

CHAPTER 1

Introduction to Financial Statements

Study Objectives

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

Study Objective 1 - Describe the Primary Forms of Business Organization

A business may be organized as a **sole proprietorship, partnership, or corporation.**

- ◆ **Sole proprietorship** - a business owned by one person
 - Advantages
 - simple to establish
 - owner controlled
 - tax advantages
 - Disadvantages
 - proprietor personally liable
 - financing may be difficult
 - transfer of ownership may be difficult
- ◆ **Partnership** - a business owned by two or more people
 - Advantages
 - simple to establish
 - shared control
 - broader skills and resources
 - tax advantages
 - Disadvantages
 - partners personally liable
 - transfer of ownership may be difficult
- ◆ **Corporation** - a separate legal entity owned by stockholders
 - Advantages
 - easy to transfer ownership
 - greater capital raising potential
 - lower legal liability
 - Disadvantages
 - unfavorable tax treatment

Study Objective 2 - Identify the Users and Uses of Accounting

The **primary function of accounting** is to

- A. **provide financial information for decision making.** The users of financial information fall into two categories--**internal users** and **external users**.

- ◆ **Internal users** - users within the organization.
 - ◆ Marketing managers, production supervisors, finance directors and company officers
 - ◆ Questions asked by internal users - What is the cost of manufacturing each unit of product? Which product is the most profitable?

- ◆ **External users** - users who are outside the organization.
 - Investors (owners)
 - Creditors (suppliers and bankers)
 - Others (i.e. IRS, SEC, FTC, etc.)
 - Internal users may ask: How does the company compare in size and profitability with competitors?
Will the company be able to pay its debts as they come due?

Study Objective 3 - Explain the Three Principal Types of Business Activity

There are three types of business activity: (Note: These activities are the sources of cash generation and will be central to the discussion on the statement of cash flows)

1. **Operating activities** - comprise the primary activities for which the organization is in business.
 - a. **Sources of funds (Cash)**
 - . Revenue is generated from sales or services
 - b. **Uses of funds**
 - . Expenses are incurred in earning revenue
2. **Investing activities** - obtaining resources or assets needed to operate the business (i.e. equipment, office supplies, etc.).
 - c. **Sources of funds**
 - . When people invest in our business
 - . Sale of property, plant and/or equipment
 - . Collection of principal on loans to other businesses
 - d. **Uses of funds**
 - . When we invest in another business, that is a use of funds
 - . Purchase assets that are going to benefit the business for several periods
2. **Financing activities** - to start or expand a business the owner or owners quite often need cash from outside sources. The two primary sources are:
 - a. **Sources of funds**
 - Borrowing from creditors which creates a liability (are a source of funds)
 - . bank loan
 - . debt securities (bonds)
 - . goods on credit from suppliers
 - . Selling ownership interests in the corporation to shareholders
 - b. **Uses of funds**
 - . Payments of dividends to stockholders
 - . Redemption of long-term debt or purchase of "treasury stock"

Study Objective 4 - Describe the Content and Purpose of Each of the Financial Statements

Accountants communicate with users through four **financial statements**:

◆ **Income Statement**

- Summarizes all **revenue** and **expenses** for period--month, quarter, or year. (Income is measured from...to i.e. over a period of time)
 - If **revenues** exceed **expenses**, the result is a **net income**.
 - If **expenses** exceed **revenue**, the result is a (**net loss**).
 - The difference between Revenues and Expenses is indicative of the success or failure of the company's operations during the period reported.

◆ **Retained Earnings Statement**

- Represents the totality of revenues less expenses less dividends +- the effects of prior period adjustments and quasi-reorganizations of a business from the first day of operations through the current period.
- The Statement of Retained Earnings will reflect the amount paid out in dividends and amount of net income or net loss for the current period.
- Shows changes in retained earnings balance during period covered by statement.

