Accounting Part 1

STUDY UNIT

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Study Unit

Accounting, Part 1

By

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Preview

When you complete this study unit, you'll be able to

- Prepare, in correct format, the four basic financial statements (the balance sheet, the income statement, the statement of owner's equity, and the cash flow statement)
- Recognize major classifications within each of these statements
- Understand how basic transactions affect each of these statements
- Identify the type of information provided by these four statements

Contents

Accounting, Part 1

TRANSACTIONS AND THEIR EFFECT ON FINANCIAL REPORTS

The Accounting Function

Your first study unit, *Introduction to Accounting,* introduced some of the basic terms, definitions, and concepts involved in the accounting process. That text defined *accounting* itself as essentially a system for accumulating and communicating financial information pertaining to the economic activities of all forms of business and governmental organizations. In this text, you'll be introduced to the proper format of the four basic financial statements, as well as to how business transactions affect these statements. The actual mechanics involved in processing the information from business transactions will be reserved for the next study unit. By our delaying this discussion, you'll gain a better feel for the end product before you become involved with the specific mechanics of the accounting process.

We can begin this discussion by restating that the primary functions of accounting are to *accumulate* and *communicate* historical financial information. Communication will most often take the form of written reports. The best-known examples of financial reports are the general-purpose financial statements that most businesses publish at least once a year. These financial statements are designed to show an organization's financial position and the results of its operations, and often they're used to evaluate the effectiveness of the company's management.

Thus, financial statements are the means by which useful financial information can be communicated to interested users inside and outside the organization.

Basic Financial Statements

We have said that financial statements are prepared periodically to communicate useful financial information to a company's management, to its owners and potential owners, to its creditors, and to other interested outsiders. Financial statements are the end result of the accounting process. Most businesses prepare such statements at least once a year, while many businesses prepare them as often as quarterly or even monthly.

The four basic financial statements are the balance sheet, the income statement, the statement of owner's equity (or statement of retained earnings if the business is a corporation), and the cash flows statement. To gain an understanding of how these financial statements are prepared, and of how they can be used, is a primary goal of the study of accounting.

Balance Sheet Fundamentals

The *balance sheet* is a formal financial statement said to be based upon the accounting equation because it expresses the same fundamental relationship between assets, liabilities, and owner's equity. The balance sheet, sometimes called the *statement of financial position* or the *statement of financial condition,* is designed to show the financial status of a business at a particular point in time. It provides information pertaining to a company's financial position by listing, in an orderly fashion, the company's assets, liabilities, and owner's equity on a given date.

Two different, but generally accepted, formats of the balance sheet have evolved over time. Figures 1 and 2 show how the information in the balance sheet is presented under these two alternative formats. These formats make it convenient for the reader or user to determine the kind of assets the business owns, the recorded value of each asset, the total value for each classification of assets, and the total value of all the assets owned by the company.

Futura Company ← a
Balance Sheet ← b (1)
June 30, 20XX ← c

3 use colon

Assets ← 2			Liabilities and Owner's Equity ← 2		
Current assets:			Current liabilities:		
Cash	26000 –		Accounts payable	39000 –	
Marketable securities	9000 –		Wages payable	1100 –	
Accounts receivable	12000 –		Interest payable	3600 –	
4 → Merchandise inventory	40000 –		Taxes payable	2300 –	
Prepaid insurance	3000 –		Total current liabilities		46000 –
Total current assets ← 5		90000 –			
			Long-term liabilities:		
Investments:			Note payable - due	20000 –	
Investment in securities	15000 –		January 31, 20XX		
Land held for future site	7000 –		Mortgage payable - due	80000 –	
Total investments		22000 –	November 30, 20XX		
			Total long-term liabilities		100000 –
Property, plant, and equipment					
Land	18000 –		Total liabilities		146000 –
Building	70000 –				
Equipment	21000 –		Owner's Equity:		
Total property, plant, and equip.		109000 –	John Carr, capital		97000 –
Intangible assets:					
Patents	14000 –				
Copyrights	8000 –				
Total intangible assets	6	22000 –			
Total assets		243000 –	Total liabilities and owner's equity		243000 –
		7			

FIGURE 1—Balance Sheet: Account Form

Futura Company
Balance Sheet
June 30, 20XX

Assets		
Current assets:		
Cash	26000 –	
Marketable securities	9000 –	
Accounts receivable	12000 –	
Merchandise inventory	40000 –	
Prepaid insurance	3000 –	
Total current assets		90000 –
Investments:		
Investment in securities	15000 –	
Land held for future site	7000 –	
Total investments		22000 –
Property, plant, and equipment		
Land	18000 –	
Building	70000 –	
Equipment	21000 –	
Total property, plant, and equip.		109000 –
Intangible assets:		
Patents	14000 –	
Copyrights	8000 –	
Total intangible assets		22000 –
Total assets		243000 –
Liabilities and Owner's Equity		
Current liabilities:		
Accounts payable	39000 –	
Wages payable	1100 –	
Interest payable	3600 –	
Taxes payable	2300 –	
Total current liabilities		46000 –
Long-term liabilities:		
Note payable - due January 31, 20XX	20000 –	
Mortgage payable - due November 30, 20XX	80000 –	
Total long-term liabilities		100000 –
Total liabilities		146000 –
Owner's equity		
John Carr, capital		97000 –
Total liabilities and owner's equity		243000 –

FIGURE 2—Balance Sheet: Report Form

Also shown in the balance sheet are the claims against the company's assets, represented by the liabilities and the owner's equity. The liabilities are shown by type, classification, and amount, and they represent the amount of creditors' claims against the company's total assets. The owner's equity shows the amount of the owner's claims against the company's total assets. For example, looking at Figure 1, we can tell at a glance that the resources of Futura Company total $243,000, and that these resources (assets) are being financed by two sources: $146,000 by the creditors (liabilities) and $97,000 by the owner (owner's equity).

The Balance Sheet Format

As was previously mentioned, there are two generally accepted formats for presenting the balance sheet. These two formats are the *account form* and the *report form.*

Account form. This form presents the assets on the left-hand side and the liabilities and owner's equity on the right-hand side (Figure 1). In published annual reports, the account form of the balance sheet continues to be used most often, though recently there has been a noticeable shift toward use of the report form.

Report form. This form presents the assets at the top of the page and the liabilities and owner's equity beneath the assets, in a vertical arrangement (Figure 2).

There's no significant theoretical difference between the two forms. The data presented are the same; the only difference between the two forms lies in their arrangement. Regardless of which form is used, the assets, liabilities, and owner's equity will be presented according to the classifications described in your first text. These classifications are reviewed briefly in the following paragraphs.

Current assets. It's customary to list the items in the "Current assets" section of the form in the order of their liquidity; that is, by the ease with which they can be converted into cash—beginning, of course, with cash itself, followed by marketable securities, accounts and notes receivable, merchandise inventory, and prepaid expenses.

Investment assets. Under the heading "Investments" are those long-term investments made for income-producing purposes. Also listed are funds that have been set up for a designated purpose, such as the accumulation of funds which will be used in some future period to retire an outstanding debt. Such funds are called *sinking funds.* You should also remember from your previous text that the items listed under "Investments" differ from the current marketable securities by being long term in nature. For example, if management purchases the stock of another company because it believes that this stock represents a wise long-term investment, it will probably hold this stock for more than one year and should therefore classify the stock as long term, as part of its investments. Conversely, if management had purchased this stock primarily because the company had excess cash and wanted to convert some of this cash into an income-generating asset, it would probably liquidate this stock within the next year. Management would therefore classify these assets as short term and include them under "Current assets" as *Marketable securities.*

Property, plant, and equipment. This category includes those assets which are used to operate the business, and which have a useful life extending beyond a period of one year. Land, buildings, machinery, and equipment are examples of assets properly classified as property, plant, and equipment. These assets are sometimes referred to as *fixed assets.*

Intangible assets. These assets are assets which have legal rights extending beyond a one-year period, or which give the business a competitive advantage. Such assets usually have no physical existence. In other words, since they usually represent rights, such as the exclusive right to sell a certain product within a certain region, they differ from, for example, a truck which you can touch and which certainly has a physical existence. Patents, copyrights, trademarks, and franchises are examples of assets properly classified as intangible.

Current liabilities. These liabilities are obligations which must be met within the current operating cycle, usually a year, and which are generally satisfied by the use of current assets. Items typically found under "Current liabilities" are amounts owed on accounts payable, notes payable, wages payable, taxes payable, and interest payable.

Long-term liabilities. Debts having a maturity date extending beyond the current operating cycle, usually more than a year in the future, are included under "Long-term liabilities." Examples would include long-term notes payable, mortgages payable, and bonds payable.

