

FINANCIAL STATEMENTS AND THE ANNUAL REPORT

Study Links

A Look at the Previous Chapter

Chapter 1 introduced the role of accounting in our society. We explored how investors, creditors, and others use accounting and the outputs of an accounting system—financial statements—in making informed decisions.

A Look at This Chapter

In this chapter, we take a closer look at the financial statements, as well as the other elements that make up an annual report. In the first part of the chapter, we explore the underlying conceptual framework of accounting. Every discipline has a set of interrelated concepts, principles, and conventions that guide daily practice. In the second part of the chapter, we will see how the concepts introduced in the first part of the chapter are used in the development of financial statements.

A Look at Upcoming Chapters

Chapter 2 focuses on the end result by examining the outputs of an accounting system, the financial statements. We will take a step back in Chapters 3 and 4, to consider how economic events are processed in an accounting system and are then summarized in the financial statements.

FOCUS ON FINANCIAL RESULTS

Gateway, the computer manufacturer and retailer, had a banner year in 1998, setting company records for sales and market share. Some important strategic moves accompanied these financial gains. The company moved its headquarters to San Diego and expanded its offices to Irvine, California. A large new manufacturing center in Salt Lake City was opened in 1998, and new information technology headquarters opened in Lakewood, Colorado, along with phone centers in Colorado Springs and Rio Rancho, New Mexico. The company introduced new products, including notebook and networking hardware and customer support software and services. It also hired 10 new top-level executives. Quick response to competitors and continual change are critical in this fast-paced industry.

All these changes cost money, but Gateway sees it as money well spent. Investments in the future make sense to this successful and growing firm. In fact, Gateway's 1998 annual report says the company is already starting to see the results of the changes.

According to John Todd, senior vice president and chief financial officer, "A company has three kinds of resources—human, technology, and financial." Gateway's 1998 balance sheet highlights the big changes in the firm's financial resources. Its holdings of cash and cash equivalents almost doubled, and property, plant, and equipment also increased considerably. Are these the financial results you would expect from a firm committed to improving all three kinds of resources?

Note to students: Gateway chooses to report the current year to the right side of the prior year. Most companies report the current year on the left side.

CONSOLIDATED BALANCE SHEETS

December 31, 1997 and 1998

(in thousands, except per share amounts)

	1997	1998
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 593,601	\$ 1,169,810
Marketable securities	38,648	158,657
Accounts receivable, net	510,679	558,851
Inventory	249,224	167,924
Other	152,531	172,944
Total current assets	1,544,683	2,228,186
Property, plant and equipment, net	376,467	530,988
Intangibles, net	82,590	65,944
Other assets	35,531	65,262
	<u>\$ 2,039,271</u>	<u>\$ 2,890,380</u>

Cash and cash equivalents nearly doubled from 1997 to 1998.

Property, plant, and equipment increased considerably as company growth occurred.

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:

Notes payable and current maturities of long-term obligations	\$ 13,969	\$ 11,415
Accounts payable	488,717	718,071
Accrued liabilities	271,250	415,265
Accrued royalties	159,418	167,873
Other current liabilities	70,552	117,050
Total current liabilities	1,003,906	1,429,674
Long-term obligations, net of current maturities	7,240	3,360
Warranty and other liabilities	98,081	112,971
Total liabilities	<u>1,109,227</u>	<u>1,546,005</u>

Commitments and Contingencies (Notes 3 and 4)

Stockholders' equity:

Preferred stock, \$.01 par value, 5,000 shares authorized; none issued and outstanding	—	—
Class A common stock, nonvoting, \$.01 par value, 1,000 shares authorized; none issued and outstanding	—	—
Common stock, \$.01 par value, 220,000 shares authorized; 154,128 shares and 156,569 shares issued and outstanding, respectively	1,541	1,566
Additional paid-in capital	299,483	365,986
Retained earnings	634,509	980,908
Accumulated other comprehensive loss	(5,489)	(4,085)
Total stockholders' equity	<u>930,044</u>	<u>1,344,375</u>
	<u>\$ 2,039,271</u>	<u>\$ 2,890,380</u>



The accompanying notes are an integral part of the consolidated financial statements.

Gateway 1998 Annual Report

If you were thinking of buying shares of Gateway stock, what questions about Gateway's future plans would you want answered? Use this chapter, Gateway's annual report, and its Web site to help you identify and evaluate information about the company's financial performance and the management's plans for use of the firm's resources.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 1** Describe the objectives of financial reporting. (p. 46)
- LO 2** Describe the qualitative characteristics of accounting information. (p. 47)
- LO 3** Explain the concept and purpose of a classified balance sheet and prepare the statement. (p. 53)
- LO 4** Use a classified balance sheet to analyze a company's financial position. (p. 58)
- LO 5** Explain the difference between a single-step and a multiple-step income statement and prepare each type of income statement. (p. 60)
- LO 6** Use a multiple-step income statement to analyze a company's operations. (p. 62)
- LO 7** Identify the components of the statement of retained earnings and prepare the statement. (p. 62)
- LO 8** Identify the components of the statement of cash flows and prepare the statement. (p. 63)
- LO 9** Read and use the financial statements and other elements in the annual report of a publicly held company. (p. 64)

WHY DOES ACCOUNTING INFORMATION NEED TO BE USEFUL? OBJECTIVES OF FINANCIAL REPORTING

- LO 1** Describe the objectives of financial reporting.

