. 4

Determine the missing amounts (in millions) for the condensed balance sheets shown below.

✔ a. $10,617

	Costco (COST)	Target (TGT)	Wal-Mart (WMT)
Assets	$33,440	$41,404	$ (c)
Liabilities	22,823	(b)	122,312
Stockholders' equity	(a)	13,997	81,394

E1-7 Net income and dividends

Obj. 4

The income statement of a corporation for the month of November indicates a net income of $90,000. During the same period, $100,000 in cash dividends were paid. Would it be correct to say that the business incurred a net loss of $10,000 during the month? Discuss.

Obj. 4

✔ Company Chang: Net income, $225,000

E1-8 Net income and stockholders' equity for four businesses

Four different companies—Chang, Henry, Nagel, and Wilcox—show the same balance sheet data at the beginning and end of a year. These data, exclusive of the amount of stockholders' equity, are summarized as follows:

	Total Assets	Total Liabilities
Beginning of the year	$775,000	$400,000
End of the year	900,000	300,000

On the basis of the preceding data and the following additional information for the year, determine the net income (or loss) of each company for the year. (*Hint:* First determine the amount of increase or decrease in stockholders' equity during the year.)

Company Chang: No additional capital stock was issued, and no dividends were paid.

Company Henry: No additional capital stock was issued, but dividends of $90,000 were paid.

Company Nagel: Capital stock of $125,000 was issued, but no dividends were paid.

Company Wilcox: Capital stock of $125,000 was issued, and dividends of $90,000 were paid.

Obj. 4

✔ a. (1) $5,008,669

E1-9 Accounting equation and income statement

Staples, Inc., (SPLS) is a leading office products distributor, with retail stores in the United States, Canada, Asia, Europe, and South America. The following financial statement data were adapted from recent financial statements of Staples:

	Year 2 (in thousands)	Year 1 (in thousands)
Total assets	$10,313,728	$11,174,876
Total liabilities	(1)	5,042,613
Total stockholders' equity	5,305,059	(2)
Sales	22,492,360	
Cost of goods sold	16,691,324	
Operating expenses	5,518,665	
Other expense (net)	14,236	
Income tax expense	133,609	

a. Determine the missing data indicated for (1) and (2).

b. Using the income statement data for Year 2, determine the amount of net income or loss.

Obj. 4

E1-10 Balance sheet items

From the following list of selected items taken from the records of Flip Flop Sandals Inc. as of a specific date, identify those that would appear on the balance sheet.

1. Accounts Receivable
2. Common Stock
3. Cash
4. Fees Earned
5. Rent Expense
6. Salaries Expense
7. Salaries Payable
8. Supplies
9. Supplies Expense
10. Utilities Expense

Obj. 4

E1-11 Income statement items

Based on the data presented in Exercise 1-10, identify those items that would appear on the income statement.

E1-12 Financial statement items

Obj. 4

Identify each of the following items as (a) an asset, (b) a liability, (c) revenue, (d) an expense, or (e) a dividend:

1. Amounts due from customers
2. Amounts owed suppliers
3. Cash on hand
4. Cash paid to stockholders
5. Cash sales
6. Equipment
7. Note payable owed to the bank
8. Rent paid for the month
9. Sales commissions paid to salespersons
10. Wages paid to employees

E1-13 Statement of stockholders' equity

Obj. 4

Financial information related to Webber Company for the month ended June 30, 20Y7, is as follows:

Common Stock, June 1, 20Y7	$ 60,000
Stock issued in June	40,000
Net income for June	175,000
Dividends during June	30,000
Retained earnings, June 1, 20Y7	290,000

✔ Retained earnings, June 30, 20Y7, $435,000

Prepare a statement of stockholders' equity for the month ended June 30, 20Y7.

E1-14 Income statement

Obj. 4

Maynard Services was organized on August 1, 20Y5. A summary of the revenue and expense transactions for August follows:

Fees earned	$3,400,000
Wages expense	2,150,000
Miscellaneous expense	55,000
Rent expense	320,000
Supplies expense	30,000

✔ Net income: $845,000

Prepare an income statement for the month ended August 31.

E1-15 Missing amounts from balance sheet and income statement data

Obj. 4

✔ (a) $90,000

One item is omitted in each of the following summaries of balance sheet and income statement data for four different corporations, AL, CO, KS, and MT.

	AL	CO	KS	MT
Beginning of the year:				
Assets	$400,000	$300,000	$550,000	$ (d)
Liabilities	200,000	130,000	325,000	350,000
End of the year:				
Assets	800,000	460,000	660,000	1,200,000
Liabilities	450,000	110,000	360,000	700,000
During the year:				
Additional issue of capital stock	(a)	50,000	100,000	100,000
Dividends	50,000	20,000	(c)	90,000
Revenue	175,000	(b)	115,000	420,000
Expenses	65,000	70,000	130,000	480,000

Determine the missing amounts, identifying them by letter. [*Hint:* First determine the amount of increase or decrease in stockholders' equity during the year.]

Note: The spreadsheet icon indicates an Excel template is available on the student companion site at www.cengagebrain.com.

Obj. 4

E1-16 Balance sheets, net income

✔ b. $53,000

Financial information related to Montana Interiors for October and November 20Y8 is as follows:

	October 31, 20Y8	November 30, 20Y8
Accounts payable	$ 40,000	$ 65,000
Accounts receivable	75,000	118,000
Capital stock	60,000	60,000
Retained earnings	?	?
Cash	110,000	140,000
Supplies	15,000	20,000

a. Prepare balance sheets for Montana Interiors as of October 31 and as of November 30, 20Y8.

b. Determine the amount of net income for November, assuming that no additional capital stock was issued and no dividends were paid during the month.

c. Determine the amount of net income for November, assuming that no additional capital stock was issued but dividends of $20,000 were paid during the month.

Obj. 4

E1-17 Financial statements

Each of the following items is shown in the financial statements of ExxonMobil Corporation. Identify the financial statement (balance sheet or income statement) in which each item would appear.

a. Accounts payable
b. Cash equivalents
c. Crude oil inventory
d. Equipment
e. Exploration expenses
f. Income taxes payable
g. Investments
h. Long-term debt
i. Marketable securities
j. Notes and loans payable
k. Operating expenses
l. Prepaid taxes
m. Retained earnings
n. Sales
o. Selling expenses

Obj. 4

E1-18 Statement of cash flows

Indicate whether each of the following cash activities would be reported on the statement of cash flows as (a) an operating activity, (b) an investing activity, or (c) a financing activity.

1. Issued common stock
2. Paid rent
3. Paid for office equipment
4. Sold services
5. Issued a note payable
6. Sold excess office equipment
7. Paid officers' salaries
8. Paid for advertising
9. Paid insurance
10. Paid dividends

Obj. 4

E1-19 Statement of cash flows

Indicate whether each of the following activities would be reported on the statement of cash flows as (a) an operating activity, (b) an investing activity, or (c) a financing activity.

1. Cash received from investment by stockholders
2. Cash received from fees earned
3. Cash paid for expenses
4. Cash paid for land

E1-20 Statement of cash flows

Obj. 4

Looney Inc. was organized on July 1, Year 1. A summary of cash flows for July follows.

✔ Net cash flows from operating activities, $220,000

Cash receipts:	
Cash received from customers	$600,000
Cash received from issuance of common stock	200,000
Cash received from note payable	75,000
Cash payments:	
Cash paid out for expenses	$380,000
Cash paid out for purchase of equipment	95,000
Cash paid as dividends	25,000

Prepare a statement of cash flows for the month ended July 31, Year 1.

E1-21 Using financial statements

Obj. 4

A company's stakeholders often differ in their financial statement focus. For example, some stakeholders focus primarily on the income statement, while others focus primarily on the statement of cash flows or the balance sheet. For each of the following situations, indicate which financial statement would be the likely focus for the stakeholder. Choose either the income statement, balance sheet, or statement of cash flows, and justify your choice.

Situation 1: Assume that you are considering purchasing a personal computer from Dell.

Situation 2: Assume that you are considering investing in LinkedIn (capital market stakeholder).

Situation 3: Assume that you are employed by Campbell Soup Co. (product market stakeholder) and are considering whether to extend credit for a 60-day period to a new grocery store chain that has recently opened throughout the Midwest.

Situation 4: Assume that you are considering taking a job (internal stakeholder) with either Sears or JCPenney.

Situation 5: Assume that you are a banker for US Bank (capital market stakeholder), and you are considering whether to grant a major credit line (loan) to Target. The credit line will allow Target to borrow up to $400 million for a five-year period at the market rate of interest.

E1-22 Financial statement items

Obj. 4

Amazon.com, Inc., (AMZN) operates as an online retailer in North America and internationally. Both Amazon and third parties, via the Amazon.com Web site, sell products across various product categories.

The following items were adapted from a recent annual report of Amazon.com for the year ending December 31:

	In millions
1. Accounts payable	$16,459
2. Accounts receivable	5,612
3. Cash	14,557
4. Cost of sales	62,752
5. Income tax expense	167
6. Interest expense	210
7. Inventories	8,299
8. Net cash provided by operating activities	6,842
9. Net cash fl ws used for investing activities	(5,065)
10. Net sales	88,988
11. Other expense	118
12. Other income	76
13. Property, plant, and other long-term assets	16,967
14. Selling, general, and administrative expenses	26,058
15. Retained earnings (Dec. 31)	2,190

Using the following notations, indicate on which financial statement you would find each of the preceding items. (*Note:* An item may appear on more than one statement.)

IS	Income statement
SE	Statement of stockholders' equity
BS	Balance sheet
SCF	Statement of cash fl ws

Obj. 4

E1-23 Income statement

✔ Net loss, $241

Based on the Amazon.com, Inc., financial statement data shown in Exercise 1-22, prepare an income statement for the year ending December 31.

Obj. 4

E1-24 Financial statement items

Though the McDonald's (MCD) menu of hamburgers, cheeseburgers, the Big Mac®, Quarter Pounder®, Filet-O-Fish®, and Chicken McNuggets® is easily recognized, McDonald's financial statements may not be as familiar. The following items were adapted from a recent annual report of McDonald's Corporation:

1. Accounts payable
2. Accrued interest payable
3. Cash
4. Cash provided by operations
5. Common Stock
6. Food and packaging costs used in operations
7. Income tax expense
8. Interest expense
9. Inventories
10. Long-term debt payable
11. Net income
12. Net increase in cash
13. Notes payable
14. Notes receivable
15. Occupancy and rent expense
16. Payroll expense
17. Prepaid expenses not yet used in operations
18. Property and equipment
19. Retained earnings
20. Sales

Identify the financial statement on which each of the preceding items would appear. An item may appear on more than one statement. Use the following notations:

IS	Income statement
SE	Statement of stockholders' equity
BS	Balance sheet
SCF	Statement of cash fl ws

Obj. 4

E1-25 Financial statements

✔ Correct amount of total assets is $200,000

Outlaw Realty, organized August 1, 20Y7, is owned and operated by Julie Baxter. How many errors can you find in the following financial statements for Outlaw Realty, prepared after its first month of operations? Assume that the cash balance on August 31, 20Y7, is $51,600 and that cash flows from operating activities is reported correctly.