Owner's (or owners') equity. The financial interest of the owner or owners will appear in this section, and if the business is either a proprietorship or a partnership, the amount(s) will be identified by the owner's name and the word *Capital.* If the business is a corporation, the format of this section of the balance sheet becomes more complex; the amounts will be identified by several accounts which provide additional information such as whether the dollar amounts represent retained earnings, and/or owner contributions, and whether the owner contributions were in excess of an amount called *par value.* A complete explanation of all the accounts found in a corporation's "Owners' equity" section will be reserved until a later text. For the present, we'll continue to focus on proprietorships and partnerships.

Preparing a Balance Sheet

You must follow the format described below whenever you prepare a balance sheet. Figure 1 represents the balance sheet of the Futura Company, owned by John Carr. It gives the required format, with the various items identified by numbered tags. Study Figure 1 carefully, paying particular attention to the orderly arrangement of the entries. You should use this same format when preparing all future balance sheets. Notice that the numbers are encircled and refer to the following:

- The balance sheet must have a heading ①. This heading is centered at the top of the page and gives

    a. The name of the company.

    b. The name of the financial statement.

c. The date for which the statement was prepared.

- The assets heading and the liabilities and owner's equity headings ② are centered.
- The classification titles, such as "Current assets" ③, are listed at the margin and are followed by a colon.
- The items listed under a classification, such as "Merchandise inventory" ④, are indented, and only the first letter of each item is capitalized.
- Words used to describe classification totals ⑤ are indented.
- A single rule ⑥ is drawn below a column of figures to be added.
- A double rule ⑦ is drawn below final totals. This practice of underlining the final totals twice is done to highlight these numbers.

Note that dollar signs, commas, and decimal points aren't generally used when a balance sheet is prepared on ruled accounting paper, which provides money columns.

The balance sheet in Figure 1 illustrates the presentation of the assets, liabilities, and owner's equity of the Futura Company when the account form is used. Note that the total liabilities and owner's equity of $243,000 is shown on the same line and directly opposite the total assets of $243,000. In the account form of the balance sheet, these totals should always appear opposite each other on the same line; and they must, of course, always be equal, since total assets equal the sum of the financial interests in the assets. That is,

$$A = L + OE$$

where A = Assets

L = Liabilities

OE = Owner's equity

Using the same data, the balance sheet of the Future Company is shown in report form and illustrated in Figure 2.

Information Provided by the Balance Sheet

Important facts can be determined by studying a firm's balance sheet. The balance sheet should be used as a source of data when it's necessary to gather pertinent information relating to a specific financial situation. From the balance sheet of the Futura Company, the following information can be developed:

1. The company is owned by John Carr, a single proprietor.
2. The total assets owned by the Futura Company on June 30, 20XX were valued at $243,000.
3. The current, and therefore relatively liquid, assets of the company total $90,000.
4. The cash available for immediate disbursement, if required, totals $26,000.
5. If the company sold its marketable securities for $9,000 and collected its receivables, it would have $47,000 (26,000 + 9,000 + 12,000) in cash available for disbursement. This would be a sufficient amount to pay all of the $46,000 in current obligations (liabilities) should that become necessary.
6. The creditors have provided $146,000 (total liabilities), and therefore $146,000 of the company's total assets is financed by the creditors.
7. The owner has provided $97,000, and therefore $97,000 of the company's total assets is financed by the owner. This amount represents his initial investment along with any accumulated earnings which have been left to reinvest in the business.

All of the preceding information was developed from data presented in the company's balance sheet. This example illustrates the significance of balance sheet analysis when the financial status of any company is evaluated.

Self-Check 1

At the end of each section of *Accounting, Part 1,* you'll be asked to pause and check your understanding of what you've just read by completing a "Self-Check" exercise. Answering these questions will help you review what you've studied so far. Please complete *Self-Check 1* now.

Indicate whether each of the following statements is True or False.

_______ 1. A balance sheet is sometimes referred to as a *statement of financial position* or a *statement of financial condition.*

_______ 2. In the account form of a balance sheet, assets are shown on the left-hand side and liabilities and owner's equity are shown on the right-hand side.

_______ 3. The balance sheet shows how well a company operated for a period of time.

_______ 4. Total liabilities show the amount of company resources financed by creditors.

_______ 5. There are two categories of persons who have claims against a company's assets: short-term creditors and long-term creditors.

_______ 6. The balance sheet is said to be based upon the accounting equation because it expresses the fundamental relationship between assets, liabilities, and owner's equity. Therefore, if a company's balance sheet reveals that the company had total assets of $100,000, and that its total liabilities were $70,000, it must also show total owner's equity of $30,000.

Check your answers with those on page 49.

Analyzing the Effects of Business Transactions on the Balance Sheet

Business transactions are exchanges of goods or services, or both, among people or business units. A particular business unit may engage in hundreds, thousands, or even a greater number of transactions during each working day. Some examples of common business transactions are the following:

1. Investment of the cash needed to start a business
2. Purchase of equipment for cash
3. Purchase of equipment on credit
4. Sale of equipment for cash
5. Sale of equipment on credit
6. Collection of an amount due from a sale made on credit terms
7. Payment of an amount due from a purchase made on credit terms
8. Borrowing cash from a bank
9. Repayment of an amount that has been borrowed

The effect of every transaction can be stated in terms of increases and/or decreases in one or more of the elements of the accounting equation. The equality of the two sides of the accounting equation is always maintained. To illustrate, let's take the nine examples of business transactions just given and analyze the effect that each could have on a company's assets, liabilities, and owner's equity.

Transaction Number	**Analysis of Transaction**
1	The company's asset, cash, is increased, and the owner's equity in the business assets is also increased.
2	The asset equipment is increased because equipment is acquired, and the asset cash is decreased because cash is disbursed.

3	The asset equipment is increased because equipment is acquired, and a liability, account payable, is increased because the company is obligated to pay for the equipment at some future time.
4	The asset cash is increased by selling the equipment for cash, and another asset, equipment, is decreased because the company's equipment is gone as a result of this sale.
5	The asset accounts receivable is increased because equipment is sold on account, and another asset, equipment, is decreased because the company's equipment is gone as a result of this sale.
6	The asset cash is increased by the collection of an amount due, and another asset, accounts receivable, is decreased because the amount has been collected.
7	The asset cash is decreased by paying the amount due, and the liability accounts payable is also decreased because payment eliminates the obligation to pay at some future time.
8	The asset cash is increased by borrowing cash, and the liability note payable is also increased because borrowing cash creates a liability for repayment at some future time.
9	The asset cash is decreased by this payment, and the liability note payable is also decreased because the payment eliminates the obligation to pay at some future time.

Transaction Analysis Illustrated

As stated previously, business transactions affect one or more of the three elements of the accounting equation. We'll now illustrate the separate effects of individual business transactions on a company's assets, liabilities, and owner's equity.

For the purpose of our illustration, assume that Richard Dane, an architect, establishes a new business on March 1 under the name of Dane Architecture Company.

Transaction 1

Dane deposits $15,000 in a bank account in the name of Dane Architecture Company.

Effect of transaction 1 on the accounting equation. Dane Architecture Company has increased its asset cash by $15,000 and has also increased the owner's equity by the proprietor's investment of $15,000. After this transaction, the accounting equation appears as follows:

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY	
Cash	$15,000	=	0	+	R. Dane, Capital	$15,000

Transaction 2

The next transaction entered into by the Dane Architecture Company is the purchase of stationery and supplies to be used in operating the business. The supplies cost $600 and payment was made in cash.

Effect of transaction 2 on the accounting equation. Dane Architecture Company has acquired a new asset, called *office supplies,* and has also decreased its asset cash by the amount paid out. This transaction is an exchange of one asset for another. Note that there is no change recorded in either the liabilities or the owner's equity. The accounting equation now appears as follows:

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY	
Cash	$14,400	=	0	+	R. Dane, Capital	$15,000
Office supplies	600					
	$15,000	=	0	+		$15,000

Transaction 3

The firm purchased equipment from a vendor, who agreed that the payment of $3,000 could be made in the near future. This type of agreement is said to be a purchase of equipment *on account.*

Effect of transaction 3 on the accounting equation. The new equipment increased the firm's assets. It also created an obligation to pay for the equipment in the future, as revealed by the firm's liability. The accounting equation is, of course, affected and will appear as follows:

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY	
Cash	$14,400		Accounts payable	+	R. Dane, Capital	
Office supplies	600					
Equipment	3,000		$3,000			$15,000
	$18,000	=	$3,000	+		$15,000

Transaction 4

Dane Architecture Company issued a check for $500 as payment to their creditor on account.

Effect of transaction 4 on the accounting equation. As a result of this transaction, the asset cash is decreased by $500 and the liability accounts payable is also decreased by $500. The equation, as always, is affected by the transaction, but remains balanced as illustrated below:

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY	
Cash	$13,900		Accounts payable	+	R. Dane, Capital	
Office supplies	600					
Equipment	3,000		$2,500			$15,000
	$17,500	=	$2,500	+		$15,000

Transaction 5

Richard Dane, the proprietor, withdraws $200 in cash for his personal use.