The users of financial information are the main reason financial statements are prepared. After all, it is the investors, creditors, and other groups and individuals outside and inside the company who must make economic decisions based on these statements. Therefore, as we learned in Chapter 1, financial statements must be based on agreed-upon assumptions like time-period, going concern, and other generally accepted accounting principles.

Moreover, when the accountants for companies like Ben & Jerry's and Gateway prepare their financial statements, they must keep in mind financial reporting objectives, which are focused on providing the most understandable and useful information possible. Financial reporting has one overall objective and a set of related objectives, all of them concerned with how the information may be most useful to the readers.

THE PRIMARY OBJECTIVE: PROVIDE INFORMATION FOR DECISION MAKING

The primary objective of financial reporting is *to provide economic information to permit users of the information to make informed decisions*. Users include both the management of a company (internal users) and others not involved in the daily operations of the business (external users). Without access to the detailed records of the business and without the benefit of daily involvement in the affairs of the company, external users make their decisions based on *financial statements* prepared by management. According to the Financial Accounting Standards Board (FASB), "Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions".¹

We see from this statement how closely the objective of financial reporting is tied to decision making. *The purpose of financial reporting is to help the users reach their decisions in an informed manner.*

¹Statement of Financial Accounting Concepts [SFAC] No. 1, "Objectives of Financial Reporting by Business Enterprises" (Stamford, Conn.: Financial Accounting Standards Board, November 1978), par. 34.

SECONDARY OBJECTIVE: REFLECT PROSPECTIVE CASH RECEIPTS TO INVESTORS AND CREDITORS

Present stockholders must decide whether to hold their stock in a company or sell it. For potential stockholders, the decision is whether to buy the stock in the first place. Bankers, suppliers, and other types of creditors must decide whether to lend money to a company. In making their decisions, all these groups rely partially on the information provided in financial statements. (Other sources of information are sometimes as important, or more important, in reaching a decision. For example, the most recent income statement may report the highest profits in the history of a company. However, a potential investor may choose not to buy stock in a company if the *Wall Street Journal* or *Business Week* reports that a strike is likely to shut down operations for an indeterminable period of time.)

www.wsj.com
www.businessweek.com

If you buy stock in a company, your primary concern is the *future cash to be received from the investment*. First, how much, if anything, will you periodically receive in *cash dividends*? Second, how much cash will you receive from the *sale of the stock*? The interests of a creditor, such as a banker, are similar. The banker is concerned with receiving the original amount of money lent and the interest on the loan. In summary, another objective of financial reporting is to “provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans”.²

SECONDARY OBJECTIVE: REFLECT PROSPECTIVE CASH FLOWS TO THE ENTERPRISE

As an investor your ultimate concern is not the company’s cash flows—how much comes in and goes out in the course of doing business—but the cash you receive from your investment. But since your investment depends to some extent on the company’s business skills in managing its cash flows, another objective of accounting is to provide information that will allow users to make decisions about the cash flows of a company. (We will discuss cash flows briefly later in the chapter and will return to them in Chapter 12.)

SECONDARY OBJECTIVE: REFLECT THE ENTERPRISE’S RESOURCES AND CLAIMS TO ITS RESOURCES

The FASB emphasizes the roles of the balance sheet and the income statement in providing useful information. These financial statements should reflect what *resources* (or assets) the company or enterprise has, what *claims to these resources* (liabilities and stockholders’ equity) there are, and the effects of transactions and events that change these resources and claims.³ Thus, another objective of financial reporting is to show the effect of transactions on the entity’s “accounting equation.”

Exhibit 2-1 summarizes the objectives of financial reporting as they pertain to someone considering whether to buy stock in Gateway. The exhibit should help you to understand how something as abstract as a set of financial reporting objectives can be applied to a decision-making situation.

WHAT MAKES ACCOUNTING INFORMATION USEFUL? QUALITATIVE CHARACTERISTICS

Since accounting information must be useful for decision making, what makes this information useful? This section focuses on the qualities that accountants strive for in

LO 2 Describe the qualitative characteristics of accounting information.

²SFAC No. 1, par. 37.

³SFAC No. 1, par. 40.

EXHIBIT 2-1 The Application of Financial Reporting Objectives

Financial Reporting Objective	Potential Investor's Questions
1. The primary objective: Provide information for decision making.	"Based on the financial information, should I buy shares of stock in Gateway?"
2. Secondary objective: Reflect prospective cash receipts to investors and creditors.	"How much cash will I receive in dividends each year and from the sale of the stock of Gateway in the future?"
3. Secondary objective: Reflect prospective cash flows to an enterprise.	"After paying its suppliers and employees, and meeting all of its obligations, how much cash will Gateway take in during the time I own the stock?"
4. Secondary objective: Reflect resources and claims to resources.	"How much has Gateway invested in new plant and equipment?"

their financial reporting and on some of the challenges they face in making reporting judgments. It also reveals what users of financial information expect from financial statements.

