INTRODUCTION TO FINANCIAL STATEMENTS

study objectives

After studying this chapter, you should be able to:

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

The Navigator is a learning system designed to prompt you to use the learning aids in the chapter and to set priorities as you study.
Many students who take this course do not plan to be accountants. If you are in that group, you might be thinking, “If I’m not going to be an accountant, why do I need to know accounting?” In response, consider this quote from Harold Geneen, the former chairman of IT&T: “To be good at your business, you have to know the numbers—cold.” Success in any business comes back to the numbers. You will rely on them to make decisions, and managers will use them to evaluate your performance. That is true whether your job involves marketing, production, management, or information systems.

In business, accounting and financial statements are the means for communicating the numbers. If you don’t know how to read financial statements, you can’t really know your business.

Many companies spend significant resources teaching their employees basic accounting so that they can read financial statements and understand how their actions affect the company’s financial results. One such company is Springfield ReManufacturing Corporation (SRC). When Jack Stack and 11 other managers purchased SRC for 10 cents a share, it was a failing division of International Harvester. Jack’s 119 employees were counting on him for their livelihood. He decided that for the company to survive, every employee needed to think like a businessperson and to act like an owner. To accomplish this, all employees at SRC took basic accounting courses and participated in weekly reviews of the company’s financial statements. SRC survived, and eventually thrived. To this day, every employee (now numbering more than 1,000) undergoes this same training.

Many other companies have adopted this approach, which is called “open-book management.” Even in companies that do not practice open-book management, employees generally assume that managers in all areas of the company are “financially literate.”

Taking this course will go a long way to making you financially literate. In this book you will learn how to read and prepare financial statements, and how to use basic tools to evaluate financial results. In this first chapter we will introduce you to the financial statements of a real company whose products you are probably familiar with—Tootsie Roll. Tootsie Roll’s presentation of its financial results is complete, yet also relatively easy to understand.

Tootsie Roll started off humbly in 1896 in a small New York City candy shop owned by an Austrian immigrant, Leo Hirshfield. The candy’s name came from his five-year-old daughter’s nickname—“Tootsie.” Today the Chicago-based company produces more than 49 million Tootsie Rolls and 16 million Tootsie Pops each day. In fact, Tootsie Pops are at the center of one of science’s most challenging questions: How many licks does it take to get to the Tootsie Roll center of a Tootsie Pop? The answer varies: Licking machines created at Purdue University and the University of Michigan report an average of 364 and 411 licks, respectively. In studies using human lickers, the answer ranges from 144 to 252. We recommend that you take a few minutes today away from your studies to determine your own results.

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

The purpose of this chapter is to show you what role accounting plays in providing financial information. The content and organization of the chapter are as follows.

### Forms of Business Organization

Suppose you graduate with a business degree and decide you want to start your own business. But what kind of business? You know that you enjoy working with people, especially teaching them new skills. And, ever since you were young, you have spent most of your free time outdoors, kayaking, backpacking, skiing, rock climbing, and mountain biking. You therefore realize that you might be most successful in opening an outdoor guide service where you grew up, in the Sierra Nevada mountains.

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

You might choose the sole proprietorship form for your outdoor guide service. A business owned by one person is a **sole proprietorship**. It is simple to set up and gives you control over the business. Small owner-operated businesses such as barber shops, law offices, and auto repair shops are often sole proprietorships, as are farms and small retail stores.

Another possibility is for you to join forces with other individuals to form a partnership. A business owned by two or more persons associated as partners is a **partnership**. Partnerships often are formed because one individual does not have enough economic resources to initiate or expand the business. Sometimes, partners bring unique skills or resources to the partnership. You and your partners should formalize your duties and contributions in a written partnership agreement. Retail and service-type businesses, including professional practices (lawyers, doctors, architects, and certified public accountants), often organize as partnerships.

As a third alternative, you might organize as a corporation. A business organized as a separate legal entity owned by stockholders is a **corporation**. Investors in a corporation receive shares of stock to indicate their ownership claim. Buying stock in a corporation is often more attractive than investing in a partnership because shares of stock are easy to sell (transfer ownership). Selling a proprietorship or partnership interest is much more involved. Also, individuals...
Users and Uses of Financial Information

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

**INTERNAL USERS**

Internal users of accounting information are managers who plan, organize, and run a business. These include marketing managers, production supervisors, finance directors, and company officers. In running a business, managers must answer many important questions, as shown in Illustration 1-1 (page 6).

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**Do it!**

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

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

**Solution**

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

Related exercise material: BE1-1 and Do it! 1-1.
Introduction to Financial Statements

Questions Asked by Internal Users

Finance
Is cash sufficient to pay dividends to Microsoft stockholders?

Marketing
What price for an Apple iPod will maximize the company’s net income?

Human Resources
Can we afford to give General Motors employees pay raises this year?

Management
Which PepsiCo product line is the most profitable? Should any product lines be eliminated?

Illustration 1-1
Questions that internal users ask

Illustrations like this one convey information in pictorial form to help you visualize and apply the ideas as you study.

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

Accounting Across the Organization

The Scoop on Accounting

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

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


What are the benefits to the company and to the employees of making the financial statements available to all employees? (See page 41.)

EXTERNAL USERS

There are several types of external users of accounting information. Investors (owners) use accounting information to make decisions to buy, hold, or sell stock. Creditors such as suppliers and bankers use accounting information to evaluate the risks of selling on credit or lending money. Some questions that investors and creditors may ask about a company are shown in Illustration 1-2.
The information needs and questions of other external users vary considerably. **Taxing authorities**, such as the Internal Revenue Service, want to know whether the company complies with the tax laws. **Customers** are interested in whether a company like General Motors will continue to honor product warranties and otherwise support its product lines. **Labor unions**, such as the Major League Baseball Players Association, want to know whether the owners have the ability to pay increased wages and benefits. **Regulatory agencies**, such as the Securities and Exchange Commission or the Federal Trade Commission, want to know whether the company is operating within prescribed rules. For example, Enron, Dynegy, Duke Energy, and other big energy-trading companies reported record profits at the same time as California was paying extremely high prices for energy and suffering from blackouts. This disparity caused regulators to investigate the energy traders to make sure that the profits were earned by legitimate and fair practices.

**Accounting Across the Organization**

**Spinning the Career Wheel**

One question that business students frequently ask is, “How will the study of accounting help me?” It should help you a great deal, because a working knowledge of accounting is desirable for virtually every field of business. Some examples of how accounting is used in business careers include:

**General management:** Imagine running Ford Motors, Massachusetts General Hospital, California State University–Fullerton, a McDonald’s franchise, a Trek bike shop. All general managers need to understand accounting data in order to make wise business decisions.

**Marketing:** A marketing specialist at a company like Procter & Gamble develops strategies to help the sales force be successful. But making a sale is meaningless unless it is a profitable sale. Marketing people must be sensitive to costs and benefits, which accounting helps them quantify and understand.

**Finance:** Do you want to be a banker for Citicorp, an investment analyst for Goldman Sachs, a stock broker for Merrill Lynch? These fields rely heavily on accounting. In all of them you will regularly examine and analyze financial statements. In fact, it is difficult to get a good job in a finance function without two or three courses in accounting.

**Real estate:** Are you interested in being a real estate broker for Prudential Real Estate? Because a third party—the bank—is almost always involved in financing a real estate transaction, brokers must understand the numbers involved: Can the buyer afford to make the payments to the bank? Does the cash flow from an industrial property justify the purchase price? What are the tax benefits of the purchase?

How might accounting help you? (See page 41.)

**ETHICS IN FINANCIAL REPORTING**

People won’t gamble in a casino if they think it is “rigged.” Similarly, people won’t “play” the stock market if they think stock prices are rigged. In recent years the financial press has been full of articles about financial scandals at Enron, WorldCom, HealthSouth, and AIG. As more scandals came to light, a mistrust of financial reporting in general seemed to be developing. One article in the Wall Street Journal noted that “repeated disclosures about questionable accounting practices have bruised investors’ faith in the reliability of earnings reports, which in turn has sent stock prices tumbling.”

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1"U.S. Share Prices Slump,” Wall Street Journal (February 21, 2002).
Information would have no credibility. There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

United States regulators and lawmakers were very concerned that the economy would suffer if investors lost confidence in corporate accounting because of unethical financial reporting. In 2002, Congress passed the **Sarbanes-Oxley Act (SOX)** to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals. As a result of SOX, top management must now certify the accuracy of financial information. In addition, penalties for fraudulent financial activity are much more severe. Also, SOX increased the independence of the outside auditors who review the accuracy of corporate financial statements, and increased the oversight role of boards of directors.

Effective financial reporting depends on sound ethical behavior. To sensitize you to ethical situations and to give you practice at solving ethical dilemmas, we address ethics in a number of ways in this book: (1) A number of the **Feature Stories** and other parts of the text discuss the central importance of ethical behavior to financial reporting. (2) **Insight boxes** with an ethics perspective highlight ethics situations and issues in actual business settings. (3) At the end of the chapter, an **Ethics Case** simulates a business situation and asks you to put yourself in the position of a decision maker in that case.

When analyzing these various ethics cases and your own ethical experiences, you should apply the three steps outlined in Illustration 1-3.

**Illustration 1-3**  Steps in analyzing ethics cases

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

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

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

**Ethics Insight**

**The Numbers Behind Not-for-Profit Organizations**

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

**What benefits does a sound accounting system provide to a not-for-profit organization? (See page 41.)**
Business Activities

All businesses are involved in three types of activity—financing, investing, and operating. For example, Leo Hirshfield, the founder of Tootsie Roll, obtained cash through financing to start and grow his business. Some of this financing came from personal savings, and some likely came from outside sources like banks. Hirshfield then invested the cash in equipment to run the business, such as mixing equipment and delivery vehicles. Once this equipment was in place, he could begin the operating activities of making and selling candy.

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

FINANCING ACTIVITIES

It takes money to make money. The two primary sources of outside funds for corporations are borrowing money and issuing (selling) shares of stock in exchange for cash.

Tootsie Roll Industries may borrow money in a variety of ways. For example, it can take out a loan at a bank or borrow directly from investors by issuing debt securities called bonds. Persons or entities to whom Tootsie Roll owes money are its creditors. Amounts owed to creditors—in the form of debt and other obligations—are called liabilities. Specific names are given to different types of liabilities, depending on their source. Tootsie Roll may have a note payable to a bank for the money borrowed to purchase delivery trucks. Debt securities sold to investors that must be repaid at a particular date some years in the future are bonds payable.

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

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

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

INVESTING ACTIVITIES

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

Cash is one of the more important assets owned by Tootsie Roll or any other business. If a company has excess cash that it does not need for a while, it might
choose to invest in securities (stocks or bonds) of other corporations. **Investments** are another example of an investing activity.