▪ **Format:**

Retained Earnings at beginning of year:	\$5,000,000
Add: Net Income (or deduct net loss)	1,000,000
Less: Dividends Declared:	(700,000)
+/- Effects of a prior period adjustment	(200,000)
Less: Adjustment due to Quasi-Reorganization	<u>(150,000)</u>
Retained Earnings at End of Year:	\$4,950,000

○ **Balance Sheet**

- The Balance sheet is a position statement...shows the position of the business at a point in time
 - Compare this to the Income Statement that measures performance over time.
 - The Balance Sheet shows relationship between **assets** and **equities**--**assets=equities**--on a particular date.
- **Assets** and **equities** (**liabilities** and **stockholders' equity**) must balance.

◆ **Statement of Cash Flows**

- Reports the cash effects of a company's operations for a period of time.
- Shows cash increases and decreases from investing and financing activities.
- Indicates increase or decrease in cash balance as well as ending cash balance.

• **Interrelationship of Statements**

- Retained earnings statement is dependant on results of the income statement
- Balance sheet and retained earnings statement are interrelated.
- Statement of cash flows and balance sheet are interrelated.

Study Objective 5 - Explain the Meaning of Assets, Liabilities, and Stockholders' Equity and State the Basic Accounting Equation

- ◆ **Assets** - resources owned by the business.

- ◆ Assets will benefit the business for more than the immediate short term...usually at least 1 year
 - ◆ This is opposed to an expense...items which benefit the business only for the immediate short term
 - ◆ For example: if a business buys a delivery truck, the truck is an asset. The gas and oil used to operate the truck are expenses

- ◆ **Liabilities** - creditors claims on total **assets** (obligations or debts of the business).

- ◆ **Stockholders' Equity** - ownership claim on total **assets**.
 - ◆ Stockholders equity is what's left over after all the liabilities are satisfied
- ◆ **The accounting equation:**

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

Study Objective 6 - Describe the Components that Supplement the Financial Statements in an Annual Report

Companies traded on an organized exchange like the New York Stock Exchange or The American Stock Exchange are required to provide shareholders with an **annual report** which always includes **financial statements**. In addition, the annual report includes the following information:

- ◆ **Management Discussion and Analysis** - covers three aspects of a company: liquidity, capital resources, and results of operation.

- ◆ **Notes to Financial Statements**
 - Clarify information presented in the financial statements.
 - Describe accounting policies or explain uncertainties and contingencies.

- ◆ **Auditor's Report**
 - Auditor, a professional accountant, who conducts an independent examination of the financial accounting data presented by a company.
 - Auditor gives an unqualified opinion if the financial statements present the financial position, results of operations, and cash flows in accordance with accepted accounting standards.

Study Objective 7 - Explain the Basic Assumptions and Principles Underlying Financial Statements

The preparation of financial statements relies on the following key assumptions and principles:

- ◆ **Monetary unit assumption**
 - States that only transactions expressed in terms of money be included in accounting records.
 - Assumes that unit of measure remains constant over time.

- ◆ **Economic entity assumption**
 - Assumes economic events can be identified with a particular unit of accountability.
 - Requires economic activities of an entity be kept separate from those of owner and separate from all other

economic entities.

- ◆ **Time period assumption** - allows the business to be divided into artificial time periods.

- ◆ **Going concern assumption**
 - Assumes business will be in existence long enough to carry out goals.
 - Assumption allows use of cost when recording assets.

- ◆ **Cost principle** - requires assets to be recorded at original cost as it is verifiable.

- ◆ **Full disclosure principle** - requires all circumstances and events that would make a difference to financial statement users should be disclosed.

Chapter 1 Review

- ✓ Name the three primary forms of business organization.

- ✓ Identify the users of accounting information. How do they use this information?

- ✓ Explain the three types of business activity.

- ✓ Describe the content and usefulness of each of the financial statements.

- ✓ Explain the meaning of assets, liabilities, and stockholders equity and state the basic accounting equation.

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

- ✓ Explain the basic assumptions and principles underlying financial statements.