Quantitative considerations, such as tuition costs, certainly were a concern when you chose your current school. In addition, your decision required you to make subjective judgments about the *qualitative* characteristics you were looking for in a college. Similarly, there are certain qualities that make accounting information useful.

UNDERSTANDABILITY

For anything to be useful, it must be understandable. Usefulness and understandability go hand in hand. However, **understandability** of financial information varies considerably, depending on the background of the user. For example, should financial statements be prepared so that they are understandable by anyone with a college education? Or should it be assumed that all readers of financial statements have completed at least one accounting course? Is a background in business necessary for a good understanding of financial reports, regardless of one's formal training? As you might expect, there are no simple answers to these questions. However, the FASB believes that financial information should be comprehensible to *those who are willing to spend the time to understand it*: "Financial information is a tool and, like most tools, cannot be of much direct help to those who are unable or unwilling to use it or who misuse it. Its use can be learned, however, and financial reporting should provide information that can be used by all—nonprofessionals as well as professionals—who are willing to learn to use it properly."⁴

RELEVANCE

Understandability alone is certainly not enough to render information useful. To be useful, information must be relevant. **Relevance** is the capacity of information to make a difference in a decision.⁵ For example, assume that you are a banker evaluating the financial statements of a company that has come to you for a loan. All of the financial statements point to a strong and profitable company. However, today's newspaper revealed that the company has been named in a multimillion-dollar lawsuit. Undoubtedly, this information would be relevant to your talks with the company, and disclosure of the lawsuit in the financial statements would make them even more relevant to your lending decision.

⁴*SFAC No. 1*, par. 36.

⁵*Statement of Financial Accounting Concepts [SFAC] No. 2*, "Qualitative Characteristics of Accounting Information" (Stamford, Conn.: Financial Accounting Standards Board, May 1980), par. 47.

UNDERSTANDABILITY

The quality of accounting information that makes it comprehensible to those willing to spend the necessary time.

RELEVANCE

The capacity of information to make a difference in a decision.



ACCOUNTING FOR YOUR DECISIONS

You Are the Stockholder

ABC Technology produces a highly technical product used in the computer industry. You are a stockholder and are currently in the process of reading this year's annual report. You find that you can't understand the report because it contains so much accounting jargon. But the annual report contains a 1-800 number for shareholder inquiries. You call the number and complain about the annual report, but the corporate spokesman politely tells you that "that's the way people talk in accounting." Is your complaint valid?

ANS: One of the purposes of an annual report is to interest potential stockholders in the company. A small percentage of those potential investors are professional money managers who are familiar with the accounting terminology. However, most readers are individual investors who probably don't have a sophisticated accounting background. It is true that the report must assume a minimum level of formal education; accountants expect those who read the report to take the time to understand it. Technicalities aside, however, it is important to write an annual report for as broad an audience as possible.

RELIABILITY

What makes accounting information reliable? According to the FASB, "Accounting information is reliable to the extent that users can depend on it to represent the economic conditions or events that it purports to represent."⁶

Reliability has three basic characteristics:

- **Verifiability** Information is verifiable when we can make sure that it is free from error—for example, by looking up the cost paid for an asset in a contract or an invoice.

RELIABILITY

The quality that makes accounting information dependable in representing the events that it purports to represent.

BUSINESS STRATEGY

Dell Computers, like Gateway, is in the business of selling computers directly to consumers and to business and government organizations. It makes each machine to order and, like Gateway, carries a very small inventory at any one time. Dell also shares with Gateway a strategy of growth, seeking to enlarge its market share against such established giants as Compaq and IBM. However, focusing only on growth led Dell to two missteps in the mid-1990s. First, the firm expanded its product line with notebook computers that fell short of its quality standards, and second, Dell began selling its computers through retail outlets such as CompUSA, Wal-Mart, and Staples.

The flawed notebook computers were quickly withdrawn from the market, and within a year the firm also took itself out of the retail business, which had increased sales at first but which ultimately led to a net loss due to the high cost of protecting dealers from price changes.

Dell is now refocusing on its real strength: selling directly to large and small customers who know what they need and want. As Chairman Michael Dell tells it today: "The real benefit in exiting retail was not just the profit and loss, but the internal clarification. Everybody began to understand the strategy of Dell."

SOURCE: Lawrence M. Fisher, "Inside Dell Computer Corporation: Managing Working Capital," *Strategy and Business* 10 (first quarter 1998): 68–75.

www.dell.com

⁶SEAC No. 2, par. 62.

- **Representational faithfulness** Information is representationally faithful when it corresponds to an actual event—such as when the purchase of land corresponds to a transaction in the company’s records.
- **Neutrality** Information is neutral when it is not slanted to portray a company’s position in a better or worse light than the actual circumstances would dictate—such as when the probable losses from a major lawsuit are disclosed accurately in the notes to the financial statements, with all its potential effects on the company, rather than minimized as a very remote possible loss.

COMPARABILITY AND CONSISTENCY

COMPARABILITY

For accounting information, the quality that allows a user to analyze two or more companies and look for similarities and differences.