**OPERATING ACTIVITIES**

Once a business has the assets it needs to get started, it can begin its operations. Tootsie Roll is in the business of selling all things that taste, look, or smell like candy. It sells Tootsie Rolls, Tootsie Pops, Blow Pops, Caramel Apple Pops, Mason Dots, Mason Crows, Sugar Daddy, and Sugar Babies. We call amounts earned on the sale of these products **revenues**. **Revenue** is the increase in assets resulting from the sale of a product or service in the normal course of business. For example, Tootsie Roll records revenue when it sells a candy product.

Revenues arise from different sources and are identified by various names depending on the nature of the business. For instance, Tootsie Roll’s primary source of revenue is the sale of candy products. However, it also generates interest revenue on debt securities held as investments. Sources of revenue common to many businesses are **sales revenue**, **service revenue**, and **interest revenue**.

The company purchases its longer-lived assets through investing activities as described earlier. Other assets with shorter lives, however, result from operating activities. For example, supplies are assets used in day-to-day operations. Goods available for future sales to customers are assets called **inventory**. Also, if Tootsie Roll sells goods to a customer and does not receive cash immediately, then the company has a right to expect payment from that customer in the near future. This right to receive money in the future is called an **account receivable**.

Before Tootsie Roll can sell a single Tootsie Roll, Tootsie Pop, or Blow Pop, it must purchase sugar, corn syrup, and other ingredients, mix these ingredients, process the mix, and wrap and ship the finished product. It also incurs costs like salaries, rents, and utilities. All of these costs, referred to as **expenses**, are necessary to produce and sell the product. In accounting language, **expenses** are the cost of assets consumed or services used in the process of generating revenues.

Expenses take many forms and are identified by various names depending on the type of asset consumed or service used. For example, Tootsie Roll keeps track of these types of expenses: **cost of goods sold** (such as the cost of ingredients); **selling expenses** (such as the cost of salespersons’ salaries); **marketing expenses** (such as the cost of advertising); **administrative expenses** (such as the salaries of administrative staff, and telephone and heat costs incurred at the corporate office); **interest expense** (amounts of interest paid on various debts); and **income taxes** (corporate taxes paid to government).

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

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

11

BUSINESS ACTIVITIES

before you go on...

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

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

Solution

2. Truck purchased: Asset.
5. Amount earned from providing service: Revenue.
6. Amounts owed to suppliers: Liabilities.

Related exercise material: BE1-3, Do it 1-2, and E1-3.

Communicating with Users

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

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

To introduce you to these statements, we have prepared the financial statements for your outdoor guide service, Sierra Corporation, after your first month of operations. To summarize, you officially started your business in Truckee, California, on October 1, 2012. Sierra provides guide services in the Lake Tahoe area of the Sierra Nevada mountains. Its promotional materials describe outdoor day trips, such as rafting, snowshoeing, and hiking, as well as multi-day backcountry experiences. To minimize your initial investment, at this point the company has limited outdoor equipment for customer use. Instead, your customers either bring their own equipment or you arrange for them to rent equipment through local outfitters. The financial statements for Sierra’s first month of business are provided in the following pages.

INCOME STATEMENT

The income statement reports the success or failure of the company’s operations for a period of time. To indicate that its income statement reports the

International Note The primary types of financial statements required by International Financial Reporting Standards (IFRS) and U.S. generally accepted accounting principles (GAAP) are the same. Neither IFRS nor GAAP is very specific regarding format requirements for the primary financial statements. However, in practice, some format differences do exist in presentations commonly employed by IFRS companies compared to GAAP companies.
results of operations for a period of time, Sierra dates the income statement “For the Month Ended October 31, 2012.” The income statement lists the company’s revenues followed by its expenses. Finally, Sierra determines the net income (or net loss) by deducting expenses from revenues. Sierra Corporation’s income statement is shown in Illustration 1-4. Congratulations, you are already showing a profit!

**Illustration 1-4** Sierra Corporation’s income statement

**SIERRA CORPORATION**
Income Statement
For the Month Ended October 31, 2012

<table>
<thead>
<tr>
<th>Revenues</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Service revenue</td>
<td>$10,600</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries expense</td>
<td>$5,200</td>
</tr>
<tr>
<td>Supplies expense</td>
<td>1,500</td>
</tr>
<tr>
<td>Rent expense</td>
<td>900</td>
</tr>
<tr>
<td>Insurance expense</td>
<td>50</td>
</tr>
<tr>
<td>Interest expense</td>
<td>50</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>40</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td><strong>7,740</strong></td>
</tr>
</tbody>
</table>

**Net income** $ 2,860

**Helpful Hint** The heading identifies the company, the type of statement, and the time period covered. Sometimes, another line indicates the unit of measure, e.g., “in thousands” or “in millions.”

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

**Decision Toolkits** summarize the financial decision-making process.

Why are financial statement users interested in net income? **Investors are interested in a company’s past net income because it provides useful information for predicting future net income.** Investors buy and sell stock based on their beliefs about a company’s future performance. If investors believe that Sierra will be successful in the future and that this will result in a higher stock price, they will buy its stock. Creditors also use the income statement to predict future earnings. When a bank loans money to a company, it believes that it will be repaid in the future. If it didn’t think it would be repaid, it wouldn’t loan the money. Therefore, prior to making the loan the bank loan officer uses the income statement as a source of information to predict whether the company will be profitable enough to repay its loan. Thus, reporting a strong profit will make it easier for Sierra to raise additional cash either by issuing shares of stock or borrowing.

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

**DECISION TOOLKIT**

<table>
<thead>
<tr>
<th>DECISION CHECKPOINTS</th>
<th>INFO NEEDED FOR DECISION</th>
<th>TOOL TO USE FOR DECISION</th>
<th>HOW TO EVALUATE RESULTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are the company’s operations profitable?</td>
<td>Income statement</td>
<td>The income statement reports on the success or failure of the company’s operations by reporting its revenues and expenses.</td>
<td>If the company’s revenue exceeds its expenses, it will report net income; otherwise it will report a net loss.</td>
</tr>
</tbody>
</table>

**RETIRED EARNINGS STATEMENT**

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

The retained earnings statement shows the amounts and causes of changes in retained earnings during the period. The time period is the same as that covered by the income statement. The beginning retained earnings amount appears on the first line of the statement. Then the company adds net income and deducts dividends to determine the retained earnings at the end of the period. If a company has a net loss, it deducts (rather than adds) that amount in the retained earnings statement. Illustration 1-5 presents Sierra Corporation's retained earnings statement.

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

DECISION TOOLKIT

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

BALANCE SHEET

The balance sheet reports assets and claims to assets at a specific point in time. Claims to assets are subdivided into two categories: claims of creditors and claims of owners. As noted earlier, claims of creditors are called liabilities. Claims of owners are called stockholders’ equity.

Illustration 1-6 shows the relationship among the categories on the balance sheet in equation form. This equation is referred to as the basic accounting equation.

\[ \text{Assets} = \text{Liabilities} + \text{Stockholders’ Equity} \]
This relationship is where the name “balance sheet” comes from. Assets must balance with the claims to assets.

As you can see from looking at Sierra’s balance sheet in Illustration 1-7, the balance sheet presents the company’s financial position as of a specific date—in this case, October 31, 2012. It lists assets first, followed by liabilities and stockholders’ equity. Stockholders’ equity is comprised of two parts: (1) common stock and (2) retained earnings. As noted earlier, common stock results when the company sells new shares of stock; retained earnings is the net income retained in the corporation. Sierra has common stock of $10,000 and retained earnings of $2,360, for total stockholders’ equity of $12,360.

**SIERRA CORPORATION**

**Balance Sheet**

**October 31, 2012**

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$15,200</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>200</td>
</tr>
<tr>
<td>Supplies</td>
<td>1,000</td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>550</td>
</tr>
<tr>
<td>Equipment, net</td>
<td>4,960</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$21,910</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes payable</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>2,500</td>
</tr>
<tr>
<td>Salaries payable</td>
<td>1,200</td>
</tr>
<tr>
<td>Unearned service revenue</td>
<td>800</td>
</tr>
<tr>
<td>Interest payable</td>
<td>50</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td><strong>$ 9,550</strong></td>
</tr>
</tbody>
</table>

Stockholders’ equity

| Common stock       | 10,000 |
| Retained earnings  | 2,360  |
| **Total stockholders’ equity** | **12,360** |

| **Total liabilities and stockholders’ equity** | **$21,910** |

Creditors analyze a company’s balance sheet to determine the likelihood that they will be repaid. They carefully evaluate the nature of the company’s assets and liabilities. In operating the Sierra Corporation guide service, the balance sheet will be used to determine whether cash on hand is sufficient for immediate cash needs. The balance sheet will also be used to evaluate the relationship between debt and stockholders’ equity to determine whether the company has a satisfactory proportion of debt and common stock financing.
STATEMENT OF CASH FLOWS

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

Users are interested in the statement of cash flows because they want to know what is happening to a company’s most important resource. In operating Sierra, the statement of cash flows will provide answers to these simple but important questions:

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

The statement of cash flows for Sierra, in Illustration 1-8, shows that cash increased $15,200 during the month. This increase resulted because operating...

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

<table>
<thead>
<tr>
<th>SIERRA CORPORATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of Cash Flows</td>
</tr>
<tr>
<td>For the Month Ended October 31, 2012</td>
</tr>
</tbody>
</table>

Cash flows from operating activities
- Cash receipts from operating activities $11,200
- Cash payments for operating activities (5,500)
  - Net cash provided by operating activities $ 5,700

Cash flows from investing activities
- Purchased office equipment (5,000)
  - Net cash used by investing activities (5,000)

Cash flows from financing activities
- Issuance of common stock 10,000
- Issued note payable 5,000
- Payment of dividend (500)
  - Net cash provided by financing activities 14,500

Net increase in cash 15,200
Cash at beginning of period 0
Cash at end of period $15,200

Ethics Insight

Rocking the Bottom Line

What topic has performers such as Tom Waits, Clint Black, Sheryl Crow, and Madonna so concerned that they are pushing for new laws regarding its use? Accounting. Recording-company accounting to be more precise. Musicians receive royalty payments based on the accounting done by their recording companies. Many performers say that the recording companies—either intentionally or unintentionally—have very poor accounting systems, which, the performers say, has resulted in many inaccurate royalty payments. They would like to see laws created that would hit the recording companies with stiff fines for accounting errors.

What is one way that some of these disputes might be resolved? (See page 41.)
activities (services to clients) increased cash $5,700, and financing activities increased cash $14,500. Investing activities used $5,000 of cash for the purchase of equipment.