Chapter 1

In deciding which organizational form to choose, you must consider such issues as taxes, liability concerns, and ease of financing. _____ and _____ get favorable tax treatment relative to _____. A disadvantage of _____ and _____ is that _____ and _____ are personally liable for all debts of the business, where as _____ are not. The _____ form also has the advantage that transfer of ownership simply requires the sale of shares, which often is accomplished on an organized stock exchange like the New York Stock Exchange. Selling a _____ or _____ interest is more involved. Consequently, obtaining financing may be easier for a _____ than for a _____ or _____.

Although the combined number of _____ and _____ in the United States is more than five times the number of _____, the revenue produced by _____ is eight times greater. Most of the largest enterprises in the United States--for example, *Coca-Cola*, *General Motors*, *Citigroup*, and *Microsoft* are _____.

Solutions to Reading Comprehension Check I

Chapter 1

In deciding which organizational form to choose, you must consider such issues as taxes, liability concerns, and ease of financing. Proprietorships and partnerships get favorable tax treatment relative to corporations. A disadvantage of proprietorships and partnerships is that proprietors and partners are personally liable for all debts of the business, where as corporate shareholders are not. The corporate form also has the advantage that transfer of ownership simply requires the sale of shares, which often is accomplished on an organized stock exchange like the New York Stock Exchange. Selling a proprietorship or partnership interest is more involved. Consequently, obtaining financing may be easier for a corporation than for a proprietorship or partnership.

Although the combined number of proprietorships and partnerships in the United States is more than five times the number of corporations, the revenue produced by corporations is eight times greater. Most of the largest enterprises in the United States-- for example, Coca-Cola, General Motors, Citigroup, and Microsoft are corporations.

Chapter 1

For business purposes, it is customary to arrange the data in the format of four different _____
_____, which form the backbone of financial accounting. For example, to present a picture at a point in
time of what your business owns (its _____) and what it owes (its _____), you would present
a _____. To inform the loan officer how successfully your business performed during
a period of time, you would reports its _____ and _____ in the _____
_____. To indicate how much of previous income was distributed to you and the other owners of your
business in the form of _____, and how much was retained in the business to allow for future growth, you
would present a _____ _____. And finally, of particular interest to
your bankers and other creditors, you would present a _____ of _____.

Solutions to Reading Comprehension Check II

Chapter 1

For business purposes, it is customary to arrange the data in the format of four different financial statements, which form the backbone of financial accounting. For example, to present a picture at a point in time of what your business owns (its assets) and what it owes (its liabilities), you would present a balance sheet. To inform the loan officer how successfully your business performed during a period of time, you would report its revenues and expenses in the income statement. To indicate how much of previous income was distributed to you and the other owners of your business in the form of dividends, and how much was retained in the business to allow for future growth, you would present a retained earnings statement. And finally, of particular interest to your bankers and other creditors, you would present a statement of cash flows.

Chapter 1

- _____ 1. An accounting principle that states that assets should be recorded at their cost.
- _____ 2. Debts and obligations of a business.
- _____ 3. Resources owned by a business.
- _____ 4. The amount by which expenses exceed revenues.
- _____ 5. An association of two or more persons to carry on as co-owners of a business for profit.
- _____ 6. The amount of net income kept in the corporation for future use, not distributed to stockholders as dividends.
- _____ 7. $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$.
- _____ 8. Distributions of cash or other assets from an incorporated business to its shareholders.
- _____ 9. The cost of assets consumed or services used in the process of ongoing operations to generate resources.
- _____ 10. A financial statement that reports the assets, liabilities, and stockholders' equity at a specific date.

Solutions to Vocabulary Quiz

Chapter 1

1. Cost principle
2. Liabilities
3. Assets
4. Net loss
5. Partnership
6. Retained earnings
7. Accounting equation
8. Dividends
9. Expenses
10. Balance sheet

Chapter 1

1. All of the following are characteristics of a sole proprietorship **except**:
 - a. a business owned by one person.
 - b. owner has control of the business.
 - c. a separate legal entity.
 - d. small owner-operated business.

2. All of the following are characteristics of a corporation **except**:
 - a. a separate legal entity
 - b. ownership evidenced by shares of stock.
 - c. produce eight times more revenue than sole proprietorships and partnerships in the United States.
 - d. owners have unlimited liability.

