# CHAPTER 2

# Financial Statements and the Annual Report

## OVERVIEW OF EXERCISES, PROBLEMS, AND CASES

| Learning Outcomes | Exercises | Estimated Time in Minutes | Level |
|---|---|---|---|
| **Module 1** | | | |
| **1.** Describe the objectives of financial reporting. | | | |
| **2.** Describe the qualitative characteristics of accounting information. | 1 | 10 | Easy |
| **Module 2** | | | |
| **3.** Explain the concept and purpose of a classified balance sheet and prepare the statement. | 2 | 10 | Mod |
| | 3 | 10 | Easy |
| | 5 | 10 | Easy |
| | 12* | 10 | Mod |
| **4.** Use a classified balance sheet to analyze a company's financial position. | 4 | 10 | Easy |
| **Module 3** | | | |
| **5.** Explain the difference between a single-step and a multiple-step income statement and prepare each type of income statement. | 6 | 10 | Easy |
| | 7 | 10 | Mod |
| | 12* | 10 | Mod |
| | 13* | 15 | Mod |
| | 14* | 5 | Easy |
| **6.** Use a multiple-step income statement to analyze a company's operations. | 8 | 10 | Easy |
| | 13* | 15 | Mod |
| | 14* | 5 | Easy |
| **7.** Identify the components of the statement of retained earnings and prepare the statement. | 9 | 10 | Mod |
| | 12* | 10 | Mod |
| **8.** Identify the components of the statement of cash flows and prepare the statement. | 10 | 10 | Easy |
| **Module 4** | | | |
| **9.** Read and use the financial statements and other elements in the annual report of a publicly held company. | 11 | 20 | Diff |

*Exercise, problem, or case covers two or more learning outcomes
Level = Difficulty levels: Easy; Moderate (Mod); Difficult (Diff)

| Learning Outcomes | Problems and Alternates | Estimated Time in Minutes | Level |
|---|---|---|---|
| **Module 1** | | | |
| **1.** Describe the objectives of financial reporting. | 12* | 45 | Diff |
| **2.** Describe the qualitative characteristics of accounting information. | 1 | 15 | Diff |
| | 2 | 15 | Mod |
| | 10* | 35 | Mod |
| | 11* | 20 | Mod |
| **Module 2** | | | |
| **3.** Explain the concept and purpose of a classified balance sheet and prepare the statement. | 3 | 50 | Mod |
| **4.** Use a classified balance sheet to analyze a company's financial position. | 4 | 20 | Easy |
| | 5 | 15 | Mod |
| | 10* | 35 | Mod |
| | 12* | 45 | Diff |
| **Module 3** | | | |
| **5.** Explain the difference between a single-step and a multiple-step income statement and prepare each type of income statement. | 6 | 30 | Mod |
| | 7 | 45 | Mod |
| | 11* | 20 | Mod |
| **6.** Use a multiple-step income statement to analyze a company's operations. | | | |
| **7.** Identify the components of the statement of retained earnings and prepare the statement. | | | |
| **8.** Identify the components of the statement of cash flows and prepare the statement. | 8 | 30 | Mod |
| | 12* | 45 | Diff |
| **Module 4** | | | |
| **9.** Read and use the financial statements and other elements in the annual report of a publicly held company. | 9 | 30 | Diff |

*Exercise, problem, or case covers two or more learning outcomes
Level = Difficulty levels: Easy; Moderate (Mod); Difficult (Diff)

| Learning Outcomes | Cases | Estimated Time in Minutes | Level |
|---|---|---|---|
| **Module 1** | | | |
| **1.** Describe the objectives of financial reporting. | | | |
| **2.** Describe the qualitative characteristics of accounting information. | 5 | 30 | Mod |
| **Module 2** | | | |
| **3.** Explain the concept and purpose of a classified balance sheet and prepare the statement. | | | |
| **4.** Use a classified balance sheet to analyze a company's financial position. | 1 | 30 | Mod |
| | 2 | 20 | Mod |
| | 6* | 30 | Mod |
| **Module 3** | | | |
| **5.** Explain the difference between a single-step and a multiple-step income statement and prepare each type of income statement. | | | |
| **6.** Use a multiple-step income statement to analyze a company's operations. | 6* | 30 | Mod |
| **7.** Identify the components of the statement of retained earnings and prepare the statement. | | | |
| **8.** Identify the components of the statement of cash flows and prepare the statement. | 3 | 25 | Mod |
| **Module 4** | | | |
| **9.** Read and use the financial statements and other elements in the annual report of a publicly held company. | 4 | 20 | Mod |

*Exercise, problem, or case covers two or more learning outcomes
Level = Difficulty levels: Easy; Moderate (Mod); Difficult (Diff)

# EXERCISES

LO 2

## EXERCISE 2-1 CHARACTERISTICS OF USEFUL ACCOUNTING INFORMATION

**1.** materiality
**2.** relevance
**3.** faithful representation
**4.** consistency
**5.** understandability
**6.** comparability

LO 3

## EXERCISE 2-2 THE OPERATING CYCLE

**1.** For a company that sells a product, the operating cycle begins when the cash is invested in inventory and ends when cash is collected by the company from its customers. Two Wheeler's operating cycle would be a minimum of 45 days (for cash sales) and a maximum of 75 days (for sales on credit: 45 days to sell the bike and 30 days to collect).

**2.** The operating cycle for Baxter, the manufacturer of the bikes, would normally be longer than Two Wheeler's. This is because a manufacturer incurs various costs to produce the bikes before it sells them to retailers such as Two Wheeler and eventually collects cash from the sales. On the other hand, the retailer only buys a finished good from the manufacturer and then sells it to the customer.

LO 3

## EXERCISE 2-3 CLASSIFICATION OF FINANCIAL STATEMENT ITEMS

**1.** CA
**2.** SE
**3.** NCA
**4.** CA
**5.** CL
**6.** NCA
**7.** CL
**8.** SE
**9.** NCA
**10.** LTL

LO 4

## EXERCISE 2-4 CURRENT RATIO

1. Current Ratio = Current Assets/Current Liabilities

   December 31, 2015:

   Current Ratio = ($6,000 + $10,000 + $8,000)/($7,000 + $1,000 + $4,000)
   = $24,000/$12,000
   = 2.0 to 1

   December 31, 2016:

   Current Ratio = ($3,000 + $15,000 + $12,000)/($12,000 + $2,000 + $6,000)
   = $30,000/$20,000
   = 1.5 to 1

2. Baldwin's current ratio decreased from 2.0 at the end of 2015 to 1.5 at the end of 2016. In general, the higher the current ratio, the more liquid the company.

3. Cash decreased by 50%, from $6,000 to $3,000, and accounts receivable increased by 50%, from $10,000 to $15,000. Inventory also increased by 50%, from $8,000 to $12,000. Not only did Baldwin's current ratio decrease, but its current assets are also less liquid at the end of the year, with more invested in receivables and inventory and less in cash.

LO 3

## EXERCISE 2-5 CLASSIFICATION OF ASSETS AND LIABILITIES

1. CA
2. CL
3. CA
4. NCA
5. CL
6. CL
7. CA
8. LTL
9. NCA

LO 5

## EXERCISE 2-6 SELLING EXPENSES AND GENERAL AND ADMINISTRATIVE EXPENSES

1. Advertising expense—S
2. Depreciation expense—store furniture and fixtures—S
3. Office rent expense—G&A
4. Office salaries expense—G&A
5. Store rent expense—S
6. Store salaries expense—S
7. Insurance expense—G&A*
8. Supplies expense—G&A*
9. Utilities expense—G&A*

*Each of these could be classified as a selling expense if the cost is related in some way to the sales function; e.g., insurance on cars driven by salespeople could be classified as a selling expense.

LO 5

## EXERCISE 2-7 MISSING INCOME STATEMENT AMOUNTS

| | Sara's Coffee Shop | Amy's Deli | Jane's Bagels |
|---|---|---|---|
| Net sales | $35,000 | **(3) $63,000** | $78,000 |
| Cost of goods sold | **(1) 28,000** | 45,000 | **(7) 39,000** |
| Gross profit | 7,000 | 18,000 | **(6) 39,000** |
| Selling expenses | 3,000 | **(4) 6,000** | 9,000 |
| General and administrative expenses | 1,500 | 2,800 | **(5) 4,600** |
| Total operating expenses | **(2) 4,500** | 8,800 | 13,600 |
| Net income | $ 2,500 | $ 9,200 | $25,400 |

Solved as follows (in the order listed):

**(1)** $35,000 – $7,000 = $28,000
**(2)** $3,000 + $1,500 = $4,500
**(3)** $45,000 + $18,000 = $63,000
**(4)** $8,800 – $2,800 = $6,000
**(5)** $13,600 – $9,000 = $4,600
**(6)** $25,400 + $13,600 = $39,000
**(7)** $78,000 – $39,000 = $39,000

LO 6

## EXERCISE 2-8 INCOME STATEMENT RATIO

**Profit margin:**

Net Income/Revenues = $45,000*/$134,800 = <u>33.4%</u>

*$134,800 – $38,310 – $36,990 – $580 – $13,920 = $45,000

A profit margin of 33% indicates that for every dollar of sales, Holly Enterprises has $0.33 in net income. It would be beneficial to compare the company's profit margin with some of its competitors and with previous years.

LO 7

### EXERCISE 2-9 STATEMENT OF RETAINED EARNINGS

**LANDON CORPORATION**
**STATEMENT OF RETAINED EARNINGS**
**FOR THE YEAR ENDED DECEMBER 31, 2016**

| | | |
|---|---|---|
| Retained earnings, January 1, 2016 | | $130,520* |
| Net income for 2016 | | 145,480 |
| Dividends declared and paid | | (40,000) |
| Retained earnings, December 31, 2016 | | $236,000 |
| *Retained earnings, January 2, 2014 | | $ 0 |
| Net income: | | |
| 2014 | $ 85,200 | |
| 2015 | 125,320 | 210,520 |
| Dividends: | | |
| 2014 | $ (40,000) | |
| 2015 | (40,000) | (80,000) |
| Retained earnings, December 31, 2015 | | $130,520 |

LO 8

### EXERCISE 2-10 COMPONENTS OF THE STATEMENT OF CASH FLOWS

1. Paid for supplies—O
2. Collected cash from customers—O
3. Purchased land (held for resale)—O
4. Purchased land (for construction of new building)—I
5. Paid dividend—F
6. Issued stock—F
7. Purchased computers (for use in the business)—I
8. Sold old equipment—I

LO 9

## EXERCISE 2-11 BASIC ELEMENTS OF FINANCIAL REPORTS

1. **Management discussion and analysis—**The information in this section of the annual report is prepared by management and is management's opportunity to explain various items that appear in the financial statements. Increases and decreases in various items are highlighted and reasons for these changes are given. The information in this section is not subject to any outside review or support. Users must rely on the integrity of management that the information contained in the report is reliable.

2. **Product/markets of company—**Management provides information in the annual report about the company's products and markets. The detail provided by management differs widely among companies, but most companies describe their various products and often show pictures of them. The distribution system for the products, i.e., whom the company sells to, is also described. Because the company's products and markets are a matter of public knowledge, they are subject to verification.

3. **Financial statements—**These are the responsibility of management and are normally prepared by the controller. They include the income statement, balance sheet, statement of changes in stockholders' equity, and statement of cash flows. The information provided in the financial statements is subject to verification as part of the external audit.

4. **Notes to financial statements—**These are also the responsibility of management, and they include detailed explanations about the various items appearing in the financial statements. One of the first notes in most annual reports is a summary of the significant accounting policies, such as the company's inventory valuation methods and depreciation methods. The information included in the notes is subject to review by the independent auditors and is therefore highly verifiable.

5. **Independent accountants' report—**As the name implies, this report is prepared by the independent auditors. It includes information about the scope of the audit (the statements included in the audit), the auditing standards followed in conducting the audit, and an opinion as to the fairness of presentation of the financial statements. Because the public relies on the auditors to render an impartial opinion, the auditing profession is subject to a set of high ethical standards in performing audits.

## MULTI-CONCEPT EXERCISES

LO 3,5,7

### EXERCISE 2-12 FINANCIAL STATEMENT CLASSIFICATION

BS = Balance sheet; IS = Income statement; RE = Retained earnings statement

1. Accounts payable—BS
2. Accounts receivable—BS
3. Advertising expense—IS
4. Bad debt expense—IS
5. Bonds payable—BS
6. Buildings—BS
7. Cash—BS
8. Common stock—BS
9. Depreciation expense—IS
10. Dividends—RE
11. Land held for future expansion—BS
12. Loan payable—BS
13. Office supplies—BS
14. Patent—BS
15. Patent amortization expense—IS
16. Prepaid insurance—BS
17. Retained earnings—BS and RE
18. Sales—IS
19. Utilities expense—IS
20. Wages payable—BS

LO 5,6

### EXERCISE 2-13 SINGLE- AND MULTIPLE-STEP INCOME STATEMENT

1. Sales—B
2. Cost of goods sold—B
3. Selling expenses—M*
4. Total revenues—S
5. Utilities expense—B
6. Administrative expense—M*
7. Net income—B
8. Supplies on hand—N
9. Accumulated depreciation—N
10. Income before income taxes—M
11. Gross profit—M

*This assumes that selling and administrative expenses are each headings for a group of expenses. If this is the case, they would appear only on a multiple-step income statement.

LO 5,6 **EXERCISE 2-14 MULTIPLE-STEP INCOME STATEMENT**

**Profit margin:**

Net Income/Sales = $614,200*/$1,200,000 = 51.2%

*$1,200,000 – $450,000 – $60,800 – $75,000 = $614,200*

| | |
|---|---|
| Sales | $1,200,000 |
| Cost of sales | 450,000 |
| Gross profit | $ 750,000 |
| Total operating expenses | 135,800** |
| Net income | $ 614,200* |

**Total Operating Expenses = Selling Expenses ($60,800) + General and Administrative Expenses ($75,000) = $135,800

Gaynor Corporation has been very profitable on the basis of its very high profit margin of 51.2%. Before making an investment, however, you would want to consider how this ratio compares with that of prior years and with that of other companies in the same line of business.

## PROBLEMS

LO 2 **PROBLEM 2-1 MATERIALITY**

1. Among the questions that might be answered by the analysis that was performed are these: Is the usage of any of the items cyclical? Is there a relationship between the usage of any two or more of the items? Is the amount being spent on these items material? Would it be feasible to set up an account at an office supply store for some of these items if they are used in large quantities? From this analysis, the company might decide to change the timing of its ordering to correspond to its need.
2. This question deals with the concept of materiality. It is likely this information would be more relevant for a real estate company than for a hardware store. Normally, a realtor would use more office supplies, relative to its use of other types of supplies, and thus the amount spent on office supplies would be more material to it than to a hardware store.