DEPRECIATION

The process of allocating the cost of a long-term tangible asset over its useful life.

Comparability allows comparisons to be made *between or among companies*. Generally accepted accounting principles (GAAP) allow a certain amount of freedom in choosing among competing alternative treatments for certain transactions.

For example, under GAAP, companies may choose from a number of methods of accounting for the depreciation of certain long-term assets. **Depreciation** is the *process of allocating* the cost of a long-term tangible asset, such as a building or equipment, over its useful life. Each method may affect the value of the assets differently. (We discuss depreciation in Chapter 8.) How does this freedom of choice affect the ability of investors to make comparisons between companies?

Assume you were considering buying stock in one of three companies. As their annual reports indicate, two of the companies use what is called the “accelerated” depreciation method, and the other company uses what is called the “straight-line” depreciation method. (We’ll learn about these methods in a later chapter.) Does this lack of a common depreciation method make it impossible for you to compare the performance of the three companies?

Obviously, comparisons among the companies would be easier and more meaningful if all three used the same depreciation method. However, comparisons are not impossible just because companies use different methods. Certainly, the more alike—that is, uniform—statements are in terms of the principles used to prepare them, the more comparable they will be. However, the profession allows a certain freedom of choice in selecting from among alternative generally accepted accounting principles.

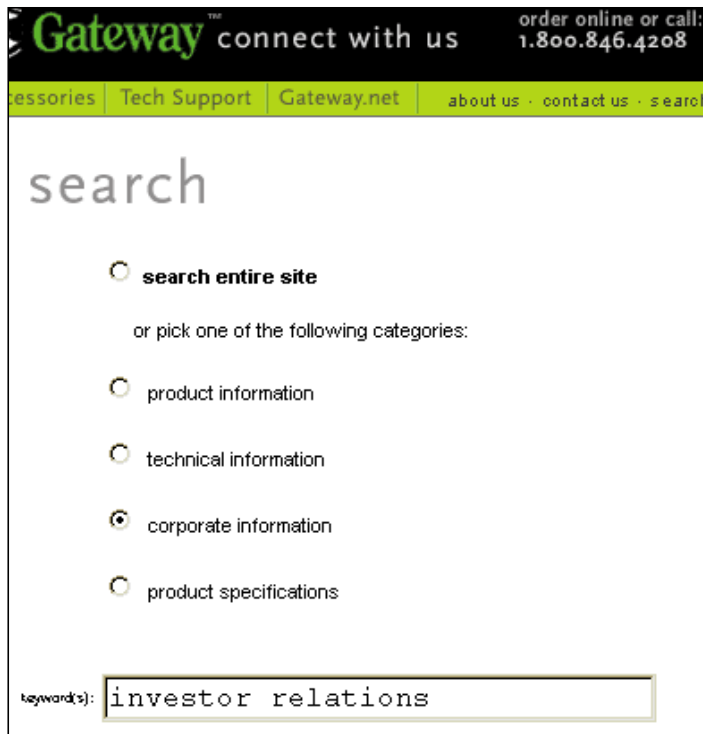
To render statements of companies using different methods more meaningful, *disclosure* assumes a very important role. For example, as we will see later in this chapter, the first footnote in the annual report of a publicly traded company is the disclosure of its accounting policies. The reader of this footnote for each of the three companies is made aware that the companies do not use the same depreciation method. Disclosure of accounting policies allows the reader to make some sort of subjective adjustment to the statements of one or more of the companies and thus to compensate for the different depreciation method being used.

Consistency is closely related to the concept of comparability. Both involve the relationship between two numbers. *However, whereas financial statements are comparable when they can be compared between one company and another, statements are consistent when they can be compared within a single company from one accounting period to the next.*

Occasionally, companies decide to change from one accounting method to another. Will it be possible to compare a company’s earnings in a period in which it switches methods with its earnings in prior years if the methods differ? Like the different methods used by different companies, changes in accounting methods from one period to the next do not make comparisons impossible, only more difficult. When a company makes an accounting change, accounting standards require various disclosures to help the reader evaluate the impact of the change.

CONSISTENCY

For accounting information, the quality that allows a user to compare two or more accounting periods for a single company.



Companies still produce printed annual reports as a way to summarize the past year's business activities, discuss the firm's performance, preview upcoming products and business trends, and give investors and other users of financial information a format for analyzing the financial information. But most companies also provide annual report information—along with news reports and current information—at the *Investor Relations* page on their Web site. You can search for Gateway's at www.gateway.com.

MATERIALITY

For accounting information to be useful, it must be relevant to a decision. The concept of **materiality** is closely related to relevance and deals with the size of an error in accounting information. The issue is whether the error is large enough to affect the judgment of someone relying on the information. Consider the following example. A company pays cash for two separate purchases: one for a \$5 pencil sharpener and the other for a \$50,000 computer. Theoretically, each expenditure results in the acquisition of an asset that should be depreciated over its useful life. However, what if the company decides to account for the \$5 as an expense of the period rather than treat it in the theoretically correct manner by depreciating it over the life of the pencil sharpener? *Will this error in any way affect the judgment of someone relying on the financial statements?* Because such a slight error will *not* affect any decisions, minor expenditures of this nature are considered *immaterial* and are accounted for as an expense of the period.