3. Corporations may issue several classes of stock, but the stock representing the primary ownership interest is:
 - a. common stock.
 - b. retained earnings.
 - c. financing activity.
 - d. dividends.

4. Resources owned by a business and used in carrying out its operating activities are:
 - a. liabilities
 - b. stockholders' equity.
 - c. revenues.
 - d. assets.

5. Acquiring long-term assets necessary to operate the business is called a(n):
 - a. financing activity.
 - b. operating activity.
 - c. revenue activity.
 - d. investing activity.

6. Debt securities sold to investors and due to be repaid at a particular date some years in the future are called:
 - a. bonds payable.
 - b. accounts payable.
 - c. wages payable.
 - d. notes payable.

7. The term used to describe the total assets that Starbucks receives in exchange for its coffee is:
 - a. cash.
 - b. revenue.
 - c. inventory.
 - d. accounts receivable.

8. The financial statement which presents a picture at a point in time of what a business owns and owes is a(n):
- income statement.
 - retained earnings statement.
 - balance sheet.
 - statement of cash flows.
9. Net income shown on the income statement is added to the beginning balance of retained earnings in the:
- income statement.
 - retained earnings statement
 - balance sheet.
 - statement of cash flows.
10. To report the success or failure of the company's operations during the period is the purpose of the:
- income statement.
 - retained earnings statement.
 - balance sheet.
 - statement of cash flows.

Solutions to Multiple Choice Quiz

Chapter 1

1. c
2. d
3. a
4. d
5. d
6. a
7. b
8. c
9. b
10. a

Exercise 1 - Research and Communication Activity

Chapter 1

You and your college roommate have decided to go into business together after graduation. Your roommate contends that you have always gotten along and therefore do not need a partnership agreement. You, however, feel somewhat uncomfortable about not having a formal partnership agreement. Not wanting to argue, you decide to write the roommate a memo to (1) explain why you need a formal agreement and (2) outline the issues that need to be addressed in the agreement.

Solution:

DATE: 5/1/0X

TO: My Roommate

FROM: Marketing Student

SUBJECT: Partnership Agreement

After conducting research, speaking with a number of professionals, and considering the venture we are about to undertake, I am even more confident that we need a partnership agreement. Although we have remained friends during the four years of college, a misunderstanding concerning the partnership could jeopardize our friendship.

At a minimum, the partnership agreement should address:

- Exact name of the business
- Specific nature of the venture
- Names and addresses of partners
- Duties and responsibilities of partners
- Division of profits or losses
- Addition of new partners
- Withdrawal of existing partner
- Additional investments

If there are other issues you would like to see addressed, please let me know. I am excited about our new business undertaking. However, I am more concerned that our friendship stay intact.

Exercise 2 - Research and Communication Activity

Chapter 1

In your textbook you will find a passage which reads, "Although the combined number of proprietorships and partnerships in the United States is more than five times the number of corporations, the revenue produced by corporations is eight times greater. Most of the largest enterprises in the United States- for example Coca-Cola, General Motors, Citigroup, and Microsoft are corporations.

Given these facts, chances are that at some point in your life you may work for a corporation or want to form a corporation.

1. List the advantages of the corporate form of organization.
2. Use the resources in the reference section of your library or call the Secretary of State in your state to determine how you would go about forming a corporation in your state. Outline the major steps in forming a corporation.

Solutions:

1. Easy transfer of ownership, greater raising capital potential, and lower legal liability.
2. In the Commonwealth of Kentucky, one or more persons may act as an incorporator or incorporators of a corporation by delivering articles of incorporation to the Secretary of State for filing.

The articles of incorporation of a business corporation must set forth:

- a. The name of the corporation that satisfies the requirements of the Commonwealth of Kentucky;
- b. The number of shares the corporation is authorized to issue;
- c. The street address of the corporation's initial registered office and the name of its initial registered agent at that office;
- d. The mailing address of the corporation's principal office; and
- e. The name and mailing address of each incorporator.

The articles of incorporation may set forth:

- a. The names and mailing addresses of the individuals who will serve as the initial directors.
- b. Other provisions not inconsistent with the laws of the Commonwealth of Kentucky.