LO 2

**PROBLEM 2-2 COSTS AND EXPENSES**

1. **Display fixtures in a retail store—**Only a portion of the cost would appear in the period of acquisition; the fixtures should be depreciated over their useful lives.
2. **Advertising—**All.
3. **Merchandise for sale—**Only the cost of the merchandise sold during the current period would appear on the income statement; the remainder would appear as an asset on the balance sheet.
4. **Incorporation**—Because of the difficulty in determining the period over which benefits will be received from the costs necessary to incorporate, accounting standards require that these costs be expensed as incurred.
5. **Cost of a franchise—**This is a cost that should benefit several future periods, and only a portion should be expensed in the current period; the cost of the franchise should be treated as an intangible asset and amortized over the periods during which benefits are expected.
6. **Office supplies—**The portion of the supplies used should be recognized as an expense in the current period; the unused portion should be reported as a current asset.
7. **Wages and salaries—**All.
8. **Computer software**—Assuming that the software was purchased, an intangible asset should be recognized and a portion of the cost recognized as expense in each of the periods benefited.
9. **Computer hardware**—Only the portion of the cost associated with the benefits provided during the current period would be recognized as depreciation expense; the cost should be written off over the useful life of the hardware.

LO 3 **PROBLEM 2-3 CLASSIFIED BALANCE SHEET**

**1.** Classified balance sheet:

**RUTH CORPORATION**
**BALANCE SHEET**
**DECEMBER 31, 2016**

| | | | |
|---|---|---|---|
| **Assets** | | | |
| Current assets: | | | |
| Cash | | $ 13,230 | |
| Accounts receivable | | 23,450 | |
| Inventory | | 45,730 | |
| Prepaid rent | | 1,500 | |
| Office supplies | | 2,340 | |
| Total current assets | | | $ 86,250 |
| Long-term investments | | | 85,000 |
| Property, plant, and equipment: | | | |
| Land | | $250,000 | |
| Automobiles | $112,500 | | |
| Accumulated depreciation | 22,500 | 90,000 | |
| Buildings | $200,000 | | |
| Accumulated depreciation | 40,000 | 160,000 | |
| Total property, plant, and equipment | | | 500,000 |
| Intangible assets: | | | |
| Patents | | | 40,000 |
| Total assets | | | $711,250 |
| **Liabilities** | | | |
| Current liabilities: | | | |
| Accounts payable | | $ 18,255 | |
| Income taxes payable | | 6,200 | |
| Interest payable | | 1,500 | |
| Notes payable, due June 30, 2017 | | 10,000 | |
| Salaries and wages payable | | 4,200 | |
| Total current liabilities | | | $ 40,155 |
| Long-term debt: | | | |
| Bonds payable, due December 31, 2020 | | | 160,000 |
| Total liabilities | | | $200,155 |

**PROBLEM 2-3 (Concluded)**

| | | |
|---|---|---|
| **Stockholders' Equity** | | |
| Contributed capital: | | |
| Capital stock, $10 par value, | | |
| 15,000 shares issued and outstanding.................. | $150,000 | |
| Paid-in capital in excess of par value .......................... | 50,000 | |
| Total contributed capital.................................................. | $200,000 | |
| Retained earnings.......................................................... | 311,095 | |
| Total stockholders' equity ........................................... | | 511,095 |
| Total liabilities and stockholders' equity ........................... | | $711,250 |

**2.** Current Ratio = Current Assets/Current Liabilities

$86,250/$40,155 = 2.15 to 1

**3.** From the current ratio alone, Ruth appears to be relatively liquid. To fully assess its liquidity, however, it would be useful to look more specifically at the composition of the current assets and liabilities. How long does it take to sell inventory? How long does it take to collect an account receivable? Also, you would want to compare Ruth's current ratio at the end of this period with those of prior periods and with the current ratio for companies in the same industry.

LO 4

## PROBLEM 2-4 FINANCIAL STATEMENT RATIOS

**1. a.** Working capital at 12/31/16:

Current assets: $27,830 + $20,200 + $450 + $24,600 + $6,250 + $3,600 = $82,930
Current liabilities: $8,400 + $1,450 + $1,200 = $11,050
Working capital: $82,930 – $11,050 = $71,880

Working capital at 12/31/15:

Current assets: $35,770 + $19,450 + $700 + $26,200 + $5,020 + $4,800 = $91,940
Current liabilities: $5,200 + $1,200 + $12,000 + $1,230 + $1,600 = $21,230
Working capital: $91,940 – $21,230 = $70,710

**b.** Current ratio at 12/31/16:
$82,930/$11,050 = 7.50 to 1

Current ratio at 12/31/15:
$91,940/$21,230 = 4.33 to 1

**PROBLEM 2-4 (Concluded)**

**2.** Both the absolute liquidity position of the company and the relative liquidity position of the company have improved during 2016. First, the absolute position, as indicated by the amount of working capital, has improved from $70,710 to $71,880. The liquidity of the company has also improved on a relative basis, as indicated by the increase in the current ratio from 4.33 to 7.50. The primary reason for the improvement in the company's liquidity is the repayment during the year of the $12,000 note payable, along with the $1,200 of interest payable on the note. This is counterbalanced somewhat, though, by the decrease in accounts receivable from $35,770 to $27,830.

LO 4

**PROBLEM 2-5 WORKING CAPITAL AND CURRENT RATIO**

**1.** Current Ratio = Current Assets/Current Liabilities
= ($23,000 + $13,000 + $45,000 + $800)/($54,900 + $1,200)
= $81,800/$56,100 = 1.46 to 1

Working Capital = Current Assets – Current Liabilities
= $81,800 – $56,100 = $25,700

**2.** One concern is the relatively large percentage of the current assets tied up in inventory. This asset accounts for $45,000/$81,800, or 55% of the total current assets. What is the normal period of time it takes to sell inventory? Is any part of the inventory slow moving or obsolete?

**3.** On the basis of the current ratio alone, Stevenson appears to be relatively liquid, although it would be important to compare the ratio with those of prior years and with those of other companies in the same industry.

LO 5 **PROBLEM 2-6 SINGLE-STEP INCOME STATEMENT**

**1.** Single-step income statement:

**SHAW CORPORATION**
**INCOME STATEMENT**
**FOR THE CURRENT YEAR**

| | | |
|---|---|---|
| Revenues: | | |
| Sales | $48,300 | |
| Interest | 1,340 | |
| Rent | 6,700 | |
| Total revenues | | $56,340 |
| Expenses: | | |
| Advertising | $ 1,500 | |
| Commissions | 2,415 | |
| Cost of goods sold | 29,200 | |
| Depreciation—office building | 2,900 | |
| Income tax | 1,540 | |
| Insurance—salesperson's auto | 2,250 | |
| Interest | 1,400 | |
| Salaries and wages—office | 12,560 | |
| Supplies—office | 890 | |
| Total expenses | | 54,655 |
| Net income | | $ 1,685 |

**2.** A single-step income statement does not lend itself as readily to analysis as does a multiple-step statement. The lack of any grouping of the various expenses makes any type of analysis more difficult.

LO 5

**PROBLEM 2-7 MULTIPLE-STEP INCOME STATEMENT AND PROFIT MARGIN**

**1.** Multiple-step income statement:

**SHAW CORPORATION**
**INCOME STATEMENT**
**FOR THE CURRENT YEAR**

| | | | |
|---|---|---|---|
| Sales | | $48,300 | |
| Cost of goods sold | | 29,200 | |
| Gross profit | | | $ 19,100 |
| Operating expenses: | | | |
| Selling expenses: | | | |
| Advertising | $ 1,500 | | |
| Commissions | 2,415 | | |
| Insurance—salesperson's auto | 2,250 | | |
| Total selling expenses | | $ 6,165 | |
| General and administrative expenses: | | | |
| Depreciation—office building | $ 2,900 | | |
| Salaries and wages—office | 12,560 | | |
| Supplies—office | 890 | | |
| Total general and administrative expenses | | 16,350 | |
| Total operating expenses | | | 22,515 |
| Loss from operations | | | $ (3,415) |
| Other revenues and expenses: | | | |
| Interest expense | | $ 1,400 | |
| Interest revenue | | 1,340 | |
| Rent revenue | | 6,700 | |
| Excess of other revenues over other expenses | | | 6,640 |
| Income before taxes | | | $ 3,225 |
| Income tax expense | | | 1,540 |
| Net income | | | $ 1,685 |

**2.** The main advantages of the multiple-step income statement are the groupings of various items and the provision of important subtotals such as income from operations.

**3.** Profit Margin = Net Income/Sales
= $1,685/$48,300 = 3.5%

**4.** A profit margin of 3.5% means that for every dollar of sales the company has net income of $0.035. This would appear to be a reasonable profit margin, but it would be important to compare the profit margin with prior years and with other companies in the same industry.

LO 8 **PROBLEM 2-8 STATEMENT OF CASH FLOWS**

**1.**

**COLORADO CORPORATION**
**STATEMENT OF CASH FLOWS**
**FOR THE FIRST YEAR**

| | | |
|---|---|---|
| Cash flows from operating activities: | | |
| Cash collected from customers | $ 93,970 | |
| Cash paid for inventory | (65,600) | |
| Cash paid in salaries and wages | (20,400) | |
| Cash paid in taxes | (3,100) | |
| Net cash provided by operating activities | | $ 4,870 |
| Cash flows from investing activities: | | |
| Payment on office building | | (210,000) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of stock | $250,000 | |
| Proceeds from long-term note | 60,000 | |
| Dividends declared and paid | (5,600) | |
| Net cash provided by financing activities | | 304,400 |
| Net increase in cash | | $ 99,270 |
| Cash at beginning of year | | 0 |
| Cash at end of year | | $ 99,270 |

*Note:* Colorado should report one significant noncash activity as supplementary information to its statement of cash flows: the three-year, $90,000 note signed to finance the purchase of the office building.

**2.** First, the statement of cash flows reports on operations on a cash basis, as opposed to the income statement which is prepared on an accrual basis. Second, investing and financing activities are also reported on a statement of cash flows. For example, information about dividends paid during the year is shown on a statement of cash flows but not on an income statement. It is interesting to note that Colorado paid more in dividends, $5,600, than the amount of cash it generated from operations, $4,870.

LO 9

**PROBLEM 2-9 BASIC ELEMENTS OF FINANCIAL REPORTS**

Letter from the President to Stockholders of Grammar Inc.:

On the surface, 2016 does not appear to have been a successful year for Grammar Inc. One specific event, however, caused the net loss we experienced for the year. Operating income was $380,000 in 2016; however, the sale of a subsidiary at a loss of $400,000 resulted in a net loss for the year of $20,000. The sale of this unprofitable unit of the business should allow us to concentrate our attention in the future on our successful businesses and clear the way for a return to overall profitability in 2017.

I should point out to you that aside from the loss experienced on the sale of the subsidiary, 2016 was a very good year. We were able to control our operating expenses, as operating income as a percentage of sales increased from 20% to 38%. These are clear signals that Grammar is moving in the right direction and should have a solid year of operations in 2017.

## MULTI-CONCEPT PROBLEMS

LO 2,4

**PROBLEM 2-10 MAKING BUSINESS DECISIONS: LOANING MONEY TO THE COCA-COLA COMPANY**

.

**Part A. Ratio Decision Model**

**1.** Formulate the Question:
Is The Coca-Cola Company liquid enough to pay its obligations as they come due?

**2.** Gather the Information from the Financial Statements:
Current assets: From the balance sheet
Current liabilities: From the balance sheet

**3.** Calculate the Ratio:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

The Coca-Cola Company (in millions of dollars at December 31, 2014):

Current Assets: $8,958 + $9,052 + $3,665 + $4,466 + $3,100 + $3,066 + $679 = $32,986

Current Liabilities: $9,234 + $19,130 + $3,552 + $400 + $58 = $32,374

$$\text{Current Ratio} = \frac{\$32{,}986}{\$32{,}374} = 1.02 \text{ to } 1$$

**PROBLEM 2-10 (Continued)**

**4.** Compare the Ratio with Other Ratios:

| Current Ratio | | | |
|---|---|---|---|
| **The Coca-Cola Company** | | **PepsiCo** | |
| **December 31, 2014** | **December 31, 2013** | **December 27, 2014** | **December 28, 2013** |
| 1.02 to 1 | 1.13 to 1 | 1.14 to 1 | 1.24 to 1 |

**Calculations:**

The Coca-Cola Company at December 31, 2013:
($10,414+ $6,707 + $3,147 + $4,873 + $3,277 + $2,886)/($9,577+ $16,901 + $1,024 + $309) = $31,304/$27,811 = 1.13 to 1

PepsiCo at December 27, 2014:
($6,134+ $2,592 + $6,651 + $3,143 + $2,143)/($5,076 + $13,016) = $20,663/$18,092 = 1.14 to 1

PepsiCo at December 28, 2013:
($9,375+ $303 + $6,954 + $3,409 + $2,162)/($5,306 + $12,533) = $22,203/$17,839 = 1.24 to 1

**5.** Interpret the Ratios:

The Coca-Cola Company's current ratio is slightly lower at the end of 2014 compared to the end of 2013, 1.02 compared to 1.13. Similarly, PepsiCo's current ratio decreased slightly from one year to the next, 1.14 compared to 1.24. On the basis of the current ratios alone, the two companies are similar in terms of liquidity at the end of 2014.

The composition of a company's current assets adds another level to the analysis of liquidity. The Coca-Cola Company's cash and cash equivalents and short-term investments, the most liquid of assets, make up over one half of its current assets at the end of 2014. PepsiCo's cash and cash equivalents and short-term investments comprise less than one-half of its current assets at the end of 2014. On the other hand, PepsiCo's accounts and notes receivable, also highly liquid, are 32% of current assets, contrasting with The Coca-Cola Company's trade accounts receivable of 14%. Although receivables are considered very liquid, questions may arise about collectibility.

**PROBLEM 2-10 (Continued)**

## Part B. Business Decision Model

**1.** Formulate the Question:
After considering all relevant information, should I loan money to The Coca-Cola Company?

**2.** Gather Information from the Financial Statements and Other Sources:
The information will come from a variety of sources, not limited to but including:
- **a.** The balance sheet provides information about liquidity.
- **b.** The income statement provides information about profitability.
- **c.** The statement of cash flows reports on the company's cash inflows and outflows.
- **d.** The outlook for the beverage industry, including consumer trends, foreign markets, labor issues, and other factors.
- **e.** The outlook for the economy during the time the loan would be outstanding.
- **f.** Projections for interest rates for similar loans during the term of the loan.
- **g.** Alternative uses for the bank's money.

**3.** Analyze the Information Gathered:
The information gathered in (2) above must be analyzed. Among the relevant questions that must be answered are the following:
- **a.** Refer to part (5) of the Ratio Decision Model for a comparison of the current ratios for The Coca-Cola Company and its competitor, PepsiCo, over the last two years. The analysis also needs to consider the composition of the current assets. For example, cash and receivables are more liquid than inventories and prepaid expenses. The company's existing long-term liabilities must also be taken into account.
- **b.** What has been the trend in profits over recent years? Has the company been able to increase revenues and at the same time control its costs?
- **c.** How much cash has the company spent in recent years to retire existing debt? What other significant cash outflows have been made?
- **d.** What is the company's share of the growing market for sports drinks? How significant are revenues from Asian markets?
- **e.** Is inflation projected to increase during this time? Are labor costs likely to increase?
- **f.** Are interest rates projected to increase or decrease during the term of the loan?
- **g.** If a loan is not made to The Coca-Cola Company, what other uses does the bank have for the money?