The *threshold* for determining materiality will vary from one company to the next, depending to a large extent on the size of the company. Many companies establish policies that *any* expenditure under a certain dollar amount should be accounted for as an expense of the period. The threshold might be \$50 for the corner grocery store but \$1,000 for a large corporation. Finally, in some instances the amount of a transaction may be immaterial by company standards but may still be considered significant by financial statement users. For example, a transaction involving either illegal or unethical behavior by a company officer would be of concern, regardless of the dollar amounts involved.

MATERIALITY

The magnitude of an accounting information omission or misstatement that will affect the judgment of someone relying on the information.

CONSERVATISM

The concept of **conservatism** is a holdover from earlier days when the primary financial statement was the balance sheet and the primary user of this statement was the banker. It was customary to deliberately understate assets in the balance sheet because this resulted in an even larger margin of safety that the assets being provided as collateral for a loan were sufficient.

CONSERVATISM

The practice of using the least optimistic estimate when two estimates of amounts are about equally likely.

EXHIBIT 2-2 Qualitative Characteristics of Accounting Information

SITUATION A bank is trying to decide whether to extend a \$1 million loan to Russell Corporation. Russell presents the bank with its most recent balance sheet, showing its financial position on a historical cost basis. Each quality of the information is summarized in the form of a question.

Quality	Question
Understandability	Can the information be used by those willing to learn to use it properly?
Relevance	Would the information be useful in deciding whether or not to loan money to Russell?
Reliability	
Verifiability	Can the information be verified? Is the information free from error?
Representational faithfulness	Is there agreement between the information and the events represented?
Neutrality	Is the information slanted in any way to present the company more favorably than is warranted?
Comparability	Are the methods used in assigning amounts to assets the same as those used by other companies?
Consistency	Are the methods used in assigning amounts to assets the same as those used in prior years?
Materiality	Will a specific error in any way affect the judgment of someone relying on the financial statements?
Conservatism	If there is any uncertainty about any of the amounts assigned to items in the balance sheet, are they recognized using the least optimistic estimate?

Today the balance sheet is not the only financial statement, and deliberate understatement of assets is no longer considered desirable. The practice of conservatism is reserved for those situations in which there is *uncertainty* about how to account for a particular item or transaction: “Thus, if two estimates of amounts to be received or paid in the future are about equally likely, conservatism dictates using the less optimistic estimate; however, if two amounts are not equally likely, conservatism does not necessarily dictate using the more pessimistic amount rather than the more likely one.”⁷

Various accounting rules are based on the concept of conservatism. For example, inventory held for resale is reported on the balance sheet at *the lower-of-cost-or-market value*. This rule requires a company to compare the cost of its inventory with the market price, or current cost to replace that inventory, and report the lower of the two amounts on the balance sheet at the end of the year. In Chapter 6 we will more fully explore the lower-of-cost-or-market rule as it pertains to inventory.

Exhibit 2-2 summarizes the qualities that make accounting information useful as these characteristics pertain to a banker’s decision regarding whether to lend money to a company.

FINANCIAL REPORTING: AN INTERNATIONAL PERSPECTIVE

In Chapter 1 we introduced the International Accounting Standards Committee (IASC) and its efforts to improve the development of accounting standards around the world. Interestingly, four of the most influential members of this group, representing the standard-setting bodies in the United States, the United Kingdom, Canada, and Australia, agree on

⁷*SFAC No. 2*, par. 95.

the primary objective of financial reporting. All recognize that the primary objective is to provide information useful in making economic decisions.

The standard-setting body in the United Kingdom distinguishes between qualitative characteristics that relate to *content* of the information presented and those that relate to *presentation*. Similar to the FASB, this group recognizes relevance and reliability as the primary characteristics related to content. Comparability and understandability are the primary qualities related to the presentation of the information.

The concept of conservatism is also recognized in other countries. For example, both the IASC and the standard-setting body in the United Kingdom list “prudence” among their qualitative characteristics. Prudence requires the use of caution in making the various estimates required in accounting. Like the U.S. standard-setting body, these groups recognize that prudence does not justify the deliberate understatement of assets or revenues or the deliberate overstatement of liabilities or expenses.

THE CLASSIFIED BALANCE SHEET

Now that we have learned about the conceptual framework of accounting, we turn to the outputs of the system: the financial statements. First, we will consider the significance of a *classified balance sheet*. We will then examine the *income statement*, the *statement of retained earnings*, and the *statement of cash flows*. The chapter concludes with a brief look at the financial statements of a real company, Gateway, and at the other elements in an annual report.

LO 3 Explain the concept and purpose of a classified balance sheet and prepare the statement.

WHAT ARE THE PARTS OF THE BALANCE SHEET? UNDERSTANDING THE OPERATING CYCLE

In the first part of this chapter, we stressed the importance of *cash flow*. For a company that sells a product, the **operating cycle** begins when cash is invested in inventory and ends when cash is collected by the enterprise from its customers.