OUTLAW REALTY
Income Statement
August 31, 20Y7

Sales commissions		$ 408,400
Operating expenses:		
Office salaries expense	$272,600	
Rent expense	31,200	
Miscellaneous expense	2,200	
Automobile expense	7,900	
Total operating expenses		(313,900)
Net income		$ 134,500

JULIE BAXTER
Statement of Stockholders' Equity
August 31, Year 1

	Common Stock	Retained Earnings	Total
Balances, August 1, 20Y7	$ 0	$ 7,800	$ 7,800
Issuance of common stock			100,000
Net income		134,500	134,500
Dividends		12,000	12,000
Balances, August 30, 20Y7	$100,000	$154,300	$254,300

Balance Sheet
For the Month Ended August 31, 20Y7

Assets		
Cash		$ 51,600
Accounts payable		17,500
Land		60,000
Total assets		$129,100
Liabilities		
Accounts receivable		$ 81,200
Prepaid expenses		7,200
Stockholders' Equity		
Common stock	$100,000	
Retained earnings	140,300	240,300
Total liabilities and stockholders' equity		$328,700

Statement of Cash Flows
August 31, 20Y7

Cash fl ws from operating activities:		
Cash received from customers	$327,200	
Cash paid for operating expenses	303,600	
Net cash fl ws from operating activities		$ 23,600
Cash fl ws from financing a tivities:		
Cash received from issuance of common stock	$100,000	
Dividends paid to stockholders	(12,000)	
Net cash fl ws from financing a tivities		88,000
Net cash fl w and cash balance as of August 31, 20Y7		$111,600

E1-26 Accounting concepts

Obj. 5

Match each of the following statements with the appropriate accounting concept. Some concepts may be used more than once, while others may not be used at all. Use the notations shown to indicate the appropriate accounting concept.

Accounting Concept	Notation
Accounting period concept	P
Adequate disclosure concept	D
Business entity concept	B
Cost concept	C
Going concern concept	G
Matching concept	M
Objectivity concept	O
Unit of measure concept	U

Statements

1. Assume that a business will continue forever.
2. Material litigation involving the corporation is described in a note.
3. Monthly utilities costs are reported as expenses along with the monthly revenues.
4. Personal transactions of owners are kept separate from the business.
5. This concept supports relying on an independent actuary (statistician), rather than the chief operating officer of the corporation, to estimate a pension liability.
6. Changes in the use of accounting methods from one period to the next are described in the notes to the financial statements.
7. Land worth $800,000 is reported at its original purchase price of $220,000.
8. This concept justifies recording only transactions that are expressed in dollars.
9. If this concept was ignored, the confidence of users in the financial statements could not be maintained.
10. The changes in financial condition are reported at the end of the month.

Obj. 5

E1-27 Business entity concept

Crazy Mountain Sports sells hunting and fishing equipment and provides guided hunting and fishing trips. Crazy Mountain is owned and operated by Karl Young, a well-known sports enthusiast and hunter. Karl's wife, Mila, owns and operates Mila's Boutique, a women's clothing store. Karl and Mila have established a trust fund to finance their children's college education. The trust fund is maintained by First Bank in the names of their children, Steve and Isabelle.

For each of the following transactions, identify which of the entities listed should record the transaction in its records.

Entities	
C	Crazy Mountain Sports
B	First Bank Trust Fund
M	Mila's Boutique
X	None of the above

1. Karl paid a local doctor for a physical, which was required by the workmen's compensation insurance policy carried by Crazy Mountain Sports.
2. Karl received a cash advance from customers for a guided hunting trip.
3. Mila paid her dues to the YWCA.
4. Karl paid a breeder's fee for an English Springer spaniel to be used as a hunting guide dog.
5. Mila deposited a $10,000 personal check in the trust fund at First Bank.
6. Karl paid for an advertisement in a hunters' magazine.
7. Mila authorized the trust fund to purchase mutual fund shares.
8. Mila donated several dresses from the store's inventory to a local charity auction for the benefit of a women's abuse shelter.
9. Karl paid for dinner and a movie to celebrate the couple's fifteenth wedding anniversary.
10. Mila purchased two dozen spring dresses from a Boise designer for a special spring sale.

Problems

P1-1 Income statement, retained earnings statement, and balance sheet

Obj. 4

The amounts of the assets and liabilities of Glacier Travel Service as of September 30, 20Y6, the end of the current year, and its revenue and expenses for the year are listed below. The retained earnings were $150,000 and the common stock was $50,000 as of October 1, 20Y5, the beginning of the current year. Dividends of $10,000 were paid during the year.

✔ 1. Net income: $115,000

Accounts payable	$ 175,000
Accounts receivable	321,000
Cash	166,000
Common stock	70,000
Fees earned	900,000
Miscellaneous expense	37,000
Rent expense	180,000
Supplies	13,000
Supplies expense	38,000
Taxes expense	30,000
Utilities expense	75,000
Wages expense	425,000

Instructions

1. Prepare an income statement for the current year ended September 30, 20Y6.
2. Prepare a statement of stockholders' equity for the current year ended September 30, 20Y6.
3. Prepare a balance sheet as of September 30, 20Y6.

P1-2 Missing amounts from financial statements

Obj. 4

The financial statements at the end of Paradise Realty's first month of operations are shown below.

✔ j. $314,000

PARADISE REALTY
Income Statement
For the Month Ended November 30, 20Y3

Fees earned		$149,300
Operating expenses:		
Wages expense	$ (a)	
Rent expense	14,400	
Supplies expense	12,000	
Utilities expense	8,100	
Miscellaneous expense	4,950	
Total operating expenses		(69,300)
Net income		$ (b)

PARADISE REALTY
Statement of Stockholders' Equity
For the Month Ended November 30, 20Y3

	Common Stock	Retained Earnings	Total
Balances, Nov. 1, 20Y3	$ 0	$ 0	$ 0
Issuance of common stock	270,000		270,000
Net income		(c)	(c)
Dividends		(d)	(d)
Balances, Nov. 30, 20Y3	$270,000	$(e)	$314,000

PARADISE REALTY
Balance Sheet
November 30, 20Y3

Assets		
Cash		$ 99,200
Supplies		6,000
Land		(f)
Total assets		$ (g)
Liabilities		
Note payable		$ 7,200
Stockholders' Equity		
Common stock	$ (h)	
Retained earnings	(i)	
Total stockholders' equity		(j)
Total liabilities and stockholders' equity		$ (k)

PARADISE REALTY
Statement of Cash Flows
For the Month Ended November 30, 20Y3

Cash flows from operating activities:		
Cash received from customers	$ (l)	
Cash paid for expenses and to creditors	(68,100)	
Net cash flows from operating activities		$ (m)
Cash flows used for investing activities:		
Cash paid for acquisition of land		(216,000)
Cash flows from financing activities:		
Cash received from issuing common stock	$270,000	
Deduct dividends	(36,000)	
Net cash flows from financing activities		(n)
Net increase in cash during month		$ (o)
Cash as of November 1		0
Cash as of November 30		$ (o)

Instructions

1. Would you classify a realty business such as Hamel Realty as a manufacturing, merchandising, or service business?
2. By analyzing the interrelationships among the financial statements, determine the proper amounts for (a) through (o).

Obj. 4

P1-3 Income statement, retained earnings statement, and balance sheet

✔ 1. Net loss (1,636)

The following financial data were adapted from a recent annual report of Target Corporation (TGT) for the year ending January 31.

	In millions
Accounts payable	$ 7,759
Cash	2,210
Common stock	53
Cost of goods sold	51,278
Debt and other borrowings	12,705
Income tax expense	1,204
Interest expense	882
Inventories	8,790
Other assets	4,446
Other expenses	6,214
Other liabilities	6,943
Property, plant, and equipment	25,958
Sales	72,618
Selling, general, and administrative expenses	14,676

Instructions

1. Prepare Target's income statement for the year ending January 31.
2. Prepare Target's statement of stockholders' equity for the year ending January 31. Use the following additional information for the year:

No common stock was issue during the year	
Retained earnings Feb. 1 of prior year	$12,599
Dividends	1,319
Other stockholder equity items on Feb. 1 of prior year	3,579
Increase in other stockholder equity items	721

3. Prepare a balance sheet as of January 31.

P1-4 Statement of cash flows

Obj. 4

The following cash data for the year ended December 31 were adapted from a recent annual report of Alphabet (GOOG), formerly known as Google. The cash balance as of January 1 was $18,347 (in millions).

✔ Net decrease in cash, $(1,798)

	In millions
Payments on debt	$ 4,111
Purchases of property, plant, and equipment	9,915
Purchases of investments (marketable securities)	13,796
Cash fl ws from operating activities	26,024

Instructions

Prepare Alphabet's statement of cash flows for the year ended December 31.

P1-5 Financial statements, including statement of cash flows

Obj. 4

Pendray Systems Corporation began operations on January 1, 20Y5 as an online retailer of computer software and hardware. The following financial statement data were taken from Pendray's records at the end of its first year of operations, December 31, 20Y5.

✔ 1. Net income, $335,000

Accounts payable	$ 40,000
Accounts receivable	88,000
Cash	?
Cash payments for operating activities	896,000
Cash receipts from operating activities	1,087,000
Common stock	120,000
Cost of sales	650,000
Dividends	90,000
Income tax expense	87,000
Income taxes payable	15,000
Interest expense	3,000
Inventories	111,000
Note payable (due in ten years)	80,000
Property, plant, and equipment	265,000
Retained earnings	?
Sales	1,175,000
Selling and administrative expenses	100,000

Instructions

1. Prepare an income statement for the year ended December 31, 20Y5.
2. Prepare a statement of stockholders' equity for the year ended December 31, 20Y5.
3. Prepare a balance sheet as of December 31, 20Y5.
4. Prepare a statement of cash flows for the year ended December 31, 20Y5.

Metric-Based Analysis

Obj. 6

MBA 1-1 Quantitative metrics

Interpublic Group of Companies Inc. (IPG) is an advertising and marketing service company that operates throughout the world. In addition, the company provides event planning, public relations, and brand management services. Twitter Inc. (TWTR) operates as a worldwide platform for individuals to communicate with each other by sending Tweets using their mobile devices.