**4.** Make the Decision:
Taking into account all of the various sources of information, decide either to loan money to The Coca-Cola Company or find an alternative use for the money.

**PROBLEM 2-10 (Concluded)**

**5.** Monitor Your Decision:
If you decide to make the loan, you will need to monitor it periodically. During the time the loan is outstanding, you will want to assess the company's continuing liquidity as well as other factors you considered before making the loan.

LO 2,5

**PROBLEM 2-11 COMPARABILITY AND CONSISTENCY IN INCOME STATEMENTS**

**1.** The income statement for 2015 is in single-step format, and the 2016 statement uses the multiple-step format.

**2.**

**GLEESON COMPANY**
**INCOME STATEMENT**
**FOR THE YEAR ENDED DECEMBER 31, 2015**

| | |
|---|---|
| Sales | $1,500,000 |
| Cost of sales | (450,000) |
| Gross profit | $1,050,000 |
| Selling expenses | $ 593,000* |
| Administrative expenses | 94,000** |
| Total selling and administrative expenses | $ 687,000 |
| Net income | $ 363,000 |

*$398,000 + $175,000 + $20,000
**$54,000 + $40,000

LO 1,4,8

**PROBLEM 2-12 CASH FLOW**

Cash available to pay a dividend on December 31, 2017:

| | |
|---|---|
| Cash balance, September 30, 2017 | $ 5,000 |
| Accounts receivable collections | 39,406* |
| Note receivable due on November 1 | 10,000 |
| Interest due on November 1: $10,000 × 5% | 500 |
| Cash paid for purchases | (15,762)** |
| Mortgage note payments: 3 months × $1,200 | (3,600) |
| Operating expenses: 3 months × $3,000 | (9,000) |
| Cash balance, December 31, 2017 | $ 26,544 |

| | |
|---|---|
| *September sales collected in October | $ 12,500 |
| October sales collected in November: $12,500 × 1.05 | 13,125 |
| November sales collected in December: $13,125 × 1.05 | 13,781 |
| Total accounts receivable collections | $ 39,406 |

| | |
|---|---|
| **September purchases paid for in October | $ 5,000 |
| October purchases paid for in November: $13,125 × 40% | 5,250 |
| November purchases paid for in December: $13,781 × 40% | 5,512 |
| Total payments on account | $ 15,762 |

*Note:* Because inventory levels are maintained at $75,000, purchases are equal to 40% of sales each month.

*Conclusion:* 50,000 shares of common stock × $0.50 per share will require cash of $25,000 to pay the quarterly dividend. With $26,544 of cash available, Franklin will barely be able to meet the dividend payment. Unless one or more of the following actions are successful in increasing the cash balance, management should not recommend the normal quarterly dividend of $0.50 per share:

Reduce inventory levels.
Speed up the collection of receivables.
Lengthen the average amount of time taken to pay for purchases of inventory.
Reduce operating expenses.

## ALTERNATE PROBLEMS

LO 2

### PROBLEM 2-1A MATERIALITY

1. The pattern of long-distance calls might point to alternative long-distance plans with one of the many carriers now in this business. For example, some companies might give a discount for calls made in off-peak hours. The analysis might point to misuse by certain employees (overuse, personal use, etc.), a situation that could be corrected by talking to the employees who are misusing the long-distance service.

2. This question deals with the concept of materiality. It would be difficult to decide which of the two types of companies, a realtor or a hardware store, would make more long-distance calls relative to its size. A realtor might make a large number of long-distance calls if it deals with out-of-state clients. The hardware store might regularly order inventory from vendors outside of its area code.

LO 2

### PROBLEM 2-2A COSTS AND EXPENSES

1. **Point-of-sale systems in a retail store**—The cost associated with these systems is a tangible asset that should be reported in the Long-Term Assets section of the balance sheet and depreciated over the life of the systems; only a portion would be recognized as expense during the current period.

2. **An ad in the yellow pages**—All of the cost for the ad would normally be expensed in the period the cost is incurred unless there was evidence that the ad would provide benefits for a number of future periods.

3. **An inventory-control computer software system**—Assuming that the software was purchased, an intangible asset should be recognized and a portion of the cost recognized as expense in each of the periods benefited.

4. **Shipping merchandise for resale to chain outlets**—All of the costs associated with shipping merchandise for resale would normally be recognized as expense when the costs are incurred. Even though one could argue that under the matching principle these costs should be recognized as expense only when the inventory is sold, the practical difficulty in associating shipping costs with specific items sold results in most companies expensing these costs as incurred.

LO 3 **PROBLEM 2-3A CLASSIFIED BALANCE SHEET**

**1.** Classified balance sheet:

**SINGER COMPANY**
**BALANCE SHEET**
**DECEMBER 31, 2016**

| | | | |
|---|---|---|---|
| **Assets** | | | |
| Current assets: | | | |
| Cash | | $ 60,790 | |
| Marketable securities | | 15,000 | |
| Accounts receivable | | 26,700 | |
| Merchandise inventory | | 112,900 | |
| Prepaid rent | | 3,600 | |
| Office supplies | | 400 | |
| Total current assets | | | $219,390 |
| Property, plant, and equipment: | | | |
| Land | | $250,000 | |
| Buildings | $150,000 | | |
| Accumulated depreciation | 40,000 | 110,000 | |
| Equipment | $ 84,500 | | |
| Accumulated depreciation | 12,500 | 72,000 | |
| Total property, plant, and equipment | | | 432,000 |
| Intangible assets: | | | |
| Patents | | | 45,000 |
| Total assets | | | $696,390 |
| **Liabilities** | | | |
| Current liabilities: | | | |
| Accounts payable | | $ 34,280 | |
| Income taxes payable | | 7,500 | |
| Interest payable | | 2,200 | |
| Notes payable, due April 15, 2017 | | 6,500 | |
| Salaries payable | | 7,400 | |
| Total current liabilities | | | $ 57,880 |
| Long-term debt: | | | |
| Bonds payable, due December 31, 2022 | | | 250,000 |
| Total liabilities | | | $307,880 |

**PROBLEM 2-3A (Concluded)**

| | | |
|---|---|---|
| **Stockholders' Equity** | | |
| Contributed capital: | | |
| Capital stock, $1 par value, 200,000 shares issued and outstanding | $200,000 | |
| Paid-in capital in excess of par value | 75,000 | |
| Total contributed capital | $275,000 | |
| Retained earnings | 113,510 | |
| Total stockholders' equity | | 388,510 |
| Total liabilities and stockholders' equity | | $696,390 |

**2.** Current Ratio = Current Assets/Current Liabilities
$219,390/$57,880 = 3.79 to 1

**3.** From the current ratio alone, Singer appears to be relatively liquid. In fact, Singer may be too liquid, in that its cash balance is greater than its total current liabilities. Singer may be missing significant investment opportunities by maintaining such a large cash balance. To fully assess its liquidity, it would be useful to look more specifically at the activity in accounts receivable and merchandise inventory. How long does it take to collect an account receivable? How long does it take to sell inventory? Also, you would want to compare Singer's current ratio at the end of this period with prior periods and with the current ratio for companies in the same industry.

LO 4 **PROBLEM 2-4A FINANCIAL STATEMENT RATIOS**

**1. a.** Working capital at 12/31/16:

Current assets: $16,500 + $12,750 + $200 + $900 + $400 = $30,750
Current liabilities: $10,500 + $1,800 + $10,000 = $22,300
Working capital: $30,750 – $22,300 = $8,450

Working capital at 12/31/15:

Current assets: $26,000 + $11,800 + $1,100 + $250 = $39,150
Current liabilities: $6,500 + $800 + $5,800 = $13,100
Working capital: $39,150 – $13,100 = $26,050

**b.** Current ratio at 12/31/16:
$30,750/$22,300 = 1.38 to 1

Current ratio at 12/31/15:
$39,150/$13,100 = 2.99 to 1

**PROBLEM 2-4A (Concluded)**

**2.** Both the absolute liquidity position of the company and the relative liquidity position of the company have declined during 2016. First, the absolute position, as indicated by the amount of working capital, has decreased from $26,050 to $8,450. The liquidity of the company has also decreased on a relative basis, as indicated by the decrease in the current ratio from 2.99 to 1.38. The primary reasons for the decline in the company's liquidity are the significant increases in accounts payable and taxes payable and the decrease in accounts receivable.

LO 4

**PROBLEM 2-5A WORKING CAPITAL AND CURRENT RATIO**

**1.** Current Ratio = Current Assets/Current Liabilities
= ($23,000 + $43,000 + $75,000 + $2,800)/($84,900 + $3,200)
= $143,800/$88,100 = 1.63 to 1

Working Capital = Current Assets – Current Liabilities
= $143,800 – $88,100 = $55,700

**2.** Even though Kapinski has a current ratio that is over 1 to 1, it may experience trouble paying its bills, specifically its accounts payable. This depends on two factors: (1) how long it normally takes to collect accounts receivable and (2) the normal length of time to sell inventory. In addition, the company must be concerned about whether any portion of the accounts receivable may prove to be uncollectible and whether any portion of the inventory is not saleable.

**3.** Three things Kapinski might be able to do to help it pay its bills on time:

**a.** Decrease the average collection period for accounts receivable.

**b.** Negotiate with suppliers to increase the time Kapinski is given to pay for its accounts payable.

**c.** Reduce its inventory levels.

LO 5

### PROBLEM 2-6A SINGLE-STEP INCOME STATEMENT

**1.** Single-step income statement:

**CORBIN ENTERPRISES**
**INCOME STATEMENT**
**FOR THE CURRENT YEAR**

| | | |
|---|---|---|
| Revenues: | | |
| Sales | $350,000 | |
| Dividend | 2,700 | |
| Total revenues | | $352,700 |
| Expenses: | | |
| Cost of goods sold | $150,000 | |
| Wages—office | 45,600 | |
| Income tax | 30,700 | |
| Rent—office | 26,400 | |
| Rent—salesperson's car | 18,000 | |
| Advertising | 9,000 | |
| Utilities | 6,750 | |
| Depreciation—computer | 4,500 | |
| Interest | 1,900 | |
| Supplies—office | 1,300 | |
| Total expenses | | 294,150 |
| Net income | | $ 58,550 |

**2.** A single-step income statement does not lend itself as readily to analysis as does a multiple-step statement. The lack of any type of grouping of the various expenses makes any type of analysis more difficult.

LO 5 **PROBLEM 2-7A MULTIPLE-STEP INCOME STATEMENT AND PROFIT MARGIN**

**1.** Multiple-step income statement:

**CORBIN ENTERPRISES**
**INCOME STATEMENT**
**FOR THE CURRENT YEAR**

| | | | |
|---|---|---|---|
| Sales | | $350,000 | |
| Cost of goods sold | | 150,000 | |
| Gross profit | | | $200,000 |
| Operating expenses: | | | |
| Selling expenses: | | | |
| Advertising | $ 9,000 | | |
| Rent—salesperson's car | 18,000 | | |
| Total selling expenses | | $ 27,000 | |
| General and administrative expenses: | | | |
| Depreciation—computer | $ 4,500 | | |
| Rent—office | 26,400 | | |
| Supplies—office | 1,300 | | |
| Wages—office | 45,600 | | |
| Utilities | 6,750 | | |
| Total general and administrative expenses | | 84,550 | |
| Total operating expenses | | | 111,550 |
| Income from operations | | | $ 88,450 |
| Other revenues and expenses: | | | |
| Interest expense | | $ 1,900 | |
| Dividend revenue | | 2,700 | |
| Excess of other revenues over other expenses | | | 800 |
| Income before taxes | | | $ 89,250 |
| Income tax expense | | | 30,700 |
| Net income | | | $ 58,550 |

**2.** The main advantages of the multiple-step income statement are the groupings of various items and the provision of important subtotals such as income from operations.

**3.** Profit Margin = Net Income/Sales
= $58,550/$350,000 = 16.7%

**4.** A profit margin of 16.7% means that for every dollar of sales the company has net income of $0.167. This would appear to be a good profit margin, but it would be important to compare the profit margin with prior years and with other companies in the same industry.

LO 8 **PROBLEM 2-8A STATEMENT OF CASH FLOWS**

**1.**

**WISCONSIN CORPORATION**
**STATEMENT OF CASH FLOWS**
**FOR THE FIRST YEAR**

| | | |
|---|---|---|
| Cash flows from operating activities: | | |
| Cash collected from customers | $ 310,000 | |
| Cash paid for inventory | (185,000) | |
| Cash paid in salaries and wages | (30,100) | |
| Cash paid in taxes | (40,000) | |
| Net cash provided by operating activities | | $ 54,900 |
| Cash flows from investing activities: | | |
| Purchase of manufacturing facility | | (150,000) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of stock | $ 400,000 | |
| Proceeds from long-term note | 50,000 | |
| Dividends declared and paid | (4,000) | |
| Net cash provided by financing activities | | 446,000 |
| Net increase in cash | | $ 350,900 |
| Cash at beginning of year | | 0 |
| Cash at end of year | | $ 350,900 |

*Note:* Wisconsin should report one significant noncash activity as supplementary information to its statement of cash flows: the five-year, $150,000 note signed to finance the purchase of the manufacturing facility.

**2.** First, the statement of cash flows reports on operations on a cash basis, as opposed to the income statement which is prepared on an accrual basis. Second, investing and financing activities are also reported on a statement of cash flows. For example, information about dividends paid during the year are shown on a statement of cash flows but not on an income statement.

LO 9 **PROBLEM 2-9A BASIC ELEMENTS OF FINANCIAL REPORTS**

**Letter from the President to Stockholders of Thesaurus Inc.:**

Thesaurus Inc. has just completed another very successful year. The decrease in net income from 2015 to 2016 was due to a single, nonrecurring gain in 2015, a $400,000 gain on the sale of a subsidiary in that year. A comparison of the operating income of the two years shows a distinct improvement, from $100,000 in 2015 to $380,000 in 2016.

All signs point to a successful year just completed. We were able to control our operating expenses: operating income as a percentage of operating revenues increased from 50% to 76%. These are clear signals that Thesaurus is moving in the right direction and should have a solid year of operations in 2017.

## ALTERNATE MULTI-CONCEPT PROBLEMS

LO 2,4

### PROBLEM 2-10A MAKING BUSINESS DECISIONS: LOANING MONEY TO STARWOOD HOTELS & RESORTS WORLDWIDE, INC.

**Part A. Ratio Decision Model**

**1.** Formulate the Question:
Is Starwood Hotels & Resorts Worldwide, Inc., liquid enough to pay its obligations as they come due?