Assume that on August 1 a retailer, Laptop Computer Sales, buys a computer for \$5,000 from the manufacturer, BIM Corp. At this point, Laptop has merely substituted one asset, cash, for another, inventory. On August 20, 20 days after buying the computer, Laptop sells it to an accounting firm, Arthur & Company, for \$6,000. Under the purchase agreement, Arthur will pay for the computer within the next 30 days. At this point, both the form of the asset and the amount have changed. The form of the asset held by Laptop has changed from inventory to accounts receivable. Also, because the inventory has been sold for \$1,000 more than its cost of \$5,000, the size of the asset held, the account receivable, is now \$6,000. Finally, on September 20, Arthur pays \$6,000 to Laptop, and the operating cycle is complete. As we will explore more fully in later chapters, Laptop has earned \$1,000, the difference between what it sold the computer for and what it initially paid for the computer. The cycle starts again when Laptop buys another computer for resale.

Laptop’s operating cycle is summarized in Exhibit 2-3. The length of the company’s operating cycle was 50 days. The operating cycle consisted of two distinct parts. From the time Laptop purchased the inventory, 20 days elapsed before it sold the computer. Another 30 days passed before the account receivable was collected. The length of the operating cycle depends to a large extent on the nature of a company’s business. For example, in our illustration, the manufacturer of the computer, BIM Corp., received cash immediately from Laptop and did not have to wait to collect a receivable. However, additional time is added to the operating cycle of BIM Corp. to *manufacture* the computer.

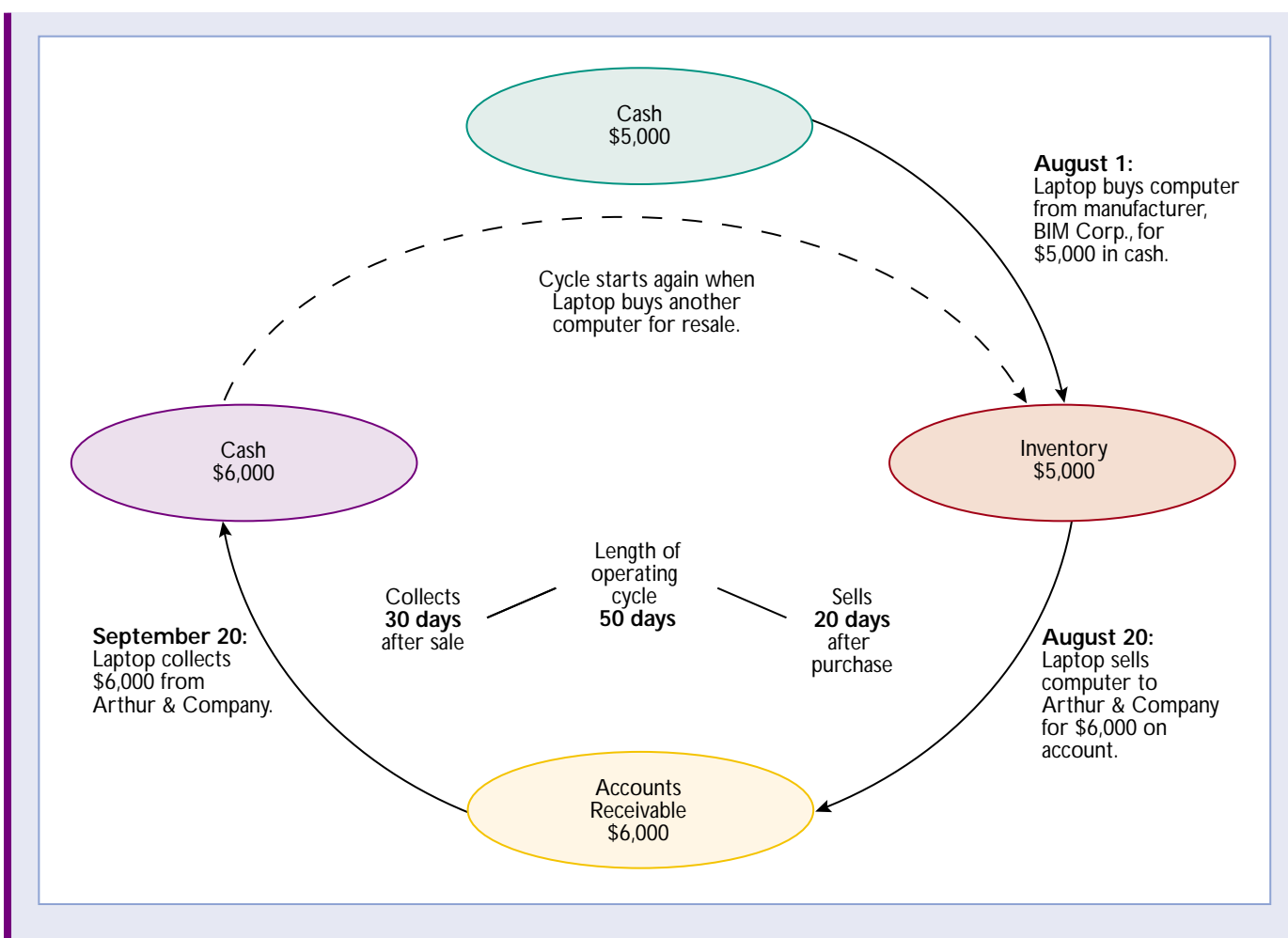
The operating cycle of the accounting firm in our example, Arthur & Company, differs from that of either the manufacturer or the retailer. Arthur sells a service rather

OPERATING CYCLE

The period of time between the purchase of inventory and the collection of any receivable from the sale of the inventory.