**INTERRELATIONSHIPS OF STATEMENTS**

Illustration 1-9 shows simplified financial statements of Tootsie Roll Industries, Inc. (We have simplified the financial statements to assist your learning.) Tootsie Roll's actual financial statements are presented in Appendix A, at the end of the textbook. Note that the numbers in Tootsie Roll's statements are presented in thousands—that is, the last three 000s are omitted. Thus, Tootsie Roll's net income in 2009 is $53,475,000, not $53,475. Because the results on some financial statements become inputs to other statements, the statements are interrelated. These interrelationships can be seen in Tootsie Roll's financial statements, as follows.

1. The retained earnings statement depends on the results of the income statement. Tootsie Roll reported net income of $53,475,000 for the period. It adds the net income amount to the beginning amount of retained earnings in order to determine ending retained earnings.

2. The balance sheet and retained earnings statement are also interrelated. Tootsie Roll reports the ending amount of $145,928,000 on the retained earnings statement as the retained earnings amount on the balance sheet.

3. Finally, the statement of cash flows relates to information on the balance sheet. The statement of cash flows shows how the Cash account changed during the period. It shows the amount of cash at the beginning of the period, the sources and uses of cash during the period, and the $90,990,000 of cash at the end of the period. The ending amount of cash shown on the statement of cash flows must agree with the amount of cash on the balance sheet.

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

### Income Statement

For the Year Ended December 31, 2009 (in thousands)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$499,331</td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>$319,497</td>
</tr>
<tr>
<td>Selling, marketing, and administrative expense and other</td>
<td>115,655</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>10,704</td>
</tr>
<tr>
<td>Total expenses</td>
<td>445,856</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 53,475</td>
</tr>
</tbody>
</table>

### Retained Earnings Statement

For the Year Ended December 31, 2009 (in thousands)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings, January 1, 2009</td>
<td>$142,872</td>
</tr>
<tr>
<td>Add: Net income</td>
<td>53,475</td>
</tr>
<tr>
<td>Less: Dividends and other (net)</td>
<td>50,419</td>
</tr>
<tr>
<td>Retained earnings, December 31, 2009</td>
<td>$145,928</td>
</tr>
</tbody>
</table>

### Balance Sheet

December 31, 2009 (in thousands)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 90,990</td>
</tr>
<tr>
<td>Investments</td>
<td>8,663</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>45,909</td>
</tr>
<tr>
<td>Inventories</td>
<td>56,387</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>8,562</td>
</tr>
<tr>
<td>Property, plant and equipment, net</td>
<td>407,015</td>
</tr>
<tr>
<td>Other assets</td>
<td></td>
</tr>
<tr>
<td>Total assets</td>
<td>$838,247</td>
</tr>
<tr>
<td>Liabilities and Stockholders' Equity</td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$ 9,140</td>
</tr>
<tr>
<td>Dividends payable</td>
<td>4,458</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>42,468</td>
</tr>
<tr>
<td>Deferred income taxes payable</td>
<td>84,582</td>
</tr>
<tr>
<td>Bonds payable</td>
<td>7,500</td>
</tr>
<tr>
<td>Employee benefits payable and other</td>
<td>77,614</td>
</tr>
<tr>
<td>Stockholders' equity</td>
<td>506,557</td>
</tr>
<tr>
<td>Common stock</td>
<td>145,928</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>652,485</td>
</tr>
<tr>
<td>Total liabilities and stockholders' equity</td>
<td>$838,247</td>
</tr>
</tbody>
</table>

### Statement of Cash Flows

For the Year Ended December 31, 2009 (in thousands)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flows from operating activities</td>
<td>$491,344</td>
</tr>
<tr>
<td>Cash payments for operating activities</td>
<td>(416,063)</td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
<td>$ 75,281</td>
</tr>
<tr>
<td>Cash flows from investing activities</td>
<td></td>
</tr>
<tr>
<td>Capital expenditures and acquisitions</td>
<td>(20,831)</td>
</tr>
<tr>
<td>Net purchases/sales of investment securities and other</td>
<td>6,180</td>
</tr>
<tr>
<td>Net cash used by investing activities</td>
<td>(14,651)</td>
</tr>
<tr>
<td>Cash flows from financing activities</td>
<td></td>
</tr>
<tr>
<td>Repurchase of common stock</td>
<td>(20,723)</td>
</tr>
<tr>
<td>Dividends paid in cash</td>
<td>(17,825)</td>
</tr>
<tr>
<td>Net cash used by financing activities</td>
<td>(38,548)</td>
</tr>
<tr>
<td>Net increase (decrease) in cash</td>
<td>22,082</td>
</tr>
<tr>
<td>Cash at beginning of year</td>
<td>68,908</td>
</tr>
<tr>
<td>Cash at end of year</td>
<td>$ 90,990</td>
</tr>
</tbody>
</table>
Do it!  
CSU Corporation began operations on January 1, 2012. The following information is available for CSU Corporation on December 31, 2012:

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

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

Solution

### CSU CORPORATION

#### Income Statement
For the Year Ended December 31, 2012

<table>
<thead>
<tr>
<th>Revenue</th>
<th>$17,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service revenue</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expense</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent expense</td>
<td>$9,000</td>
</tr>
<tr>
<td>Insurance expense</td>
<td>1,000</td>
</tr>
<tr>
<td>Supplies expense</td>
<td>200</td>
</tr>
</tbody>
</table>

| Expense Total    | 10,200  |

| Net income       | $6,800  |

### CSU CORPORATION

#### Retained Earnings Statement
For the Year Ended December 31, 2012

<table>
<thead>
<tr>
<th>Retained earnings, January 1</th>
<th>$0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add: Net income</td>
<td>6,800</td>
</tr>
<tr>
<td>Less: Dividends</td>
<td>600</td>
</tr>
</tbody>
</table>

| Retained earnings, December 31| $6,200 |

### CSU CORPORATION

#### Balance Sheet
December 31, 2012

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,400</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>1,800</td>
</tr>
<tr>
<td>Supplies</td>
<td>4,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>16,000</td>
</tr>
</tbody>
</table>

| Total assets                  | $23,200 |

<table>
<thead>
<tr>
<th>Liabilities and Stockholders' Equity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes payable</td>
<td>$5,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>2,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total liabilities</th>
<th>$7,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stockholders' equity</td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>10,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>6,200</td>
</tr>
</tbody>
</table>

| Total stockholders' equity        | $16,200 |
| Total liabilities and stockholders' equity | $23,200 |

Related exercise material: BE1-5, BE1-6, BE1-7, BE1-8, BE1-9, BE1-10, BE1-11, and E1-14.
OTHER ELEMENTS OF AN ANNUAL REPORT

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

Management Discussion and Analysis

The management discussion and analysis (MD&A) section covers various financial aspects of a company, including its ability to pay near-term obligations, its ability to fund operations and expansion, and its results of operations. Management must highlight favorable or unfavorable trends and identify significant events and uncertainties that affect these three factors. This discussion obviously involves a number of subjective estimates and opinions. A brief excerpt from the MD&A section of Tootsie Roll’s annual report is presented in Illustration 1-10.

Notes to the Financial Statements

Explanatory notes and supporting schedules accompany every set of financial statements and are an integral part of the statements. The notes to the financial statements clarify the financial statements, and provide additional detail. Information in the notes does not have to be quantifiable (numeric). Examples of notes are descriptions of the significant accounting policies and methods used in preparing the statements, explanations of uncertainties and contingencies, and various statistics and details too voluminous to be included in the statements. The notes are essential to understanding a company’s operating performance and financial position.

Illustration 1-11 is an excerpt from the notes to Tootsie Roll’s financial statements. It describes the methods that Tootsie Roll uses to account for revenues.

Auditor’s Report

An auditor’s report is prepared by an independent outside auditor. It states the auditor’s opinion as to the fairness of the presentation of the financial position and results of operations and their conformance with generally accepted accounting standards.
An auditor is an accounting professional who conducts an independent examination of a company's financial statements. Only accountants who meet certain criteria and thereby attain the designation Certified Public Accountant (CPA) may perform audits. If the auditor is satisfied that the financial statements provide a fair representation of the company's financial position and results of operations in accordance with generally accepted accounting principles, then the auditor expresses an unqualified opinion. If the auditor expresses anything other than an unqualified opinion, then readers should only use the financial statements with caution. That is, without an unqualified opinion, we cannot have complete confidence that the financial statements give an accurate picture of the company's financial health. For example, in April 2009 Blockbuster, Inc.'s auditor stated that its financial situation raised "substantial doubt about the Company's ability to continue as a going concern."

Illustration 1-12 is an excerpt from the auditor's report from Tootsie Roll's 2009 annual report. Tootsie Roll received an unqualified opinion from its auditor, PricewaterhouseCoopers.

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

TOOTSI ROLL INDUSTRIES, INC.
Excerpt from Auditor’s Report

To the Board of Directors and Shareholders of Tootsie Roll Industries, Inc.
In our opinion, the accompanying consolidated statements of financial position and the related consolidated statements of earnings, comprehensive earnings and retained earnings, and of cash flows present fairly, in all material respects, the financial position of Tootsie Roll Industries, Inc. and its subsidiaries at December 31, 2009 and December 31, 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

before you go on...

COMPONENTS OF ANNUAL REPORTS

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

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

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

Solution

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

Related exercise material: BE1-11, Do it! 1-4, and E1-17.
The Hershey Company, located in Hershey, Pennsylvania, is the leading North American manufacturer of chocolate—for example, Hershey’s Kisses, Reese’s Peanut Butter Cups, Kit Kat, and Take 5 bars. Imagine that you are considering the purchase of shares of Hershey’s common stock.

Instructions
Answer these questions related to your decision whether to invest.
(a) What financial statements should you request from the company?
(b) What should these financial statements tell you?
(c) Should you request audited financial statements? Explain.
(d) Appendix B at the end of this book contains financial statements for Hershey. What comparisons can you make between Tootsie Roll and Hershey in terms of their respective results from operations and financial position?

Solution
(a) Before you invest, you should investigate the income statement, retained earnings statement, statement of cash flows, and balance sheet.
(b) You would probably be most interested in the income statement because it tells about past performance and thus gives an indication of future performance. The retained earnings statement provides a record of the company’s dividend history. The statement of cash flows reveals where the company is getting and spending its cash. This is especially important for a company that wants to grow. Finally, the balance sheet reveals the relationship between assets and liabilities.
(c) You would want audited financial statements. These statements indicate that a CPA (certified public accountant) has examined and expressed an opinion that the statements present fairly the financial position and results of operations of the company. Investors and creditors should not make decisions without studying audited financial statements.
(d) Many interesting comparisons can be made between the two companies. Tootsie Roll is smaller, with total assets of $838,247,000 versus $3,675,031,000 for Hershey, and it has lower revenue—$499,331,000 versus $5,298,660,000 for Hershey. In addition, Tootsie Roll’s cash provided by operating activities of $75,281,000 is less than Hershey’s $1,065,749,000.