**2.** Gather the Information from the Financial Statements:

Current assets: From the balance sheet
Current liabilities: From the balance sheet

**3.** Calculate the Ratio:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Starwood Hotels & Resorts Worldwide, Inc. (in millions of dollars at December 31, 2014):

Current Assets: $935 + $84 + $661 + $236 + $47 + $199 + $159 = $2,321

Current Liabilities: $297 + $101 + $73+ $1,307 + $416 + $256 = $2,450

$$\text{Current Ratio} = \frac{\$2{,}321}{\$2{,}450} = 0.95 \text{ to } 1$$

**4.** Compare the Ratio with Other Ratios:

| Current Ratio | | | |
|---|---|---|---|
| **Starwood Hotels & Resorts Worldwide, Inc.** | | **Hyatt Hotels Corporation and Subsidiaries** | |
| **December 31, 2014** | **December 31, 2013** | **December 31, 2014** | **December 31, 2013** |
| 0.95 to 1 | 1.04 to 1 | 2.34 to 1 | 1.34 to 1 |

**Calculations:**
Starwood Hotels & Resorts Worldwide, Inc. at December 31, 2013:
($616 + $134 + $643 + $217 + $54 + $211 + $121)/($2 + $105 + $97 + $1,092 + $404 + $224) = $1,996/$1,924 = 1.04 to 1

Hyatt Hotels Corporation and Subsidiaries at December 31, 2014:
($685 + $359 + $130 + $274 + $17 + $108 + $47 + $26 + $63)/($9 + $130 + $468 + $120 + $3) = $1,709/$730 = 2.34 to 1
Hyatt Hotels Corporation and Subsidiaries at December 31, 2013:
($454+ $184 + $30 + $273 + $77 + $122 + $12 + $11)/($194 + $133 + $411 + $133) = $1,163/$871 = 1.34 to 1

**PROBLEM 2-10A (Continued)**

**5.** Interpret the Ratios:
Starwood Hotels & Resorts Worldwide's current ratio is slightly lower at the end of 2014 compared to the end of 2013, 0.95 compared to 1.04. Hyatt Hotel's current ratio increased significantly from one year to the next, 2.34 compared to 1.34. On the basis of the current ratios alone, Hyatt is more liquid at the end of 2014 than is Starwood.

The composition of a company's current assets adds another level to the analysis of liquidity. Both companies' cash and cash equivalents, the most liquid of assets, comprise about 40% of their current assets at the end of 2014.

## Part B. Business Decision Model

**1.** Formulate the Question:
After considering all relevant information, should I loan money to Starwood Hotels & Resorts Worldwide?

**2.** Gather Information from the Financial Statements and Other Sources:
The information will come from a variety of sources, not limited to but including:
- **a.** The balance sheet provides information about liquidity.
- **b.** The income statement provides information about profitability.
- **c.** The statement of cash flows reports on the company's cash inflows and outflows.
- **d.** The outlook for the hospitality industry, including consumer trends, foreign competition for travel dollars, labor issues, and other factors.
- **e.** The outlook for the economy during the time the loan would be outstanding.
- **f.** Projections for interest rates for similar loans during the term of the loan.
- **g.** Alternative uses for the bank's money.

**3.** Analyze the Information Gathered:
The information gathered in 2. above must be analyzed. Among the relevant questions that must be answered are the following:
- **a.** Refer to part (5) of the Ratio Decision Model for a comparison of the current ratios for Starwood Hotels & Resorts Worldwide and its competitor, Hyatt Hotels, over the last two years. The analysis also needs to consider the composition of the current assets. For example, cash and receivables are more liquid than inventories and prepaid expenses. The company's existing long-term liabilities must also be taken into account.
- **b.** What has been the trend in profits over recent years? Has the company been able to increase revenues and at the same time control its costs?
- **c.** How much cash has the company spent in recent years to retire existing debt? What other significant cash outflows have been made?
- **d.** What is the company's share of the hospitality industry's market? How significant are revenues from foreign locations?
- **e.** Is inflation projected to increase during this time? Are labor costs likely to increase?
- **f.** Are interest rates projected to increase or decrease during the term of the loan?
- **g.** If a loan is not made to Starwood Hotels & Resorts Worldwide, what other uses does the bank have for the money?

**PROBLEM 2-10A (Concluded)**

**4.** Make the Decision:
Taking into account all of the various sources of information, decide either to loan money to Starwood Hotels & Resorts Worldwide or find an alternative use for the money.

**5.** Monitor Your Decision:
If you decide to make the loan, you will need to monitor it periodically. During the time the loan is outstanding, you will want to assess the company's continuing liquidity as well as other factors you considered before making the loan.

LO 2,5

**PROBLEM 2-11A COMPARABILITY AND CONSISTENCY IN INCOME STATEMENTS**

**1.** The income statements for both years are in single-step form.

**2.** Income statement items as a percentage of sales:

| | **2016** | **2015** |
|---|---|---|
| Sales | 100.0% | 100.0% |
| Cost of sales | 36.0 | 30.0 |
| Sales salaries | 25.1 | 26.5 |
| Delivery expense | 10.6 | 11.7 |
| Office supplies | 3.2 | 3.6 |
| Depreciation—truck | 2.4 | 2.7 |
| Computer line expense | 1.4 | 1.3 |
| Total expenses | 78.7% | 75.8% |
| Net income | 21.3% | 24.2% |

Restating each item on the income statement as a percentage of sales allows the reader to better understand how successful a business was in controlling costs. For example, Chisholm Company increased its sales by $200,000 for the year, but this did not translate to an increase in the bottom line, i.e., net income. The restatement of each of the expenses as a percentage of sales reveals why net income did not increase. Total expenses, as a percentage of sales, increased from 75.8% to 78.7%. Aside from a slight increase in one of the minor expenses, computer lines, only one other expense increased as a percentage of sales. The primary reason for the increase in expenses as a percentage of sales was the increase in the cost of Chisholm's products from 30% to 36% of sales.

LO 1,4,8 **PROBLEM 2-12A CASH FLOW**

**Cash available to pay a dividend on December 31, 2017:**

| | |
|---|---|
| Cash balance, December 1, 2017 | $ 15,000 |
| Cash collections from November 2017 sales | 40,000* |
| Operating expenses | (10,000) |
| Payroll: 2 × $4,500 | (9,000) |
| Cash balance, December 31, 2017 | $ 36,000 |

*Accounts receivable balance on December 1.

*Conclusion:* Roosevelt has $50,000 par value of stock, with the par value of each share set at $2. Thus, there are 25,000 shares of stock outstanding. At $1 per share in dividends, $25,000 in cash will be needed to meet the annual dividend payment. On the surface, it appears that Roosevelt should have no trouble in paying its annual dividend—the above analysis indicates a December 31, 2017, cash balance of $36,000. However, the $30,000 note payable, along with six months' interest of $450 ($30,000 × 3% × 6/12), will be due two weeks into the new year (January 15, 2018). If we assume that accounts receivable are collected relatively evenly over the month, the balance available to repay the $30,000 note and interest on January 15, 2018, would be only $29,000:

| | |
|---|---|
| December sales $40,000 × 95% | $ 38,000 |
| Unearned revenue already collected | (2,000) |
| December sales collected in January | $ 36,000 |
| Divided by 2 (assuming receivables are collected ratably over the month) | ÷ 2 |
| Cash available on January 15 from December sales | $ 18,000 |
| Cash available, December 31, 2017 | 36,000 |
| Dividend payment | (25,000) |
| Cash available to repay note and interest | $ 29,000 |

*Conclusion:* Roosevelt should not declare its normal annual dividend of $1 per share.

# DECISION CASES

## READING AND INTERPRETING FINANCIAL STATEMENTS

LO 4

### DECISION CASE 2-1 COMPARING TWO COMPANIES IN THE SAME INDUSTRY: CHIPOTLE AND PANERA BREAD

(Amounts in thousands of dollars)

**1.** Panera Bread

| | |
|---|---|
| 12/30/14 Working capital: | \$406,166 – \$352,712 = \$53,454 |
| 12/31/13 Working capital: | \$302,716 – \$303,325 = \$(609) |
| Change in working capital: | \$53,454 – \$(609) = \$54,063 |

Chipotle:

| | |
|---|---|
| 12/31/14 Working capital: | \$878,479 – \$245,710 = \$632,769 |
| 12/31/13 Working capital: | \$666,307 – \$199,228 = \$467,079 |
| Change in working capital: | \$632,769 – \$467,079 = \$165,690 |

**2.** Panera Bread

| | |
|---|---|
| 12/30/14 Current ratio: | \$406,166/\$352,712 = 1.15:1 |
| 12/31/13 Current ratio: | \$302,716/\$303,325 = 1.00:1 |
| Percentage change in ratio: | (1.15 – 1.00)/1.00 = 15.0% increase |

Chipotle:

| | |
|---|---|
| 12/31/14 Current ratio: | \$878,479/\$245,710 = 3.58:1 |
| 12/31/13 Current ratio: | \$666,307/\$199,228 = 3.34:1 |
| Percentage change in ratio: | (3.58 – 3.34)/3.34 = 7.2% increase |

**3.** The composition of current assets is similar for the two companies. One noticeable difference is the large amount of investments in Chipotle's current assets. Given the nature of the business, neither company carries large amounts in inventory. Cash and cash equivalents is the largest current asset for both companies.

**4.** The current ratios for both companies increased during the year, Panera Bread's by 15.0% and Chipotle's by 7.2%. However, Chipotle's current ratio at the end of 2014 of 3.58 is much higher than Panera Bread's ratio of 1.15.

LO 4

### DECISION CASE 2-2 READING PANERA BREAD'S BALANCE SHEET

**1.** Cash and cash equivalents is the largest of Panera Bread's current assets on December 30, 2014. It represents $196,493 thousand/$406,166 thousand, or 48.4% of the total current assets. Large amounts of cash on hand increases a company's liquidity, but generally speaking cash is a non-earning asset and amounts beyond what is needed to meet liquidity needs should be invested.

**2.** Inventories is the smallest of Panera Bread's current assets, representing only $22,811/$406,166, or 5.6% of total current assets. This is not unusual for a company in the restaurant business, especially one like Panera that relies on fresh baked products for sale to customers.

## MAKING FINANCIAL DECISIONS

LO 8

### DECISION CASE 2-3 ANALYSIS OF CASH FLOW FOR A SMALL BUSINESS

All financial decisions involve a trade-off between risk and return. The offer to work for an investment firm for $40,000 per year may be much less risky than running one's own business. Charles needs to consider, however, how likely it is that the employment with the investment firm will continue indefinitely. For example, could a downswing in the economy cause the firm to cut Charles's position?

Charles has experienced for himself the risks and rewards of running a business. To date, the business has not produced significant profits: only $11,500 over a two-year period. However, the significant increase in commissions revenue from one year to the next is very encouraging. This is an example of the potential rewards of running a business.

This case also illustrates the difference between income and cash flow. Because depreciation is not a cash flow, there is a significant difference between the cash flow for each of the two years and net income. Assuming that the revenues and all of the expenses other than depreciation result in cash flows of the business, the cash inflow for the first year is ($11,000) + $15,000 (add-back of depreciation), or $4,000. The cash inflow for the second year is even better, after adjusting for depreciation: $22,500 + $15,000, or $37,500.

LO 9

### DECISION CASE 2-4 FACTORS INVOLVED IN AN INVESTMENT DECISION

Sections of the annual report that should be read in comparing investment alternatives:

1. **Financial statements, including income statement, balance sheet, statement of stockholders' equity, and statement of cash flows**—The statements give an overall picture of the financial position and results of operations of the companies.
2. **Notes to the financial statements**—The notes are an integral part of the financial statements. They give the reader an indication of the accounting policies used; the various legal obligations, such as those for leases and pension plans; the composition of the long-term assets; and many other details.
3. **Management's discussion and analysis**—This report by management will reveal how management views the year just completed in comparison to prior years and how it feels about the company's prospects in the future.
4. **Other information contained in the annual report**—This might include descriptions of the company's services as well as plans for expansion and other nonfinancial information. The investor may also want to consult various trade publications for insights into the industry.

## ETHICAL DECISION MAKING

LO 2

### DECISION CASE 2-5 THE EXPENDITURE APPROVAL PROCESS

The sales rep should be skeptical about Roberto's request for two separate bills for $900 each. If the rep is aware that the request was made to circumvent a corporate policy, it would be unethical of the rep to comply with the request. This certainly puts the rep in a predicament: should he or she risk losing the sale by refusing to write up two separate bills?

Roberto is not acting in an ethical manner by requesting two bills, given that it is a deliberate attempt on his part to circumvent corporate policy. He may not agree with the policy, but it is not ethical to devise a scheme to work around the policy. Instead, he should write a memo to the corporate chief financial officer to explain his dissatisfaction with the policy and why it is not appropriate in this particular situation.

Whether or not the corporate policy is appropriate is difficult to answer without additional information. At the very least, it seems unreasonable that it should take three weeks for the approval process.

LO 4,6

**DECISION CASE 2-6 SUSAN APPLIES FOR A LOAN**

1. **Recognize an ethical dilemma:**

   The ethical dilemma for you is whether you should present financial statements to the banker that are incomplete (that make Susan's financial position appear to be better than it actually is).

2. **Analyze the key elements in the situation:**

   **a.** Your decision affects not only Susan but also the banker. Susan could benefit if a balance sheet is not provided and the bank could be harmed.

   **b.** Susan would benefit by getting a loan based on incomplete information and the bank would be at risk by not having all the information it needs to make a decision.

   **c.** The bank has the right to all the relevant information it needs to make a loan decision.

   **d.** The interests of Susan, the owner of the business, and those of the bank are in conflict in this situation.

   **e.** Your responsibility is to present a balance sheet that accurately reflects all of Susan's debts.

3. **List alternatives and evaluate the impact of each on those affected:**

   The alternatives are to follow Susan's instructions and not provide a balance sheet or discuss with her your concerns. If the balance sheet is not provided, the banker will not have all the relevant information useful to the decision process. Without the balance sheet, the banker will not be able to predict future cash outflows related to the company's debt. Also, the information is not neutral because it is presented to show the company's financial health as better than it is.

4. **Select the best alternative:**

   You should provide the balance sheet to the bank. If the banker does not receive the balance sheet and makes a decision only based on the income statement, this user of the information will not evaluate the risk of the company correctly. It is unlikely that the banker would consider making the loan on the basis of the quarterly income statements alone. The most recent balance sheet tells the banker about the overall financial strength of the company, and it is an integral part of any loan analysis. As the chief financial officer for the organization, you have a responsibility to provide the banker with the necessary information needed to make an informed decision on the loan. Susan would rather not show the banker the balance sheet because it would reveal the substantial loan already on the books. You are obligated, however, to provide the balance sheet to the bank if it would be relevant to the bank's decision. Without it, it is unlikely the bank will make the loan.

Chapter 2

# Financial Statements and the Annual Report

**After studying this chapter, students should be able to:**

- Describe the objectives of financial reporting. (Module 1–LO1).
- Describe the qualitative characteristics of accounting information. (Module 1–LO2).
- Explain the concept and purpose of a classified balance sheet and prepare the statement. (Module 2–LO3).
- Use a classified balance sheet to analyze a company's financial position. (Module 2–LO4).
- Explain the difference between a single-step and a multiple-step income statement and prepare each type of income statement. (Module 3–LO5).
- Use a multiple-step income statement to analyze a company's operations. (Module 3–LO6).
- Identify the components of the statement of retained earnings and prepare the statement. (Module 3–LO7).
- Identify the components of the statement of cash flows and prepare the statement. (Module 3–LO8).
- Read and use the financial statements and other elements in the annual report of a publicly held company. (Module 4–LO9).