For each company, go to the Securities and Exchange Commission (SEC) Internet site *http://www.sec.gov/edgar/searchedgar/companysearch.html.* In the search box "Fast Search," enter the Central Index Key (stock market ticker symbol) shown next to the company name. Once the EDGAR Search screen appears, type in 10-K for Filing Type. Open the most recent 10-K file and search the file for "metric" using the "Edit and Find" functions.

1. List the quantitative metrics that appear in each company's 10-K.
2. Comment on the differences in the metrics for each company listed in (1).

Obj. 6

MBA 1-2 Quantitative metrics

JetBlue Airways Corporation (JBLU) is a passenger airline with flights to destinations throughout the United States, the Caribbean, and Latin America. Costco (COST) operates membership retail warehouses offering a variety of products including foods, electronics, appliances, and clothing.

For each company, go to the Securities and Exchange Commission (SEC) Internet site *http://www.sec.gov/edgar/searchedgar/companysearch.html.* In the search box "Fast Search," enter the Central Index Key (stock market ticker symbol) shown next to the company name. Once the EDGAR Search screen appears, type in 10-K for Filing Type. Open the most recent 10-K file and search the file for "metric" using the "Edit and Find" functions.

1. List the quantitative metrics that appear in each company's 10-K.
2. Comment on the differences in the metrics for each company listed in (1).

Obj. 6

MBA 1-3 Return on assets

The financial statements of The Hershey Company (HSY) are shown in Exhibits 6 through 9 of this chapter. Based upon these statements, answer the following questions.

1. What are Hershey's sales (in millions)?
2. What is Hershey's cost of sales (in millions)?
3. What is Hershey's net income (in millions)?
4. What is Hershey's percent of cost of sales to sales? Round to one decimal place.
5. The percent that a company adds to its cost of sales to determine the selling price is called a markup. What is Hershey's markup percent? Round to one decimal place.
6. What is the percentage of net income to sales for Hershey? Round to one decimal place.
7. Hershey had total assets of $4,412 (million) at the beginning of the year. Compute the return on assets for Hershey for the year shown in Exhibits 6–9.

MBA 1-4 Return on assets

Obj. 6

The following data (in millions) were adapted from recent financial statements of Tootsie Roll Industries Inc. (TR):

Sales	$543
Cost of goods sold	342
Net income	63
Average total assets	899

1. What is Tootsie Roll's percent of the cost of sales to sales? Round to one decimal place.
2. The percent a company adds to its cost of sales to determine selling price is called a markup. What is Tootsie Roll's markup percent? Round to one decimal place.
3. What is the percentage of net income to sales for Tootsie Roll? Round to one decimal place.
4. Compute the return on assets for Tootsie Roll.
5. Using your answers to MBA 1-3, compare the markup percentages and return on assets for Hershey and Tootsie Roll.

MBA 1-5 Return on assets

Obj. 6

Pfizer Inc. (PFE) discovers, produces, and distributes medicines, including Celebrex and Lipitor. Ford (F) Motor Co. develops, markets, and produces automobiles and trucks. Microsoft Corporation (MSFT) develops, produces, and distributes a variety of computer software and hardware products including Windows, Office, Excel, and the Xbox.

1. Without computing the return on assets, rank from highest to lowest Pfizer, Ford, and Microsoft in terms of their return on assets.
2. The following data (in millions) were taken from recent financial statements of each company:

	Pfizer	Ford	Microsoft
Net income	$ 9,135	$ 3,187	$ 12,193
Total assets at the beginning of the year	172,101	202,179	172,384
Total assets at the end of the year	169,274	208,527	176,223

   Compute the return on assets for each company using the preceding data, and rank the companies' return on assets from highest to lowest. Round the return on assets to one decimal place.
3. Analyze and explain the rankings in (2).

MBA 1-6 Return on assets

Obj. 6

ExxonMobil Corporation (XOM) explores, produces, and distributes oil and natural gas. The Coca-Cola Company (KO) produces and distributes soft drink beverages, including Coke. Wal-Mart Stores, Inc., (WMT) operates retail stores and supermarkets.

1. Without computing the return on assets, rank from highest to lowest Exxon-Mobil, Coca-Cola, and Wal-Mart in terms of their return on assets.
2. The following data (in millions) were taken from recent financial statements of each company:

	ExxonMobil	Coca-Cola	Wal-Mart
Net income	$ 32,520	$ 7,098	$ 16,363
Total assets at the beginning of the year	346,808	90,055	204,751
Total assets at the end of the year	349,493	92,023	203,706

   Compute the return on assets for each company using the preceding data, and rank the companies' return on assets from highest to lowest. Round the return on assets to one decimal place.
3. Analyze and explain the rankings in (2).

Obj. 6

MBA 1-7 Return on assets

Tiffany & Co. (TIF) designs and sells jewelry including rings, watches, and necklaces throughout the world. The following data (in millions) were taken from recent financial statements of Tiffany:

Net income	$ 891
Total assets at the beginning of the year	4,752
Total assets at the end of the year	5,181

1. Compute the return on assets for Tiffany using the preceding data. Round to one decimal place.
2. Using your answers to MBA 1-6, compare the return on assets for Wal-Mart to that of Tiffany.

Cases

Case 1-1 Integrity, objectivity, and ethics at The Hershey Company

The management of The Hershey Company (HSY) has asked union workers in two of its highest-cost Pennsylvania plants to accept higher health insurance premiums and take a wage cut. The workers' portion of the insurance cost would double from 6% of the premium to 12%. In addition, workers hired after January 2000 would have their hourly wages cut by $4, which would be partially offset by a 2% annual raise. Management says that the plants need to be more cost competitive. Management has indicated that if the workers accept the proposal, the company would invest $30 million to modernize the plants and move future projects to the plants. Management has refused, however, to guarantee more work at the plants even if the workers approve the proposal. If the workers reject the proposal, management implies that it would move future projects to other plants and that layoffs might be forthcoming. Do you consider management's actions ethical?

Source: Susan Govzdas, "Hershey to Cut Jobs or Wages," *Central Penn Business Journal*, September 24, 2004.

GROUP PROJECT

Case 1-2 Ethics and professional conduct in business

Loretta Smith, president and owner of Custom Enterprises, applied for a $250,000 loan from City National Bank. The bank requested financial statements from Custom Enterprises as a basis for granting the loan. Loretta has told her accountant to provide the bank with a balance sheet. Loretta has decided to omit the other financial statements because there was a net loss during the past year.

In groups of three or four, discuss the following questions:

1. Is Loretta behaving in a professional manner by omitting some of the financial statements?
2. a. What types of information about their businesses would owners be willing to provide bankers? What types of information would owners not be willing to provide?
   b. What types of information about a business would bankers want before extending a loan?
   c. What common interests are shared by bankers and business owners?

GROUP PROJECT

Case 1-3 How businesses make money

Assume that you are the chief executive officer for a national poultry producer. The company's operations include hatching chickens through the use of breeder stock and feeding,

raising, and processing the mature chicks into finished products. The finished products include breaded chicken nuggets and patties and deboned, skinless, and marinated chicken. The company sells its products to schools, military services, fast-food chains, and grocery stores.

In groups of four or five, discuss the following business emphasis and risk issues:

1. In a commodity business like poultry production, what do you think is the dominant business emphasis? What are the implications in this dominant emphasis for how you would run the company?
2. Identify at least two major business risks for operating the company.
3. How could the company try to differentiate its products?

Case 1-4 Net income versus cash flow

On January 9, 20--, Dr. Susan Tempkin established DocMed, a medical practice organized as a professional corporation. The below conversation took place the following September between Dr. Tempkin and a former medical school classmate, Dr. Phil Anzar, at an American Medical Association convention in London.

Dr. Anzar: Susan, good to see you again. Why didn't you call when you were in Chicago? We could have had dinner together.

Dr. Tempkin: Actually, I never made it to Chicago this year. My husband and kids went to our Wisconsin Dells condo twice, but I got stuck in New York. I opened a new consulting practice this January and haven't had any time for myself since.

Dr. Anzar: I heard about it . . . Doc . . . something . . . right?

Dr. Tempkin: Yes, DocMed. My husband chose the name.

Dr. Anzar: I've thought about doing something like that. Are you making any money? I mean, is it worth your time?

Dr. Tempkin: You wouldn't believe it. I started by opening a bank account with $40,000, and my August bank statement shows a balance of $215,000. Not bad for eight months—all pure profit.

Dr. Anzar: Maybe I'll try it in Chicago. Let's have breakfast together tomorrow and you can fill me in on the details.

Comment on Dr. Tempkin's statement that the difference between the opening bank balance ($40,000) and the August statement balance ($215,000) is pure profit.

Case 1-5 The accounting equation

Review financial statements for three well-known companies, such as **Ford Motor Co. (F)**, **General Motors (GM)**, **International Business Machines (IBM)**, **Microsoft (MSFT)**, or **Amazon (AMZ)**. The financial statements may be found at http://www.sec.gov/edgar/searchedgar/companysearch.html. Enter the company's stock market symbol in the Fast Search box, enter 10-K in the Filing Type box, and click on the latest 10-K. If you wish, you can save the whole 10-K report to your computer.

Examine the balance sheet for each company and determine the total assets, liabilities, and stockholders' equity. Verify that total assets equal the total of the liabilities plus stockholders' equity.

Case 1-6 Financial analysis of Enron Corporation

Enron Corporation, headquartered in Houston, Texas, provided products and services for natural gas, electricity, and communications to wholesale and retail customers. Enron's operations were conducted through a variety of subsidiaries and affiliates that involved transporting gas through pipelines, transmitting electricity, and managing energy commodities. The following data were taken from Enron's December 31, 2000, financial statements:

	In millions
Total revenues	$100,789
Total costs and expenses	98,836
Operating income	1,953
Net income	979
Total assets	65,503
Total liabilities	54,033
Total stockholders' equity	11,470
Net cash flows from operating activities	4,779
Net cash flows from investing activities	(4,264)
Net cash flows from financing activities	571
Net increase in cash	1,086

At the end of 2000, the market price of Enron's stock was approximately $83 per share. Eventually, however, Enron's stock was selling for $0.22 per share.

Review the preceding financial statement data and search the Internet for articles on Enron Corporation. Briefly explain why Enron's stock dropped so dramatically in such a short time.

Answers to Self-Examination Questions

1. **D** A corporation, organized in accordance with state or federal statutes, is a separate legal entity in which ownership is divided into shares of stock (answer D). A proprietorship (answer A) is an unincorporated business owned by one individual. A service business (answer B) provides services to its customers. It can be organized as a proprietorship, partnership, or corporation. A partnership (answer C) is an unincorporated business owned by two or more individuals.

2. **A** The resources owned by a business are called assets (answer A). The debts of the business are called liabilities (answer B), and the equity of the owners is called stockholders' equity (answer D). The relationship among assets, liabilities, and stockholders' equity is expressed as the accounting equation (answer C).