Study Tip

The operating cycle of a business is the basis for deciding which assets are current and which are noncurrent. When you look at a company’s balance sheet, be sure you understand the length of its operating cycle so you are clear about how it classifies its assets.



than a product. Its operating cycle is determined by two factors: the length of time involved in providing a service to the client and the amount of time required to collect any account receivable.

A classified balance sheet for a hypothetical company, Dixon Sporting Goods Inc., is shown in Exhibit 2-4. You will want to refer to it as you learn about the different categories on a classified balance sheet. (The bulleted numbers below refer to Exhibit 2-4.)

CURRENT ASSETS 1

The basic distinction on a classified balance sheet is between current and noncurrent items. **Current assets** are “cash and other assets that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of a business or within one year if the operating cycle is shorter than one year.”⁸

Most businesses have an operating cycle shorter than one year. The operating cycle for Laptop Computer Sales in our illustration was 50 days. Therefore cash, accounts receivable, and inventory are classified as current assets because they *are* cash, will be *realized* in (converted to) cash (accounts receivable), or will be *sold* (inventory) within one year.

⁸Accounting Principles Board, *Statement of the Accounting Principles Board, No. 4*, “Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises” (New York: American Institute of Certified Public Accountants, 1970), par. 198.

CURRENT ASSET
An asset that is expected to be realized in cash or sold or consumed during the operating cycle or within one year if the cycle is shorter than one year.

DIXON SPORTING GOODS INC. BALANCE SHEET AT DECEMBER 31, 2001																									
ASSETS																									
<p>1 These assets are realizable, sold, or consumed in one year or operating cycle.</p>	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td colspan="2">Current assets</td> </tr> <tr> <td>▶ Cash</td> <td style="text-align: right;">\$ 5,000</td> </tr> <tr> <td>▶ Marketable securities</td> <td style="text-align: right;">11,000</td> </tr> <tr> <td>▶ Accounts receivable</td> <td style="text-align: right;">23,000</td> </tr> <tr> <td>▶ Merchandise inventory</td> <td style="text-align: right;">73,500</td> </tr> <tr> <td>▶ Prepaid insurance</td> <td style="text-align: right;">4,800</td> </tr> <tr> <td>▶ Store supplies</td> <td style="text-align: right;">700</td> </tr> <tr> <td>Total current assets</td> <td style="text-align: right;">\$118,000</td> </tr> </table>	Current assets		▶ Cash	\$ 5,000	▶ Marketable securities	11,000	▶ Accounts receivable	23,000	▶ Merchandise inventory	73,500	▶ Prepaid insurance	4,800	▶ Store supplies	700	Total current assets	\$118,000								
Current assets																									
▶ Cash	\$ 5,000																								
▶ Marketable securities	11,000																								
▶ Accounts receivable	23,000																								
▶ Merchandise inventory	73,500																								
▶ Prepaid insurance	4,800																								
▶ Store supplies	700																								
Total current assets	\$118,000																								
<p>2 These assets will not be realizable, sold, or consumed within one year or operating cycle.</p>	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td colspan="2">Investments</td> </tr> <tr> <td>▶ Land held for future office site</td> <td style="text-align: right;">150,000</td> </tr> <tr> <td colspan="2">Property, plant, and equipment</td> </tr> <tr> <td>▶ Land</td> <td style="text-align: right;">100,000</td> </tr> <tr> <td>▶ Buildings</td> <td style="text-align: right;">\$150,000</td> </tr> <tr> <td> Less: Accumulated depreciation</td> <td style="text-align: right;">60,000 90,000</td> </tr> <tr> <td>▶ Store furniture and fixtures</td> <td style="text-align: right;">\$ 42,000</td> </tr> <tr> <td> Less: Accumulated depreciation</td> <td style="text-align: right;">12,600 29,400</td> </tr> <tr> <td>Total property, plant, and equipment</td> <td style="text-align: right;">219,400</td> </tr> <tr> <td colspan="2">Intangible assets</td> </tr> <tr> <td>▶ Franchise agreement</td> <td style="text-align: right;">55,000</td> </tr> <tr> <td>Total assets</td> <td style="text-align: right;">\$542,400</td> </tr> </table>	Investments		▶ Land held for future office site	150,000	Property, plant, and equipment		▶ Land	100,000	▶ Buildings	\$150,000	Less: Accumulated depreciation	60,000 90,000	▶ Store furniture and fixtures	\$ 42,000	Less: Accumulated depreciation	12,600 29,400	Total property, plant, and equipment	219,400	Intangible assets		▶ Franchise agreement	55,000	Total assets	\$542,400
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<p>5 These are owners' claims on assets.</p>	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td colspan="2">Contributed capital</td> </tr> <tr> <td>Capital stock, \$10 par, 5,000 shares issued and outstanding</td> <td style="text-align: right;">\$ 50,000</td> </tr> <tr> <td>Paid-in capital in excess of par value</td> <td style="text-align: right;">25,000</td> </tr> <tr> <td>Total contributed capital</td> <td style="text-align: right;">\$ 75,000</td> </tr> <tr> <td>Retained earnings</td> <td style="text-align: right;">287,500</td> </tr> <tr> <td>Total stockholders' equity</td> <td style="text-align: right;">362,500</td> </tr> <tr> <td>Total liabilities and stockholders' equity</td> <td style="text-align: right;">\$542,400</td> </tr> </table>	Contributed capital		Capital stock, \$10 par, 5,000 shares issued and outstanding	\$ 50,000	Paid-in capital in excess of par value	25,000	Total contributed capital	\$ 75,000	Retained earnings	287,500	Total stockholders' equity	362,500	Total liabilities and stockholders' equity	\$542,400										
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Can you think of a situation in which a company's operating cycle is longer than one year? A construction company is a good example. A construction company essentially builds an item of inventory, such as an office building, to a customer's specifications. The entire process, including constructing the building and collecting the sales amount from the customer, may take three years to complete. According to our earlier definition, because the inventory will be sold and the account receivable will be collected within the operating cycle, they will still qualify as current assets.