# Chapter Outline

## MODULE 1 FINANCIAL REPORTING OBJECTIVES AND CHARACTERISTICS OF USEFUL INFORMATION

**Module 1**
**LO 1**

### Financial Reporting Objectives and Characteristics of Useful Information

Financial reporting has one overriding objective: to provide useful information to those who must make financial decisions.

- To external users, the financial statements and the notes and other information found in the annual report are the key sources of information needed to make their business decisions.
  - Balance sheet shows what obligations are due in near future and what assets are available to satisfy them.
  - Income statement shows revenue and expenses for a period of time.
  - Statement of cash flows shows where cash came from and how it was used during the period.
  - Notes provide essential details about accounting policies and other key factors that affect the company's financial condition and performance.
- In preparing the financial statements, accountants must consider:
  - The objectives of financial reporting.
  - The characteristics that make accounting information useful.
  - The most useful way to display the information in the financial statements.
- Financial information users are the main reason financial statements are prepared.
  - They must make economic decisions based on these statements.
- Financial reporting has one overall objective and a set of related objectives, all concerned with how the information may be most useful to the readers.
- The overall objective of financial reporting is to provide financial information to permit external users of the information to make informed decisions on whether to provide resources to the company.
  - Users include management of a company (internal users) and others not involved in the daily operations of the business (external users).
  - External users make their decisions based on general-purpose financial statements prepared by management.
- The purpose of financial reporting is to help the users reach their decision in an informed manner.
  - Investors need information about prospective cash receipts. How much cash will be received from:
    - Dividends.
    - Sale of stock.
  - Creditors need information about prospective cash receipts:
    - How much cash will be received from interest on the loan.

        - ♦ When and if the loan will be repaid.
    - The company needs information on its own prospective cash flows.
    - The company needs information about its resources and claims to those resources.

**Module 1**
**LO 2**

## What Makes Accounting Information Useful? Qualitative Characteristics

Qualitative (i.e., non-numerical) characteristics that make accounting information useful (EXAMPLE 2-2 summarizes these characteristics):

### Understandability

- **Understandability**: the quality of accounting information that makes it comprehensible to those willing to spend the necessary time to understand it. Two fundamental characteristics make accounting information useful – the information must be relevant and it must be a faithful representation.

### Relevance

- **Relevance**: the capacity of information to make a difference in a decision.
    - Predictive value – help determine if a decision should be made.
    - Confirming value – confirm that the right decision was made.

### Faithful Representation

- **Faithful representation**: the quality of information that makes it complete, neutral, and free from error.
    - Neutral: information is not slanted to make a company’s position look any better or worse than the actual circumstances would dictate.

### Comparability and Consistency

- **Comparability**: for accounting information, the quality that allows a user to analyze two or more companies and look for similarities and differences.
    - Not necessarily uniformity – alternative methods are acceptable under GAAP.
        - ♦ Companies can choose from several depreciation methods. **Depreciation** is the process of allocating the cost of a long-term tangible asset over its useful life.
    - Disclosure allows reader to make adjustments for these differences.
- **Consistency:** allows the financial statements to be compared within a single company from one accounting period to the next.
    - If a company makes an accounting change, accounting standards require various disclosures to help the reader evaluate the impact of the change.

### Materiality

- **Materiality**: the magnitude of an accounting information omission or misstatement that will affect the judgment of someone relying on the information.
  - The issue is whether the error is large enough to affect the judgment of someone relying on the information.
  - The threshold varies from one company to the next depending largely on the company's size.
    - The amount of a transaction may be immaterial but still be considered significant because of the type of transaction – transactions involving illegal or unethical behavior by a company officer.

### Conservatism

- **Conservatism**: the practice of using the least optimistic estimate when two estimates of amounts are about equally likely.
  - Applies when there is uncertainty about how to account for a particular item or transactions.
  - Various accounting rules are based on the concept of conservatism.
    - Inventory is reported at the lower-of-cost-or-market value.

### An International Perspective on Qualitative Characteristics

- The International Accounting Standards Board (IASB) has the same objectives and qualitative characteristics of financial reporting as the FASB.

# MODULE 2 CLASSIFIED BALANCE SHEETS

Module 2
**LO 3**

## Classified Balance Sheets

### Understanding the Operating Cycle

- The operating cycle for a company that sells a product is the period of time between the purchase of inventory and the collection of any receivable from the sale of the inventory.
- Begins when cash is invested in inventory and ends when cash is collected by the enterprise from its customers.

### Current Assets

The basic distinction on a classified balance sheet is between current and noncurrent items (EXAMPLE 2-4 is an example of a classified balance sheet).

- Current assets are assets that are expected to be realized in cash or sold or consumed during the operating cycle of a business or within one year, if the cycle is shorter than one year.
  - Most businesses have an operating cycle shorter than one year.

- Cash, accounts receivable, and inventory are current assets because they are cash or will be realized in (converted to) cash within one year.
- Short-term investments or marketable securities are investments of excess cash made for the short term.
- Prepaid assets represent a prepayment of expenses such as rent, office supplies and insurance. They are current because they are usually consumed within one year.

## Noncurrent Assets

Noncurrent assets (also called long-term assets) are any assets not meeting the definition of a current asset. Noncurrent assets include:

- Investments:
  - Securities not expected to be sold within the next year.
  - Land held for future use or buildings not currently used in operations.
  - Funds reserved for a special purpose.
- Property, Plant, and Equipment: tangible, productive assets used in the operations of a business rather than held for resale.
  - The distinction between inventory and equipment depends on the company’s intent when acquiring the asset.
  - The relative size of property, plant, and equipment depends on a company’s business (Carnival Corporation versus Microsoft).
  - Assets in this category are depreciated, except for land.
    - Separate accumulated depreciation account is used to account for depreciation recorded on the asset over its life.
- Intangible assets: provide benefits to the firm over the long-term.
  - They lack physical substance.
  - Include trademarks, copyrights, franchise rights, patents and goodwill.
  - The cost principle governs the accounting for intangibles.
  - Amortization is the process of writing off intangibles to expense over their useful life.

## Current Liabilities

Current liabilities are obligations that will be satisfied within the next operating cycle or one year, if the cycle is shorter than one year.

- The classification of a note payable depends on its maturity date.
  - If the note will be paid within the next year, it is current. Otherwise, it is long-term.
- Includes accounts payable, wages payable, income taxes payable.
- Most liabilities are satisfied by the payment of cash.
- Some liabilities are satisfied by performing services.

## Long-Term Liabilities

Long-term liabilities are any obligations that will not be paid within the next year or the operating cycle, whichever is longer.

- Includes long-term notes payable and bonds payable.

## Stockholders' Equity

Stockholders' equity represents owners' claims on the assets of the business that arise from contributed capital and earned capital.

- Capital stock indicates the owners' investment in the business.
  - Common stock – the most basic form of ownership.
  - Preferred stock – form of capital stock that carries with it certain preferences and has priority over common stock.
  - May appear as two separate items on the balance sheet – Par Value and Paid-In Capital in Excess of Par Value.
    - Total represents the amount that has been paid by the owners for stock.
- Retained earnings represents the accumulated earnings, or net income of the business since its inception less all dividends paid during that time.

**Module 2**
**LO 4**

# Using a Classified Balance Sheet: Introduction to Ratios

A company's ability to pay its debts as they come due can be measured by computing the working capital and current ratio.

## Working Capital

- Liquidity is the ability of a company to pay its debts as they come due.
- Working capital is a measure of liquidity.
- Current Assets less Current Liabilities equals working capital at a point in time.
- Bankers and other creditors are interested in a company's liquidity.
- Companies strive for a balance – too little working capital may make it difficult to pay debts; too much working capital indicates the company is not investing enough in productive assets.

## Current Ratio

- Working capital is limited in its informational values because it is an absolute dollar amount.
- The current ratio allows comparison of working capital for companies of various sizes and of a single company over time.
  - Measures short-term liquidity.
  - Current Assets ÷ Current Liabilities

- In general, the higher the current ratio, the more liquid the company.
- General rule of thumb 2:1 current ratio is good. Also depends on industry company is in.
- *Composition* of assets as well as the numerical calculation is important.
  - ♦ Examining the relative sizes of the various current assets for a company may reveal strengths and weaknesses not evident in the current ratio.
  - ♦ The frequency with which assets (accounts receivable, inventory) turnover is also important.

# MODULE 3 INCOME STATEMENTS, STATEMENTS OF RETAINED EARNINGS, AND STATEMENTS OF CASH FLOWS

**Module 3**
**LO 5**

## Income Statements, Statements of Retained Earnings, and Statements of Cash Flows

The income statement summarizes the results of operations for a period of time. All companies prepare income statements at least annually. Companies that report to the SEC prepare financial statements every three months. Monthly income statements can be prepared for internal use by management.

### What Appears on the Income Statement?

- The income statement reports the excess of revenues over expenses –the net income of the period. Or in the event of an excess of expenses over revenues, the income statement reports the net loss for the period.
  - The terms profits or earnings are synonyms for net income.
- Revenue is the inflow of assets resulting from sale of products and services; an expense is the outflow of assets resulting from the sale of goods and services.
- Gains and losses are special types of revenues and expenses reported on the income statement.

### Format of the Income Statement

Corporations use one of two formats to prepare the income statement. Both forms are generally accepted, although more companies use the multiple-step format.

- **Single-step:** all expenses and losses are added together and deducted in a single step from the sum of all revenues and gains to arrive at net income. (Example 2-6)
  - No attempt to classify revenues or expenses.
  - Advantage is simplicity.
- **Multiple-step:** subdivides statement into specific sections, and provides the reader with important subtotals. (Example 2-7)
  - Gross Profit: Sales less Cost of Goods Sold.
    - ♦ Cost of goods sold is the cost of the units of inventory sold during the period.
  - Income from Operations: Gross Profit less Operating Expenses.

        - ♦ Operating expenses are further subdivided into selling expenses and general and administrative expenses.
    - Income before Income Taxes: Operating income adjusted by other revenue and expenses not generated or used by operations.
    - Income tax expense is then deducted to arrive at Net Income.

**Module 3**
**LO 6**

## Using an Income Statement

The income statement can be used to evaluate the profitability of a business.

- **Profit margin**: Net income ÷ Sales.
    - If the profit margin is high, generally means that the company is generating revenue but that it is also controlling its costs.
    - Also called return on sales.
- When evaluating any financial statement ratio, must consider:
    - How does this year's ratio differ from ratios of prior years?
    - How does the ratio compare with the industry norms?

**Module 3**
**LO 7**

## The Statement of Retained Earnings

The statement of stockholders' equity explains the changes in the components of owners' equity during the period. (EXAMPLE 2-9)

- Retained earnings and capital stock are the two primary components of stockholders' equity.
- If there were no changes to the company's capital stock during the period, the company may choose to present a statement of retained earnings instead.
- Statement of retained earnings reports the net income and any dividends declared during the period. It provides an important link between the income statement and balance sheet.
    - Net income from the income statement is added to retained earnings.
    - Dividends do not appear on the income statement since they are a distribution to the owners. Direct deduction from retained earnings.

**Module 3**
**LO 8**

## The Statement of Cash Flows

All publicly held corporations are required to present the statement of cash flows in their annual reports. (Example 2-10)

- The statement of cash flows summarizes a company's operating, investing, and financing activities for the period. Each of these categories can result in a net inflow or net outflow of cash.

- **Operating activities** involve the sale or purchase of a product or sale of a service.
- **Investing activities** involve the acquisition and sale of long-term or noncurrent assets.
- **Financing activities** involve the issuance and repayment, or retirement, of long-term liabilities and capital stock and the payment of dividends.
- The balance of cash on the bottom of the statement of cash flows must agree with the balance for cash as shown on the balance sheet.

# MODULE 4 READING AND USING THE ANNUAL REPORT

**Module 4**
**LO 9**

## Reading and Using the Annual Report

### Panera Bread's Balance Sheet (EXHIBIT 2-1)

- Consolidated financial statements – reflect the position and results of all operations that are controlled by a single entity.
- Panera Bread owns other companies that are called subsidiaries.
- SEC requires balance sheets as of the two most recent year-ends and income statements for each of the three most recent years.
- Amounts generally stated in thousands of dollars (materiality concept).

### Panera Bread's Income Statement (EXHIBIT 2-2)

- Multiple-step income statements for a three-year period are presented.
- The term "Cost of food and paper products" is used instead of cost of goods sold.
- Inclusion of data for three years allows for the analysis of certain trends.
- For Panera Bread, note the steady increase in net sales.

## Making Business Decisions

### The Current Ratio

- **Ratio Analysis Model**: used to determine the company's liquidity.
  - Formulate the Question: How liquid is Panera Bread?
  - Gather the Information from the Financial Statements: Current ratios and current liabilities can be found on the balance sheet.
  - Calculate the Ratio: Current Ratio: = Current Assets/Current Liabilities = $406,166/$352,712 = 1.15 to 1
  - Compare the Ratio with Other Ratios: Panera's current ratio for the last two years (2014 and 2013) are 1.15 and 1.00, respectively. Chipotle's current ratio for the period are 3.58 and 3.34, respectively.
  - Interpret the Results: Panera's ratio increased slightly from 2013 to 2014. Chipotle's current ratios for both years are much higher than Panera's. This is due to the fact that Chipotle has a large amount of investments classified as current assets.

- **Business Decision Model:**
  - Formulate the Question: Should a banker loan money to Panera Bread?
  - Gather Information from the Financial Statements and Other Sources: This information will come from a variety of sources, not limited to, but including the following:
    - The balance sheet, income statement, and statement of cash flows.
    - The outlook for the restaurant industry.
    - The outlook for the economy during the period of time the loan would be outstanding. Is inflation projected to increase or decrease?
    - Projections for interest rates for similar loans during the term of the loan.
    - Alternative uses for the bank's money.
  - Analyze the Information Gathered:
    - Compare Panera Bread's current ratio with Chipotle's as well as with industry averages.
    - Look at trends over time in the current ratios.
    - Review projections for economic outlook and interest rates.
  - Make the Decision: Taking into account all of the various sources of information, decide to either:
    - Loan money to Panera Bread or
    - Find an alternative use for the money.
  - Monitor the Decision: If the loan is made, periodically monitor the loan by assessing the company's continuing liquidity as well as other factors considered before making the loan.

## The Profit Margin

- **Ratio Analysis Model**: used to determine the company's profitability.
  - Formulate the Question: How profitable is Panera Bread?
  - Gather the Information from the Financial Statements: Net income and net sales or revenues can be found on the income statement.
  - Calculate the Ratio: profit margin = net income/net sales or revenues = $179,293/$2,529,195 = 7.1%.
  - Compare the Ratio with Other Ratios: Panera's profit margin for the last two years (2014 and 2013) is 7.1% and 8.2%, respectively. Chipotle's profit margin for the period are 10.8% and 10.2%, respectively.
  - Interpret the Ratios: Both companies' profit margins indicate that the companies are able to control their expenses while increasing their revenues. Panera Bread's profit margin decreased by 1.1% over the two-year period, while Chipotle's increased by 0.6%.

- **Business Decision Model:**
  - Formulate the Question: If you were an investor, would you buy stock in Panera Bread?
  - Gather Information from the Financial Statements and Other Sources: This information will come from a variety of sources, not limited to, but including the following:
    - The balance sheet, income statement, and statement of cash flows.
    - The outlook for the restaurant industry.