Effect of transaction 5 on the accounting equation. This transaction reduces the firm's cash asset by $200, and it also reduces the owner's financial interest in the assets of the firm by $200. The new balances appear in the elements included in the accounting equation and are shown as follows:

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY	
Cash	$13,700		Accounts payable	+	R. Dane, Capital	
Office supplies	600					
Equipment	3,000		$2,500			$14,800
	$17,300	=	$2,500	+		$14,800

Transaction 6

The company borrowed $3,000 in cash from State Bank.

Effect of transaction 6 on the accounting equation. This transaction increased the company's cash by $3,000 and also created a $3,000 company liability, called *notes payable.* The owner's equity was, of course, not changed by this transaction. The elements of the accounting equation would now appear as follows:

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY	
Cash	$16,700		Accounts payable		R. Dane, Capital	$14,800
Office supplies	600		$2,500	+		
Equipment	3,000		Notes payable			
			$3,000			
	$20,300	=	$5,500	+		$14,800

Transaction 7

The company sold a piece of equipment that it no longer needed for $1,000 on account. The $1,000 sales price was exactly the amount that the equipment cost when purchased by Dane.

Effect of transaction 7 on the accounting equation. This transaction increased the company's accounts receivable asset by $1,000 and decreased its equipment asset by the same dollar amount. Therefore, this, too, was a transaction that resulted in an exchange of assets. Although the total assets, liabilities, and owner's equity haven't changed, the transaction does affect items making up the total assets. The accounting equation at this point appears as follows:

ASSETS		=	LIABILITIES		+	OWNER'S EQUITY	
Cash	$16,700		Accounts payable	$2,500	+	R. Dane, Capital	$14,800
Accounts receivable	1,000		Notes payable	$3,000			
Office supplies	600						
Equipment	2,000						
	$20,300	=		$5,500	+		$14,800

Transaction 8

The Dane Architecture Company collected one-half of the amount that was outstanding on its accounts receivable.

Effect of transaction 8 on the accounting equation. This transaction increased the company's asset cash and decreased its asset accounts receivable. The remaining balance in the accounts receivable is therefore $500. The elements in the accounting equation now appear as follows:

ASSETS		=	LIABILITIES		+	OWNER'S EQUITY	
Cash	$17,200		Accounts payable	$2,500	+	R. Dane, Capital	$14,800
Accounts receivable	500		Notes payable	$3,000			
Office supplies	600						
Equipment	2,000						
	$20,300	=		$5,500	+		$14,800

Summary of Transactions

The business transactions of the Dane Architecture Company are summarized in Figure 3. Presenting the transactions in this summary form serves to emphasize three important points:

1. Completed business transactions cause changes in the elements which make up the accounting equations.

2. The changes resulting from the transactions are reflected as increases or decreases, or both, in one or more items within the elements of the accounting equation.
3. Regardless of the number or the type of completed transactions, the two sides of the accounting equation will always remain equal.

From the summary of transactions, it's possible to develop the company's balance sheet as of March 31. This balance sheet is illustrated in Figure 4.

Note that, on a formal printed or typed balance sheet, a dollar sign is used at the top of each column of figures. Also, whenever a line is drawn to indicate the addition or subtraction of amounts, it's assumed that a new column has been created, and therefore a dollar sign will appear next to the first amount under that line. Dollar signs should always be aligned down the entire column.

	ASSETS									**LIABILITIES**				**OWNER'S EQUITY**
	Cash	+	Accounts Receivable	+	Office Supplies	+	Equip.	=	Accounts payable	+	Notes payable	+	R. Dane, Capital	
Transaction														
1	+ $15,000												+	$15,000
2	− 600			+	$600									
3						+	$3,000	+	$3,000					
4	− 500							−	500					
5	− 200												−	200
6	+ 3,000									+	$3,000			
7		+	$1,000				1,000							
8	+ 500	−	500											
Balances	$17,200	+	$500	+	$600	+	$2,000	=	$2,500	+	$3,000	+		$14,800

FIGURE 3—Summary of Transaction: Dane Architecture Company

DANE ARCHITECTURE COMPANY
Balance Sheet
March 31, 20XX

Assets		
Current assets:		
Cash	$17,200	
Accounts receivable	500	
Office supplies	600	
Total current assets		$18,300
Property, plant, and equipment:		
Equipment		2,000
Total assets		$20,300
Liabilities and Owner's Equity		
Current liabilities:		
Accounts payable	$ 2,500	
Notes payable	3,000	
Total current liabilities		$5,500
Owner's equity:		
R. Dane, capital		14,800
Total liabilities and owner's equity		$20,300

FIGURE 4—Balance Sheet: Dane Architecture Company

Self-Check 2

A transaction summary for the Century Company, a sole proprietorship, is shown here.

	ASSETS				LIABILITIES		OWNER'S EQUITY
	Cash	+ Accounts Receivable	+ Office Supplies	+ Equip.	= Accounts payable	+ Notes payable	+ L. Hunter, Capital
Transaction							+ 25,000
1	+ $25,000						
2				+ $10,000	+ $10,000		
3	− 100		+ $500		+ 400		
4		+ $2,000		− 2,000			
5	− 400				− 400		
6	+ 3,000					+ $3,000	
7	+ 2,000	− 2,000					
8	− 500						− 500

Each of the lines designated 1 through 8 indicates the effect of a completed business transaction on the accounting equation.

Requirements:

1. Describe each transaction.

2. Determine the balances in each column. Also determine the totals for assets, liabilities, and owner's equity to verify the accounting equation of A = L + OE.

Check your answers with those on page 49.

DETERMINING THE PROFITABILITY OF OPERATIONS

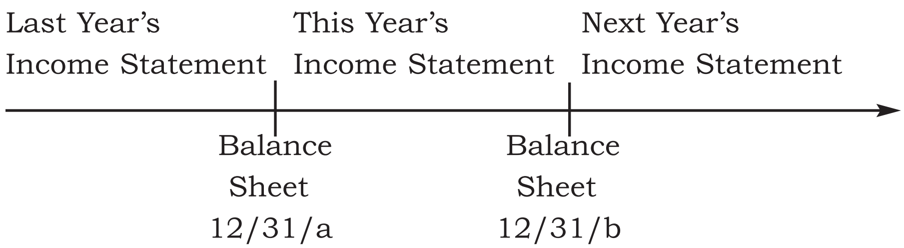
Income Statement Fundamentals

The *income statement,* sometimes referred to as a *profit and loss statement,* is a formal financial statement designed to show a company's operating results for a period of time. The purpose of an income statement is found in its definition: to show a company's operating results *during a certain period of time.* The statement summarizes and reports those transactions which will disclose whether a company's profit-directed activities for a particular time period have resulted in a net income or a net loss. Thus, the income statement will show in summary form both the amount and the sources of a company's revenue and the amount and kinds of expenses that the company incurred during the period. From these, it can be determined whether the company's activities led to a net income or a net loss for the period.

Accounting Period

An income statement shows a company's operating results during the period of time that elapses between two balance sheet dates. This time period, called the *accounting period,* is the interval of time for which the income statement is customarily prepared. Ordinarily, the income statement is prepared for a period of one month, three months, or a full year.

The following diagram should serve to illustrate the accounting period concept. The horizontal line represents a part of the total life of a business, and this line has been divided into accounting periods of one year each.



Note that the income statement for this illustration would cover a time period of one year, and that it would end with a balance sheet at the end of the period.

When the income statement indicates that a company's total revenue has exceeded total costs and expenses, the company has earned a *net income* and its owner's equity will be increased. Conversely, when a company's income statement indicates that its total costs and expenses have exceeded its total revenue, the company has incurred a *net loss* and its owner's equity will be decreased.

Income Statement Format

To see how the income statement summarizes and reports the revenue and expense transactions of a company, let's assume that the following transactions affecting the Dane Architecture Company occurred during the month of March.

Fees earned for architectural services performed:	
Collected in cash	$7,000
Billed for collection in the future (accounts receivable)	3,000
Total fees earned	$10,000

Expenses to operate the business during March:	
Paid to company employees	$6,800
Paid to landlord	500
Newspaper ad to be paid for at some future time (accounts payable)	100
Paid to telephone company	40
Paid to electric company	80
Paid to water company	10
Paid to transportation company	70
Total expenses incurred	$7,600

The Dane Architecture Company's operating results for the month of March are reported by the income statement, shown in Figure 5.