While useful, these basic measures are not enough to determine whether one company is a better investment than the other. In later chapters, you will learn of tools that will allow you to compare the relative profitability and financial health of these and other companies.
4 Describe the content and purpose of each of the financial statements. An income statement presents the revenues and expenses of a company for a specific period of time. A retained earnings statement summarizes the changes in retained earnings that have occurred for a specific period of time. A balance sheet reports the assets, liabilities, and stockholders’ equity of a business at a specific date. A statement of cash flows summarizes information concerning the cash inflows (receipts) and outflows (payments) for a specific period of time.

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

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

<table>
<thead>
<tr>
<th>DECISION CHECKPOINTS</th>
<th>INFO NEEDED FOR DECISION</th>
<th>TOOL TO USE FOR DECISION</th>
<th>HOW TO EVALUATE RESULTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are the company’s operations profitable?</td>
<td>Income statement</td>
<td>The income statement reports on the success or failure of the company’s operations by reporting its revenues and expenses.</td>
<td>If the company’s revenue exceeds its expenses, it will report net income; otherwise it will report a net loss.</td>
</tr>
<tr>
<td>What is the company’s policy toward dividends and growth?</td>
<td>Retained earnings statement</td>
<td>How much of this year’s income did the company pay out in dividends to shareholders?</td>
<td>A company striving for rapid growth will pay a low (or no) dividend.</td>
</tr>
<tr>
<td>Does the company rely primarily on debt or stockholders’ equity to finance its assets?</td>
<td>Balance sheet</td>
<td>The balance sheet reports the company’s resources and claims to those resources. There are two types of claims: liabilities and stockholders’ equity.</td>
<td>Compare the amount of debt versus the amount of stockholders’ equity to determine whether the company relies more on creditors or owners for its financing.</td>
</tr>
<tr>
<td>Does the company generate sufficient cash from operations to fund its investing activities?</td>
<td>Statement of cash flows</td>
<td>The statement of cash flows shows the amount of cash provided or used by operating activities, investing activities, and financing activities.</td>
<td>Compare the amount of cash provided by operating activities with the amount of cash used by investing activities. Any deficiency in cash from operating activities must be made up with cash from financing activities.</td>
</tr>
</tbody>
</table>

Glossary

Accounting (p. 5) The information system that identifies, records, and communicates the economic events of an organization to interested users.

Annual report (p. 19) A report prepared by corporate management that presents financial information including financial statements, notes, a management discussion and analysis section, and an independent auditor’s report.

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

Auditor’s report (p. 19) A report prepared by an independent outside auditor stating the auditor’s opinion as
to the fairness of the presentation of the financial position and results of operations and their conformance with generally accepted accounting standards.

**Balance sheet (p. 13)** A financial statement that reports the assets and claims to those assets at a specific point in time.

**Basic accounting equation (p. 13)** Assets = Liabilities + Stockholders’ Equity.

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

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

**Corporation (p. 4)** A business organized as a separate legal entity having ownership divided into transferable shares of stock.

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

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

**Income statement (p. 11)** A financial statement that presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time.

**Liabilities (p. 9)** The debts and obligations of a business. Liabilities represent the amounts owed to creditors.

**Management discussion and analysis (MD&A) (p. 19)** A section of the annual report that presents management’s views on the company’s ability to pay near-term obligations, its ability to fund operations and expansion, and its results of operations.

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

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

**Notes to the financial statements (p. 19)** Notes that clarify information presented in the financial statements, as well as expand upon it where additional detail is needed.

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

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

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

**Revenue (p. 10)** The increase in assets that result from the sale of a product or service in the normal course of business.

**Sarbanes-Oxley Act (p. 8)** Regulations passed by Congress in 2002 to try to reduce unethical corporate behavior.

**Sole proprietorship (p. 4)** A business owned by one person.

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

**Stockholders’ equity (p. 13)** The owners’ claim to assets.

---

**Comprehensive Do it!**

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

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

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

The company paid dividends during the year of $5,000 cash. The balance in the corporate bank account at December 31, 2012, was $49,500.

---

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

Using the format of the Sierra Corporation statements in this chapter, prepare an income statement, retained earnings statement, balance sheet, and statement of cash flows. *(Hint: Prepare the statements in the order stated to take advantage of the flow of information from one statement to the next, as shown in Illustration 1-9 on page 17.)*

**ICE CAMP**

**Income Statement**  
For the Year Ended December 31, 2012

<table>
<thead>
<tr>
<th>Revenues</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service revenue</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries and wages</td>
<td>$20,000</td>
</tr>
<tr>
<td>Insurance expense</td>
<td>10,000</td>
</tr>
<tr>
<td>Supplies expense</td>
<td>9,000</td>
</tr>
<tr>
<td>Rent expense</td>
<td>8,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>800</td>
</tr>
</tbody>
</table>

Total expenses: $47,800

Net income: $52,200

**ICE CAMP**

**Retained Earnings Statement**  
For the Year Ended December 31, 2012

<table>
<thead>
<tr>
<th>Retained earnings, January 1, 2012</th>
<th>$ 0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add: Net income</td>
<td>52,200</td>
</tr>
<tr>
<td>Less: Dividends</td>
<td>5,000</td>
</tr>
<tr>
<td>Retained earnings, December 31, 2012</td>
<td>$47,200</td>
</tr>
</tbody>
</table>

**ICE CAMP**

**Balance Sheet**  
December 31, 2012

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$49,500</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>20,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>13,500</td>
</tr>
<tr>
<td>Total assets</td>
<td>$83,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Stockholders’ Equity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes payable</td>
<td>$10,000</td>
</tr>
<tr>
<td>Interest payable</td>
<td>800</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$10,800</td>
</tr>
<tr>
<td>Stockholders’ equity</td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>25,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>47,200</td>
</tr>
<tr>
<td>Total stockholders’ equity</td>
<td>$72,200</td>
</tr>
<tr>
<td>Total liabilities and stockholders’ equity</td>
<td>$83,000</td>
</tr>
</tbody>
</table>
ICE CAMP

Statement of Cash Flows
For the Year Ended December 31, 2012

Cash flows from operating activities
  Cash receipts from operating activities $80,000
  Cash payments for operating activities (47,000)
  Net cash provided by operating activities $33,000

Cash flows from investing activities
  Purchase of equipment (13,500)
  Net cash used by investing activities (13,500)

Cash flows from financing activities
  Issuance of common stock 25,000
  Issuance of notes payable 10,000
  Dividends paid (5,000)
  Net cash provided by financing activities 30,000

Net increase in cash 49,500
Cash at beginning of period 0
Cash at end of period $49,500

This would be a good time to look at the Student Owner's Manual in the Preface to the book. Knowing the purpose of the different types of homework will help you understand what each contributes to your accounting skills and competencies.

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

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

Self-Test Questions

Answers are on page 42.

1. Which is not one of the three forms of business organization?
   (a) Sole proprietorship. (c) Partnership.
   (b) Creditorship. (d) Corporation.

2. Which is an advantage of corporations relative to partnerships and sole proprietorships?
   (a) Lower taxes.
   (b) Harder to transfer ownership.
   (c) Reduced legal liability for investors.
   (d) Most common form of organization.

3. Which statement about users of accounting information is incorrect?
   (a) Management is considered an internal user.
   (b) Taxing authorities are considered external users.
   (c) Regulatory authorities are considered internal users.
   (d) Present creditors are considered external users.

4. Which of the following did not result from the Sarbanes-Oxley Act?
   (a) Top management must now certify the accuracy of financial information.
   (b) Penalties for fraudulent activity increased.
   (c) Independence of auditors increased.
   (d) Tax rates on corporations increased.

5. Which is not one of the three primary business activities?
   (a) Financing. (c) Advertising.
   (b) Operating. (d) Investing.

6. Which of the following is an example of a financing activity?
   (a) Issuing shares of common stock.
   (b) Selling goods on account.
   (c) Buying delivery equipment.
   (d) Buying inventory.

7. Net income will result during a time period when:
   (a) assets exceed liabilities.
   (b) assets exceed revenues.
   (c) expenses exceed revenues.
   (d) revenues exceed expenses.
chapter 1 Introduction to Financial Statements

8. The financial statements for Joseph Corporation contained the following information.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$5,000</td>
</tr>
<tr>
<td>Sales revenue</td>
<td>75,000</td>
</tr>
<tr>
<td>Cash</td>
<td>15,000</td>
</tr>
<tr>
<td>Salaries and wages expense</td>
<td>20,000</td>
</tr>
<tr>
<td>Rent expense</td>
<td>10,000</td>
</tr>
</tbody>
</table>

What was Joseph Corporation’s net income?

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

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

(a) The investing section.
(b) The operating section.
(c) The financing section.
(d) The cash flow statement does not give this information.

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

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

11. Which financial statement reports assets, liabilities, and stockholders’ equity?

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

12. Stockholders’ equity represents:

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

13. As of December 31, 2012, Stoneland Corporation has assets of $3,500 and stockholders’ equity of $1,500. What are the liabilities for Stoneland Corporation as of December 31, 2012?

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

14. The element of a corporation’s annual report that describes the corporation’s accounting methods is the:

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

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

(a) income statement.
(b) auditor’s opinion.
(c) balance sheet.
(d) comparative statements.

Questions

1. What are the three basic forms of business organizations?
2. What are the advantages to a business of being formed as a corporation? What are the disadvantages?
3. What are the advantages to a business of being formed as a partnership or sole proprietorship? What are the disadvantages?
4. “Accounting is ingrained in our society and is vital to our economic system.” Do you agree? Explain.
5. Who are the internal users of accounting data? How does accounting provide relevant data to the internal users?
6. Who are the external users of accounting data? Give examples.
7. What are the three main types of business activity? Give examples of each activity.
8. Listed here are some items found in the financial statements of Ellyn Toth, Inc. Indicate in which financial statement(s) each item would appear.
   (a) Service revenue.
   (b) Equipment.
   (c) Advertising expense.
   (d) Accounts receivable.
   (e) Common stock.
   (f) Interest payable.
9. Why would a bank want to monitor the dividend payment practices of the corporations it lends money to?
10. “A company’s net income appears directly on the income statement and the retained earnings statement, and it is included indirectly in the company’s balance sheet.” Do you agree? Explain.
11. What is the primary purpose of the statement of cash flows?
12. What are the three main categories of the statement of cash flows? Why do you think these categories were chosen?
13. What is retained earnings? What items increase the balance in retained earnings? What items decrease the balance in retained earnings?
14. What is the basic accounting equation?
15. (a) Define the terms assets, liabilities, and stockholders’ equity.
   (b) What items affect stockholders’ equity?
16. Which of these items are liabilities of White Glove Cleaning Service?
   (a) Cash.
   (b) Accounts payable.
   (c) Dividends.
   (d) Accounts receivable.
Brief Exercises

(c) Supplies.  (h) Service revenue.
(f) Equipment.  (i) Rent expense.
(g) Salaries and wages payable.