        - ♦ The outlook for the economy during the period of time you expect to hold the stock. Is inflation projected to increase or decrease?
        - ♦ Projections for interest rates for similar loans during the term of the loan.
        - ♦ Alternative uses for your money.
    - Analyze the Information Gathered:
        - ♦ Compare Panera Bread's profit margin with Chipotle's as well as with industry averages.
        - ♦ Look at trends over time in the profit margins.
        - ♦ Review projections for economic outlook.
    - Make the Decision: Taking into account all of the various sources of information, decide to either:
        - ♦ Buy stock in Panera Bread or
        - ♦ Find an alternative use for the money.
    - Monitor the Decision: If you decide to buy the stock, periodically monitor the investment by assessing the company's continuing profitability as well as other factors considered before making the investment.

## Other Elements of an Annual Report

- ■ Privately held companies tend to distribute only financial statements, without the additional information normally included in the annual reports of public companies.
- ■ Although the formats of annual reports vary, certain basic elements have become standard in the annual reports of publicly held companies:
    - Letter from the president or chair of the board of directors.
    - A section describing the company's products and markets.
    - The financial report or review, which consists of the financial statements accompanied by notes to explain various items on the statements.
- ■ Report of Independent Accountants (Auditors' Report) (Exhibit 2-3).
    - The opinion rendered by a public accounting firm concerning the fairness of the presentation of the financial statements.
    - States "in our opinion" and "present fairly."
    - Management is responsible for the statements.
        - ♦ Auditors express an opinion on the statements.
    - Do not certify to the total accuracy.
        - ♦ Render an opinion as to the reasonableness of the statements.
        - ♦ Auditing firms perform various tests of the accounting records to be able to assure itself that the statements are free of material misstatement.
- ■ Ethical responsibility of management and auditors to stockholders.
    - Stockholders need assurances that the financial statements are a fair representation of the company's operations and financial position.
    - Management and auditors have an ethical responsibility to the shareholders.
- ■ Management Discussion and Analysis provides explanation for certain amounts in the statements and provides insights concerning future trends in the business.

    - Gives management opportunity to provide insights into future trends.
- Notes to consolidated financial statements satisfy the requirement for full disclosure.
    - Discloses all the relevant facts to a company's results and financial position.
    - Note 2 is a summary of significant accounting policies for Panera Bread.

# Lecture Suggestions

**Module 1**
**LO 1**

Where can external users obtain financial information about a company? Discuss the convenience, for both the user and the company, of having standard, published financial statements, instead of responding to requests for information as they come in. Also, discuss the convenience of having this information available on the company's and SEC's web sites.

**Module 1**
**LO 2**

These characteristics are fundamental to all future topics, so a brief discussion of each one is useful. The following is one approach (The balance sheet for Dixon Sporting Goods is illustrated in Example 2-4):

- *Understandability*: Are the Dixon Sporting Goods statements written in clear, concise language?
- *Relevance*: What information in the Dixon Sporting Goods balance sheet is of interest to a supplier who is considering selling to the company on a 30-day account?
- *Reliability*: Can a stockholder verify the information in Dixon Sporting Goods's balance sheet concerning shares of stock outstanding and their book value? What makes this information reliable?
- *Comparability*: Where in Dixon Sporting Goods annual report is information found that allows the reader to make comparisons with other companies? Where is information that allows comparison with Dixon Sporting Goods past performance?
- *Materiality*: Why does the threshold vary from one company to the next?
- *Conservatism*: Why are expenses recognized when they are likely, but revenues only when they are certain?

**Module 2**
**LO 3**

Have students list as many businesses as they can to fit into each type of business: service, merchandiser, and manufacturer. Encourage them to think about small, local businesses, not just big corporations. Then, ask them to discuss types of assets and liabilities that could be found in these businesses and classify as current or noncurrent. Ask them to estimate the operating cycle for each type of business. Are some assets and liabilities common to all types of businesses?

**Module 2**
**LO 4**

Have students review a classified balance sheet and identify the subtotals presented. Practice comparing components of a balance sheet from year to year to get an idea of trends.

**Module 3**
**LO 5**

Identify the important subtotals presented on a multiple-step income statement and their importance to income statement analysis. Which format do students prefer and why? Can you determine the gross profit from a single-step income statement?

**Module 3**
**LO 6**

Students have calculated a number of ratios, and will try to memorize all of them in anticipation of an exam. Point out that for most of the ratios the calculation is obvious. Once you know what gross profit is, what else could the gross profit ratio be but the ratio of gross profit to sales? Note that most of the ratios that use strictly income statement numbers are calculated with sales as a denominator. Assign a number of exercises from both the end of the text chapter and from the Projects and Activities section of this manual for practice in working *with* these ratios, not just calculating them, so that by the time they finish, students will have become thoroughly familiar with the ratios and will not have to memorize, which is a useless exercise. Always require a few words of comment on the ratio, if only to compare with a prior year or to ask what a "logical" level for that item might be. It is important to stress from the beginning that ratios are least useful taken alone. They must be compared to the company itself in past years, and to related companies, or industry averages. Can you compare the ratios of a grocery store to a manufacturing company?

**Module 3**
**LO 7**

How does the statement of retained earnings link the income statement and the balance sheet? What causes owners' equity to increase? What causes owners' equity to decrease? Would a net loss cause owners' equity to increase or decrease?

**Module 3**
**LO 8**

Discuss the difference between a cash inflow and a cash outflow, with examples of each.

**Module 4**
**LO 9**

Briefly discuss the types of audit opinion: unqualified, qualified, adverse, and disclaimer. What does each mean for the company? How might each affect the opinions of current and potential investors? Have the students pick a company and go online and look at their financial statements. Who are the auditors? What kind of an opinion did they receive? What kind of opinion did companies such as Enron and WorldCom receive before their frauds were exposed?

# Projects and Activities

Module 1
**LO 2**

## What Makes Accounting Information Useful? Qualitative Characteristics

### In-class discussion: How understandable are the financial statements of Dixon Sporting Goods?

You have been introduced in these opening chapters to the concept of presenting financial data in the form of organized statements, and have not learned much detail about how and why items find their way into these statements. You have, however, had the opportunity to look at the reports of more than one large corporation. Examine the income statement, balance sheet, and statement of cash flows of Dixon Sporting Goods.

- Team presentation: Work together with four or five classmates to prepare a presentation for your class to explain the Dixon Sporting Goods financial statements: the income statement, the balance sheet, the statement of retained earnings, and the statement of cash flows, or the equivalents of these for Dixon Sporting Goods. Explain what each line item is.
- Class response and discussion: What is difficult to understand in the Dixon Sporting Goods financial statements? Is it the overall presentation, or just a few items? Do these difficulties make it doubtful that you could make a meaningful decision based on these statements? Were your classmates able to clarify any of these items for you?
- Would some additional training in accounting probably clear up a lot of your questions, or is it the presentation itself that makes the statements difficult to understand? What would you change about the statements?
- Do the statements, taken as a whole, fulfill the goal of understandability as set out by the FASB? Review the definition of "understandability" given in this chapter.

***Solution***

- Students once again look closely at a set of financial statements. They will find the Dixon Sporting Goods statements reasonably straightforward and probably understandable by most people since revenues, costs and expenses, cash, and supplies are all nearly every day terms. However, make sure students understand the real definition of these terms – not what they think they are. Accounting has a "jargon" of its own. Few will question at this point in their learning where the numbers came from, so complicated accounting procedures are not a worry. The sorting of items between the statements probably would not make much sense at all to many laymen, but the students have had enough of an introduction that they should begin to see what goes where, and why. You might want to take a little time while they are looking at these statements to review this, since students continue to mix items within the statements well into the course.
- The statement of cash flows will be the most difficult, and mainly in the operating section where it is not intuitively obvious to students.
- The students will have their own opinions about understandability, and about possible format changes.

### In-class discussion: Asset valuation

Look at Dixon Sporting Goods balance sheet, and consider the total listed for Property, Plant and Equipment, of $219,400.

- What, physically, might this number represent?
- Could they sell these assets for $219,400? Is it what they paid for them?

***Solution***

- These are tangible, productive assets used in the operation of Dixon's business. Land and buildings are self-explanatory. Store furniture and fixtures could include the sales registers and shelving, etc to place their products. It would not include anything that would be sold to customers. You may also want to point out that the land and building are currently being used in operations. If they were not, for example, vacant land being held for a future store site, it would not be part of property, plant, and equipment since it is not being used in current operations.
- The amount given is what the items cost less the depreciation taken on these assets. Students sometimes mistakenly assume these assets are "worth" $219,400. They continue to see these items in the abstract, unconnected to physical realities, and need to be reminded about specifically what balance sheet amounts represent. Nowhere on the financial statements will one find the selling price of the property, plant, and equipment, unless the company chose to disclose this information in the footnotes.

### In-class discussion: Materiality

All businesses are subject to various types of legal proceedings. Merck & Co. Inc., a global health care company that manufacturers prescription medicines, has been a defendant in a number of product liability lawsuits. In the notes to Merck's 2014 financial statements, the company states:

"The Company is involved in various claims and legal proceedings of a nature considered normal to its business, including product liability, intellectual property, and commercial litigation, as well as certain additional matters including environmental matters. Except for the *Vioxx* Litigation (as defined below) for which a separate assessment is provided in this Note, in the opinion of the Company, it is unlikely that the resolution of these matters will be material to the Company's financial position, results of operations or cash flows."[1]

"There are various other pending legal proceedings involving the Company, principally product liability and intellectual property lawsuits. While it is not feasible to predict the outcome of such proceedings, in the opinion of the Company, either the likelihood of loss is remote or any reasonably possible loss associated with the resolution of such proceedings is not expected to be material to the Company's financial position, results of operations or cash flows either individually or in the aggregate."[2]

- Explain in your own words what Merck means by this statement. In particular, include what they mean by "material" and "remote." Who is in the best position to determine the outcome of a lawsuit?

---

[1] Merck & Co., Inc., December 31, 2014 10-K, p. 106.

[2] Merck & Co., Inc., December 31, 2012 10-K, p.115-116.

***Solution***

An item with material effect would influence the decision of an informed reader of the financial statements. Merck believes that if the outcome of the litigation is not favorable, the numbers on the financial statements will not be significantly different. The Company's legal counsel is in the best position to determine the outcome of the legal proceedings.

Module 3
**LO 6**

# Using an Income Statement

### Outside assignment: Whose statement?

It is often possible to tell a lot about a company by looking at one or more of their financial statements, without knowing anything else about them. Carefully look over the following financial statement from an actual company.

**XXX Corporation[3]**
**Consolidated Statement of Operations**
**Year Ended December 31, XXXX**
**($ millions)**

| | |
|---|---|
| OPERATING REVENUES: | |
| Passenger | $ 17,658 |
| Freight | 175 |
| Other | 772 |
| Total operating revenues | 18,605 |
| OPERATING EXPENSES: | |
| Salaries, wages, and benefits | 5,434 |
| Fuel and oil | 5,293 |
| Maintenance, materials and repairs | 978 |
| Aircraft rentals | 295 |
| Landing fees and other rentals | 1,111 |
| Depreciation and amortization | 938 |
| Acquisition and integration | 126 |
| Other operating expenses | 2,205 |
| Total operating expenses | 16,380 |
| OPERATING INCOME | 2,225 |
| OTHER EXPENSES (INCOME): | |
| Interest expense | 130 |
| Capitalized interest | (23) |
| Interest income | (7) |
| Other (gains) losses, net | 309 |
| Total other expenses (income) | 409 |
| INCOMME BEFORE INCOME TAXES | 1,816 |
| PROVISION FOR INCOME TAXES | 680 |
| NET INCOME | 1,136 |

- Which financial statement is this? Did the title confuse you, or is it an accurate description of what follows? Do you think it is *better* than the title you are accustomed to?
- Does this business appear to be a retailer, a manufacturer, or a service company? How can you tell?
- What business do you believe they are in? Again, what tells you this?
- Can you calculate gross profit for this company? Can you calculate their profit margin? Why or why not?

[3] Southwest Airlines Co., December 31, 2014 10-K, p.72.

***Solution***

- The statement is the income statement. The statement of operations is an equally acceptable title for it, reflecting what the statement is - a summary of the company's operations for the year cited.
- This is the 2014 income statement for Southwest Airlines, a service company. The lack of a gross profit line or any reference to cost of goods sold indicates a service company. Line items such as Passenger and Freight revenues signal a transportation company, and expenses such as Landing Fees and Aircraft Rentals clearly indicate an airline.
- Southwest Airlines has no gross profit (no cost of goods sold) so they have no gross profit rate. The profit margin on the other hand can be calculated. The computation is net income ÷ sales ($1,136 ÷ $18,605 = 6.11%).

**Module 4**
**LO 9**

## Other Elements of an Annual Report

### Outside assignment: Annual reports

Have students pick a company and obtain their annual report online. Look at the Management's Discussion and Analysis. In your own words, what is management's outlook for the future? What are their major strengths and weaknesses?

Look at the Report of the Independent Auditors. Who audited the financial statements? What type of audit opinion did they give?

- Solution

Answers will vary depending on the company chosen by the student.

### Food for thought: Auditor obligations

An article in *The Wall Street Journal* said that the auditors for Wiz Technology resigned in a dispute over the company's accounting for executive salaries. Even though the article was published many years ago, the issues are timeless especially in light of the current accounting scandals. The article said,

> In a filing with the Securities and Exchange Commission, the vendor of low-price computer software said its accountants, Corbin & Wertz of Irvine, Calif., disagreed with management's decision to capitalize an undisclosed amount of executive salaries and other costs as "inventory."
>
> Corbin & Wertz resigned after Wiz Technology filed its quarterly results with the SEC despite the accountants' objections, according to the 8-K filing. A Corbin & Wertz official declined to discuss the matter.[4]

Explain why, in your opinion, the auditors felt compelled to resign.

***Solution***

Auditors certify that the statements are prepared in accordance with generally accepted accounting principles, consistently applied. If this was not the case, and if the company did not agree to an acceptable

[4]*The Wall Street Journal*, July 3, 1995, "Accountants Resign At Wiz Technology Over Salary Entries."

audit qualification in the auditors' opinion, the auditors could only choose between rendering an opinion that they did not believe to be true, or resigning to avoid rendering any opinion.

Another article in *The Wall Street Journal* noted that audit firms are dropping risky clients more frequently, in the wake of stockholder lawsuits against accountants, to avoid the costs of litigation.[5] With litigation settlement costs for the Big Five ( now Big Four) accounting firms in excess of $1 billion a year, the firms feel that they must protect themselves by eliminating clients with potential problems.

### Ethical decision: Auditor's report

As a member of a small CPA firm, you have been asked to review the December 31 year-end financial statements of a small ($2 million revenue) company in an East Coast city. The company has applied for a long-term loan from the bank. You are interested to note as you begin your review of the company's records that a principal stockholder is your former college roommate. You are preparing your report and wonder about the following items:

- The company decided during the last month of the year to change their method of accounting for depreciation for this year's financial statements. You do not believe that any adjustments were made to prior years' reported results as a consequence of this change.
- You have been working at the bookkeeper's desk while she is away on vacation. You pushed the desk blotter aside at one point and noticed underneath it a bill to the company from a local florist for $55. The bill is dated December, but you do not see it recorded anywhere in the company's books. A number of other unopened envelopes are under the blotter, the contents of which cannot be judged from the outside.
- You read in yesterday's newspaper that a local manufacturer is seriously contemplating a move to Atlanta. You know from your audit that they are an important customer of the company you are reviewing.

