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2

BASIC FINANCIAL STATEMENTS

Chapter Summary

Financial statements are the primary means of communicating financial information to users. Chapter 2 covers the income statement, balance sheet, and statement of cash flows.

Chapter 1 set forth the objectives of the financial reporting process, and offered the observation that these objectives are met in large part by a set of financial statements. In this chapter, we take up the task of introducing the balance sheet, income statement, and the statement of cash flows.

The presentation is organized around the accounting equation. The equation serves as the basis for elementary transaction analysis. A continuing illustration examines the impact of a number of simple transactions upon the balance sheet of a simple service business. Revenue and expense transactions have been included so that we might introduce the income statement and statement of cash flows at an elementary level. This in turn has provided the opportunity to discuss and illustrate statement articulation.

Before closing, the chapter emphasizes the importance of adequate disclosure regarding both financial and nonfinancial information, thereby reinforcing the Chapter 1 theme that the financial reporting process is broader than the financial statements.

The chapter also covers accounting principles dealing with asset valuation, as well as an introduction to forms of business organization.

Learning Objectives

1. Explain the nature and general purpose of financial statements.
2. Explain certain accounting principles that are important for an understanding of financial statements and how professional judgment by accountants may affect the application of those principles.

3. Demonstrate how certain business transactions affect the elements of the accounting equation: $\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$.
4. Explain how the statement of financial position, often referred to as the balance sheet, is an expansion of the basic accounting equation.
5. Explain how the income statement reports an enterprise's financial performance for a period of time in terms of the relationship of revenues and expenses.
6. Explain how the statement of cash flows presents the change in cash for a period of time in terms of the company's operating, investing, and financing activities.
7. Explain how the statement of financial position (balance sheet), income statement, and statement of cash flows relate to each other.
8. Explain common forms of business organization—sole proprietorship, partnership, and corporation—and demonstrate how they differ in terms of their statements of financial position.
9. Discuss the importance of financial statements to a company and its investors and creditors and why management may take steps to improve the appearance of the company in its financial statements.

Brief topical outline

- A Introduction to financial statements
- B A starting point: statement of financial position
 - 1 The concept of the business entity
 - 2 Assets
 - a The cost principle
 - b The going-concern assumption
 - c The objectivity principle – see *Your Turn* (page 43)
 - d The stable-dollar assumption – see *Case in Point* (page 44)
 - 3 Liabilities
 - 4 Owners' equity
 - a Increases in owners' equity
 - b Decreases in owners' equity
 - 5 The accounting equation
 - 6 The effects of business transactions (illustrated on pages 46-50)
 - 7 Effects of these business transactions on the accounting equation
- C Income statement (illustrated on page 53)
- D Statement of cash flows (illustrated on page 54) – see *Case in Point* (page 54)
- E Relationships among financial statements
- F Financial analysis and decision making – see *Your Turn* (page 57)

G Forms of business organization

- 1 Sole proprietorships
- 2 Partnerships
- 3 Corporations
- 4 Reporting ownership equity in the statement of financial position
(illustrated on pages **58 & 59**)

H The use of financial statements by external parties

- 1 The short run versus the long run
- 2 Evaluating short-term liquidity
- 3 The need for adequate disclosure
- 4 Management's interest in financial statements – see *Ethics, Fraud & Corporate Governance* (page **61**)

I Concluding remarks

Topical coverage and suggested assignment

		Homework Assignment (To Be Completed Prior to Class)				
Class Meetings on Chapter	Topical Outline Coverage	Discussion Questions	Brief Exercises	Exercises	Problems	Critical Thinking Cases
1	A - D	3, 4, 5, 8	1, 3, 4	1, 4, 6	1, 3, 6	1
2	E - I	9, 14, 15	7, 9, 10	11, 12, 13	7, 8, 9	3

Comments and observations

Teaching objectives for Chapter 2

The chapter introduces technical material, including the balance sheet, income statement, statement of cash flows, several generally accepted accounting principles, the accounting equation, and the effects of business transactions upon assets, liabilities, and owners' equity.