17. How are each of the following financial statements interrelated? (a) Retained earnings statement and income statement. (b) Retained earnings statement and balance sheet. (c) Balance sheet and statement of cash flows.

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

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

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

21. The accounting equation is: Assets = Liabilities + Stockholders’ Equity. Appendix A, at the end of this book, reproduces Tootsie Roll’s financial statements. Replacing words in the equation with dollar amounts, what is Tootsie Roll’s accounting equation at December 31, 2009?

Brief Exercises

BE1-1  Match each of the following forms of business organization with a set of characteristics: sole proprietorship (SP), partnership (P), corporation (C).
(a) _____ Shared control, tax advantages, increased skills and resources.
(b) _____ Simple to set up and maintains control with founder.
(c) _____ Easier to transfer ownership and raise funds, no personal liability.

BE1-2  Match each of the following types of evaluation with one of the listed users of accounting information.
1. Trying to determine whether the company complied with tax laws.
2. Trying to determine whether the company can pay its obligations.
3. Trying to determine whether a marketing proposal will be cost effective.
4. Trying to determine whether the company’s net income will result in a stock price increase.
5. Trying to determine whether the company should employ debt or equity financing.
(a) _____ Investors in common stock.  (d) _____ Chief Financial Officer.
(b) _____ Marketing managers.  (e) _____ Internal Revenue Service.
(c) _____ Creditors.

BE1-3  Indicate in which part of the statement of cash flows each item would appear: operating activities (O), investing activities (I), or financing activities (F).
(a) _____ Cash received from customers.
(b) _____ Cash paid to stockholders (dividends).
(c) _____ Cash received from issuing new common stock.
(d) _____ Cash paid to suppliers.
(e) _____ Cash paid to purchase a new office building.

BE1-4  Presented below are a number of transactions. Determine whether each transaction affects common stock (C), dividends (D), revenue (R), expense (E), or does not affect stockholders’ equity (NSE). Provide titles for the revenues and expenses.
(a) Costs incurred for advertising.
(b) Assets received for services performed.
(c) Costs incurred for insurance.
(d) Amounts paid to employees.
(e) Cash distributed to stockholders.
(f) Assets received in exchange for allowing the use of the company’s building.
(g) Costs incurred for utilities used.
(h) Cash purchase of equipment.
(i) Issued common stock for cash.

BE1-5  In alphabetical order below are balance sheet items for Wyoming Company at December 31, 2012. Prepare a balance sheet following the format of Illustration 1-7.

| Accounts payable   | $65,000  |
| Accounts receivable| 71,000   |
| Cash               | 22,000   |
| Common stock       | 28,000   |
Determine where items appear on financial statements.

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

(a) _____ Income tax expense. (f) _____ Net sales.
(b) _____ Inventories. (g) _____ Cost of goods sold.
(c) _____ Accounts payable. (h) _____ Common stock.
(d) _____ Retained earnings. (i) _____ Receivables.
(e) _____ Property, plant, and equipment. (j) _____ Interest expense.

Determine proper financial statement.

BE1-7 Indicate which statement you would examine to find each of the following items: income statement (I), balance sheet (B), retained earnings statement (R), or statement of cash flows (C).

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

Use basic accounting equation.

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

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

BE1-9 At the beginning of the year, Peale Company had total assets of $800,000 and total liabilities of $500,000.

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

Identify assets, liabilities, and stockholders’ equity.

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

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

Determine required parts of annual report.

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

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

Do it! Review

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

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

Classify business activities.

Do it! 1-2 Classify each item as an asset, liability, common stock, revenue, or expense.

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

Do It! 1-3  Gould Corporation began operations on January 1, 2012. The following information is available for Gould Corporation on December 31, 2012.

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

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

Do It! 1-4  Indicate whether each of the following items is most closely associated with the management discussion and analysis (MD&A), the notes to the financial statements, or the auditor's report.

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

Exercises

E1-1  Here is a list of words or phrases discussed in this chapter:

2. Creditor 5. Stockholder 8. Auditor's opinion
3. Accounts receivable 6. Common stock

Instructions

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

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

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

Abitibi Consolidated Inc.—manufacturer and marketer of newsprint
Cal State-Northridge Stdt Union—university student union
Oracle Corporation—computer software developer and retailer
Sportsco Investments—owner of the Vancouver Canucks hockey club
Grant Thornton LLP—professional accounting and business advisory firm
Southwest Airlines—discount airline

Instructions

(a) For each of the above companies, provide examples of (1) a financing activity, (2) an investing activity, and (3) an operating activity that the company likely engages in.
(b) Which of the activities that you identified in (a) are common to most businesses? Which activities are not?
Classify accounts.  
(SO 3, 4), C

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

<table>
<thead>
<tr>
<th>Account</th>
<th>(a)</th>
<th>(b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales revenue</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Service revenue</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Supplies expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries and wages expense</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

Prepare income statement and retained earnings statement.  
(SO 4), AP

E1-4 This information relates to Alexis Co. for the year 2012.

<table>
<thead>
<tr>
<th>Account</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings, January 1, 2012</td>
<td>$67,000</td>
</tr>
<tr>
<td>Advertising expense</td>
<td>1,800</td>
</tr>
<tr>
<td>Dividends paid during 2012</td>
<td>6,000</td>
</tr>
<tr>
<td>Rent expense</td>
<td>10,400</td>
</tr>
<tr>
<td>Service revenue</td>
<td>58,000</td>
</tr>
<tr>
<td>Utilities expense</td>
<td>2,400</td>
</tr>
<tr>
<td>Salaries and wages expense</td>
<td>30,000</td>
</tr>
</tbody>
</table>

Instructions
After analyzing the data, prepare an income statement and a retained earnings statement for the year ending December 31, 2012.

Prepare income statement and retained earnings statement.  
(SO 4), AP

E1-5 The following information was taken from the 2009 financial statements of pharmaceutical giant Merck and Co. All dollar amounts are in millions.

<table>
<thead>
<tr>
<th>Account</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings, January 1, 2009</td>
<td>$43,698.8</td>
</tr>
<tr>
<td>Materials and production expense</td>
<td>9,018.9</td>
</tr>
<tr>
<td>Marketing and administrative expense</td>
<td>8,543.2</td>
</tr>
<tr>
<td>Dividends</td>
<td>3,597.7</td>
</tr>
<tr>
<td>Sales revenue</td>
<td>27,428.3</td>
</tr>
<tr>
<td>Research and development expense</td>
<td>5,845.0</td>
</tr>
<tr>
<td>Tax expense</td>
<td>2,267.6</td>
</tr>
<tr>
<td>Other revenue</td>
<td>11,147.7</td>
</tr>
</tbody>
</table>

Instructions
(a) After analyzing the data, prepare an income statement and a retained earnings statement for the year ending December 31, 2009.
(b) Suppose that Merck decided to reduce its research and development expense by 50%. What would be the short-term implications? What would be the long-term implications? How do you think the stock market would react?

Prepare a retained earnings statement.  
(SO 4), AP

E1-6 Presented here is information for Packee Inc. for 2012.

<table>
<thead>
<tr>
<th>Account</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings, January 1</td>
<td>$130,000</td>
</tr>
<tr>
<td>Revenue from legal services</td>
<td>400,000</td>
</tr>
<tr>
<td>Total expenses</td>
<td>175,000</td>
</tr>
<tr>
<td>Dividends</td>
<td>65,000</td>
</tr>
</tbody>
</table>

Instructions
Prepare the 2012 retained earnings statement for Packee Inc.

Interpret financial facts.  
(SO 4), AP

E1-7 Consider each of the following independent situations.

(a) The retained earnings statement of Scott Corporation shows dividends of $68,000, while net income for the year was $75,000.
(b) The statement of cash flows for Silberman Corporation shows that cash provided by operating activities was $10,000, cash used in investing activities was $110,000, and cash provided by financing activities was $130,000.

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

E1-8 The following items and amounts were taken from Linus Inc.'s 2012 income statement and balance sheet.

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 84,700</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>88,419</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>123,192</td>
</tr>
<tr>
<td>Sales revenue</td>
<td>584,951</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>438,458</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>6,499</td>
</tr>
<tr>
<td>Salaries and wages expense</td>
<td>115,131</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>49,384</td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>7,818</td>
</tr>
<tr>
<td>Service revenue</td>
<td>4,806</td>
</tr>
<tr>
<td>Inventory</td>
<td>$ 64,618</td>
</tr>
<tr>
<td>Interest expense</td>
<td>1,882</td>
</tr>
</tbody>
</table>

Instructions
(a) In each case, identify on the blank line whether the item is an asset (A), liability (L), stockholder's equity (SE), revenue (R), or expense (E) item.
(b) Prepare an income statement for Linus Inc. for the year ended December 31, 2012.

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

LIAM, INC.
Balance Sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Stockholders' Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Accounts payable</td>
</tr>
<tr>
<td>Inventory</td>
<td>Stockholders' equity</td>
</tr>
<tr>
<td>Buildings</td>
<td>Common stock</td>
</tr>
<tr>
<td>Total assets</td>
<td>Retained earnings</td>
</tr>
<tr>
<td></td>
<td>Total liabilities and stockholders' equity</td>
</tr>
</tbody>
</table>

Income Statement

<table>
<thead>
<tr>
<th>Revenues</th>
<th>$85,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>(c)</td>
</tr>
<tr>
<td>Salaries and wages expense</td>
<td>10,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$ (d)</td>
</tr>
</tbody>
</table>

Retained Earnings Statement

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

Instructions
Calculate the missing amounts.

E1-10 Deer Track Park is a private camping ground near the Lathom Peak Recreation Area. It has compiled the following financial information as of December 31, 2012.

| Revenues during 2012: camping fees | $132,000 |
| Accounts payable                   | 11,000   |
| Cash                               | 8,500    |
| Equipment                          | 114,000  |

Compute net income and prepare a balance sheet.
Instructions
(a) Determine Deer Track Park's net income for 2012.
(b) Prepare a retained earnings statement and a balance sheet for Deer Track Park as of December 31, 2012.
(c) Upon seeing this income statement, Ken Zilber, the campground manager, immediately concluded, "The general store is more trouble than it is worth—let’s get rid of it.” The marketing director isn’t so sure this is a good idea. What do you think?