3. **A** The balance sheet is a listing of the assets, liabilities, and stockholders' equity of a business at a specific date (answer A). The income statement (answer B) is a summary of the revenue and expenses of a business for a specific period of time. The retained earnings statement (answer C) summarizes the changes in retained earnings during a specific period of time. The statement of cash flows (answer D) summarizes the cash receipts and cash payments for a specific period of time.

4. **D** The accounting equation is:

   Assets = Liabilities + Stockholders' Equity

   Therefore, if assets are $20,000 and liabilities are $12,000, stockholders' equity is $8,000 (answer D), as indicated in the following computation:

Assets	= Liabilities + Stockholders' Equity
+$20,000	= $12,000 + Stockholders' Equity
+$20,000 − $12,000	= Stockholders' Equity
+$8,000	= Stockholders' Equity

5. **B** Net income is the excess of revenue over expenses, or $7,500 (answer B). If expenses exceed revenue, the difference is a net loss. Dividends are the opposite of the stockholders investing in the business and do not affect the amount of net income or net loss.

Chapter 2

Basic Accounting Systems: Cash Basis

What's Covered:

Topics: Basic Accounting Systems: Cash Basis

Systems Elements
- Rules (Obj. 1)
- Framework (Obj. 1)
- Controls (Obj. 1)

Recording Transactions
- First-Period Transactions (Obj. 2)
- First-Period Financial Statements (Obj. 3)
- Second-Period Transactions (Obj. 4)
- Second-Period Financial Statements (Obj. 5)

Metric-Based Analysis
- Transactions
  - Liquidity: Cash (Obj. 2,4)
  - Profitabili y: Net Income (Obj. 2,4)
- Financial Statements
  - Common-Sized Statements (Obj. 6)

Learning Objectives

Obj.1 Describe the basic elements of a financial accounting system.

Obj.2 Analyze, record, and summarize transactions for a corporation's first pe iod of operations.

Obj.3 Prepare financial st tements for a corporation's first pe iod of operations.

Obj.4 Analyze, record, and summarize transactions for a corporation's second period of operations.

Obj.5 Prepare financial st tements for a corporation's second period of operations.

Obj.6 Describe and illustrate the use of common-sized income statements in assessing a company's performance.

Chapter Metrics

Use the following metrics to analyze transactions and financial st tements.

TRANSACTIONS

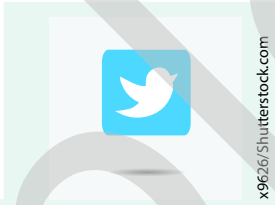
Liquidity: Cash

Profitability: Net Income—Cash Basis

FINANCIAL STATEMENTS

Common-Sized Statements

Twitter Connection


x9626/Shutterstock.com

Every day it seems like you get an incredible amount of incoming e-mail messages; you get them from your friends, relatives, subscribed e-mail lists, and even spammers! But how do you organize all of these messages? You might create folders to sort messages by sender, topic, or project. Perhaps you use keyword search utilities. You might even use fil ers or rules to automatically delete spam or send messages from your best friend to a special folder. In any case, you are organizing information so that it is simple to retrieve and allows you to more easily understand, respond to, or refer to the messages.

In the same way that you organize your e-mail, companies develop an organized method for processing, recording, and summarizing financial transactions. For example, **Twitter** is an information network used by millions to share messages of up to 140 characters. Such messages, called Tweets, are available free to the public. Twitter earns revenue by selling advertisements on the Internet as "Promoted Tweets, "Promoted Trends," or "Promoted Accounts." In order to analyze revenue by these three sources, Twitter records and summarizes its revenues by each advertising category. In addition, Twitter records and summarizes various metrics for its customers such as Retweets, clicks, replies, mentions, and follows. In doing so, Twitter has an integrated information system that includes an accounting component.

This chapter describes the basic elements of financial accounting systems. Such systems process, record, and summarize financial transactions, allowing for the preparation of fina - cial statements, as discussed in Chapter 1.

The simplest form of an accounting system records and summarizes only transactions involving the receipt and payment of cash. For this reason, this chapter describes and illustrates a cash basis accounting system. This serves as a foundation for later discussions of more complex accounting systems and financial eporting issues.

Objective 1
Describe the basic elements of a financial accounting system.

Elements of an Accounting System

A financial accounting system is designed to produce financial statements. The financial statements include the income statement, statement of stockholders' equity, balance sheet, and statement of cash flows.

The basic elements of a **financial accounting system** include:

- *Rules* for determining what, when, and the amount that should be recorded
- A *framework* for preparing financial statements
- *Controls* to determine whether errors may have arisen in the recording process

Rules

The rules for determining what, when, and the amount recorded are derived from the eight concepts discussed in Chapter 1. These concepts are the basis of generally accepted accounting principles (GAAP), which require the recording of transactions affecting elements of the financial statements.

A **transaction** is an economic event that under GAAP affects the financial statements. A transaction may affect one, two, or more items within the financial statements. For example, equipment purchased for cash affects only assets. That is, one asset (equipment) increases while another asset (cash) decreases. If, on the other hand, the equipment is purchased on credit, assets (equipment) and liabilities (accounts or notes payable) increase.

Twitter Connection

Twitter records transactions using generally accepted accounting principles (GAAP).

Framework

Transactions must be analyzed, recorded, and summarized using a framework. The accounting equation is the basis for all such frameworks. The accounting equation is expressed as follows:

Assets = Liabilities + Stockholders' Equity

Using the accounting equation as a framework, **Twitter** reported in recent financial statements (in millions) assets of $5,583, liabilities of $1,957, and stockholders equity of $3,626, which can be expressed in the form of the accounting equation as: $5,583 = $1,957 + $3,626.

Twitter Connection

By expanding the accounting equation, as shown in Exhibit 1, an integrated financial statement approach can be designed for analyzing, recording, and summarizing transactions. This is done by including columns for the statement of cash flows, balance sheet, and income statement.

The *left-hand* column in Exhibit 1 shows the effects of transactions on the statement of cash flows. Each cash transaction is recorded and classified as an operating, investing, or financing activity. This serves as a basis for preparing the statement of cash flows.

The cash at the beginning of the period plus or minus the cash flows from operating, investing, and financing activities equals the end-of-period cash. This end-of-period cash amount is reported as an asset on the balance sheet. Thus, the statement of cash flows is integrated with the balance sheet in Exhibit 1.

Twitter reported cash of $1,511 million on its balance sheet and statement of cash fl ws.

Twitter Connection

Exhibit 1 Integrated Financial Statement Framework

Integrated Financial Statement Framework

BALANCE SHEET

	Assets	=	Liabilities	+	Stockholders' Equity	
	Assets	**=**	**Liabilities**	**+**	**Capital Stock +**	**Retained Earnings**
Transaction	XXX		XXX		XXX	XXX
	XXX					
	XXX		XXX		XXX	XXX

STATEMENT OF CASH FLOWS

+/– Operating activities	XXX
+/– Investing activities	XXX
+/– Financing activities	XXX
Increase or decrease in cash	XXX
Beginning cash	XXX
Ending cash	XXX

INCOME STATEMENT

Revenues	XXX
Expenses	XXX
Net income or loss	XXX

The *right-hand* column in Exhibit 1 shows the effects of transactions on the income statement. Each revenue and expense transaction is recorded and classified as a revenue or expense. This serves as a basis for preparing the income statement.

Net income for the period (revenues less expenses) is added to beginning retained earnings.[1] Thus, revenue and expense transactions are also recorded under the Retained Earnings column of the balance sheet. By doing so, the balance sheet is integrated with the income statement in Exhibit 1.

Exhibit 1 also illustrates the importance of the balance sheet as the connecting link between the statement of cash flows and the income statement.[2] This integrated financial statement approach for analyzing, recording, and summarizing transactions is illustrated later in this chapter.

The integrated financial statement approach shown in Exhibit 1 is an invaluable tool for analyzing transactions and their effects on the financial statements. It is also an aid for analyzing and interpreting a company's financial statements. This is because, without understanding how a company's financial statements are integrated, important trends or events may be missed or misinterpreted.

To illustrate, assume a company reports net income (profits) on its income statement. As a result, it might be mistakenly concluded that the company's operations are doing well and no major changes are necessary. In fact, the company might be experiencing a continuing negative net cash flow from operations and thus be headed towards bankruptcy. This is why it is essential to analyze all the financial statements and their integration.

Controls

The integrated financial statement approach shown in Exhibit 1 has built-in controls to ensure that all transactions are correctly analyzed, recorded, and summarized. These controls include the following:[3]

1. The accounting equation must balance.
2. The ending cash on the statement of cash flows must equal the cash on the balance sheet.
3. The net income on the income statement must equal the net effects of revenues and expenses on retained earnings.

First, the accounting equation requires that total assets equal total liabilities plus total stockholders' equity. If at the end of the period this equality does not hold, an error has occurred.

To illustrate, assume that a cash purchase of equipment for $10,000 is incorrectly recorded as a $10,000 increase in equipment and a $10,000 increase (instead of decrease) in cash. In this case, the total assets exceed the total liabilities plus stockholders' equity by $20,000. Likewise, assume that the equipment was increased by $10,000, but the $10,000 decrease in cash was omitted. In this case, the total assets exceed total liabilities plus stockholders' equity by $10,000. In both cases, the inequality of the equation indicates that an error has occurred.

The equality of the equation doesn't necessarily mean that no errors have occurred. To illustrate, assume that a business purchased $10,000 of equipment on credit and recorded the transaction as an increase in equipment of $10,000. However, instead of increasing the liabilities by $10,000, the transaction was recorded as a $10,000 decrease in cash. In this case, the accounting equation still balances, even though cash and liabilities are understated by $10,000.

Second, the ending Cash shown in the Statement of Cash Flows column must equal the ending cash under Assets in the Balance Sheet column. If these two amounts do not agree, an error has occurred.

To illustrate, assume that a $5,000 cash receipt was recorded as an increase in Cash in the Balance Sheet column under Assets but was omitted from the Statement of Cash Flows column. In this case, the ending cash shown in the Statement of Cash Flows column would be $5,000 less than the balance of Cash under Assets in the Balance Sheet column.

1. A net loss for the period, which occurs when expenses exceed revenues, is subtracted from beginning retained earnings.
2. In Chapter 3, the use of the balance sheet to reconcile net cash flows from operating activities with net income is described and illustrated.
3. Additional accounting controls are discussed in Chapter 5.

Third, the net income or loss from the Income Statement column must equal the net effects of revenues and expenses on retained earnings. If these two amounts do not agree, an error has occurred.

To illustrate, assume that a $7,500 payment for rent expense was recorded under Retained Earnings in the Balance Sheet column but was omitted from the Income Statement column. In this case, the Net income in the Income Statement column would be $7,500 more than the net effects of revenues and expenses on retained earnings.