Our objectives in presenting this chapter are:

- 1 Describe the nature of financial statements. Explain the role of *generally accepted accounting principles* in this process.
- 2 Illustrate and explain a *balance sheet*. Define the terms *assets*, *liabilities*, and *owners' equity*, and discuss the basic accounting principles relating to asset valuation. Discuss the uses and limitations of this financial statement.
- 3 Introduce the *accounting equation* and illustrate the effects of business transactions upon this equation and upon a balance sheet.
- 4 Introduce the *income statement*, emphasizing the nature of *revenues* and *expenses*.
- 5 Introduce the statement of *cash flows* and distinguish among *operating*, *investing*, and *financing* activities.
- 6 Explain and illustrate the concept of financial statement articulation.
- 7 Define proprietorship, partnership, and the corporation as forms of business organization, and illustrate the effect of the form of organization on the presentation of owners' equity in the financial statements.
- 8 Explain the importance of adequate disclosure.

General comments

Introducing the financial statements Our overriding objective in this chapter is to introduce students to the balance sheet, income statement, and statement of cash flows. We find Problem 8 useful for this purpose. Exercise 1 defining assets and liabilities, stimulates student interest when discussed in class. Also, it is short enough that they can be discussed without having been assigned as homework. We also recommend Problem 9 or 10 for initiating a lively classroom discussion of many of the concepts introduced in this chapter.

In covering Chapter 2, we like to continue the overview of the financial reporting process begun in Chapter 1. Cases 2 and 6 provide a useful framework for this discussion, but there is not enough time for both of them. Therefore, we rotate these cases in and out of our assignment schedules. If Case 6 is discussed, it would be appropriate to explain, in simple terms, the meaning and significance of debt covenants, in order to cultivate student appreciation of the importance of the accounting issues in this case.

Have you considered using annual reports? One method of bringing the "real world" into the classroom is through the use of annual reports. Annual report information can be obtained through the SEC's EDGAR database available on the Internet, or from individual company home pages.

We encourage students to review these reports throughout the course and to note any similarities and variations between their reports and the textbook treatment of various topics. These comparisons increase students' interest in the course, prompt interesting questions, and demonstrate the diversity, which exists in practice.

Any annual report works fine. In fact a diversity of reports sparks comparisons and discussions among students, and prevents one company from being asked to supply an unreasonable number of reports. The reports need not be current to be useful. Once obtained, they may be passed on to future students for at least several semesters.

An aside In discussing the valuation of assets in the balance sheet of a business, the text stresses the cost principle. Therefore, the statement is made that the balance sheet of a business does not show "how much the company is worth." A different standard prevails, however, in the preparation of personal financial statements for an individual. In an individual's personal balance sheet, generally accepted accounting principles require assets to be valued at estimated market values. In addition, the estimated income tax liability, which would result from selling the assets at these values also, is included in an individual's balance sheet. Thus, the owners' equity section of a personal balance sheet shows the individual's net worth.

Why have we not discussed personal financial statements in the text? The answer is that very few individuals prepare personal financial statements in conformity with generally accepted accounting principles. Most individual financial statements are prepared in conjunction with loan applications. In these cases, the lender usually supplies its own preprinted forms, which specify the lender's standards for the valuation of assets and liabilities. These standards often vary from generally accepted accounting principles. For example, most lenders do not ask a borrower to estimate the income tax liability, which would result from liquidating appreciated assets at their market values.

Supplemental Exercises

Internet Exercise

Case 2-2 instructs students to perform an analysis of an annual report. Have students download an annual report from a company web site and use this to complete the Case. Many companies make their report available on their web site, and most of the sites are relatively easy to locate through a search engine.

This chapter briefly introduces the *stable dollar assumption*. Students can become familiar with the impact of inflation on monetary valuations at www.westegg.com/inflation/. This site provides a calculator that allows a monetary amount in one year to be converted into an equivalent amount in a second year.

CHAPTER 2 **NAME** _____ **#** _____

10-MINUTE QUIZ A **SECTION** _____

Indicate the best answer for each question in the space provided.