E1-11 Kellogg Company is the world’s leading producer of ready-to-eat cereal and a leading producer of grain-based convenience foods such as frozen waffles and cereal bars. The following items were taken from its 2009 income statement and balance sheet. All dollars are in millions.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>$5,481</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>$4,835</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>7,184</td>
</tr>
<tr>
<td>Inventories</td>
<td>910</td>
</tr>
<tr>
<td>Net sales</td>
<td>12,575</td>
</tr>
<tr>
<td>Selling and administrative expenses</td>
<td>3,390</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>1,077</td>
</tr>
<tr>
<td>Cash</td>
<td>334</td>
</tr>
<tr>
<td>Common stock</td>
<td>105</td>
</tr>
<tr>
<td>Notes payable</td>
<td>44</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>476</td>
</tr>
<tr>
<td>Other expense</td>
<td>22</td>
</tr>
</tbody>
</table>

Instructions
Perform each of the following.
(a) In each case identify whether the item is an asset (A), liability (L), stockholders’ equity (SE), revenue (R), or expense (E).
(b) Prepare an income statement for Kellogg Company for the year ended December 31, 2009.

E1-12 This information is for O’Brien Corporation for the year ended December 31, 2012.

<table>
<thead>
<tr>
<th>Cash inflow</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from lenders</td>
<td>$20,000</td>
</tr>
<tr>
<td>Cash received from customers</td>
<td>50,000</td>
</tr>
<tr>
<td>Cash paid for new equipment</td>
<td>28,000</td>
</tr>
<tr>
<td>Cash dividends paid</td>
<td>8,000</td>
</tr>
<tr>
<td>Cash paid to suppliers</td>
<td>16,000</td>
</tr>
<tr>
<td>Cash balance 1/1/12</td>
<td>12,000</td>
</tr>
</tbody>
</table>

Instructions
(a) Prepare the 2012 statement of cash flows for O’Brien Corporation.
(b) Suppose you are one of O’Brien’s creditors. Referring to the statement of cash flows, evaluate O’Brien’s ability to repay its creditors.

E1-13 The following data are derived from the 2009 financial statements of Southwest Airlines. All dollars are in millions. Southwest has a December 31 year-end.

<table>
<thead>
<tr>
<th>Cash inflow</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash balance, January 1, 2009</td>
<td>$1,390</td>
</tr>
<tr>
<td>Cash paid for repayment of debt</td>
<td>122</td>
</tr>
<tr>
<td>Cash received from issuance of common stock</td>
<td>144</td>
</tr>
<tr>
<td>Cash received from issuance of long-term debt</td>
<td>500</td>
</tr>
<tr>
<td>Cash received from customers</td>
<td>9,823</td>
</tr>
<tr>
<td>Cash paid for property and equipment</td>
<td>1,529</td>
</tr>
<tr>
<td>Cash paid for dividends</td>
<td>14</td>
</tr>
<tr>
<td>Cash paid for repurchase of common stock</td>
<td>1,001</td>
</tr>
<tr>
<td>Cash paid for goods and services</td>
<td>6,978</td>
</tr>
</tbody>
</table>

Instructions
(a) After analyzing the data, prepare a statement of cash flows for Southwest Airlines for the year ended December 31, 2009.
(b) Discuss whether the company’s cash from operations was sufficient to finance its investing activities. If it was not, how did the company finance its investing activities?

E1-14 Andrew Davis is the bookkeeper for Cheyenne Company. Andrew has been trying to get the balance sheet of Cheyenne Company to balance. It finally balanced, but now he’s not sure it is correct.
Exercises 33

Instructions
Prepare a correct balance sheet.

**E1-15** The following items were taken from the balance sheet of Nike, Inc.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Cash</td>
<td>$2,291.1</td>
</tr>
<tr>
<td>2. Accounts receivable</td>
<td>2,883.9</td>
</tr>
<tr>
<td>3. Common stock</td>
<td>2,874.2</td>
</tr>
<tr>
<td>4. Notes payable</td>
<td>342.9</td>
</tr>
<tr>
<td>5. Other assets</td>
<td>3,759.9</td>
</tr>
<tr>
<td>6. Other liabilities</td>
<td>1,311.5</td>
</tr>
<tr>
<td>7. Inventories</td>
<td>$2,357.0</td>
</tr>
<tr>
<td>8. Income taxes payable</td>
<td>86.3</td>
</tr>
<tr>
<td>9. Property, plant, and equipment</td>
<td>1,957.7</td>
</tr>
<tr>
<td>10. Retained earnings</td>
<td>31,500</td>
</tr>
<tr>
<td>11. Accounts payable</td>
<td>2,815.8</td>
</tr>
</tbody>
</table>

Instructions
Perform each of the following.
(a) Classify each of these items as an asset, liability, or stockholders’ equity and determine the total dollar amount for each classification. (All dollars are in millions.)
(b) Determine Nike’s accounting equation by calculating the value of total assets, total liabilities, and total stockholders’ equity.
(c) To what extent does Nike rely on debt versus equity financing?

**E1-16** The summaries of data from the balance sheet, income statement, and retained earnings statement for two corporations, Bates Corporation and Wilson Enterprises, are presented below for 2012.

### Bates Corporation

- **Beginning of year**
  - Total assets: $110,000
  - Total liabilities: 70,000
  - Total stockholders’ equity: (a)
- **End of year**
  - Total assets: (b)
  - Total liabilities: 120,000
  - Total stockholders’ equity: 60,000
- **Changes during year in retained earnings**
  - Dividends: (c)
  - Total revenues: 215,000
  - Total expenses: 165,000

### Wilson Enterprises

- **Beginning of year**
  - Total assets: $150,000
  - Total liabilities: (d)
  - Total stockholders’ equity: 70,000
- **End of year**
  - Total assets: 180,000
  - Total liabilities: 55,000
  - Total stockholders’ equity: (e)
- **Changes during year in retained earnings**
  - Dividends: 5,000
  - Total revenues: (f)
  - Total expenses: 80,000

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

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

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

Instructions
For each of the following, state in what area of the annual report the item would be presented. If the item would probably not be found in an annual report, state “Not disclosed.”
(a) The total cumulative amount received from stockholders in exchange for common stock.
(b) An independent assessment concerning whether the financial statements present a fair depiction of the company’s results and financial position.
(c) The interest rate that the company is being charged on all outstanding debts.
(d) Total revenue from operating activities.
(e) Management’s assessment of the company’s results.
(f) The names and positions of all employees hired in the last year.

Exercises: Set B and Challenge Exercises

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

Problems: Set A

P1-1A Presented below are five independent situations.
(a) Three physics professors at MIT have formed a business to improve the speed of information transfer over the Internet for stock exchange transactions. Each has contributed an equal amount of cash and knowledge to the venture. Although their approach looks promising, they are concerned about the legal liabilities that their business might confront.
(b) Ed Toth, a college student looking for summer employment, opened a bait shop in a small shed at a local marina.
(c) Joan Stuebben and Ron Klinke each owned separate shoe manufacturing businesses. They have decided to combine their businesses. They expect that within the coming year they will need significant funds to expand their operations.
(d) Crystal, Allie, and Harry recently graduated with marketing degrees. They have decided to start a consulting business focused on marketing sporting goods over the Internet.
(e) Mark Willis wants to rent CD players and CDs in airports across the country. His idea is that customers will be able to rent equipment and CDs at one airport, listen to the CDs on their flights, and return the equipment and CDs at their destination airport. Of course, this will require a substantial investment in equipment and CDs, as well as employees and locations in each airport. Mark has no savings or personal assets. He wants to maintain control over the business.

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

P1-2A Financial decisions often place heavier emphasis on one type of financial statement over the others. Consider each of the following hypothetical situations independently.
(a) The North Face, Inc. is considering extending credit to a new customer. The terms of the credit would require the customer to pay within 30 days of receipt of goods.
(b) An investor is considering purchasing common stock of Amazon.com. The investor plans to hold the investment for at least 5 years.
(c) Chase Manhattan is considering extending a loan to a small company. The company would be required to make interest payments at the end of each year for 5 years, and to repay the loan at the end of the fifth year.
(d) The president of Campbell Soup is trying to determine whether the company is generating enough cash to increase the amount of dividends paid to investors in this and future years, and still have enough cash to buy equipment as it is needed.

Instructions
In each situation, state whether the decision maker would be most likely to place primary emphasis on information provided by the income statement, balance sheet, or statement of cash flows. In each case provide a brief justification for your choice. Choose only one financial statement in each case.
**P1-3A** On June 1, Beardsley Service Co. was started with an initial investment in the company of $22,100 cash. Here are the assets and liabilities of the company at June 30, and the revenues and expenses for the month of June, its first month of operations:

<table>
<thead>
<tr>
<th>Asset/Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 4,600</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>4,000</td>
</tr>
<tr>
<td>Service revenue</td>
<td>7,500</td>
</tr>
<tr>
<td>Supplies</td>
<td>2,400</td>
</tr>
<tr>
<td>Advertising expense</td>
<td>400</td>
</tr>
<tr>
<td>Equipment</td>
<td>26,000</td>
</tr>
<tr>
<td>Notes payable</td>
<td>$12,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>500</td>
</tr>
<tr>
<td>Supplies expense</td>
<td>1,000</td>
</tr>
<tr>
<td>Maintenance and repairs expense</td>
<td>600</td>
</tr>
<tr>
<td>Utilities expense</td>
<td>300</td>
</tr>
<tr>
<td>Salaries and wages expense</td>
<td>1,400</td>
</tr>
</tbody>
</table>

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

**Instructions**

(a) Prepare an income statement and a retained earnings statement for the month of June and a balance sheet at June 30, 2012.