Twitter Connection

In **Twitter's** annual report, it includes a report on its controls and procedures for preparing accurate financial st tements.

Recording a Corporation's First Period of Operations

Objective 2
Analyze, record, and summarize transactions for a corporation's first period of operations.

The integrated financial statement framework shown in Exhibit 1 is illustrated using the transactions for a corporation's first period of operations. Assume that on September 1, 20Y5, Lee Landry, M.D., organizes a professional corporation to practice general medicine. The business is to be known as Family Health Care, P.C., where P.C. refers to a *professional corporation.*

Each of Family Health Care's transactions during September is described and recorded in this section. The transactions begin with Dr. Landry's investment to establish the business.

Transaction (a)

Dr. Landry deposits $6,000 in a bank account in the name of Family Health Care, P.C., in return for shares of common stock in the corporation.

In recording this transaction, increases are recorded as positive numbers, while decreases are recorded as negative numbers. Negative amounts are shown in parentheses.

The effects of this transaction on Family Health Care's financial statements are recorded as follows:

1. Under the Statement of Cash Flows column, Cash from Financing activities is increased by $6,000.
2. Under the Balance Sheet column, Cash under Assets is increased by $6,000. To balance the accounting equation, **Common Stock** under Stockholders' Equity is also increased by $6,000.

Business Insight

Got the Flu? Why Not Chew Some Gum?

Facing a slumping market for sugared chewing gum—such as Juicy Fruit™ and Doublemint™—**Wm. Wrigley Jr. Company**, a subsidiary of **Mars Incorporated**, is reinventing itself by expanding its product lines and introducing new chewing gum applications. Wrigley's new products include sugarless breath mints and more powerful fl vored mint chewing gum, like Extra Polar Ice™. In addition, Wrigley is experimenting with health-care applications of chewing gum. For example, the company founded the Wrigley Science Institute™ with the objective of promoting scientific research on the benefits of chewing gum. Specificall , the Institute sponsors research in such areas as weight reduction, management and stress relief, and cognitive focus. The Institute provides grants to leading researchers who investigate the role of chewing gum in health and wellness.

Source: Wrigley.com and *USA Today*, "Wrigley Wants Science to Prove Gum-Chewing Benefit ," by Dave Carpenter, The Associated Press, March 28, 2006.

Since no revenues or expenses are affected, there are no entries under the Income Statement column. The recording of transaction (a) relates only to the business, Family Health Care, P.C. Dr. Landry's personal assets (such as a home or a personal bank account) and personal liabilities are excluded. This is because under the business entity concept, Family Health Care is treated as a separate entity, with cash of $6,000 and stockholders' equity of $6,000.

The effects of this transaction on Family Health Care's financial statements are as follows:

Financial Statement Effects

	BALANCE SHEET				
	Assets	=	**Liabilities**	+	**Stockholders' Equity**
Transaction	**Cash**	=			**Common Stock**
a. Investment by Dr. Landry	6,000				6,000

STATEMENT OF CASH FLOWS	
a. Financing	6,000

INCOME STATEMENT

Transaction Metric Effects

The effects of each transaction on liquidity and profitability metrics for Family Health Care are also illustrated. Cash is used as the liquidity metric and net income (revenues less expenses) as the profitability metric. Since this chapter illustrates only cash transactions, the profitability metric is termed Net Income – Cash Basis.

The effects of issuing $6,000 of common stock on Family Health Care's liquidity and profitability metrics are as follows:

LIQUIDITY	
Cash	$6,000

PROFITABILITY	
Net Income – Cash Basis	No Effect

Transaction (b)

Family Health Care borrows $10,000 from First National Bank to finance its operations.

To borrow the $10,000, Dr. Landry signs a note payable with First National Bank in the name of Family Health Care. The note payable is a liability that Family Health Care must pay in the future. The note payable also requires the payment of interest of $100 per month until the note of $10,000 is paid on September 30, 20Y9. The interest is to be paid at the end of each month.

The effects of this transaction on Family Health Care's financial statements are recorded as follows:

1. Under the Statement of Cash Flows column, Cash from Financing activities is increased by $10,000.
2. Under the Balance Sheet column, Cash under Assets is increased by $10,000. To balance the accounting equation, Notes Payable under Liabilities is also increased by $10,000.

This transaction changes assets and liabilities on the balance sheet but does not change Family Health Care's stockholders' equity of $6,000. Since no revenues or expenses are affected, no entries are made under the Income Statement column.

The effects of this transaction on Family Health Care's financial statements are shown below.

Financial Statement Effects

	BALANCE SHEET				
	Assets	=	Liabilities	+	Stockholders' Equity
	Cash	=	Notes Payable	+	Common Stock
Balances	6,000				6,000
b. Issued note pay.	10,000		10,000		
Balances	16,000		10,000		6,000

STATEMENT OF CASH FLOWS	
b. Financing	10,000

INCOME STATEMENT

Transaction Metric Effects

The effects of borrowing $10,000 on Family Health Care's liquidity and profitability metrics are as follows:

LIQUIDITY	
Cash	$10,000

PROFITABILITY	
Net Income – Cash Basis	No Effect

Transaction (c)

Family Health Care buys land for $12,000 cash.

The land is located near a new suburban hospital that is under construction. Dr. Landry plans to rent office space and equipment for several months. When the hospital is completed, Family Health Care will build on the land.

The effects of this transaction on Family Health Care's financial statements are recorded as follows:

1. Under the Statement of Cash Flows column, Cash from Investing activities is decreased by $12,000.
2. Under the Balance Sheet column, Cash under Assets is decreased by $12,000. To balance the accounting equation, Land under Assets is increased by $12,000.

This transaction illustrates the use of cash for an investing activity. As a result, $12,000 was entered under the Statement of Cash Flows column. In addition, the mix of assets changes on the balance sheet. Since no revenues or expenses are affected, no entries are made under the Income Statement column.

The effects of this transaction on Family Health Care's financial statements are shown below.

Financial Statement Effects

	BALANCE SHEET						
	Assets			=	Liabilities	+	Stockholders' Equity
	Cash	+	Land	=	Notes Payable	+	Common Stock
Balances	16,000				10,000		6,000
c. Purchase of land	(12,000)		12,000				
Balances	4,000		12,000		10,000		6,000

STATEMENT OF CASH FLOWS	
c. Investing	(12,000)

INCOME STATEMENT

Transaction Metric Effects

The effects of the $12,000 purchase of the land on Family Health Care's liquidity and profitability metrics are as follows:

LIQUIDITY	
Cash	$(12,000)

PROFITABILITY	
Net Income – Cash Basis	No Effect

Transaction (d)

During the first month of operations, Family Health Care earned patient fees of $5,500, receiving the fees in cash.

The effects of this transaction on Family Health Care's financial statements are recorded as follows:

1. Under the Statement of Cash Flows column, Cash from Operating activities is increased by $5,500.
2. Under the Balance Sheet column, Cash under Assets is increased by $5,500. To balance the accounting equation, Retained Earnings under Stockholders' Equity is also increased by $5,500.
3. Under the Income Statement column, Fees earned is increased by $5,500.

This transaction illustrates an inflow of cash from operating activities by earning revenues (fees earned) of $5,500. Retained Earnings is increased under Stockholders' Equity by $5,500 because fees earned contribute to net income and net income increases stockholders' equity. Since fees earned are a type of revenue, Fees earned of $5,500 is also entered under the Income Statement column.

The effects of this transaction on Family Health Care's financial statements are shown below.

Financial Statement Effects

	BALANCE SHEET								
	Assets			=	Liabilities	+	Stockholders' Equity		
	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings
Balances	4,000		12,000		10,000		6,000		
d. Fees earned	5,500								5,500
Balances	9,500		12,000		10,000		6,000		5,500

STATEMENT OF CASH FLOWS	
d. Operating	5,500

INCOME STATEMENT	
d. Fees earned	5,500

Transaction Metric Effects

The effects of receiving $5,500 of patient fees on Family Health Care's liquidity and profitability metrics are as follows:

LIQUIDITY	
Cash	$5,500

PROFITABILITY	
Net Income – Cash Basis	$5,500

Transaction (e)

Family Health Care paid expenses during September as follows: wages, $1,125; rent, $950; utilities, $450; interest, $100; and miscellaneous, $275.

Miscellaneous expenses include small amounts paid for such items as postage, newspapers, and magazines. The effects of this transaction on Family Health Care's financial statements are recorded as follows:

1. Under the Statement of Cash Flows column, Cash from Operating activities is decreased by $2,900, which is the sum of the expenses ($1,125 + $950 + $450 + $100 + $275).
2. Under the Balance Sheet column, Cash under Assets is decreased by $2,900. To balance the accounting equation, Retained Earnings under Stockholders' Equity is also decreased by $2,900.
3. Under the Income Statement column, each expense is listed as a negative amount.

This transaction illustrates an outflow of cash of $2,900 for operating activities (paying expenses). Thus, $2,900 is entered in the Statement of Cash Flows column as an Operating activity. Expenses have the opposite effect from revenues on net income and retained earnings. As a result, $2,900 is entered for Retained Earnings under Stockholders' Equity. In addition, each expense is listed under the Income Statement column as a negative amount.

The effects of this transaction on Family Health Care's financial statements are shown below.

Financial Statement Effects

BALANCE SHEET

	Assets			=	Liabilities	+	Stockholders' Equity		
	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings
Balances	9,500		12,000		10,000		6,000		5,500
e. Paid expenses	(2,900)								(2,900)
Balances	6,600		12,000		10,000		6,000		2,600

STATEMENT OF CASH FLOWS

e. Operating	(2,900)

INCOME STATEMENT

e. Wages expense	(1,125)
Rent expense	(950)
Utilities expense	(450)
Interest expense	(100)
Misc. expense	(275)

Transaction Metric Effects

The effects of paying $2,900 in expenses on Family Health Care's liquidity and profitability metrics are as follows:

LIQUIDITY

Cash	$(2,900)

PROFITABILITY

Net Income – Cash Basis	$(2,900)

Transaction (f)

Family Health Care paid $1,500 to stockholders (Dr. Lee Landry) as dividends.

Dividends are distributions of a company's earnings to stockholders. Dividends should not be confused with expenses. Dividends do not represent assets consumed or services used in earning revenues. Instead, dividends are a distribution of earnings to the stockholders.

The effects of this transaction on Family Health Care's financial statements are recorded as follows:

1. Under the Statement of Cash Flows column, Cash from Financing activities is decreased by $1,500.
2. Under the Balance Sheet column, Cash under Assets is decreased by $1,500. To balance the accounting equation, Retained Earnings under Stockholders' Equity is also decreased by $1,500.