- _____ **1** The financial statements of a business entity:
- a** Include the balance sheet, income statement, and income tax return.
 - b** Provide information about the profitability and financial position of the company.
 - c** Are the first step in the accounting process.
 - d** Are prepared for a fee by the Financial Accounting Standards Board.
- _____ **2** A balance sheet is designed to show the financial position of an entity:
- a** At a single point in time.
 - b** Over a period of time such as a year or quarter.
 - c** At December 31 of the current year.
 - d** At January 1 of the coming year.
- _____ **3** Accounts payable and notes payable are:
- a** Always less than the amount of cash a business owns.
 - b** Creditors.
 - c** Written promises to pay a certain amount, plus interest, at a definite future date.
 - d** Liabilities.
- _____ **4** The balance sheet of Dotty Designs includes the following items:
- | | |
|---------------------|------------------|
| Accounts Receivable | Cash |
| Capital Stock | Accounts Payable |
| Equipment | Supplies |
| Notes Payable | Notes Receivable |
- This list includes:
- a** Four assets and three liabilities.
 - b** Five assets and three liabilities.
 - c** Five assets and two liabilities.
 - d** Six assets and two liabilities.
- _____ **5** An accounting entity may best be described as:
- a** An individual.
 - b** A particular economic unit.
 - c** A publicly owned corporation.
 - d** Any corporation, regardless of size.

CHAPTER 2 NAME _____ # _____

10-MINUTE QUIZ B SECTION _____

Presented below is the balance sheet for Sabino Family Dentistry on January 1 of the current year.

SABINO FAMILY DENTISTRY
Balance Sheet
January 1, 20__

Assets		Liabilities & Stockholders' Equity	
Cash	\$ 33,000	Liabilities:	
Accounts receivable.....	51,150	Accounts payable	\$ 74,250
Land	313,500	Total liabilities	\$ 74,250
Building	371,250	Owners' equity:	
Equipment	<u>57,750</u>	Capital stock.....	<u>752,400</u>
Total assets.....	<u>\$826,650</u>	Total liabilities and owners' equity	<u>\$826,650</u>

During the first few days of January, the following transactions occurred:

- Jan 1 The business borrowed \$99,000 from the bank, giving a note payable due in 90 days.
- 3 Additional capital stock was issued in exchange for \$44,550 cash.
- 3 Equipment was purchased for \$62,700 on credit.
- 5 The business collected \$26,400 of its accounts receivable and paid \$37,950 of its accounts payable.

Indicate your answer to each of the following questions in the space provided.

- _____ **1** On January 6, total assets of the business amount to:
 a \$826,650. **b** \$994,950 **c** \$957,000. **d** \$950,400.

- _____ **2** On January 6, owners' equity amounts to:
 a \$752,400. **b** \$44,550. **c** \$796,950. **d** \$895,950.

- _____ **3** On January 6, the accounts payable balance is:
 a \$136,950. **b** \$36,300. **c** \$24,750. **d** \$99,000.

- _____ **4** On January 6, the accounts receivable balance is:
 a \$24,750. **b** \$38,775. **c** \$77,550. **d** \$63,525.

- _____ **5** On January 6, the cash balance is:
 a \$127,050. **b** \$138,600. **c** \$165,000. **d** \$202,950

CHAPTER 2 NAME _____ # _____

10-MINUTE QUIZ C SECTION _____

Presented below is the balance sheet for Manhattan Family Dentistry on January 1 of the current year.

MANHATTAN FAMILY DENTISTRY
Balance Sheet
January 1, 20__

Assets		Liabilities & Stockholders' Equity	
Cash	\$ 20,000	Liabilities:	
Accounts receivable.....	31,000	Accounts payable	\$ 45,000
Land	190,000	Total liabilities	\$ 45,000
Building	225,000	Owners' equity:	
Equipment	<u>35,000</u>	Capital stock.....	<u>456,000</u>
Total assets.....	<u>\$501,000</u>	Total liabilities and owners' equity	<u>\$501,000</u>

During the first few days of January, the following transactions occurred:

- Jan 2 Equipment was purchased for \$38,000 on credit.
- 2 The business collected \$16,000 of its accounts receivable and paid \$23,000 of its accounts payable.
- 3 The business borrowed \$60,000 from the bank, giving a note payable due in 90 days.
- 3 Additional capital stock was issued in exchange for \$27,000 cash.

Complete the following balance sheet for Manhattan Family Dentistry on January 4 of the current year.