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

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

**P1-4A** Presented below is selected financial information for Yvonne Corporation for December 31, 2012.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$ 25,000</td>
</tr>
<tr>
<td>Cash paid to suppliers</td>
<td>104,000</td>
</tr>
<tr>
<td>Building</td>
<td>200,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>50,000</td>
</tr>
<tr>
<td>Cash dividends paid</td>
<td>7,000</td>
</tr>
<tr>
<td>Cash paid to purchase equipment</td>
<td>$12,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>40,000</td>
</tr>
<tr>
<td>Cash received from customers</td>
<td>132,000</td>
</tr>
<tr>
<td>Cash received from issuing common stock</td>
<td>22,000</td>
</tr>
</tbody>
</table>

**Instructions**

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

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

**P1-5A** Gabelli Corporation was formed on January 1, 2012. At December 31, 2012, John Paulus, the president and sole stockholder, decided to prepare a balance sheet, which appeared as follows.

```
GABELLI CORPORATION
Balance Sheet
December 31, 2012

Assets                              Liabilities and Stockholders’ Equity
Cash                                 $20,000          Accounts payable $30,000
Accounts receivable                 50,000           Notes payable     15,000
Inventory                            36,000           Boat loan         22,000
Boat                                 24,000           Stockholders’ equity 64,000

```

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

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

**Instructions**

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

(b) Provide a corrected balance sheet for Gabelli Corporation. *(Hint: To get the balance sheet to balance, adjust stockholders’ equity.)*
Problems: Set B

P1-1B  Presented below are five independent situations.
(a) Rachel Jackson, a college student looking for summer employment, opened a vegetable stand along a busy local highway. Each morning she buys produce from local farmers, then sells it in the afternoon as people return home from work.
(b) Colin Doyle and Jason Elliot each owned separate swing-set manufacturing businesses. They have decided to combine their businesses and try to expand their reach beyond their local market. They expect that within the coming year they will need significant funds to expand their operations.
(c) Three chemistry professors at FIU have formed a business to employ bacteria to clean up toxic waste sites. Each has contributed an equal amount of cash and knowledge to the venture. The use of bacteria in this situation is experimental, and legal obligations could result.
(d) Brittany Medler has run a successful, but small cooperative health food store for over 20 years. The increased sales of her store have made her believe that the time is right to open a national chain of health food stores across the country. Of course, this will require a substantial investment in stores, inventory, and employees in each store. Brittany has no savings or personal assets. She wants to maintain control over the business.
(e) Cheryl Lamb and Tom Majors recently graduated with masters degrees in economics. They have decided to start a consulting business focused on teaching the basics of international economics to small business owners interested in international trade.

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

P1-2B  Financial decisions often place heavier emphasis on one type of financial statement over the others. Consider each of the following hypothetical situations independently.
(a) An investor is considering purchasing common stock of the Bally Total Fitness company. The investor plans to hold the investment for at least 3 years.
(b) Boeing is considering extending credit to a new customer. The terms of the credit would require the customer to pay within 60 days of receipt of goods.
(c) The president of Northwest Airlines is trying to determine whether the company is generating enough cash to increase the amount of dividends paid to investors in this and future years, and still have enough cash to buy new flight equipment as it is needed.
(d) Bank of America is considering extending a loan to a small company. The company would be required to make interest payments at the end of each year for 5 years, and to repay the loan at the end of the fifth year.

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

P1-3B  Special Delivery was started on May 1 with an investment of $45,000 cash. Following are the assets and liabilities of the company on May 31, 2012, and the revenues and expenses for the month of May, its first month of operations.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$6,200</td>
<td>Notes payable</td>
<td>$28,000</td>
</tr>
<tr>
<td>Service revenue</td>
<td>10,400</td>
<td>Salaries and wages expense</td>
<td>2,000</td>
</tr>
<tr>
<td>Advertising expense</td>
<td>800</td>
<td>Equipment</td>
<td>56,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>2,400</td>
<td>Maintenance and repairs expense</td>
<td>2,900</td>
</tr>
<tr>
<td>Cash</td>
<td>15,800</td>
<td>Insurance expense</td>
<td>400</td>
</tr>
</tbody>
</table>

No additional common stock was issued in May, but a dividend of $1,700 in cash was paid.

Instructions
(a) Prepare an income statement and a retained earnings statement for the month of May and a balance sheet at May 31, 2012.
(b) Briefly discuss whether the company’s first month of operations was a success.
(c) Discuss the company’s decision to distribute a dividend.

**P1-4B**  
Presented below are selected financial statement items for Rowe Corporation for December 31, 2012.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$ 55,000</td>
</tr>
<tr>
<td>Cash paid to suppliers</td>
<td>154,000</td>
</tr>
<tr>
<td>Buildings</td>
<td>400,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>20,000</td>
</tr>
<tr>
<td>Cash dividends paid</td>
<td>6,000</td>
</tr>
<tr>
<td>Cash paid to purchase equip.</td>
<td>30,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>40,000</td>
</tr>
<tr>
<td>Revenues</td>
<td>200,000</td>
</tr>
<tr>
<td>Cash received from customers</td>
<td>172,000</td>
</tr>
<tr>
<td>Cash received from issuing bonds payable</td>
<td>40,000</td>
</tr>
</tbody>
</table>

**Instructions**

(a) Determine which items should be included in a statement of cash flows, and then prepare the statement for Rowe Corporation.
(b) Comment on the adequacy of net cash provided by operating activities to fund the company’s investing activities and dividend payments.

**P1-5B**  
Austin Corporation was formed during 2011 by Joanna Kay. Joanna is the president and sole stockholder. At December 31, 2012, Joanna prepared an income statement for Austin Corporation. Joanna is not an accountant, but she thinks she did a reasonable job preparing the income statement by looking at the financial statements of other companies. She has asked you for advice. Joanna’s income statement appears as follows.

**AUSTIN CORPORATION**  
**Income Statement**  
**For the Year Ended December 31, 2012**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$17,000</td>
</tr>
<tr>
<td>Service revenue</td>
<td>47,000</td>
</tr>
<tr>
<td>Rent expense</td>
<td>10,000</td>
</tr>
<tr>
<td>Insurance expense</td>
<td>7,000</td>
</tr>
<tr>
<td>Vacation expense</td>
<td>4,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$43,000</td>
</tr>
</tbody>
</table>

Joanna has also provided you with these facts.

1. Included in the service revenue account is $3,000 of revenue that the company earned and received payment for in 2011. She forgot to include it in the 2011 income statement, so she put it in this year’s statement.
2. Joanna operates her business out of the basement of her parents’ home. They do not charge her anything, but she thinks that if she paid rent it would cost her about $10,000 per year. Therefore, she included $10,000 of rent expense in the income statement.
3. To reward herself for a year of hard work, Joanna went to Greece. She did not use company funds to pay for the trip, but she reported it as an expense on the income statement since it was her job that made her need the vacation.

**Instructions**

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

**Problems: Set C**

Visit the book’s companion website, at [www.wiley.com/college/kimmel](http://www.wiley.com/college/kimmel), and choose the Student Companion site to access Problem Set C.

**Continuing Cookie Chronicle**

**CCC1** Natalie Koebel spent much of her childhood learning the art of cookie-making from her grandmother. They spent many happy hours mastering every type of cookie imaginable and later devised new recipes that were both healthy and delicious. Now at
Chapter 1 Introduction to Financial Statements

At the start of her second year in college, Natalie is investigating possibilities for starting her own business as part of the entrepreneurship program in which she is enrolled. A long-time friend insists that Natalie has to include cookies in her business plan. After a series of brainstorming sessions, Natalie settles on the idea of operating a cookie-making school. She will start on a part-time basis and offer her services in people's homes. Now that she has started thinking about it, the possibilities seem endless. During the fall, she will concentrate on holiday cookies. She will offer group sessions (which will probably be more entertainment than education) and individual lessons. Natalie also decides to include children in her target market. The first difficult decision is coming up with the perfect name for her business. She settles on "Cookie Creations," and then moves on to more important issues.

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

Financial Reporting and Analysis

FINANCIAL REPORTING PROBLEM: Tootsie Roll Industries Inc.

BYP1-1 The 2009 financial statements of Tootsie Roll Industries, Inc. are provided in Appendix A.

Instructions
Refer to Tootsie Roll’s financial statements to answer the following questions.
(a) What were Tootsie Roll’s total assets at December 31, 2009? At December 31, 2008?
(b) How much cash did Tootsie Roll have on December 31, 2009?
(c) What amount of accounts payable did Tootsie Roll report on December 31, 2009? On December 31, 2008?
(d) What were Tootsie Roll’s total revenues in 2009? In 2008?
(e) What is the amount of the change in Tootsie Roll’s net income from 2008 to 2009?

COMPARATIVE ANALYSIS PROBLEM: Tootsie Roll vs. Hershey

BYP1-2 Tootsie Roll’s financial statements are presented in Appendix A, and the financial statements of The Hershey Company are presented in Appendix B.

Instructions
(a) Based on the information in these financial statements, determine the following for each company.
(1) Total assets at December 31, 2009.
(2) Net property, plant, and equipment at December 31, 2009.
(3) Total revenue for 2009.
(4) Net income for 2009.
(b) What conclusions concerning the two companies can you draw from these data?
RESEARCH CASE
BYP1-3 The September 3, 2009, issue of BusinessWeek includes an article by Lindsey Gerdes entitled “The Best Places to Launch a Career.” It provides interesting information regarding the job opportunities for accounting students.

Instructions
Read the article and answer the following questions. (The article can be found at www.businessweek.com/magazine/content/09_37/b4146032027785.htm.)
(a) What position did each of the “Big Four” (the four largest international accounting firms) receive in the survey?
(b) To what did the article attribute the accounting firms’ success?
(c) What was the starting salary for a new employee at Deloitte and Touche?
(d) The accounting firms’ hiring was affected by the recession although not as much as many of the other employers in the survey. Which one of the Big Four firms had the smallest decline in hiring, and which had the largest?

INTERPRETING FINANCIAL STATEMENTS
BYP1-4 Xerox was not having a particularly pleasant year. The company’s stock price had already fallen in the previous year from $60 per share to $30. Just when it seemed things couldn’t get worse, Xerox’s stock fell to $4 per share. The data below were taken from the statement of cash flows of Xerox. All dollars are in millions.

<table>
<thead>
<tr>
<th>Activity</th>
<th>Amount (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash used in operating activities</td>
<td>(663)</td>
</tr>
<tr>
<td>Cash used in investing activities</td>
<td>(644)</td>
</tr>
<tr>
<td>Financing activities</td>
<td></td>
</tr>
<tr>
<td>Dividends paid</td>
<td>(587)</td>
</tr>
<tr>
<td>Net cash received from issuing debt</td>
<td>3,498</td>
</tr>
<tr>
<td>Cash provided by financing activities</td>
<td>2,911</td>
</tr>
</tbody>
</table>

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

FINANCIAL ANALYSIS ON THE WEB
BYP1-5 Purpose: Identify summary information about companies. This information includes basic descriptions of the company’s location, activities, industry, financial health, and financial performance.
Address: http://biz.yahoo.com/i, or go to www.wiley.com/college/kimmel
Steps
1. Type in a company name, or use the index to find company name.
2. Choose Quote, then choose Profile, then choose Income Statement. Perform instructions (a) and (b) below.
3. Choose Industry to identify others in this industry. Perform instructions (c)–(e) below.

Instructions
Answer the following questions.
(a) What was the company’s net income? Over what period was this measured?
(b) What was the company’s total sales? Over what period was this measured?
(c) What is the company’s industry?
(d) What are the names of four companies in this industry?
(e) Choose one of the competitors. What is this competitor’s name? What were its sales? What was its net income?
Critical Thinking

DECISION MAKING ACROSS THE ORGANIZATION

BYP1-6 Kim Walters recently accepted a job in the production department at Tootsie Roll. Before she starts work, she decides to review the company’s annual report to better understand its operations.