Should these items be disclosed in your report? Why or why not? If you disclose, how should your disclosure be phrased? Should you disclose any other facts to the company, to your employer, or in your report? Should the audit have been conducted differently? In your answers, try to keep in mind some of the fundamental qualitative principles underlying financial reporting and cite them where relevant.

#### *Solution*

First, you probably should have stopped and called in another member of the firm to do the review the moment you discovered the identity of the principal stockholder. Even if you have no ongoing relationship with your former roommate (and no indication is given one way or the other), it is always prudent to avoid even the appearance of impartiality or a conflict of interest.

- The change in accounting method should be disclosed. It affects comparability of the statements to prior years. As the statements now stand, they cannot be compared to prior years. Students are probably not going to realize that restatement is necessary, but they should note the lack of comparability, and therefore the inconsistency.
- On the other hand, the florist's bill is immaterial and may not be a concern in and of itself. Perhaps worth questioning is its location. Why was it under the blotter, and what else was under there? This appears to be an unusual mail sorting system.
- The customer's planned exodus is a potential problem for the company. This disclosure may cause a conflict between the management of the company and the auditor. The auditor will see it as a contingency that should be a footnote to the statements. Management may prefer to ignore it,

[5] *The Wall Street Journal*, June 26, 1995, "Big Accounting Firms Weed out Risky Clients."

claiming it will not be a problem. The bank wants to be sure their loan will be repaid. The departure of a customer may influence their decision on the loan. They may hear about it from another source. The company will make a more positive impression if it discloses and explains the customer's move rather than allow the bank to find out, perhaps from only partial information, what the business implications of this event will be. A major loss of business will be seen as a possibility unless the company can produce evidence that their customer will still be sending orders from Atlanta, or that potential new customers exist to fill the gap. The auditor has a responsibility to disclose anything that could significantly impact the company financially. This item appears to fall into that category.

## Decision Models

## Using Decision Models

### Outside assignment: Grizzly, Inc. Current ratio, Business Decision Model, and Ratio Analysis Model

Assume that you are a lending officer for a large bank. The management of Grizzly Inc. has come to you asking for a loan. They have provided you with their Income Statement and Balance Sheet as of December 31, 2016. (Note: this information is located in the solution to the review problem).

***Required:***

One of the first steps you undertake is to determine Grizzly's liquidity. Use the five steps in the ratio analysis model to analyze the current ratio.

As a loan officer, you must consider a variety of factors, including financial ratios, before making the loan. Use the Business Decision Model to decide if the bank should make a loan offer to Grizzly.

***Solution: Ratio Analysis Model***

1. **Formulate the Question**. Is Grizzly Inc. liquid enough to pay its obligations as they come due?
2. **Gather the Information from the Financial Statements.** Current assets and current liabilities are both found on the balance sheet.
3. **Calculate the Ratio**. $\dfrac{\text{Current Assets}}{\text{Current Liabilities}}$

   Current Assets = $20,500

   Current Liabilities = $9,700

   Current ratio = $\dfrac{20{,}500}{9{,}700}$ = 2.11 to 1
4. **Compare the Ratio With Other Ratios.** There are no other ratios in this problem to compare this ratio to. The ratio appears reasonable if compared to the 2 to 1 rule of thumb.
5. **Interpret the Ratio.** You may want to ask Grizzly for their 2015 financial statements so you can see the trend of the current ratio. Is it going up or down? The components of the current ratio are also important when assessing a company's liquidity. Accounts receivable and inventory account for approximately 70% of Grizzly's current assets, while cash accounts for only 12% of current assets. You may want to determine how current the receivables are. You may also want to compare their ratio with other companies in the same line of business.

***Solution – Business Decision Model***

1. **Formulate the Question.** After considering all relevant information, should I (the bank) loan money to Grizzly Inc.?
2. **Gather Information From the Financial Statements and Other Sources.** The information will come from a variety of sources, including:
    a. The balance sheet will provide information about liquidity and the items that make up current assets and current liabilities.
    b. The income statement will provide information about profitability.
    c. The statement of cash flows will provide information about the company's cash receipts and cash payments from operating, investing, and financing activities.
    d. The notes to the financial statements will provide additional information about the company to supplement the financial statements.
    e. An internet search will provide current and historical information on the company, the industry it is in, and its competitors. Look for the outlook for the industry, any news items about the company, including lawsuits.
    f. Alternative uses for the bank's money.
3. **Analyze the Information Gathered.**
    a. Use the Ratio Decision Model to compute and analyze the liquidity ratios. Analyze the composition of the current assets to determine how liquid they really are. Can all of the receivables be collected? Is there any obsolete inventory that can't be sold?
    b. Can we obtain prior year financial statements to see a trend in the ratio?
    c. Are there any other liquidity ratios that can be computed?
    d. How much long-term debt does the company have? When is this debt due?
    e. What is the company's share of sales in the entire Northwest?
    f. Is the company considering expansion of other stores? Are they considering expanding to other sections of the country?
    g. What is the outlook for interest rates during the term of the loan?
4. **Make the Decision.** Taking into account all of the information gathered, decide to loan the money to Grizzly Inc., or find an alternative use to the money.
5. **Monitor the Decision.** If the loan is made, it will need to be periodically monitored. Interim financial statements may be requested from Grizzly, Inc. The outlook for the economy in general and for outdoor recreational stores in particular, will need to be monitored.

# Chapter 2

## Financial Statements and the Annual Report

# Learning Objectives

**LO1** Describe the objectives of financial reporting.

**LO2** Describe the qualitative characteristics of accounting information.

**LO3** Explain the concept and purpose of a classified balance sheet and prepare the statement.

**LO4** Use a classified balance sheet to analyze a company's financial position.

**LO5** Explain the difference between a single-step and a multiple-step income statement and prepare each type of income statement.

# Learning Objectives (continued)

**LO6** Use a multiple-step income statement to analyze a company's operations.

**LO7** Identify the components of the statement of retained earnings and prepare the statement.

**LO8** Identify the components of the statement of cash flows and prepare the statement.

**LO9** Read and use the financial statements and other elements in the annual report of a publicly held company.

# Module 1 Financial Reporting Objectives and Characteristics of Useful Information

- In preparing financial statements, accountants consider:
  - The objectives of financial reporting
  - The characteristics that make accounting information useful
  - The most useful way to display the information found in the balance sheet, the income statement, and the statement of cash flows

# Objectives of Financial Reporting

- To provide useful information to those who must make financial decisions
  - **Balance sheet**—assets, liabilities, and owners' equity
  - **Income statement**—revenues and expenses
  - **Statement of cash flows**—cash flows from operating, investing, and financing activities
  - **Notes**—accounting policies

# Qualitative Characteristics of Accounting Information

- **Understandability:** the quality of accounting information that makes it comprehensible to those willing to spend the necessary time to understand it
- **Relevance:** the capacity of information to make a difference in a decision
- **Faithful representation:** the quality of information that makes it complete, neutral, and free from error

# Qualitative Characteristics of Accounting Information (continued)

- **Comparability:** for accounting information, the quality that allows a user to analyze two or more companies and look for similarities and differences
- **Consistency:** for accounting information, the quality that allows a user to compare two or more accounting periods for a single company

# Qualitative Characteristics of Accounting Information (continued)

- **Materiality:** the magnitude of an accounting information omission or misstatement that will affect the judgment of someone relying on the information
- **Conservatism:** the practice of using the least optimistic estimate when two estimates of amounts are about equally likely

# Module 2 Classified Balance Sheets

- Classified balance sheets distinguish a current asset from a long-term asset and a current liability from a long-term liability
- Numbers on a classified balance sheet measure a company's liquidity

# Classified Balance Sheet

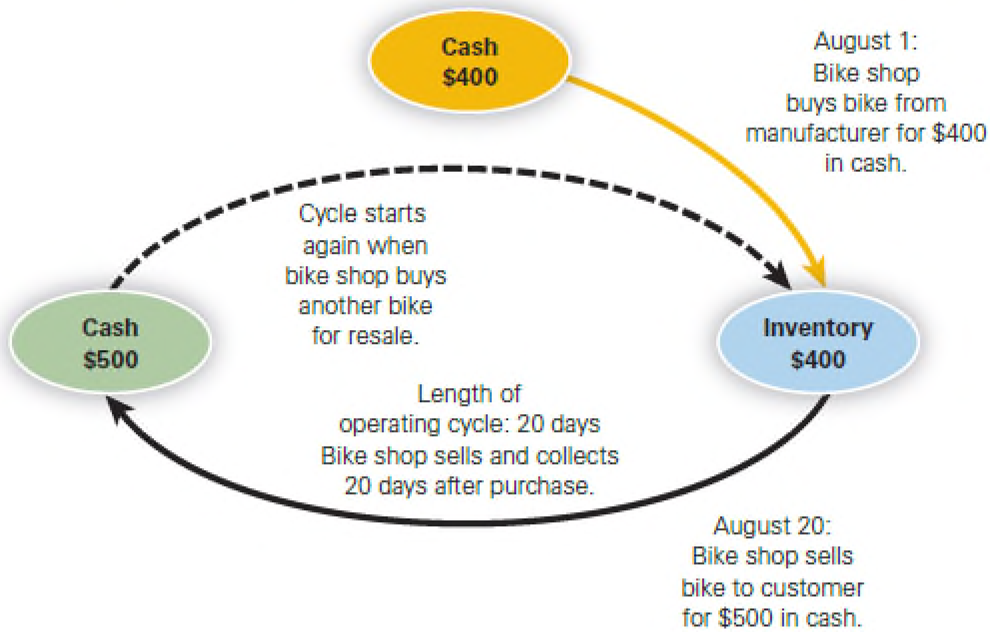
- Balance sheet classifications allow users to analyze a company's financial position
  - Liquidity relates to the ability of a company to pay its obligations as they come due
  - Working capital and the current ratio are two measures of liquidity

# Operating Cycle

- Period of time between the purchase of inventory and the collection of any receivable from the sale of the inventory

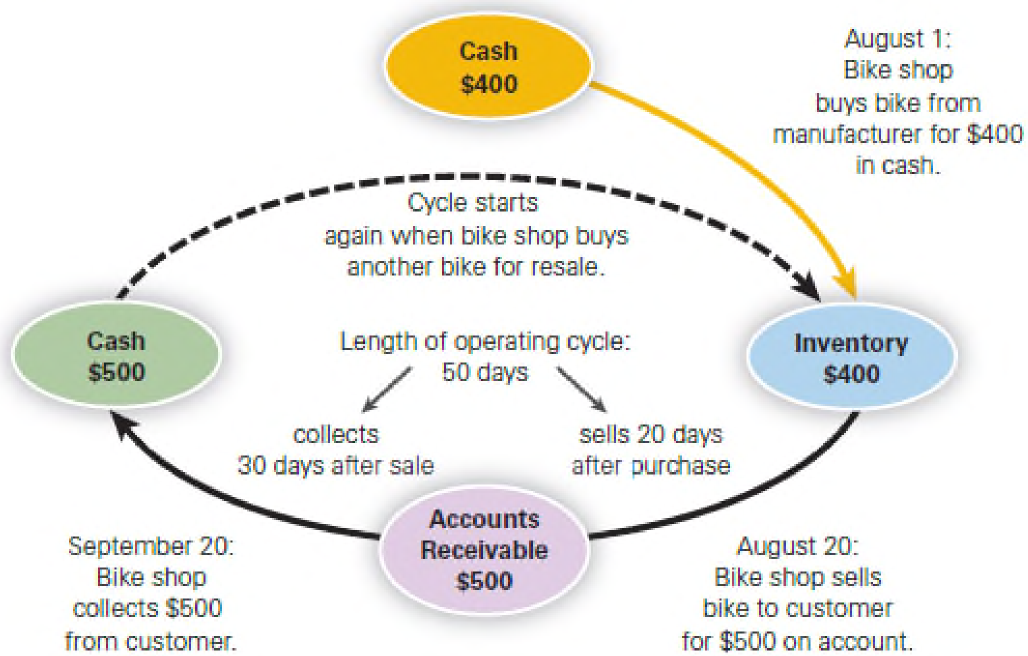
# Example 2-3—Determining the Operating Cycle

Consider the typical operating cycle for a bike shop. On August 1, the shop buys a bike from the manufacturer for $400. At this point, the shop has merely substituted one asset, cash, for another, inventory. On August 20, the shop sells the bike to a customer for $500. If the customer pays cash for the bike, the bike shop will have completed its cash-to-cash operating cycle in a total of 20 days, as shown below.



# Example 2-3—Determining the Operating Cycle (continued)

The shop's operating cycle is extended if it sells the same bike to a customer on August 20 and allows the customer to pay for it in 30 days. Instead of an operating cycle of 20 days, a total of 50 days has passed between the use of cash to buy the bike from the manufacturer and the collection of cash from the customer, as shown below:



# Current Assets

- Expected to be realized in cash, sold or consumed within one year or operating cycle (if the cycle is shorter than one year)

**Dixon Sporting Goods**
**Partial Balance Sheet**

| | | |
|---|---|---|
| **Current assets** | | |
| Cash | $ 5,000 | |
| Marketable securities | 11,000 | |
| Accounts receivable | 23,000 | |
| Merchandise inventory | 73,500 | |
| Prepaid insurance | 4,800 | |
| Store supplies | 700 | |
| **Total current assets** | | $118,000 |

# Noncurrent Assets

- Three common categories:
  - **Investments**: securities not expected to be sold within the next year
  - **Property, plant, and equipment**: tangible, productive assets used in the operation of a business
  - **Intangibles**: lack physical substance

# Noncurrent Assets (continued)

| Dixon Sporting Goods<br>Partial Balance Sheet | | | |
|---|---|---|---|
| **Investments** | | | |
| Land held for future office site | | | $150,000 |
| **Property, plant, and equipment** | | | |
| Land | | $100,000 | |
| Buildings | $150,000 | | |
| Accumulated depreciation | 60,000 | 90,000 | |
| Store furniture and fixtures | $ 42,000 | | |
| Accumulated depreciation | 12,600 | 29,400 | |
| **Total property, plant, and equipment** | | | 219,400 |
| **Intangible assets** | | | |
| Franchise agreement | | | 55,000 |

# Current Liabilities

- Obligation that will be satisfied within the next operating cycle or within one year if the cycle (as is normally the case) is shorter than one year

| Dixon Sporting Goods<br>Partial Balance Sheet | | |
|---|---|---|
| **Current liabilities** | | |
| Accounts payable | $15,700 | |
| Salaries and wages payable | 9,500 | |
| Income taxes payable | 7,200 | |
| Interest payable | 2,500 | |
| Bank loan payable | 25,000 | |
| **Total current liabilities** | | $59,900 |

# Long-Term Liabilities

- Obligation that will not be paid within the next year or an operating cycle, whichever is longer
- Example: notes payable and bonds payable

| Dixon Sporting Goods<br>Partial Balance Sheet | |
|---|---|
| **Long-term debt** | |
| Notes payable, due December 31, 2026 | $120,000 |

# Stockholders' Equity

- Owners claims on assets of the business
- Arise from two sources:
  - Contributed capital
    - Capital stock: owners' investments in business
    - Paid-in capital in excess of par value
  - Retained earnings: accumulated earnings, or net income, of the business since its inception less all dividends paid during that time

# Stockholders' Equity (continued)

**Dixon Sporting Goods**
**Partial Balance Sheet**

| | | |
|---|---|---|
| **Contributed capital** | | |
| Capital stock, $10 par, 5,000 shares issued and outstanding | $ 50,000 | |
| Paid-in capital in excess of par value | 25,000 | |
| **Total contributed capital** | $ 75,000 | |
| **Retained earnings** | 287,500 | |
| **Total stockholders' equity** | | $362,500 |

# Example 2-4—Preparing a Classified Balance Sheet

**Dixon Sporting Goods**
**Balance Sheet**
**At December 31, 2016**

**ASSETS**

These assets are cash now, will be collected in cash, or will be consumed in one year.