This transaction illustrates an outflow of cash of $1,500 for financing activities (paying dividends). Thus, $1,500 is entered in the Statement of Cash Flows column as a Financing activity. Dividends decrease retained earnings; thus, $1,500 is entered for Retained Earnings under Stockholders' Equity. Since dividends are not an expense, no entry is made under the Income Statement column.

The effects of this transaction on Family Health Care's financial statements are shown below.

Financial Statement Effects

BALANCE SHEET

	Assets			=	Liabilities	+	Stockholders' Equity		
	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings
Balances	6,600		12,000		10,000		6,000		2,600
f. Paid dividends	(1,500)								(1,500)
Balances	5,100		12,000		10,000		6,000		1,100

STATEMENT OF CASH FLOWS

f. Financing	(1,500)

INCOME STATEMENT

Transaction Metric Effects

The effects of paying dividends of $1,500 on Family Health Care's liquidity and profitability metrics are as follows:

LIQUIDITY

Cash	$(1,500)

PROFITABILITY

Net Income – Cash Basis	No Effect

Family Heath Care's September transactions are summarized in Exhibit 2 using the integrated financial statement format. Each transaction is identified by letter.

Exhibit 2 illustrates the three controls that are built into the integrated financial statement approach. These controls are as follows:

1. The accounting equation under the Balance Sheet column balances. That is, total assets of $17,100 ($5,100 + $12,000) equals total liabilities plus stockholders' equity of $17,100 ($10,000 + $6,000 + $1,100).
2. The ending cash under the Statement of Cash Flows column of $5,100 equals the cash balance under the Balance Sheet column of $5,100.
3. The net income under the Income Statement column of $2,600 equals the net effects of revenues of $5,500 and expenses of $2,900 on retained earnings ($5,500 − $2,900).

Exhibit 2 Family Health Care Summary of Transactions for September

Financial Statement Effects for September

BALANCE SHEET

	Assets			=	Liabilities	+	Stockholders' Equity		
	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings
a. Investment by Dr. Landry	6,000						6,000		
b. Issued note pay.	10,000				10,000				
c. Purchase of land	(12,000)		12,000						
d. Fees earned	5,500								5,500
e. Paid expenses	(2,900)								(2,900)
f. Paid dividends	(1,500)								(1,500)
Balances, Sept. 30	5,100		12,000		10,000		6,000		1,100

STATEMENT OF CASH FLOWS

a. Financing	6,000
b. Financing	10,000
c. Investing	(12,000)
d. Operating	5,500
e. Operating	(2,900)
f. Financing	(1,500)
Increase in cash and Sept. 30 cash	5,100

INCOME STATEMENT

d. Fees earned	5,500
e. Wages expense	(1,125)
Rent expense	(950)
Utilities expense	(450)
Interest expense	(100)
Misc. expense	(275)
Net income	2,600

Integrity, Objectivity, and Ethics in Business

A History of Ethical Conduct

The **Wm. Wrigley Jr. Company**, which is now a subsidiary of **Mars Incorporated**, has a long history of integrity, objectivity, and ethical conduct. When pressured to become part of a cartel, known as the Chewing Gum Trust, the company founder, William Wrigley Jr., said, "We prefer to do business by fair and square methods or we prefer not to do business at all." In 1932, Phillip K. Wrigley, called "PK" by his friends, became president of the Wrigley Company after his father, William Wrigley Jr., died. PK also was president of the Chicago Cubs, which played in Wrigley Field. He was financially generous to his players and frequently gave them advice on and off the field. However, as a man of integrity and high ethical standards, PK docked (reduced) his salary as president of the Wrigley Company for the time he spent working on Cubs-related activities and business.

Richard B. Levine/Newscom

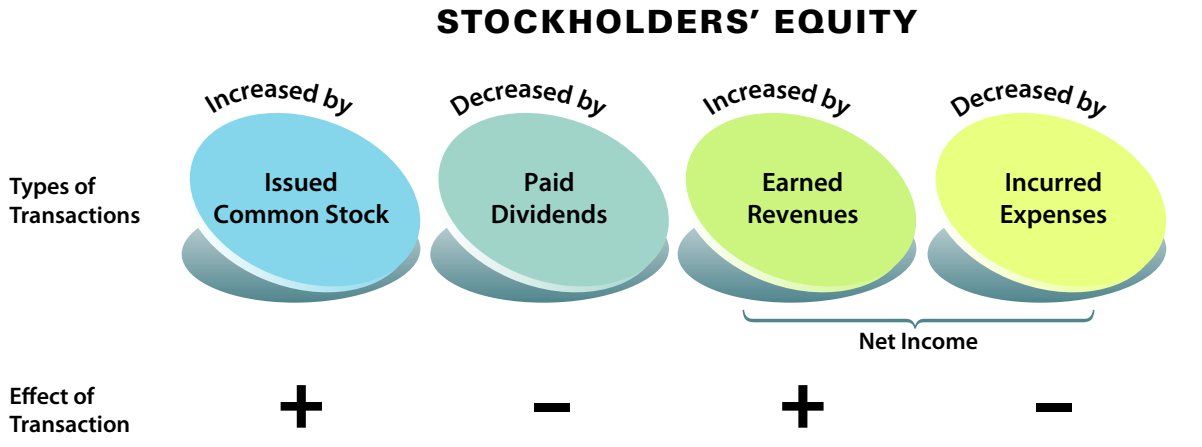
Source: St. Louis Post-Dispatch, "Sports—Backpages," January 26, 2003.

In reviewing Exhibit 2, you should note that the following apply to all companies:

- The Balance Sheet column reflects the accounting equation (Assets = Liabilities + Stockholders' Equity).
- The two sides of the accounting equation are always equal.
- Every transaction affects (increases or decreases) one or more of the balance sheet elements—assets, liabilities, or stockholders' equity.
- A transaction may or may not affect (increase or decrease) an element of the statement of cash flows or the income statement. Some transactions affect elements of both statements, some transactions affect only one statement and not the other, and some transactions affect neither statement.
- Every cash transaction increases or decreases the asset (cash) on the balance sheet. Every cash transaction also increases or decreases an operating, investing, or financing activity on the statement of cash flows.
- The ending balance of Cash under the Statement of Cash Flows column ($5,100 in Exhibit 2) agrees with the ending cash balance shown on the balance sheet. Since September was Family Health Care's first period of operations, this ending cash balance equals the net increase in cash for the period. In future periods, the net increase (decrease) in cash is added to (or subtracted from) the beginning cash balance to equal the ending cash balance. This ending cash balance is reported in the statement of cash flows and balance sheet.
- The stockholders' equity is increased by amounts invested by stockholders (common stock).
- Revenues increase stockholders' equity (retained earnings) and expenses decrease stockholders' equity (retained earnings). The effects of revenue and expense transactions are also shown in the Income Statement column.
- Stockholders' equity (retained earnings) is decreased by dividends paid to stockholders.
- The change in retained earnings for the period is the net income minus dividends. For a net loss, the change in retained earnings is the net loss plus dividends.
- The statement of cash flows is linked to the balance sheet through cash.
- The income statement is linked to the balance sheet through revenues and expenses (net income or loss), which affects retained earnings.

Exhibit 3 summarizes the effects of the various transactions affecting stockholders' equity.

Exhibit 3 Effects of Transactions on Stockholders' Equity



Transaction Metric Effects

The effects of September's transactions on Family Health Care's liquidity and profitability metrics are shown as follows:

LIQUIDITY

Transaction	Cash
a. Issued stock	$6,000
b. Issued note pay.	10,000
c. Purchased land	(12,000)
d. Earned fees	5,500
e. Paid expenses	(2,900)
f. Paid dividends	(1,500)
Total	$5,100

PROFITABILITY

	Net Income – Cash Basis
a. Issued stock	—
b. Issued note pay.	—
c. Purchased land	—
d. Earned fees	$5,500
e. Paid expenses	(2,900)
f. Paid dividends	—
Total	$2,600

September's transactions had the effect of increasing Family Health Care's liquidity metric (Cash) by $5,100. Since this is Family Health Care's first period of operations, this is also the ending balance of cash. September's transactions increased Family Health Care's profitability metric, Net Income – Cash Basis, by $2,600, which is also the amount that will be reported as net income on the income statement for September.

Financial Statements for a Corporation's First Period of Operations

Objective 3
Prepare financial statements for a corporation's first period of operations.

Exhibit 2 lists Family Health Care's September transactions in the order they occurred. Exhibit 2, however, does not group and summarize like transactions together. The accounting reports that provide this summarized information are financial statements.

Family Health Care's September financial statements can be prepared from Exhibit 2. These financial statements are shown in Exhibit 4.

The financial statements shown in Exhibit 4 are prepared from Exhibit 2 as follows:

1. The income statement is prepared using the Income Statement column.
2. The statement of stockholders' equity is prepared next because the ending balance of common stock and retained earnings is needed to prepare the balance sheet. The retained earnings column is prepared using net income from the income statement and the amount recorded for dividends.
3. The balance sheet is prepared next using the balances shown under the Balance Sheet column.
4. The statement of cash flows is prepared last using the Statement of Cash Flows column.

Each financial statement is identified by the name of the business, the title of the statement, and the date or period of time covered by the statement.

Income Statement

The income statement for Family Health Care shown in Exhibit 4 reports fees earned of $5,500, total operating expenses of $2,900, and net income of $2,600. The $5,500 of fees earned is taken from the Income Statement column of Exhibit 2. Likewise, the expenses are summarized from the Income Statement column of Exhibit 2. These expenses are reported under the heading "Operating expenses." Operating expenses are normally listed

in order of size, beginning with the largest expense. Miscellaneous expense is usually shown as the last item, regardless of amount.

Statement of Stockholders' Equity

The statement of stockholders' equity shown in Exhibit 4 reports two columns for common stock and retained earnings. Since this is the first month of Family Health Care's operations, the beginning balances of common stock and retained earnings are zero. Common stock of $6,000 is taken from Exhibit 2. Ending retained earnings of $1,100 is created by net income of $2,600 less dividends of $1,500.