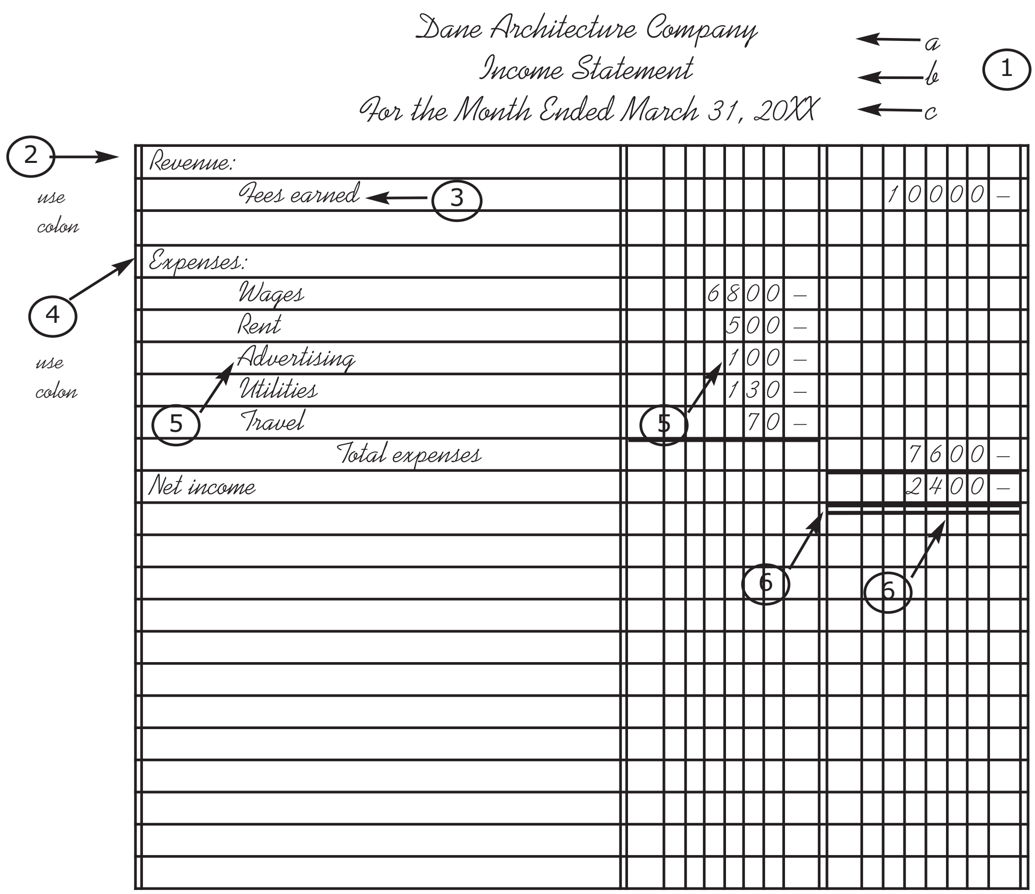


FIGURE 5—Income Statement: Dane Architecture Company

Preparing an Income Statement

There are certain procedures to follow when an income statement is prepared. The accounting profession, along with most business organizations, has adopted standard formats for presenting financial statements.

By using the generally accepted procedures, and by grouping items within the framework of the statement, accountants can make income statements more informative, thereby assisting both management and the public in their analysis of the data presented.

Outlined here are the procedures for preparing the income statement:

1. The income statement must have a heading which gives
    a. The name of the company
    b. The name of the financial statement
    c. The period of time covered by the statement
2. The revenue section is identified by the word *Revenue,* followed by a colon.
3. Each source of revenue is listed by indenting the title of the item beneath the revenue caption. When there's only one source of revenue, the amount is shown directly in the second money column. If there are several sources of revenue, the individual amounts should be listed in the first money column and the total amount entered in the second money column.
4. The expense section is identified by the word *Expenses,* followed by a colon.
5. Each item of expense is listed by indenting the title of the item beneath the expense caption. The individual amounts are listed in the first money column, and the total amount is shown in the second money column.
6. Double-ruled lines are drawn beneath the net income or the net loss to indicate that the columns are completed at that point. Remember that the net income is the difference between the total revenue and the total expenses for the period. If the total expenses exceed the total revenue, the amount will be identified as a net loss.

Content of the Income Statement

Near the top of the income statement is the heading "Revenue," and under this heading each major source of the company's revenue is listed separately. Revenue amounts represent the total price of goods sold during an accounting period or the price charged for services rendered during an accounting period, or both. In the illustrated income statement of the Dane Architecture Company, revenue totals $10,000 and represents the total fees that the company billed its clients for services rendered during the month of March.

The next section shows the heading “Expenses,” and under this heading each expense item is identified by name and amount. Expense amounts represent the cost of goods or services, or both, that were consumed while the company was generating its revenue.

Our illustrated income statement, Figure 5, shows that the Dane Architecture Company incurred expenses for wages, rent, advertising, utilities, and travel while generating its fee revenues.

Expenses are subtracted from revenues. If total revenues exceed total expenses, the amount is identified as net income. If total expenses exceed total revenues, the company has suffered a loss, and the amount by which expenses exceed revenues is shown and identified as a net loss. In our illustration, revenues exceed expenses by $2,400, and the amount is identified as the Dane Architecture Company’s net income. The amount shown for the owner’s capital will be increased by a net income and decreased by a net loss. We shall illustrate this point shortly.

It’s important to note that we’ve continued to use the *accrual basis* of accounting for net income. This means that revenues and expenses are recorded in the period in which they were either earned or incurred, regardless of when the cash receipts or payments are made. If we were to delay recording the revenues and expenses until payment was either received or made, we would be using what’s referred to as the *cash basis* of accounting. The accrual basis of accounting is considered superior to the cash basis of accounting, because it gives a more accurate measure of a company’s operating performance during an accounting period. The cash basis of accounting is frequently used for many small proprietorships and partnerships because of its simplicity. However, we use the accrual basis of accounting in this course because it’s the one that best fulfills the objectives of accounting and is also the one most generally used in business.

Income Statement for a Merchandising Firm

The procedures for presenting information, as shown in the income statement in Figure 5, are the procedures appropriate for a business which earns its revenue by performing a service. The Dane Architecture Company earned revenue by selling services for a fee.

A firm which sells a product, generally referred to as a *merchandising firm,* or a firm which produces a product, known as a *manufacturing firm,* must develop an income statement appropriate to its type of business activity.

Discussed and illustrated next are the form and content of the income statement prepared for a merchandising firm. Like all the reports previously illustrated, the format of the income statement for merchandising firms has evolved into a format that has been generally accepted by the business community. This format of the income statement is usually prepared in sections which include the following:

1. *Sales.* A firm selling merchandise refers to its revenue as sales. The amount shown represents the sales price of all the goods sold during the period of time covered by the statement.
2. *Cost of goods sold.* This section shows the cost in dollars of all the merchandise sold by the company during the period of time covered by the statement.
3. *Gross profit on sales.* Gross profit is the difference between the dollar amount shown for sales and the dollar amount shown for the cost of goods sold.
4. *Operating expenses.* These are the expenses incurred in operating the business. The operating expenses are frequently reported under subdivision headings, such as selling expenses and administrative and general expenses.
5. *Net operating income.* Net operating income is the difference between the gross profit on sales and the operating expenses.

6. *Other revenue.* This section will report all of the revenue not derived from the firm's principal business activity. Examples would be interest on investments, rental income from property not used to operate the business, and any other auxiliary revenue-producing activity.

7. *Other expenses.* Included in this section are those expenses not directly related to the firm's principal business activity. Interest paid on borrowed money would be an example of such an expense.

8. *Net income.* Net income is the net operating income plus all other revenue minus all other expenses.

Note that there are other sections to the income statement that may or may not appear, depending on the circumstances. These sections would report less common items such as the effect of discontinuing a major segment of the company's business. However, they appear only when necessary.

The income statement of the Delroy Company, a merchandising firm, for the month of October appears in Figure 6. The eight main sections just discussed are identified by the circled numbers.

Information Provided by the Income Statement

Important information can be determined from a careful study of a firm's income statement. From the income statement of the Delroy Company, the following information can be developed:

1. The statement covers a period of one month—in Figure 6, the month was October.

2. The total revenue earned from the firm's principal business activity was $60,000.

3. The total cost of the merchandise sold during the period was $27,000. Thus, the cost of the items sold represents 45% of the sales volume. This percent is computed by dividing the cost of goods sold, $27,000, by the total sales of $60,000.

4. The gross profit on sales for the period was $33,000. This amount represents 55% of the selling price ($33,000 ÷ $60,000). Hence, for each dollar of sales in October, 45¢ represents cost and 55¢ represents gross profit earned.
5. Selling expenses amounted to $16,200, which is 27% of sales revenue ($16,200 ÷ $60,000).
6. General and administrative expenses amounted to $7,200, which is 12% of sales revenue ($7,200 ÷ $60,000).
7. Operating expenses for the period totaled $23,400, which is 39% of sales revenue ($23,400 ÷ $60,000). Therefore, for every dollar earned from sales in October, 39¢ was spent for conducting the firm's business activity.
8. Net operating income earned during October was $9,600, which is 16% of the sales revenue ($9,600 ÷ $60,000).
9. Net income earned by the firm during the month of October was $9,000. This is a net income of 15% based upon sales ($9,000 ÷ $60,000). Therefore, for each dollar earned in October, 85¢ was spent for various costs and expenses and 15¢ remained as the firm's profit for the month.