MANHATTAN FAMILY DENTISTRY
Balance Sheet
January 4, 20__

Assets		Liabilities & Owners' Equity	
Cash	\$	Liabilities:	
Accounts receivable.....		Notes payable	\$
Land		Accounts payable.....	
Building		Total liabilities	\$
Equipment.....		Owners' equity:	
		Capital stock.....	
Total assets.....	\$ _____	Total liabilities and owners' equity	\$ _____

CHAPTER 2 NAME _____ # _____

10-MINUTE QUIZ D SECTION _____

Complete the January 31, 20__, balance sheet of Countrywide Legal Services using the following information.

- (1) Stockholders' equity at January 1, 20__, included capital stock of \$140,000.
- (2) The land and building were purchased by the business for a total price of \$200,000 on January 25, 20__, from a company forced out of business. On January 31, an appraiser valued the property at \$260,000.
- (3) Additional capital stock was issued in exchange for \$50,000 cash.
- (4) Retained earnings at January 31, 20____, amounted to \$49,400.

COUNTRYWIDE LEGAL SERVICES

Balance Sheet

January 31, 20__

Assets		Liabilities & Owners' Equity	
Cash	\$ 90,000	Liabilities:	
Accounts receivable.....		Notes payable	\$
Land	135,000	Accounts payable	<u>45,600</u>
Building		Total liabilities	\$
Equipment	35,000	Owners' equity:	
		Capital Stock	\$
		Retained earnings	_____
Total assets.....	<u>\$ _____</u>	Total liabilities and owners' equity	<u>\$375,000</u>

SOLUTIONS TO CHAPTER 2 10-MINUTE QUIZZES

QUIZ A

- 1 B
- 2 A
- 3 D
- 4 C
- 5 B

QUIZ B

- 1 B
- 2 C
- 3 D
- 4 A
- 5 C

Learning Objective:
2, 4, 5, 6

Learning Objective:
3, 4

QUIZ C

MANHATTAN FAMILY DENTISTRY
Balance Sheet
January 4, 20__

Assets		Liabilities & Owners' Equity	
Cash	\$ 100,000 ^a	Liabilities:	
Accounts receivable.....	15,000 ^b	Notes payable	\$ 60,000
Land	190,000	Accounts payable.....	<u>60,000^c</u>
Building	225,000	Total liabilities	\$ 120,000
Equipment	73,000 ^c	Owners' equity:	
	_____	Capital stock	<u>483,000^d</u>
Total assets.....	<u>\$603,000</u>	Total liabilities and owners' equity	<u>\$603,000</u>

Computations:

- a $\$20,000 + \$16,000$ (A/R collected) - $\$23,000$ (paid on A/P) + $\$60,000$ (borrowed) + $\$27,000$ (invested) = $\$100,000$
- b $\$31,000 - \$16,000$ collected = $\$15,000$
- c $\$35,000 + \$38,000$ (equipment purchased) = $\$73,000$
- d $\$456,000 + \$27,000$ additional investment = $\$483,000$
- e $A/P \$45,000 + \$38,000 - \$23,000$ (paid) = $\$60,000$

Learning Objective: 4

QUIZ D

COUNTRYWIDE LEGAL SERVICES
Balance Sheet
January 31, 20__

Assets		Liabilities & Owners' Equity	
Cash	\$ 90,000	Liabilities:	
Accounts receivable.....	50,000 ^c	Notes payable	\$ 90,000 ^f
Land	135,000	Accounts payable	<u>45,600</u>
Building	65,000 ^b	Total liabilities	\$135,600
Equipment	35,000	Owners' equity:	
		Capital Stock	\$190,000 ^d
		Retained earnings	<u>49,400</u> <u>\$239,400</u>
Total assets.....	<u>\$375,000^a</u>	Total liabilities and owners' equity	<u>\$375,000</u>

Computations:

- a** Total assets must be equal to total liabilities plus owners' equity of \$375,000.
- b** \$200,000 (cost of land and building) less \$135,000 for land = \$65,000 for building. (Appraised value of property ignored.)
- c** Accounts receivable must be \$50,000 to achieve total assets of \$375,000.
- d** \$140,000 (capital stock at January 1) plus \$50,000 (additional investment).
- e** Total liabilities must be \$135,600 to achieve total liabilities plus owners' equity of \$375,000.
- f** Notes payable must be \$90,000 to achieve total liabilities of \$135,600.

Learning Objective: 4