Exhibit 4 Family Health Care Financial Statements for September

Family Health Care, P.C.
Income Statement
For the Month Ended September 30, 20Y5

Fees earned		$5,500
Operating expenses:		
Wages expense	$1,125	
Rent expense	950	
Utilities expense	450	
Interest expense	100	
Miscellaneous expense	275	
Total operating expenses		(2,900)
Net income		$2,600

Family Health Care, P.C.
Statement of Stockholders' Equity
For the Month Ended September 30, 20Y5

	Common Stock	Retained Earnings	Total
Balances, Sept. 1, 20Y5	$ 0	$ 0	$ 0
Issuance of common stock	6,000		6,000
Net income		2,600	2,600
Dividends		(1,500)	(1,500)
Balances, Sept. 30, 20Y5	$ 6,000	$ 1,100	$7,100

Family Health Care, P.C.
Balance Sheet
September 30, 20Y5

Assets		
Cash		$ 5,100
Land		12,000
Total assets		$17,100
Liabilities		
Notes payable		$10,000
Stockholders' Equity		
Common stock	$6,000	
Retained earnings	1,100	
Total stockholders' equity		7,100
Total liabilities and stockholders' equity		$17,100

(Continued)

Exhibit 4 Family Health Care Financial Statements for September (Concluded)

Family Health Care, P.C.
Statement of Cash Flows
For the Month Ended September 30, 20Y5

Cash flows from operating activities:		
Cash received from customers	$ 5,500	
Cash paid for expenses	(2,900)	
Net cash flow from operating activities		$ 2,600
Cash flows used in investing activities:		
Cash paid for acquisition of land		(12,000)
Cash flows from financing activities:		
Cash received from issuing common stock	$ 6,000	
Cash received from notes payable	10,000	
Cash dividends paid to stockholder	(1,500)	
Net cash flow from financing activities		14,500
Net increase in cash		$ 5,100
September 1, 20Y5, cash balance		0
September 30, 20Y5, cash balance		$ 5,100

Balance Sheet

Family Health Care's assets, liabilities, and stockholders' equity as of September 30, 20Y5, are taken from the last line of the Balance Sheet column of Exhibit 2. The September 30, 20Y5, balance sheet is shown in Exhibit 4.

In the Assets section of the balance sheet, assets are normally listed in order of liquidity, starting with cash. **Liquidity** refers to the ability to convert an asset to cash. Land is less liquid than cash and thus would be listed second in Family Health Care's balance sheet.

In the Liabilities section of Family Health Care's balance sheet, notes payable is the only liability. When there are two or more categories of liabilities, each should be listed and the total amount reported. Liabilities should be presented in the order that they will be paid in cash. Thus, the notes payable due in 20Y9 would be listed after the liabilities that are due earlier.

The stockholders' equity for Family Health Care as of September 30, 20Y5, consists of $6,000 of common stock and retained earnings of $1,100. The retained earnings is the ending retained earnings reported on the statement of stockholders' equity.

Statement of Cash Flows

Family Health Care's statement of cash flows for September is prepared from the Statement of Cash Flows column of Exhibit 2. Cash increased from a zero balance at the beginning of the month to $5,100 at the end of the month.

The $5,100 increase in cash during September was created by:

1. Operating activities that generated $2,600 of cash
2. Investing activities that used $12,000 of cash
3. Financing activities that generated $14,500 of cash

The details of how the operating, investing, and financing activities generated or used cash is reported in the statement of cash flows. For example, financing activities generated $6,000 from the sale of common stock and $10,000 from borrowing by issuing a note payable. Financing activities used $1,500 for paying dividends.

Integration of Financial Statements

Exhibit 5 shows how Family Health Care's financial statements for September are integrated. As shown in Exhibit 5, these statements are integrated as follows:

1. The ending cash balance of $5,100 on the balance sheet equals the ending cash balance reported on the statement of cash flows.

2. The net income of $2,600 is reported on the income statement and the statement of stockholders' equity.
3. The ending common stock of $6,000 and retained earnings of $1,100 are reported in the statement of stockholders' equity and balance sheet.
4. The cash flows from operating activities of $2,600 reported on the statement of cash flows equals the net income on the income statement. The relationship between cash flows from operating activities and net income is further described and illustrated in Chapter 3.

Exhibit 5 Family Health Care Integrated Financial Statements for September

Family Health Care, P.C.
Balance Sheet
September 30, 20Y5

Assets			=	Liabilities	+	Stockholders' Equity		
Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings
$5,100		$12,000		$10,000		$6,000		$1,100
$17,100				$17,100				
Total Assets			=	Total Liabilities + Stockholders' Equity				

Family Health Care, P.C.
Statement of Cash Flows
For the Month
Ended Sept. 30, 20Y5

Operating act.	$ 2,600
Investing act.	(12,000)
Financing act.	14,500
Increase in cash and, Sept. 30 Cash	$ 5,100

Family Health Care, P.C.
Income Statement
For the Month
Ended Sept. 30, 20Y5

Revenues	$5,500
Expenses	(2,900)
Net income	$2,600

Family Health Care, P.C.
Statement of Stockholders' Equity
For the Month Ended Sept. 30, 20Y5

	Common Stock	Retained Earnings	Total
Bal. Sept. 1	$ 0	$ 0	$ 0
Insured stock	6,000		6,000
Net income		2,600	2,600
Dividends		(1,500)	(1,500)
Bal. Sept. 20	$ 6,000	$ 1,100	$7,100

Recording a Corporation's Second Period of Operations

Objective 4
Analyze, record, and summarize transactions for a corporation's second period of operations.

During October, Family Health Care entered into the following transactions:

a. Received cash fees of $6,400
b. Paid expenses as follows: wages, $1,370; rent, $950; utilities, $540; interest, $100; and miscellaneous, $220
c. Paid cash dividends of $1,000

Family Heath Care's October transactions are summarized in Exhibit 6 using the integrated financial statement format. Each transaction is identified by letter.

The Balance Sheet column of Exhibit 6 begins with the ending balances as of September 30, 20Y5, taken from Exhibit 2. This is because the balance sheet is the cumulative total of the entity's assets, liabilities, and stockholders' equity since the company's inception.

As of October 1, 20Y5, Family Health Care has cash of $5,100, land of $12,000, notes payable of $10,000, common stock of $6,000, and retained earnings of $1,100. In contrast, the statement of cash flows and the income statement report only transactions for a period and are not cumulative.

Exhibit 6 Family Health Care Summary of Transactions for October

Financial Statement Effects for October

BALANCE SHEET

	Assets			=	Liabilities	+	Stockholders' Equity		
	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings
Balances, Oct. 1	5,100		12,000		10,000		6,000		1,100
a. Fees earned	6,400								6,400
b. Paid expenses	(3,180)								(3,180)
c. Paid dividends	(1,000)								(1,000)
Balances, Oct. 31	7,320		12,000		10,000		6,000		3,320

STATEMENT OF CASH FLOWS

a. Operating	6,400
b. Operating	(3,180)
c. Financing	(1,000)
Increase in cash	2,220

INCOME STATEMENT

a. Fees earned	6,400
b. Wages expense	(1,370)
Rent expense	(950)
Utilities expense	(540)
Interest expense	(100)
Misc. expense	(220)
Net income	3,220

Transaction Metric Effects

The effects of October's transactions on Family Health Care's liquidity and profitability metrics are as follows:

October Effects

LIQUIDITY

Transaction	Cash
a. Fees earned	$6,400
b. Paid expenses	(3,180)
c. Paid dividends	(1,000)
Total	$2,220

PROFITABILITY

	Net Income – Cash Basis
a. Fees earned	$6,400
b. Paid expenses	(3,180)
c. Paid dividends	—
Total	$3,220

October's transactions had the effect of increasing Family Health Care's liquidity metric (Cash) by $2,220. Since the beginning cash balance on October 1 was $5,100, the increase of $2,220 yields an ending cash balance of $7,320, which will be reported on the balance sheet. October's transactions increased Family Health Care's profitability metric, Net Income – Cash Basis, by $3,220, which is also the amount that will be reported as net income on the income statement.

Objective 5
Prepare financial statements for a corporation's second period of operations.

Financial Statements for a Corporation's Second Period of Operations

Family Health Care's financial statements for October are shown in Exhibit 7. These statements were prepared from Exhibit 6.

Income Statement

The income statement for October reports net income of $3,220. This is an increase of $620, or 23.8% ($620÷$2,600), from September's net income of $2,600. The increase in net income was due to fees increasing from $5,500 to $6,400, a $900, or 16.4% ($900÷$5,500), increase from September. At the same time, total operating expenses increased only $280 ($3,180 – $2,900), or 9.7% ($280÷$2,900). This suggests that Family Health Care's operations are profitable and expanding.

Statement of Stockholders' Equity

The statement of stockholders' equity shown in Exhibit 7 starts with the balances of common stock and retained earnings as of October 1, 20Y5. These are the same balances as of September 30, 20Y5 shown in Exhibit 4. Since no common stock was issued during October, the common stock balance on October 31, 20Y5 is $6,000. October's net income of $3,220 is added and dividends of $1,000 are deducted from the beginning retained earnings of $1,100 to yield retained earnings of $3,320 as of October 31, 20Y5.

Exhibit 7 Family Health Care Financial Statements for October

Family Health Care, P.C.
Income Statement
For the Month Ended October 31, 20Y5

Fees earned		$6,400
Operating expenses:		
Wages expense	$1,370	
Rent expense	950	
Utilities expense	540	
Interest expense	100	
Miscellaneous expense	220	
Total operating expenses		(3,180)
Net income		$3,220

Family Health Care, P.C.
Statement of Stockholders' Equity
For the Month Ended October 31, 20Y5

	Common Stock	Retained Earnings	Total
Balances, Oct. 1, 20Y5	$6,000	$1,100	$7,100
Net income		3,220	3,220
Dividends		(1,000)	(1,000)
Balances, Oct. 31, 20Y5	$6,000	$3,320	$9,320

(Continued)

Exhibit 7 Family Health Care Financial Statements for October (Concluded)

Family Health Care, P.C.
Balance Sheet
October 31, 20Y5

Assets		
Cash		$ 7,320
Land		12,000
Total assets		$19,320
Liabilities		
Notes payable		$10,000
Stockholders' Equity		
Common stock	$6,000	
Retained earnings	3,320	
Total stockholders' equity		9,320
Total liabilities and stockholders' equity		$19,320

Family Health Care, P.C.
Statement of Cash Flows
For the Month Ended October 31, 20Y5

Cash flows from operating activities:		
Cash received from customers	$6,400	
Cash paid for expenses	(3,180)	
Net cash flow from operating activities		$ 3,220
Cash flows from investing activities		0
Cash flows used for financing activities:		
Cash dividends paid to stockholder		(1,000)
Net increase in cash		$ 2,220
October 1, 20Y5, cash balance		5,100
October 31, 20Y5, cash balance		$ 7,320

Balance Sheet

The total assets increased from $17,100 on September 30, 20Y5 (Exhibit 4), to $19,320 on October 31 (Exhibit 7). This increase of $2,220 ($19,320 – $17,100) was due to an increase in cash from $5,100 to $7,320. Total liabilities of $10,000 remained the same.

Since total assets increased by $2,220 and total liabilities remained the same, total stockholders' equity must also have increased by $2,220. This is because the accounting equation must always balance. Exhibit 7 shows that total stockholders' equity did increase by $2,220, which is the increase in retained earnings.