Delroy Company
Income Statement
For the Month of October 20XX

1	Sales			60000 –
2	Cost of goods sold			27000 –
3	Gross profit on sales			33000 –
4	Operating expenses:			
	Selling expenses			
	Sales salaries	11700 –		
	Advertising	1900 –		
	Travel	1500 –		
	Delivery	1100 –	16200 –	
	General and administrative expenses:			
	Office salaries	4200 –		
	Taxes	1300 –		
	Insurance	700 –		
	Supplies used	200 –		
	Utilities	800 –	7200 –	
	Total operating expenses			23400 –
5	Net operating income			9600 –
6	Other income - rent			200 –
				9800 –
7	Other expenses - interest			800 –
8	Net income			9000 –

FIGURE 6—Income Statement: Delroy Company

Revenue and Expense Titles

The titles used to describe revenue and expense items aren't the same for all businesses. The titles selected will depend upon the firm's type of business activity. The titles for the revenue and expense items listed on the income statement are selected carefully to provide the owner(s) and/or other interested persons with a clear description of the kinds of revenues and expenses the business had during the accounting period. Once titles have been selected, they should be used consistently so as to provide a basis for comparing the results from one accounting period to another.

Listed next are some titles commonly used for revenue and expense items.

Revenue Titles

Service revenue. This title represents the amount charged to customers for services performed during the accounting period. Specific titles, such as fees or commissions earned, are generally used to indicate the kind of service performed.

Sales. This is the appropriate title for describing the revenue-producing activity of a merchandising or manufacturing firm. The amount represents the total dollar volume of sales made to customers during the accounting period.

Rental revenue. The amount earned by permitting others to use or occupy (or both) one of the firm's assets.

Interest revenue. The amount earned either by investing money or by extending credit to your customers.

Dividend revenue. The amount earned on investments in stocks of other companies.

Expense Titles

Cost of goods sold. This title represents the cost of the merchandise sold during an accounting period.

Salaries expense. This is the gross amount earned by employees during the accounting period for their services to the firm.

Advertising expense. This is the cost incurred to promote the firm's product or service.

Travel expense. This is the cost of providing transportation for employees and others involved in the firm's business activities.

Delivery expense. This is the cost of transporting the firm's product to customers.

Taxes. These are the amounts which must be paid to federal and/or state agencies. A separate title is generally used to distinguish payroll tax expense from other business taxes.

Insurance expense. This is the cost of shifting the risk of potential losses due to fires, lawsuits, and other such occurrences, to another company or person. This amount represents that portion of the total insurance premium which expired during the accounting period.

Supplies expense. This is the cost of items used in operating certain departments, such as the office, the salesroom, and the warehouse.

Utilities expense. Generally included under this title is the cost of power, telephone service, and telegraph services for the accounting period.

Interest expense. This is the cost incurred for borrowing during an accounting period.

We've just concluded our long discussion of the income statement. Let's stop now to see how well you've mastered this material. Try the following self-check before going on with your study of the next financial statement.

Self-Check 3

Indicate whether each of the following statements are True or False.

_______ 1. The purpose of the income statement is to show a company's operating results for a period of time.

_______ 2. The income statement will show, in summary form, the amount and sources of a company's revenue and the amount and kinds of liabilities incurred during a period of time.

_______ 3. The excess of revenue over expenses is called *net income.*

_______ 4. The accounting period is the interval of time for which the income statement is prepared.

_______ 5. Revenues are the total sales price of the goods sold or of the services rendered to customers during an accounting period, or both.

_______ 6. Under the accrual method of accounting, revenues are recognized as earned as soon as the cash is received.

_______ 7. Under the accrual method of accounting, revenues are recognized as earned when accounts receivable are collected in cash.

_______ 8. Expenses represent the cost of goods or services, or both, that were consumed while the company was generating its revenue.

_______ 9. When a company shows a reported net income, its cash will increase by the same amount as the amount reported as its net income.

_______ 10. Most companies use an accrual basis of accounting.

_______ 11. Expenses are subtracted from revenues to determine whether a company has earned a net income or has incurred a net loss.

Check your answers with those on page 50.

ANALYZING THE OWNER'S INTEREST IN A BUSINESS

Information Provided by the Statement of Owner's Equity

Now we can introduce another of the basic financial statements, called the *statement of owner's equity.* The purpose of this statement is to show the changes that have occured in the owner's equity during a specific period of time, such as a month or a year. It should be noted that the statement of owner's equity is prepared only for proprietorships and partnerships; a similar but different statement, called the *statement of retained earnings,* is prepared if the business is organized as a corporation. The discussion of the statement of retained earnings will be delayed until a later lesson, when we'll focus on items specifically related to the corporate form of business organization.

The statement of owner's equity, like all financial statements, provides important financial information. To illustrate the kind of information provided by this statement, let's continue to use our company, the Dane Architecture Company, as an example.

We know that R. Dane made an initial investment of $15,000 to start a business, and that the $15,000 represented, at that time, his ownership in the business. The amount of his ownership, and therefore the amount reported for his owner's capital, could change during an accounting period for any of the following reasons:

1. He would increase the amount by making an additional investment in the business.
2. He would decrease the amount by withdrawing assets from the business.
3. He would increase the amount when revenues exceeded expenses; that is, when a net income was earned while operating the business for a period of time.

4. He would decrease the amount when expenses exceeded revenues; that is, when a net loss was incurred while operating the business for a period of time.

In our example, we found that R. Dane withdrew $200 in cash for his personal use during the month of March, and that the company had an earned net income of $2,400 from its profit-directed activities during the month of March. This information is presented in the statement of owner's equity as illustrated in Figure 7.

Dane Architecture Company
Statement of Owner's Equity
For the Month Ended March 31, 20XX

R. Dane, Capital - March 1		15000 –
Add: Net income		2400 –
Total		17400 –
Deduct: Withdrawal		200 –
R. Dane, Capital - March 31		17200 –

FIGURE 7—Statement of Owner's Equity: Dane Architecture Company

Note that the amount of $17,200 shown for R. Dane, Capital, on March 31 in the statement of owner's equity is the same amount that will appear for R. Dane, Capital, in the owner's equity section of the March 31 balance sheet prepared after taking the income and expense items into consideration. (See Figure 9.)

Basic Features of the Three Financial Statements and Their Interrelationships

The three formal financial statements which have been discussed to this point have been prepared for the Dane Architecture Company and are shown in Figure 9. All of the amounts were developed from the material presented in this text. By carefully reviewing this material, you can check your understanding of the basic features of the three statements and, more important still, the interrelationships of the statements.

In terms of basic features, it should be noted that all financial statements should have a heading which identifies the name of the company, the title of the statement, and the date or period of time. The information presented in the *balance sheet* is for a *specific date;* the information presented in the *income statement* and in the *statement of owner's equity* is for a *period of time.*

Headings, indentions, dollar signs, and rules are used in a way to highlight certain aspects and certain sections of the three statements.

When studying the interrelationships among the three statements, follow the arrowed lines. Note, in doing so, that the $2,400 of net income reported in the income statement appears as a change in owner's capital in the statement of owner's equity. Note also that, at the end of the period, the capital of $17,200 shown as R. Dane, Capital, in the statement of owner's equity is the same amount shown for owner's equity in the March 31, 20XX balance sheet.

The balance sheet shown in Figure 4 was prepared before any revenue or expenses were recorded. Figure 8 is a continuation of Figure 3 and shows the changes in the accounts which were brought about by the revenue and expense transactions described in the section "The Income Statement Format." The balance sheet shown in Figure 9 reflects the changes caused by the revenue and expense transactions.

Presented in *Self-Check 4* is a practice problem which may be challenging, but which is certainly worth a try. Remember not to look at the solution until you've tried to solve the problem on your own. If you're successful, you'll have the assurance that you're well aware of the basic features of the three financial statements and their interrelationships.