Instructions
Use the annual report provided in Appendix A to answer the following questions.
(a) What CPA firm performed the audit of Tootsie Roll’s financial statements?
(b) What was the amount of Tootsie Roll’s earnings per share in 2009?
(c) What are the company’s net sales in foreign countries in 2009?
(d) What did management suggest as the cause of the decrease in the earnings from operations in 2009?
(e) What were net sales in 2005?
(f) How many shares of Class B common stock have been authorized?
(g) How much cash was spent on capital expenditures in 2009?
(h) Over what life does the company depreciate its buildings?
(i) What was the value of raw material and supplies inventory in 2008?

COMMUNICATION ACTIVITY

BYP1-7 Jane Noonan is the bookkeeper for Wilson Company, Inc. Jane has been trying to get the company’s balance sheet to balance. She finally got it to balance, but she still isn’t sure that it is correct.

WILSON COMPANY, INC.
Balance Sheet
For the Month Ended December 31, 2012

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Stockholders’ Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>$18,000</td>
</tr>
<tr>
<td>Cash</td>
<td>9,000</td>
</tr>
<tr>
<td>Supplies</td>
<td>1,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Total assets</td>
<td>$24,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>$12,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>(6,000)</td>
</tr>
<tr>
<td>Dividends</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Notes payable</td>
<td>10,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>10,000</td>
</tr>
<tr>
<td>Total liabilities and stockholders’ equity</td>
<td>$24,000</td>
</tr>
</tbody>
</table>

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

ETHICS CASE

BYP1-8 Rules governing the investment practices of individual certified public accountants prohibit them from investing in the stock of a company that their firm audits. The Securities and Exchange Commission (SEC) became concerned that some accountants were violating this rule. In response to an SEC investigation, PricewaterhouseCoopers fired 10 people and spent $25 million educating employees about the investment rules and installing an investment tracking system.

Instructions
Answer the following questions.
(a) Why do you think rules exist that restrict auditors from investing in companies that are audited by their firms?
(b) Some accountants argue that they should be allowed to invest in a company’s stock as long as they themselves aren’t involved in working on the company’s audit or consulting. What do you think of this idea?
(c) Today a very high percentage of publicly traded companies are audited by only four very large public accounting firms. These firms also do a high percentage of the consulting work that
is done for publicly traded companies. How does this fact complicate the decision regarding whether CPAs should be allowed to invest in companies audited by their firm?

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

(e) Why do you think PricewaterhouseCoopers took such extreme steps in response to the SEC investigation?

“ALL ABOUT YOU” ACTIVITY

BYPI-9 Some people are tempted to make their finances look worse to get financial aid. Companies sometimes also manage their financial numbers in order to accomplish certain goals. Earnings management is the planned timing of revenues, expenses, gains, and losses to smooth out bumps in net income. In managing earnings, companies' actions vary from being within the range of ethical activity, to being both unethical and illegal attempts to mislead investors and creditors.

Instructions
Provide responses for each of the following questions.

(a) Discuss whether you think each of the following actions (adapted from www.fafaid.org/afasa/maximize.phtml) to increase the chances of receiving financial aid is ethical.

(i) Spend down the student's assets and income first, before spending parents' assets and income.

(ii) Accelerate necessary expenses to reduce available cash. For example, if you need a new car, buy it before applying for financial aid.

(iii) State that a truly financially dependent child is independent.

(iv) Have a parent take an unpaid leave of absence for long enough to get below the “threshold” level of income.

(b) What are some reasons why a company might want to overstate its earnings?

(c) What are some reasons why a company might want to understate its earnings?

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

FASB CODIFICATION ACTIVITY

BYPI-10 The FASB has developed the Financial Accounting Standards Board Accounting Standards Codification (or more simply "the Codification"). The FASB’s primary goal in developing the Codification is to provide in one place all the authoritative literature related to a particular topic. To provide easy access to the Codification, the FASB also developed the Financial Accounting Standards Board Codification Research System (CRS). CRS is an online, real-time database that provides easy access to the Codification. The Codification and the related CRS provide a topically organized structure, subdivided into topic, subtopics, sections, and paragraphs, using a numerical index system.

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

Instructions
Academic access to the FASB Codification is available through university subscriptions, obtained from the American Accounting Association (at http://aaahq.org/FASB/Access.cfm), for an annual fee of $150. This subscription covers an unlimited number of students within a single institution. Once this access has been obtained by your school, you should login (at http://aaahq.org/ascLogin.cfm) and familiarize yourself with the resources that are accessible at the FASB Codification site.

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

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

p. 8 The Numbers Behind Not-for-Profit Organizations Q: What benefits does a sound accounting system provide to a not-for-profit organization? A: Accounting provides at least two benefits to not-for-profit organizations. First, it helps to ensure that money is used in the way that donors intended. Second, it assures donors that their money is not going to waste and thus increases the likelihood of future donations.

p. 15 Rocking the Bottom Line Q: What is one way that some of these disputes might be resolved? A: Frequently, when contractual payments depend on accounting-based financial results, interested parties employ outside auditors to evaluate whether the financial information has been prepared fairly and accurately. The musicians would like auditors to have easy access to inventory and manufacturing information of the recording companies.

**Answers to Self-Test Questions**


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**IFRS A Look at IFRS**

Most agree that there is a need for one set of international accounting standards. Here is why:

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

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

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

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

**KEY POINTS**

- International standards are referred to as International Financial Reporting Standards (IFRS), developed by the International Accounting Standards Board (IASB).
- Recent events in the global capital markets have underscored the importance of financial disclosure and transparency not only in the United States but in markets around the world. As a result, many are examining which accounting and financial disclosure rules should be followed. As indicated in the graphic on the next page, much of the world has voted for the standards issued by the IASB. Over 115 countries require or permit use of IFRS.
U.S. standards, referred to as generally accepted accounting principles (GAAP), are developed by the Financial Accounting Standards Board (FASB). The fact that there are differences between what is in this textbook (which is based on U.S. standards) and IFRS should not be surprising because the FASB and IASB have responded to different user needs. In some countries, the primary users of financial statements are private investors; in others, the primary users are tax authorities or central government planners. It appears that the United States and the international standard-setting environment are primarily driven by meeting the needs of investors and creditors.

The internal control standards applicable to Sarbanes-Oxley (SOX) apply only to large public companies listed on U.S. exchanges. There is a continuing debate as to whether non-U.S. companies should have to comply with this extra layer of regulation. Debate about international companies (non-U.S.) adopting SOX-type standards centers on whether the benefits exceed the costs. The concern is that the higher costs of SOX compliance are making the U.S. securities markets less competitive.

The textbook mentions a number of ethics violations, such as Enron, WorldCom, and AIG. These problems have also occurred internationally, for example, at Satyam Computer Services (India), Parmalat (Italy), and Royal Ahold (the Netherlands).

IFRS tends to be simpler in its accounting and disclosure requirements; some people say it is more “principles-based.” GAAP is more detailed; some people say it is more “rules-based.” This difference in approach has resulted in a debate about the merits of “principles-based” versus “rules-based” standards.

U.S. regulators have recently eliminated the need for foreign companies that trade shares in U.S. markets to reconcile their accounting with GAAP.

The three most common forms of business organization, proprietorships, partnerships, and corporations, are also found in countries that use IFRS. Because the choice of business organization is influenced by factors such as legal environment, tax rates and regulations, and degree of entrepreneurism, the relative use of each form will vary across countries.

The conceptual framework that underlies IFRS is very similar to that used to develop GAAP. The basic definitions provided in this textbook for the key elements of financial statements, that is, assets, liabilities, equity, revenues, and expenses, are simplified versions of the official definitions provided by the FASB. The more substantive definitions, using the IASB definitional structure, are as follows.

**Assets.** A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
Liabilities. A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Liabilities may be legally enforceable via a contract or law, but need not be, i.e., they can arise due to normal business practice or customs.

Equity. A residual interest in the assets of the entity after deducting all its liabilities.

Income. Increases in economic benefits that result in increases in equity (other than those related to contributions from shareholders). Income includes both revenues (resulting from ordinary activities) and gains.

Expenses. Decreases in economic benefits that result in decreases in equity (other than those related to distributions to shareholders). Expenses includes losses that are not the result of ordinary activities.

LOOKING TO THE FUTURE

Both the IASB and the FASB are hard at work developing standards that will lead to the elimination of major differences in the way certain transactions are accounted for and reported. In fact, at one time the IASB stated that no new major standards would become effective until 2009. The major reason for this policy was to provide companies the time to translate and implement IFRS into practice, as much has happened in a very short period of time. Consider, for example, that as a result of a joint project on the conceptual framework, the definitions of the most fundamental elements (assets, liabilities, equity, revenues, and expenses) may actually change. However, whether the IASB adopts internal control provisions similar to those in SOX remains to be seen.

IFRS Self-Test Questions

1. Which of the following is not a reason why a single set of high-quality international accounting standards would be beneficial?
   (a) Mergers and acquisition activity.
   (b) Financial markets.
   (c) Multinational corporations.
   (d) GAAP is widely considered to be a superior reporting system.

2. The Sarbanes-Oxley Act determines:
   (a) international tax regulations.
   (b) internal control standards as enforced by the IASB.
   (c) internal control standards of U.S. publicly traded companies.
   (d) U.S. tax regulations.

3. IFRS is considered to be more:
   (a) principles-based and less rules-based than GAAP.
   (b) rules-based and less principles-based than GAAP.
   (c) detailed than GAAP.
   (d) None of the above.

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

5. Which of the following statements is true?
   (a) Under IFRS, the term income refers to what would be called revenues and gains under GAAP.
   (b) The term income is not used under IFRS.
   (c) The term income refers only to gains on investments.
   (d) Under IFRS, expenses include distributions to owners.

IFRS Concepts and Application

IFRS1-1 Who are the two key international players in the development of international accounting standards? Explain their role.
IFRS1-2 What might explain the fact that different accounting standard-setters have developed accounting standards that are sometimes quite different in nature?

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

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

INTERNATIONAL FINANCIAL REPORTING PROBLEM: Zetar plc

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

Instructions
Visit Zetar's corporate website and answer the following questions from Zetar's 2009 annual report.
(a) What accounting firm performed the audit of Zetar's financial statements?
(b) Over what life does the company depreciate its buildings?
(c) What is the address of the company's corporate headquarters?
(d) What is the company's reporting currency?
(e) What two segments does the company operate in, and what were the sales for each segment in the year ended April 30, 2009?

Answers to IFRS Self-Test Questions
1. d 2. c 3. a 4. c 5. a