Statement of Cash Flows

Family Health Care's statement of cash flows for October indicates that cash increased by $2,220. This increase is cash generated from operating activities of $3,220 less cash used by financing activities to pay dividends of $1,000.

The net increase in cash of $2,220 is added to the beginning cash balance of $5,100 to yield the ending cash balance of $7,320. This ending cash balance of $7,320 also appears on the October 31, 20Y5, balance sheet.

Integration of Financial Statements

Exhibit 8 illustrates that Family Health Care's financial statements for October are integrated as follows:

1. The ending cash balance of $7,320 on the balance sheet equals the ending cash balance reported on the statement of cash flows.
2. The net income of $3,220 is reported on the income statement and the statement of stockholders' equity.
3. The ending common stock of $6,000 and retained earnings of $3,320 are reported in the statement of stockholders' equity and the balance sheet.
4. The cash flows from operating activities of $3,220 reported on the statement of cash flows equals the net income on the income statement. The relationship between cash flows from operating activities and net income is further described and illustrated in Chapter 3.

Exhibit 8 Family Health Care Integrated Financial Statements for October

Family Health Care, P.C.
Balance Sheet
October 31, 20Y5

Assets			=	Liabilities	+	Stockholders' Equity		
Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings
$7,320		$12,000		$10,000		$6,000		$3,320
$19,320				$19,320				
Total Assets			=	Total Liabilities + Stockholders' Equity				

Family Health Care, P.C.
Statement of Cash Flows
For the Month
Ended Oct. 31, 20Y5

Operating act.	$ 3,220
Investing act.	0
Financing act.	(1,000)
Increase in cash	$ 2,220
Cash, Oct. 1	5,100
Cash, Oct. 31	$ 7,320

Family Health Care, P.C.
Income Statement
For the Month
Ended Oct. 31, 20Y5

Revenues	$6,400
Expenses	(3,180)
Net income	$3,220

Family Health Care, P.C.
Statement of Stockholders' Equity
For the Month Ended Oct. 31, 20Y5

	Common Stock	Retained Earnings	Total
Bal. Oct. 1	$6,000	$1,100	$7,100
Net income		3,220	3,220
Dividends		(1,000)	(1,000)
Bal. Sept. 20	$6,000	$3,320	$9,320

Metric-Based Analysis: Common-Sized Statements

Objective 6
Describe and illustrate the use of common-sized income statements in assessing a company's performance.

Common-sized financial statements are useful in assessing a company's financial condition and performance over time. Common-sized financial statements are also useful in comparing companies with one another.

Common-sized financial statements are prepared by expressing financial statement amounts as a percent of a base amount. A **common-sized income statement** is prepared by expressing income statement amounts as a percent of sales. A **common-sized balance sheet** is prepared by expressing each asset as a percent of total assets. Each liability and stockholders' equity item is expressed as a percent of total liabilities plus stockholders' equity.[4]

To illustrate common-sized income statements, we use data (in millions) adapted from recent financial statements of **The Kroger Co. (KR)**. Kroger operates over 2,600 supermarkets, over 1,300 fueling centers, and over 700 convenience stores. The following operating data were adapted from recent income statements of Kroger.

	Year 1	Year 2
Sales	$ 98,375	$108,465
Cost of sales	(78,138)	(85,512)
Gross profi	$ 20,237	$ 22,953
Operating expenses:		
Selling and administrative	$(15,196)	$ (17,161)
Other expenses	(2,316)	(2,655)
Total operating expenses	$(17,512)	$ (19,816)
Operating income	$ 2,725	$ 3,137

Kroger's common-sized income statements (rounded to one decimal place) for Year 1 and Year 2 are shown below. Each item is expressed as a percent of sales. For example, the cost of sales for Year 2 of 78.8% is computed as $85,512 ÷ $108,465.

	Year 1	Year 2	Increase (Decrease)
Sales	100.0%	100.0%	n/a
Cost of sales	(79.4)	(78.8)	(0.6)%
Gross profit	20.6%	21.2%	0.6%
Operating expenses:			
Selling and administrative	(15.4)%	(15.8)%	0.4%
Other expenses	(2.4)	(2.5)	0.1
Total operating expenses	(17.8)%	(18.3)%	0.5%
Operating income	2.8%	2.9%	(0.1)%

The common-sized income statements for Kroger indicate that the cost of sales decreased by 0.6% between Year 1 and Year 2. This decrease in cost of goods sold in Year 2 was partially offset by an increase in operating expenses of 0.5%. As a result, Kroger's operating income increased by only 0.1% between Year 1 and Year 2. These results imply that Kroger's operations did not change significantly between years.

When comparing operating performance across companies within the same industry, common-sized income statements are often prepared only through operating income rather than through net income. This is because other income and expenses are influenced by a variety of factors that are independent of operations and that can vary significantly across companies. For example, differences in the financing and tax strategies used by companies affect the comparability.

4. Since total assets equals total liabilities plus total stockholders' equity, common-sized balance sheets can be prepared simply by expressing each balance sheet item as a percent of total assets.

Key Points

1. Describe the basic elements of a financial accounting system.

The basic elements of a financial accounting system include (1) a set of rules for determining what, when, and the amount that should be recorded; (2) a framework for preparing financial statements; and (3) one or more controls to determine whether errors may have arisen in the recording process.

2. Analyze, record, and summarize transactions for a corporation's first period of operations.

Using the integrated financial statement framework, September transactions for Family Health Care are recorded and summarized in Exhibit 2.

3. Prepare financial statements for a corporation's first period of operations.

The financial statements for Family Health Care for September, its first period of operations, are shown in Exhibit 4.

4. Analyze, record, and summarize transactions for a corporation's second period of operations.

Using the accounting equation as a basic framework, October transactions for Family Health Care are recorded and summarized in Exhibit 6.

5. Prepare financial statements for a corporation's second period of operations.

The financial statements for Family Health Care for October, its second period of operations, are shown in Exhibit 7.

6. Describe and illustrate the use of common-sized income statements in assessing a company's performance.

A common-sized income statement is prepared by expressing each income statement amount as a percent of sales.

Key Terms

Common stock (49)
Common-sized balance sheet (65)
Common-sized financial statements (65)
Common-sized income statement (65)
Financial accounting system (46)
Liquidity (59)
Transaction (46)

Illustrative Problem

Beth Sumner established an insurance agency on April 1, 20Y4, and completed the following transactions during April:

a. Opened a business bank account in the name of Sumner Insurance Inc., with a deposit of $15,000 in exchange for common stock.
b. Borrowed $8,000 by issuing a note payable.
c. Received cash from fees earned, $11,500.
d. Paid rent on office and equipment for the month, $3,500.
e. Paid automobile expenses for the month, $650, and miscellaneous expenses, $300.
f. Paid office salaries, $1,400.
g. Paid interest on the note payable, $60.
h. Purchased land as a future building site, $20,000.
i. Paid dividends, $1,000.

Instructions

1. Indicate the effect of each transaction and the balances after each transaction, using the integrated financial statement framework.
2. Indicate the effects of each transaction on liquidity metric Cash and profitability metric Net Income – Cash Basis.
3. Prepare an income statement and statement of stockholders' equity for April.
4. Prepare a balance sheet as of April 30, 20Y4.
5. Prepare a statement of cash flows for April.

Solution

1.

Financial Statement Effects

	BALANCE SHEET								
	Assets			=	Liabilities	+	Stockholders' Equity		
	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings
a. Investment	15,000						15,000		
b. Issued note payable	8,000				8,000				
Balances	23,000				8,000		15,000		
c. Fees earned	11,500								11,500
Balances	34,500				8,000		15,000		11,500
d. Rent expense	(3,500)								(3,500)
Balances	31,000				8,000		15,000		8,000
e. Paid expenses	(950)								(950)
Balances	30,050				8,000		15,000		7,050
f. Paid salary expense	(1,400)								(1,400)
Balances	28,650				8,000		15,000		5,650
g. Paid interest expense	(60)								(60)
Balances	28,590				8,000		15,000		5,590
h. Purchased land	(20,000)		20,000						
Balances	8,590		20,000		8,000		15,000		5,590
i. Paid dividends	(1,000)								(1,000)
Balances, April 30	7,590		20,000		8,000		15,000		4,590

STATEMENT OF CASH FLOWS

a. Financing	15,000
b. Financing	8,000
c. Operating	11,500
d. Operating	(3,500)
e. Operating	(950)
f. Operating	(1,400)
g. Operating	(60)
h. Investing	(20,000)
i. Financing	(1,000)
Increase in cash and April 30 cash	7,590

INCOME STATEMENT

c. Fees earned	11,500
d. Rent expense	(3,500)
e. Auto expense	(650)
e. Misc. expense	(300)
f. Salary expense	(1,400)
g. Interest expense	(60)
Net income	5,590

2.

Transaction Metric Effects

LIQUIDITY

Transaction	Cash
a. Issued stock	$15,000
b. Issued note pay.	8,000
c. Earned fees	11,500
d. Paid rent exp.	(3,500)
e. Paid expenses	(950)
f. Paid salaries	(1,400)
g. Paid interest	(60)
h. Purchased land	(20,000)
i. Paid dividends	(1,000)
Total	$ 7,590

PROFITABILITY

	Net Income – Cash Basis
a. Issued stock	—
b. Issued note pay.	—
c. Earned fees	$11,500
d. Paid rent exp.	(3,500)
e. Paid expenses	(950)
f. Paid salaries	(1,400)
g. Paid interest	(60)
h. Purchased land	—
i. Paid dividends	—
Total	$ 5,590

3.

SUMNER INSURANCE, INC.
Income Statement
For the Month Ended April 30, 20Y4

Revenues:		
Fees earned		$11,500
Expenses:		
Rent expense	$3,500	
Salaries expense	1,400	
Automotive expense	650	
Interest expense	60	
Miscellaneous expense	300	
Total expenses		(5,910)
Net income		$ 5,590

SUMNER INSURANCE, INC.
Statement of Stockholders' Equity
For the Month Ended April 30, 20Y4

	Common Stock	Retained Earnings	Total
Balances, Apr. 1, 20Y4	$ 0	$ 0	$ 0
Issued common stock	15,000		15,000
Net income		5,590	5,590
Dividends		(1,000)	(1,000)
Balances, Apr. 30, 20Y4	$15,000	$ 4,590	$19,590

4.

SUMNER INSURANCE, INC.
Balance Sheet
April 30, 20Y4

Assets		
Cash		$ 7,590
Land		20,000
Total assets		$27,590
Liabilities		
Note payable		$ 8,000
Stockholders' Equity		
Common stock	$15,000	
Retained earnings	4,590	
Total stockholders' equity		19,590
Total liabilities and stockholders' equity		$27,590