		ASSETS								LIABILITIES				OWNER'S EQUITY
		Cash	+	Accounts Receivable	+	Office Supplies	+	Equipment	=	Accounts payable	+	Notes payable	+	R. Dane, Capital
Balances from Figure 3		$17,200	+	$500	+	$600	+	$2,000	=	$2,500	+	$3,000	+	$14,800
Revenue transactions	+	7,000	+	3,000					=				+	10,000 (Revenue)
Expense transactions	−	7,500							=	100			−	7,600 (Expenses)
Balances		$16,700	+	$3,500	+	$600	+	$2,000	=	$2,600	+	$3,000	+	$17,200

FIGURE 8—Summary of Income and Expense Transactions: Dane Architecture Company

DANE ARCHITECTURE COMPANY
Income Statement
For the Month of March 20XX

Revenue:		
Fees Earned		$10,000
Expenses:		
Wages	$6,800	
Rent	500	
Advertising	100	
Utilities	130	
Travel	70	
Total expenses		$7,600
Net income		$2,400

DANE ARCHITECTURE COMPANY
Statement of Owner's Equity
For the Month Ended March 31, 20XX

R. Dane, Capital—March 1, 20XX	$15,000
Add: Net income	2,400
Total	$17,400
Deduct: Withdrawal	200
R. Dane, Capital—March 31, 20XX	$17,200

DANE ARCHITECTURE COMPANY
Balance Sheet
March 31, 20XX

Current assets:		
Cash	$16,700	
Accounts receivable	3,500	
Office supplies	600	
Total current assets		$20,800
Property, plant, and equipment:		
Equipment		2,000
Total assets		$22,800

Liabilities and Owner's Equity

Current liabilities:		
Accounts payable	$ 2,600	
Notes payable	3,000	
Total current liabilities		$5,600
Owner's equity:		
R. Dane, capital		17,200
Total liabilities and owner's equity		$22,800

FIGURE 9—Relationships among Financial Statements: Dane Architecture Company

Self-Check 4

The items and amounts listed for this problem were taken from the records of the Blaine Company, which is owned and operated by Thomas Blaine. From this alphabetically arranged list, you are to present, in proper form, the following:

a. An income statement for the month of January 20XX.
b. A statement of owner's equity for the month of January 20XX.
c. A report-form balance sheet as of January 31, 20XX.

Accounts payable	$10,100
Accounts receivable	12,200
Advertising expense	1,200
Bonds payable	20,000
Cash	9,700
Commissions earned	11,400
Equipment	16,000
Insurance expense	850
Interest expense	300
Interest income	400
Interest payable	250
Investment securities (long-term)	9,500
Land	8,400
Mortgage payable	6,500
Notes receivable (due next month)	1,500
Notes receivable (due in 5 years)	8,000
Rent expense	300
Salaries expense	4,120
Supplies expense	400
Supplies on hand	680
T. Blaine, Capital (Jan. 1)	26,200
T. Blaine, Drawings	700
Travel expense	730
Utilities expense	270

Check your answers with those on page 51.

THE STATEMENT OF CASH FLOWS

Fundamentals of the Statement

The FASB (Financial Accounting Standards Board) is an extremely influential rule-making accounting body. You'll hear much more about its activities as you continue your study of accounting. In November of 1987, this board issued Standard No. 95, *Statement of Cash Flows,* which emphasizes the importance of the statement of cash flows and provides increased guidance for its construction. For many years prior to this standard, statements similar to the statement of cash flows were prepared. However, these earlier statements varied a great deal in their content and format, as well as in the titles used. Standard No. 95 was issued to provide more consistency in the content and format of these statements.

The statement of cash flows shows the flow of cash through a business. It should be noted that until the issuance of Standard No. 95, many of these similar statements defined *funds* as working capital, which is the excess of current assets over current liabilities (working capital = current assets – current liabilities). Standard No. 95 emphasizes the importance of defining "funds" as cash, and therefore recommended that cash be used instead of working capital for these statements. Therefore, from this point on, statements of cash flows will use "cash," not "working capital," as the main focus of the statement. This attempt to provide more consistency in the content of this statement was further emphasized by FASB's recommendation that these statements be titled "Statement of Cash Flows," rather than "Statement of Changes in Financial Position."

The objectives of the statement of cash flows are:

1. To show the flow of cash through a business. This is done by disclosing the company's sources of cash and its uses of cash during a particular accounting period.

2. To show these inflows and outflows of cash for three important categories of business activity: operating activities, investing activities, and financing activities.

3. To reconcile these cash flows with the beginning and ending balances in the cash account.

All this information is important to owners and managers, since they're responsible for conducting the company's business in a manner that will provide sufficient cash for company operations and growth. Of course, investors, potential investors, and creditors will also find this information useful when evaluating the effectiveness of owners' and managers' decisions regarding the sources and uses of cash.

The cash flow statement is probably associated more with corporate financial reporting than it is with single proprietorship and partnership financial reporting. Therefore, in this first instruction unit, we're simply going to introduce certain basic concepts connected with the statement, leaving the more detailed study to a later text.

To help you to fully grasp the basic concepts of the statement of cash flows, we must

1. Discuss the importance of cash flows
2. Identify the principal sources and uses of cash
3. Determine the format and content of the statement of cash flows
4. Identify the information provided by the statement of cash flows

Importance of Cash Flows

The analysis of cash is important because one of the crucial responsibilities of owners and managers is to see to it that the company has sufficient liquid resources to meet its obligations as they come due. The most liquid of all resources is cash, and therefore a careful analysis of its inflows and outflows is necessary to help ensure that a company doesn't encounter liquidity problems that could result in bankruptcy. The W. T. Grant Company is a classic example of why this focus on cash flows is so important. An analysis of W. T. Grant's cash flows would have indicated liquidity problems well before its eventual bankruptcy; years before, an analysis of its working capital, or even net income, would have indicated possible problems with cash flows.

Principal Sources and Uses of Cash

Obviously, any business transaction that involves cash will be either a source or a use of cash. However, to provide more meaningful information, these sources and uses are classified by type of activity; specifically by whether the transaction was part of *operating activities, investing activities,* or *financing activities.* Transactions considered to be part of normal operating activities would be transactions such as the collection of an account receivable or a cash payment on an account payable. Similarly, business transactions considered to be part of investing activities would be transactions such as the cash purchase of a building or the cash sale of a delivery truck. Financing activities would include transactions such as cash received through the issuance of a long-term note payable or the cash used in the retirement of bonds payable. A list of some of the typical cash receipts and payments for a business, categorized by the three types of business activity, follows:

Operating Activities

Cash inflows:

- Cash sales of goods or services
- Receipts of cash from customers for payment on their accounts
- Cash receipts from interest and dividend revenue

Cash outflows:

- Cash payments for purchase of inventory
- Cash payments to employees for services rendered
- Cash payments to the government for taxes
- Cash payments made on accounts payable
- Cash payments for other expenses such as interest and rent

Investing Activities

Cash inflows:

- Cash receipts from the sale of property, plant, or equipment
- Cash receipts from the sale of investments
- Cash receipts from the collection of principal amounts lent to other entities

Cash outflows:

Cash payments to purchase property, plant, or equipment

Cash payments to purchase the stock or bonds of other companies

Cash loaned to other businesses

Financing Activities

Cash inflows:

Cash received from the owner(s) as additional investment in the company

Cash received from the issuance of debt (for example, bonds payable, notes payable, mortgages payable)

Cash outflows:

Cash payments to the owner(s)

Cash payments to retire outstanding debt

The balance sheet will reveal the principal sources of working capital as

- Decreases in noncash assets
- Increases in liabilities
- Increases in owner's equity

Similarly, the balance sheet will reveal the principal uses of working capital as

- Increases in noncash assets
- Decreases in liabilities
- Decreases in owner's equity

Remember that a more complete discussion of the details involved in the construction of this statement will be presented in a later text.

Form and Content of the Statement

Like all other financial statements, the statement of cash flows, Figure 10, should have a centered heading which gives the company's name, the name of the statement, and the date or period of time reported by the statement. Since the statement of cash flows explains how cash has changed over a period of time, the third line of the heading should indicate the period of time covered by the statement—generally a month, a quarter of a year, or a year. The statement will first report cash flows from operating activities, that is, those activities which are part of the company's normal day-to-day business activities, such as cash sales, collections of accounts receivables, and payments on accounts payable. This section will then be followed by a section reporting cash flows from investing activities and then by a section reporting cash flows from financing activities. The net increase or decrease in cash is reported at the bottom of the statement, along with the beginning and ending balances of cash. This arrangement allows the reader to clearly see the major sources and uses of cash during the period, and to reconcile this amount with the beginning and ending balances.

THE RINALDI COMPANY
Statement of Cash Flows
For the Year Ended December 31, 20XX

Cash flows from operating activities:		
Net income		$115,000
Adjustments:		
Decrease in accounts receivable	$45,000	
Increase in inventories	(15,000)	
Decrease in accounts payable	(3,000)	27,000
Net cash provided by operating activities		$142,000
Cash flows from investing activities:		
Sale of equipment	12,000	
Purchase of land	(40,000)	
Net cash used by investing activities		(28,000)
Cash flows from financing activities:		
Withdrawal by owner	$(10,000)	
Increase in long-term notes payable	25,000	
Net cashprovided by financing activities		15,000
Net increase in cash		$129,000
Cash, January 1, 20XX		100,000
Cash, December 31, 20XX		$229,000

FIGURE 10—Statement of Cash Flows: Rinaldi Company

Note that under "Cash flows from operating activities," net income is listed as the first component. This represents a method of constructing the statement of cash flows that's referred to as the *indirect method.* This method of calculating net cash flows starts with the assumption that all of net income represents receipts of cash. This assumption is clearly incorrect, since, for example, many sales are on credit and therefore won't provide cash until a future period when the account is collected. However, the inaccuracies of this assumption are corrected when the effects of the other accounts, such as accounts receivable, are included in the report. This last part might seem very confusing, but don't worry; this concept will be discussed in more detail in a later text. For now, it will be sufficient to recognize that while not all of net income represents a source of cash, it's frequently presented as a source of cash and is then followed by changes in other accounts that will remedy any inaccuracies caused by this assumption.