Exercise 3 - Financial Statement and Creative Activity

Chapter 1

Assume that you own a business (small or large) in Campus Town USA. Assume further that you are considering a project (enlarging the parking lot, redecorating the interior, etc.) that will require you to borrow money from a local bank. The lending officer has told you that she will need to know how much money the business is making, how much money the business owes suppliers and other creditors, and how much cash and inventory you have on hand.

As part of your exercise, you are required to do the following:

1. Complete the form on the next page outlining:
 - a. The type of business you own.
 - b. The amount of money you need to borrow.
 - c. The detail of the project that will require you to borrow money.
 - d. Any additional information you think would help in applying for the loan.

2. Complete the attached loan application form for your fictitious business. Remember: You may be creative on this exercise. The numbers don't have to be real, just realistic.

Note: The attached form and loan application do not need to be typed. However, forms should be neatly handwritten.

(This activity is intended for group assignment. Also, you may want to retain students' work. After studying later chapters and learning to analyze financial statements, students can play the role of loan officer and determine whether to grant the loan.)

Exercise 3 - Financial Statement and Creative Activity (Continued)

Chapter 1

Name of Company

Type of Business

Amount Need to Borrow

Reason for Applying the Loan

Exercise 3 - Financial Statement and Creative Activity (Continued)

Chapter 1

LOAN APPLICATION FORM

Name of Company _____

Address _____

Phone Number _____

Annual Income

Revenue

Cost of goods sold

Operating expense

Rent

Utilities

Wages

Advertising

Others

Net income (loss)

Assets

Cash

Account receivable

Inventory

Property, plant, & equipment

Others

Total assets

Liability

Account payable

Notes payable

Others

Total liability

Stockholders' Equity

Total stockholders' equity

Total liability & stockholders' equity

Exercise 4 - World Wide Web Accounting Research Activity

Chapter 1

The authors provide a vignette focuses on Tootsie Roll in chapter 1 of your text book.. Learn more about Tootsie Roll by going to www.tootsie.com, click on our company and its history and then Financial.

1. Outline Tootsie Roll's Corporate Principles.
2. What was the total amount of Tootsie Roll's assets in the most current year available?
3. What was the total amount of Tootsie Roll's liabilities in the most current year available?
4. What is the amount of the difference between Tootsie Roll's assets and liabilities? What is this difference called?

Solutions: Information available on website

Note: The website is constantly being updated. Please check to see that the information requested in this exercise is available.

Exercise 5 - World Wide Web Research Activity

Chapter 1

The textbook provides a section on financing activities. Tootsie Roll first issued stock in the primary market in 1922. However, most of the news concerning the market, focuses on the secondary market.

The New York Stock Exchange website provides a discussion of financing activities which examines the primary market and the secondary market. You can access The New York Stock Exchange website at www.nyse.com. Once there, you need to go to **About the NYSE**, click on **Education**, **Education Publications**, then **You and the Investment World**. Read **Raising the Capital to Succeed** to answer the following question.

1. What is an IPO?

1. Define the primary market.

3. Define the secondary market.

4. Give examples of stock transactions occurring in the primary market and the second market.

Solution: Information available on website

Note: The website is constantly being updated. Please check to see that the information requested in this exercise is available.

Exercise 6 - World Wide Web, International, and Social Responsibility Activity

Chapter 1

Levi-Strauss, an international company with headquarters in San Francisco, was a forerunner in addressing ethical and social responsibility. You can find more about Levi-Strauss' core values by visiting the website, at www.levistrauss.com,

1. Outline the four core values that are at the heart of Levi Strauss & Co.

Solutions:

Information available on website

Exercise 7 - World Wide Web Research Activity

Chapter 1

The first chapter of your text provides information concerning the three major types of business entities: sole proprietorships, partnerships, and corporations. To learn about a fourth form of business - limited liability companies (LLCs) go to www.sos.state.ia.us/business/liabilitypart.html. Describe an LLC and outline the information concerning how to form an LLC.