These assets will not be sold or used up within one year.

| | | | |
|---|---|---|---|
| **Current assets** | | | |
| Cash | | $ 5,000 | |
| Marketable securities | | 11,000 | |
| Accounts receivable | | 23,000 | |
| Merchandise inventory | | 73,500 | |
| Prepaid insurance | | 4,800 | |
| Store supplies | | 700 | |
| **Total current assets** | | | $118,000 |
| **Investments** | | | |
| Land held for future office site | | | 150,000 |
| **Property, plant, and equipment** | | | |
| Land | | $100,000 | |
| Buildings | $150,000 | | |
| Accumulated depreciation | 60,000 | 90,000 | |
| Store furniture and fixtures | $ 42,000 | | |
| Accumulated depreciation | 12,600 | 29,400 | |
| **Total property, plant, and equipment** | | | 219,400 |
| **Intangible assets** | | | |
| Franchise agreement | | | 55,000 |
| **Total assets** | | | $542,400 |

**LIABILITIES**

These are liabilities that will be satisfied within one year.

These are liabilities that will not be satisfied within one year.

| | | |
|---|---|---|
| **Current liabilities** | | |
| Accounts payable | $ 15,700 | |
| Salaries and wages payable | 9,500 | |
| Income taxes payable | 7,200 | |
| Interest payable | 2,500 | |
| Bank loan payable | 25,000 | |
| **Total current liabilities** | | $ 59,900 |
| **Long-term debt** | | |
| Notes payable, due December 31, 2026 | | 120,000 |
| **Total liabilities** | | $179,900 |

**STOCKHOLDERS' EQUITY**

These are owners' claims on assets.

| | | |
|---|---|---|
| **Contributed capital** | | |
| Capital stock, $10 par, 5,000 shares issued and outstanding | $ 50,000 | |
| Paid-in capital in excess of par value | 25,000 | |
| **Total contributed capital** | $ 75,000 | |
| **Retained earnings** | 287,500 | |
| **Total stockholders' equity** | | 362,500 |
| **Total liabilities and stockholders' equity** | | $542,400 |

# Introduction to Ratios

- **Liquidity**: ability to pay debts as they come due
- **Working capital:**
  - Current assets – current liabilities
  - Negative working capital may signal the inability to pay creditors on a timely basis
- **Current Ratio**: higher ratio indicates high liquidity

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

# Example 2-5—Computing the Current Ratio

The following formula shows that Dixon Sporting Goods has a current ratio of just under 2 to 1:

**Current Ratio**

| **Formula** | **For Dixon Sporting Goods** |
|---|---|
| $\frac{\text{Current Assets}}{\text{Current Liabilities}}$ | $\frac{\$118{,}000}{\$59{,}900} = 1.97 \text{ to } 1$ |

**Dixon Sporting Goods**
**Partial Balance Sheet**

| | | |
|---|---|---|
| **Current assets** | | |
| Cash | $ 5,000 | |
| Marketable securities | 11,000 | |
| Accounts receivable | 23,000 | |
| Merchandise inventory | 73,500 | |
| Prepaid insurance | 4,800 | |
| Store supplies | 700 | |
| **Total current assets** | | **$118,000** |

| | | |
|---|---|---|
| **Current liabilities** | | |
| Accounts payable | $15,700 | |
| Salaries and wages payable | 9,500 | |
| Income taxes payable | 7,200 | |
| Interest payable | 2,500 | |
| Bank loan payable | 25,000 | |
| **Total current liabilities** | | **$59,900** |

# The Income Statement

- Summarizes the results of operations of an entity for a period of time
- Reports the excess of revenue over expense—that is the net income
- **Single-step income statement**: expenses are added together and subtracted from all revenues in single step
- **Multiple-step income statement**: shows classifications of revenues and expenses as well as important subtotals

# Module 3 Income Statements, Statements of Retained Earnings, and Statements of Cash Flows

- Income statements can be used to measure a company's profitability
- Information on a statement of cash flows can be used to analyze a company

# Example 2-6—Preparing a Single-Step Income Statement

A single-step format for the income statement of Dixon Sporting Goods is presented below.

**Dixon Sporting Goods**
**Income Statement (Single-Step Format)**
**For the Year Ended December 31, 2016**

| | | |
|---|---|---|
| **Revenues** | | |
| Sales | $357,500 | |
| Interest | 1,500 | |
| **Total revenues** | | $359,000 |
| **Expenses** | | |
| Cost of goods sold | $218,300 | |
| Depreciation on store furniture and fixtures | 4,200 | |
| Advertising | 13,750 | |
| Salaries and wages for sales staff | 22,000 | |
| Depreciation on buildings and amortization of trademark | 6,000 | |
| Salaries and wages for office staff | 15,000 | |
| Insurance | 3,600 | |
| Supplies | 1,050 | |
| Interest | 16,900 | |
| Income taxes | 17,200 | |
| **Total expenses** | | 318,000 |
| **Net income** | | $ 41,000 |

In a **single-step** income statement, expenses are deducted from revenues in one step.

# Example 2-7—Preparing a Multiple-Step Income Statement

In a **multiple-step** income statement:

1. Sales and the **costs** of sales are compared.
2. Expenses of the business are detailed.
3. Isolating expenses and revenues by type is useful in analyzing a business.
4. Operating income is highlighted.
5. "Nonoperating" revenues and expenses are included here.

**Dixon Sporting Goods**
**Income Statement (Multiple-Step Format)**
**For the Year Ended December 31, 2016**

| | | | |
|---|---|---|---|
| Sales | | $357,500 | |
| Cost of goods sold | | 218,300 | |
| **Gross profit** | | | $139,200 |
| **Operating expenses** | | | |
| **Selling expenses** | | | |
| Depreciation on store furniture and fixtures | $ 4,200 | | |
| Advertising | 13,750 | | |
| Salaries and wages | 22,000 | | |
| **Total selling expenses** | | $ 39,950 | |
| **General and administrative expenses** | | | |
| Depreciation on buildings and amortization of trademark | $ 6,000 | | |
| Salaries and wages | 15,000 | | |
| Insurance | 3,600 | | |
| Supplies | 1,050 | | |
| **Total general and administrative expenses** | | 25,650 | |
| **Total operating expenses** | | | 65,600 |
| **Income from operations** | | | $ 73,600 |
| **Other revenues and expenses** | | | |
| Interest revenue | | $ 1,500 | |
| Interest expense | | 16,900 | |
| **Excess of other expenses over other revenue** | | | 15,400 |
| **Income before income taxes** | | | $ 58,200 |
| Income tax expense | | | 17,200 |
| **Net income** | | | $ 41,000 |

# Example 2-8—Computing the Profit Margin

- **Profit margin**: Net income divided by sales
  - High margin implies company is generating revenue and also controlling its costs

**Profit Margin**

| Formula | For Dixon Sporting Goods |
|---|---|
| $\frac{\text{Net Income}}{\text{Sales}}$ | $\frac{\$41{,}000}{\$357{,}500} = 11\%$ |

**Dixon Sporting Goods**
**Partial Income Statement**

| | |
|---|---|
| **Sales** | $357,500 |
| **Net income** | $41,000 |

# The Statement of Retained Earnings

- Reports the net income and any dividends declared during the period
- Important link between the income statement and the balance sheet
- Explain the changes in the components of owners' equity during the period

# Example 2-9—Preparing a Statement of Retained Earnings

| Dixon Sporting Goods<br>Statement of Retained Earnings<br>For the Year Ended December 31, 2016 | |
|---|---|
| Retained earnings, January 1, 2016 | $271,500 |
| Net income for 2016 | 41,000 |
| Dividends declared and paid in 2016 | (25,000) |
| Retained earnings, December 31, 2016 | $287,500 |

# The Statement of Cash Flows

- Summarizes a company's operating, investing, and financing activities for the period
- Each of these categories can result in a net inflow or a net outflow of cash

# Example 2-10—Preparing a Statement of Cash Flows

The complete cash flow statement for Dixon Sporting Goods is given below. The balance of cash on the bottom of the statement of $5,000 must agree with the balance for cash shown on the balance sheet in Example 2-4.

**Dixon Sporting Goods**
**Statement of Cash Flows**
**For the Year Ended December 31, 2016**

| | | |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Cash collected from customers | $362,500 | |
| Cash collected in interest | 1,500 | |
| Total cash collections | | $364,000 |
| Cash payments for: | | |
| Inventory | $217,200 | |
| Salaries and wages | 38,500 | |
| Interest | 16,900 | |
| Store supplies | 850 | |
| Insurance | 4,800 | |
| Advertising | 13,750 | |
| Income taxes | 15,900 | |
| Total cash payments | | 307,900 |
| **Net cash provided by operating activities** | | $ 56,100 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Purchase of land for future office site | | (150,000) |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | |
| Dividends declared and paid | $ (25,000) | |
| Proceeds from issuance of long-term note | 120,000 | |
| **Net cash provided by financing activities** | | 95,000 |
| **Net increase in cash** | | $ 1,100 |
| Cash at beginning of year | | 3,900 |
| **Cash at end of year** | | $ 5,000 |

Operating activities involve the purchase and sale of products or services.

Investing activities involve the acquisition and sale of long-term assets.

Financing activities involve the issuance and repayment of long-term liabilities and stock and the payment of dividends.

# Module 4 Reading and Using the Annual Report

- Useful nonfinancial information can be found in a company's annual report

# The Ratio Analysis Model

1. How liquid is a company?
2. Gather the information about current assets and current liabilities
3. Calculate the current ratio
4. Compare the ratio with prior years and with competitors
5. Interpret the ratios—higher the current ratio, the more liquid the company

# The Business Decision Model

1. If you were a banker, would you be willing to loan money to a company?
2. Gather information from the financial statements and other sources
3. Compare the company's current ratios with industry averages and look at trends
4. Loan money or find an alternative use for the money
5. Monitor the loan periodically

# Other Elements of an Annual Report

- Annual reports contain more information than just the financial statements
- The Report of Independent Accountants is provided by the company's auditor
  - Auditor expresses an opinion on whether the financial statements fairly represent the accounting treatment of a company's economic activity for the year

# Other Elements of an Annual Report (continued)

- Management's Discussion and Analysis provides explanatory comments about certain results reflected in the financial statements
- Notes to the Consolidated Financial Statements are generally supplementary disclosures required by GAAP
  - Help explain detail behind the accounting treatment of certain items in the financial statements

# Review

**LO1** Describe the objectives of financial reporting.

- The objective of financial reporting is to convey useful and timely information to parties for making economic decisions.
- Decision makers include investors, creditors, and other individuals or groups inside and outside the firm.
- These decision makers need information to evaluate cash flows, resources of the company, and claims to those resources.

# Review

**LO2** Describe the qualitative characteristics of accounting information.

- Qualitative characteristics make accounting information useful to financial statements users and include:
  - Understandability—pertains to those willing to spend time to understand the information.
  - Relevance—the capacity of information to make a difference in a decision.
  - Faithful representation—information that investors can depend on must be complete, neutral, and free from error.
  - Comparability and consistency—GAAP provide guidelines that standardize accounting practices and make information comparable from one company to another or from one period to the next for the same company.
  - Conservatism—where uncertainty about how to account for economic activity exists, accounting choices that result in the least optimistic amount should be employed.

# Review

**LO3** Explain the concept and purpose of a classified balance sheet and prepare the statement.

- The classified balance sheet classifies items of assets, liabilities, and stockholders' equity in a way that makes them useful to users of this financial statement.
- Assets and liabilities are classified according to the length of time they will serve the company or require its resources.
- Current assets or liabilities are those whose expected lives are one year or one operating cycle, whichever is longer. Noncurrent assets or liabilities are expected to last beyond this period of time.
- Assets and liabilities are further subclassified into categories that describe the nature of these assets and liabilities; for example, ''Property, Plant, and Equipment.''

# Review

**LO4** Use a classified balance sheet to analyze a company's financial position.

- Balance sheet classifications allow users to analyze a company's financial position.
- Liquidity relates to the ability of a company to pay its obligations as they come due.
- Working capital and the current ratio are two measures of liquidity.

# Review

**LO5** Explain the difference between a single-step and a multiple-step income statement and prepare each type of income statement.

- The multiple-step income statement classifies revenues and expenses in a manner that makes the statement more useful than the simple single-step income statement. Important subtotals are presented in the multiple-step income statement, including the following:
  - Gross profit
  - Income from operations
  - Income before income taxes

# Review

**LO6** Use a multiple-step income statement to analyze a company's operations.

- The multiple-step income statement can be used to evaluate different aspects of a company's profitability.
- Profit margin is one useful ratio used to evaluate the relative profitability.

**LO7** Identify the components of the statement of retained earnings and prepare the statement.

- The statement of retained earnings provides a link between the income statement and the balance sheet.
- It explains the changes in retained earnings during the period, of which net income (loss) is an important component.

# Review

**LO8** Identify the components of the statement of cash flows and prepare the statement.

- The statement of cash flows classifies cash inflows and outflows as originating from three activities: operating, investing, and financing.
- Operating activities are related to the primary purpose of a business.
- Investing activities are those generally involved with the acquisition and sale of noncurrent assets.
- Financing activities are related to the acquisition and repayment of capital that ultimately funds the operations of a business; for example, issuing stock or borrowing.

# Review

**LO9** Read and use the financial statements and other elements in the annual report of a publicly held company.

- The classified balance sheet and multiple-step income statement are more complex than simpler versions of these financial statements and yield more useful information to decision makers.
- Annual reports contain more information than just the financial statements. This information can be used alone or in conjunction with the financial statements to gain a more complete financial picture of a company.
  - Management's Discussion and Analysis provides explanatory comments about certain results reflected in the financial statements and sometimes forward-looking commentary.
  - The Report of Independent Accountants is provided by the company's auditor, whose job is to express an opinion on whether the financial statements fairly represent the accounting treatment of a company's economic activity for the year.
  - Notes to the Consolidated Financial Statements are generally supplementary disclosures required by GAAP that help explain detail behind the accounting treatment of certain items in the financial statements.

# End of Chapter 2