Information Provided

The statement of cash flows provides useful information concerning the sources and uses of a company's cash during a period of time. Figure 10 shows that the Rinaldi Company's cash account increased during the year by $129,000.

It also shows the sources and uses of cash for each of the three types of business activity. The Rinaldi Company had a $142,000 net source of cash provided by its operations, a $28,000 net use of cash from its investing activities, and a $15,000 net source of cash provided by its financing activities. These three types of business activity provided the $129,000 net increase in cash ($142,000 – 28,000 + 15,000) that reconciles the beginning balance of cash, $100,000, with the ending balance of $229,000.

On a more detailed level, Figure 10 also shows that $115,000 was provided by net income; $45,000 was provided by collections of accounts receivable; $15,000 was used in the purchase of inventory; $3,000 was used to pay accounts payable; $12,000 was provided by the sale of equipment; $40,000 was used to purchase land; $10,000 was withdrawn by the owner; and $25,000 was provided by the issuance of a long-term note payable. All of these items combined explain the net source of cash of $129,000.

In conclusion, it must be emphasized that both insiders and outsiders are interested in the flow of cash through a business. Information about a company's cash flows is used primarily as a basis for evaluating the ability of a company to pay its debts as they come due. This information can frequently indicate problems that could threaten a company's survival. The statement of cash flows provides this information, and for that reason, it has been receiving increased attention by those who use financial statements in making business decisions.

Self-Check 5

Indicate whether each of the following statements are True or False.

_______ 1. The FASB has recommended that working capital be used as the definition of *funds* in the statement of cash flows.

_______ 2. Working capital, which is equal to current assets minus current liabilities, was the focus in many “funds” statements made prior to the issuance of Standard 95.

_______ 3. Transactions that increase cash are sources of funds.

_______ 4. Transactions that decrease cash are uses of funds.

_______ 5. The purchase of merchandise inventory on account is a use of cash.

_______ 6. The sale of a company’s long-term investment securities for cash is a source of cash.

_______ 7. Collecting the amount due from a customer on accounts receivable is a source of cash.

_______ 8. Decreases in cash will generally occur when liabilities are decreased and when noncash assets are increased.

_______ 9. Increases in cash will generally occur when noncash assets decrease and when liabilities and owner’s equity increase.

Check your answers with those on page 53.

SUMMARY

In this study unit, we demonstrated how financial statements provide useful financial information to interested users both inside and outside the organization. In presenting the material, we attempted to develop an understanding of how these financial statements are prepared and how they can be used. We also emphasized that financial statements represent the end product of financial accounting and the objective toward which the financial accounting system is directed.

The generally accepted financial statements that we studied were the balance sheet, the income statement, the statement of owner's equity, and the statement of cash flows. These statements were thought of as reports designed for use by decision makers.

Once again, let's review the purpose of each of the four financial statements we discussed. The *balance sheet* may be described as a list of assets and of claims against those assets; its purpose is to show the financial status of a business at a particular point in time. The *income statement* summarizes a company's revenue items, its expense items, and the difference between them, called *net income* or *net loss;* its purpose is to show a company's operating results for a period of time. The *statement of owner's equity* is designed to explain the changes that have occurred in the owner's capital over a period of time. Last, the *statement of cash flows* summarizes the flows of cash through a business. Not only does it focus on the cash provided by the operation of the business, but it also points out the cash provided or used by various financing and investing activities which took place during a particular period of time.

In addition, this study unit discusses the way business transactions affect financial reports. Business transactions are exchanges of goods or services, or both, and it's business transactions that create accounting data. Accounting systems are designed to collect and process accounting data so that the results can be reported in one or more of the four basic general-purpose financial statements. Having studied the material in this study unit, you now know that financial statements are the principal means by which a company communicates information about its resources and equities and about the changes that have occurred in those resources and equities over a period of time.

NOTES

Self-Check 1

1. True
2. True
3. False. A balance sheet shows the financial status of a company at a particular point in time.
4. True
5. False. The two categories of persons having claims against a company s assets are the creditors and the owners.
6. True

Self-Check 2

Requirement 1

1. L. Hunter, the owner of Century Company, invested $25,000 of personal cash in the business.
2. Purchased equipment that cost $10,000 on a promise to pay at some future time.
3. Purchased supplies that cost $500 by paying $100 in cash and promising to pay $400 at some future time.
4. Sold some equipment at its cost of $2,000. The equipment was sold on account—that is, on promise that it would be paid for at some future time.
5. Paid $400 of the debt, that is, paid $400 to one of the creditors on account.
6. Borrowed $3,000 of cash on a written promise to pay it back at some future time.
7. Collected $2,000 due on one of the receivables.
8. The owner, L. Hunter, withdrew $500 in cash for personal use.

Requirement 2

Balances: Cash, $29 000; Accounts receivable, no balance; Supplies, $500; Equipment, $8 000; Accounts payable, $10,000; Notes payable, $3,000; L. Hunter, Capital, $24,500.

ASSETS=		LIABILITIES	+		OWNER'S EQUITY
$37,500	=	$13,000		+	$24,500

Self-Check 3

1. True
2. False. The income statement will show the amount and sources of a company's revenue and also the amount and kinds of expenses that a company incurred during a period of time.
3. True
4. True
5. True
6. False. Revenues are earned by selling goods or rendering services to customers, or both, whether for cash or on credit terms.
7. False. When accounts receivable are collected in cash, one asset, cash, is increased and another asset, accounts receivable, is decreased. Thus this transaction results in an exchange of assets and has no effect on revenue.
8. True
9. False. Earned revenues may have created assets like accounts receivable, and expenses incurred may have created liabilities like accounts payable.These transactions did not affect cash, but they must be reported and included to determine a company's net income on the accrual basis.
10. True
11. True

Self-Check 4

BLAINE COMPANY
Income Statement
For the Month of January, 20XX

Revenue:		
Commissions earned		$11,400
Operating expenses:		
Salaries	$4,120	
Advertising	1,200	
Insurance	850	
Travel	730	
Supplies	400	
Rent	300	
Utilities	270	
Total operating expenses		7,870
Net operating income		$3,530
Other income—interest		400
		$3,930
Other expenses—interest		300
Net income		$3,630

The order in which the operating expense items are listed in the income statement varies among business firms. Here the commonly followed arrangement of listing the items by the size of the dollar amount has been used, the larger dollar amounts being listed first.

BLAINE COMPANY
Statement of Owner's Equity
For the Month Ended January 31, 20XX

Thomas Blaine, Capital—Jan. 1, 20XX	$26,200
Add: Net income	3,630
Total	$29,830
Deduct: Withdrawal	700
Thomas Blaine, Capital—Jan. 31, 20XX	$29,130

BLAINE COMPANY
Balance Sheet
January 31, 20XX

Assets		
Current assets:		
Cash	$ 9,700	
Accounts receivable	12,200	
Notes receivable	1,500	
Supplies on hand	680	
Total current assets		$24,080
Investments:		
Investment securities	$ 9,500	
Notes receivable	8,000	
Total investments		17,500
Property, plant, and equipment:		
Land	$ 8,400	
Equipment	16,000	
Total property, plant, and equipment		24,400
Total assets		$65,980
Liabilities and Owner's Equity		
Current liabilities:		
Accounts payable	$10,100	
Interest payable	250	
Total current liabilities		$10,350
Long-term liabilities:		
Bonds payable	$20,000	
Mortgage payable	6,500	
Total long-term liabilities		26,500
Total liabilities		$36,850
Owner's equity:		
Thomas Blaine, Capital		29,130
Total liabilities and owner's equity		$65,980

Self-Check 5

1. False. In statement No. 95, the FASB recommended that all companies use cash, not working capital, as the definition of *funds* used in the statement of cash flows.
2. True
3. True
4. True
5. False. Purchasing merchandise inventory on account increases a liability, but doesn't use cash until a future period when payment will be made. Therefore, this transaction isn't a use of cash.
6. True
7. True
8. True
9. True

NOTES

Glossary

accounting equation Assets = Liabilities + Owner's Equity.

accounting period The interval of time for which financial statements are prepared.

accounts payable Amounts owed to creditors for merchandise or services supplied by them on account.

accounts receivable Amounts billed and owed to a business by its customers.

assets Things of value owned.

balance sheet A formal financial statement which presents the assets, liabilities, and owner's equity of a firm at a specific date.

bonds payable Long-term debt evidenced in writing by a contract and the issuance of certificates.

buildings Structures owned by a firm and used in the operation of the business.

copyright An exclusive privilege of publication.

corporation A business unit created by charter, generally owned by a number of stockholders who contribute the resources needed to start the business. The owners (stockholders) have limited liability.

cost of goods sold The amount paid by a business for the merchandise which it sold.

creditor One to whom a business owes a debt. One who has a financial interest in the firm's assets.

current assets Cash and other resources which are reasonably expected to be converted into cash or sold or consumed in a year or less as a result of normal business operations.

current liabilities Debts which must usually be paid within one year. Their payment normally requires the use of current assets.

dividends A distribution to its stockholders of income earned by a corporation.

equipment Assets which have long-use lives, are used in the operation of a business, and aren't intended for sale.

expenses Deductions from revenue or from gross profit on sales, depending upon the type of business activity, to determine net income. The costs of operating a business.

financial statements Accounting reports, which include the balance sheet, income statement, statement of owner's equity, and statement of cash flow.

fixed assets Alternate title for property, plant, and equipment. See *property, plant, and equipment.*

franchise A right granted to a business to deal in a certain product or to operate a certain route or a given territory.

government accountant One who works for an agency of the government rather than for a firm or for himself/herself.

gross profit on sales The difference between the selling price and the cost of the product sold.

income statement A formal financial statement which summarizes a firm's revenues and costs and expenses for a given period of time.

intangible assets Noncurrent resources which provide a business with legal rights or a competitive advantage.

land Real estate owned by the firm and used in operating the business.

liabilities Debts owed.

long-term liabilities Debts not yet due, usually having a maturity date a year or more in the future.

machinery Assets used to manufacture a product; such assets have relatively long lives and are not intended for sale.

manufacturing firm A business unit which makes the product it sells.

marketable securities Temporary investments in readily marketable stocks and bonds.

merchandise firm A business unit which acquires goods for resale at a profit.

merchandise inventory The value of the goods on hand which are intended to be sold in the regular course of operating the business.

mortgage payable A written promissory note of debt, usually secured by pledging a specific asset or assets.

net income The excess of revenues over expenses for a given period of time.

net loss The excess of expenses over revenues for a given period of time.

note payable A written promise to pay to another a certain sum of money at a named future date.

note receivable A written promise by a customer to pay a certain sum of money at a named future date.

owner's equity The financial interest of the owner (or owners) in a firm's assets.

partnership A business owned by two or more individuals who provide the resources to start the business. The partners have unlimited liability.

patent An exclusive right to use a certain process to manufacture a product.

prepaid expenses Supplies and services paid for in advance and for which all benefits haven't yet been received.

private accountant One who performs an accounting service as an employee of a firm rather than as an independent contractor.

profit and loss statement Alternate title for income statement. See *income statement.*

property, plant, and equipment Owned resources which have relatively long lives, are used in operating the business, and aren't intended to be sold.

public accountant One who offers professional accounting services to the public for a fee.

revenue An inflow of assets which result from conducting the activities of a business.

sales The revenue earned from selling a firm's merchandise to its customers.

service business firm A business unit which generates revenue by performing a service as opposed to making or selling a product.

single proprietorship A business owned by one individual, who provides the resources to start the business. The owner has unlimited liability.

solvency A firm's ability to pay debts when they come due.

statement of cash flows A formal financial statement which shows the flow of cash through a business.

statement of financial condition Alternate title for balance sheet. See *balance sheet.*

statement of financial position Alternate title for balance sheet. See *balance sheet.*

statement of operations Alternate title for income statement. See *income statement.*

statement of owner's equity A formal financial statement which shows the changes that have taken place in the proprietor's capital during a designated period.

stockholders The owners of a corporation, who hold stock certificates as evidence of their ownership.

transaction An exchange of values which will cause changes in a firm's assets, liabilities, or owner's equity, or in more than one of these.

Accounting, Part 1

EXAMINATION NUMBER

06100202

Whichever method you use in submitting your exam answers to the school, you must use the number above.

For the quickest test results, go to http://www.takeexamsonline.com

When you feel confident that you have mastered the material in this study unit, go to http://www.takeexamsonline.com and submit your answers online. If you don't have access to the Internet, you can phone in or mail in your exam. Submit your answers for this examination as soon as you complete it. *Do not wait until another examination is ready.*

Questions 1–20: Select the one best answer to each question.

1. A company having total assets of $180,000 and owner's equity of $70,000 would have total liabilities of

   A. $250,000.
   B. $140,000.
   C. $110,000.
   D. $40,000.

2. A company having total liabilities of $60,000 purchased a vehicle for $5,000 in cash. Its liabilities were then

   A. $65,000.
   B. $60,000.
   C. $55,000.
   D. $50,000.

3. The operating expenses of a company include all of the following *except*

   A. wages paid to an employee.
   B. rent paid to a landlord.
   C. commissions earned by a salesperson.
   D. cash withdrawn by the owner or owners.

Examination

4. Which of the following items is reported in income statements?

   A. Cash flows
   B. Owner's investments
   C. Assets and equities
   D. Revenues and expenses

5. Which one of the following accounts would *not* appear on a balance sheet?

   A. Mortgage payable
   B. Interest expense
   C. Jack Kapp, Capital
   D. Notes receivable

6. In the preparation of an income statement, the accrual basis of accounting records

   A. expenses when they're incurred.
   B. revenues when collections are made on account.
   C. only cash sales during the period.
   D. only cash expenses during the period.

7. Which of the following transactions would *not* affect a company's net income?

   A. A cash withdrawal by the owner
   B. The payment of employees's salaries
   C. Services provided for clients on account
   D. Interest earned on invested money

8. Owner's withdrawals may be classified as

   A. uses of cash.
   B. sources of cash.
   C. sources of income.
   D. additional expenses.

9. A company with total assets of $90,000 collected $20,000 from one of its accounts receivable customers. Its total assets were then

   A. $110,000.
   B. $90,000.
   C. $70,000.
   D. $20,000.

10. A company on the accrual basis of accounting had $260,000 of revenue recorded at the time it sold $10,000 of services to a customer on account. Its revenue after this transaction totaled

   A. $270,000.
   B. $260,000.
   C. $250,000.
   D. $10,000.

Base your answers to questions 11 through 13 on the following information:

The accounts of the Eppers Company reflect the following balances.

Merchandise inventory	$31,255
Land	20,000
Salaries payable	2,240
Bonds payable	46,000
Cash	30,100
Prepaid insurance	750
Mortgage payable	20,000
Machinery	92,400
Accounts payable	18,190
Accounts receivable	12,420
Owner's equity	(?)

11. The company's current assets amount to

A. $42,520.
B. $73,775.
C. $74,525.
D. $186,925.

12. The total liabilities of the company are

A. $18,190.
B. $20,430.
C. $66,430.
D. $86,430.

13. The owner's equity in the business is

A. $74,525.
B. $100,495.
C. $186,925.
D. $273,355.

14. The books of the Marvel Company showed the following:

Current assets	$23,716
Property, plant, and equipment	45,625
Intangible assets	(?)
Current liabilities	11,217
Long-term liabilities	31,415
Owner's equity	32,709

For the company's balance sheet to balance, intangible assets would have to be valued at

A. $3,000.
B. $6,000.
C. $9,000.
D. $12,000.

15. Which of the following transactions will cause an increase in assets and an increase in liabilities?

    A. Office supplies are purchased for cash.
    B. John Klein invests an additional $2,000 in his business.
    C. Merchandise inventory is purchased on credit.
    D. Goods are sold to a customer on account.

16. The cash flow statement replaced which accounting statement?

    A. The profit and loss statement
    B. The statement of changes in financial position
    C. The statement of owner's equity
    D. The income statement

17. Financial statements report financial data for either a period of time or for a particular date. Which of the following financial statements reports financial information for a particular date.

    A. The balance sheet
    B. The cash flow statement
    C. The income statement
    D. Both the balance sheet and the income statement

18. The difference between "Net Operating Income" and "Gross Profit on Sales" is that net operating income

    A. includes amounts from the "Other Income" section of the income statement.
    B. is the same thing as gross profit on sales, and therefore there's no difference.
    C. includes deductions for operating expenses.
    D. includes deductions for "Other Expenses."

19. Which one of the following items is classified as an *investing activity*?

    A. Cash receipts from interest revenue
    B. Cash payments to purchase property
    C. Additional investment in the company by the owner
    D. Receipts of cash from customers for payment on their accounts

20. The purchase of land for cash would be reported on the statement of cash flows as a

    A. source of cash from operating activities.
    B. use of cash for investing activities.
    C. source of cash from financing activities.
    D. use of cash for financing activities.