In addition to cash, accounts receivable, and inventory, the two other most common types of current assets are marketable securities and prepaid expenses. Excess cash is often



Compare the length of the operating cycle of a builder of an office building (or of communications equipment for the Internet) to that of a computer retailer. From the time a construction project “launches” to cash collection may be years, not weeks or months.

www.ibm.com

www.uswest.com

www.microsoft.com

invested in the stocks and bonds of other companies, as well as in various government instruments. If the investments are made for the short term, they are classified as current and are typically called either *short-term investments* or *marketable securities*. (Alternatively, some investments are made for the purpose of exercising influence over another company and thus are made for the long term. These investments are classified as noncurrent assets.) Various prepayments, such as office supplies, rent, and insurance, are classified as *prepaid expenses* and thus are current assets. These assets qualify as current because they will usually be *consumed* within one year.

NONCURRENT ASSETS 2

Any assets that do not meet the definition of a current asset are classified as *long-term* or *noncurrent assets*. Three common categories of long-term assets are: investments; property, plant, and equipment; and intangibles.

Investments Recall, from the discussion of current assets, that stocks and bonds expected to be sold within the next year are classified as current assets. Securities that are *not* expected to be sold within the next year are classified as *investments*. In many cases, the investment is in the common stock of another company. Sometimes companies invest in another company either to exercise some influence or actually to control the operation of the other company. Other types of assets classified as investments are land held for future use and buildings and equipment not currently used in operations. Finally, a special fund held for the retirement of debt or for the construction of new facilities is also classified as an investment.

Property, Plant, and Equipment This category consists of the various *tangible, productive assets* used in the operation of a business. Land, buildings, equipment, machinery, furniture and fixtures, trucks, and tools are all examples of assets held for use in the *operation* of a business rather than for *resale*. The distinction between inventory and equipment, for example, depends on the company's *intent* in acquiring the asset. For example, IBM classifies a computer system as inventory because its intent in manufacturing the asset is to offer it for resale. However, this same computer in the hands of a law firm would be classified as equipment because its intent in buying the asset from IBM is to use it in the long-term operation of the business.

The relative size of property, plant, and equipment depends largely on a company's business. Consider US West, a telecommunications company with over \$18 billion in total assets at the end of 1998. Over 80% of the total assets was invested in property, plant, and equipment. On the other hand, property and equipment represented less than 7% of the total assets of Microsoft, the highly successful software company. Regardless of the relative size of property, plant, and equipment, all assets in this category are subject to depreciation, with the exception of land. A separate accumulated depreciation account is used to account for the depreciation recorded on each of these assets over its life.

Intangibles Intangible assets are similar to property, plant, and equipment in that they provide benefits to the firm over the long term. The distinction, however, is in the *form* of the asset. *Intangible assets lack physical substance*. Trademarks, copyrights, franchise rights, patents, and goodwill are examples of intangible assets. The cost principle governs the accounting for intangibles, just as it does for tangible assets. For example, the amount paid to an inventor for the patent rights to a new project is recorded as an intangible asset. Similarly, the amount paid to purchase a franchise for a fast-food restaurant for the exclusive right to operate in a certain geographic area is recorded as an intangible asset. Like tangible assets, intangibles are written off to expense over their useful lives. *Depreciation* is the name given to the process of writing off tangible assets; the same process for intangible assets is called *amortization*. Depreciation and amortization are both explained more fully in Chapter 8.

Two-Minute Review

1. Give at least three examples of current assets.
2. Give the three common categories of noncurrent assets.

Answers:

1. Cash, accounts receivable, inventory, short-term investments, and prepaid expenses.
2. Investments, property, plant, and equipment, and intangibles.



ACCOUNTING FOR YOUR DECISIONS

You Are a Student

Identify any assets you currently have, and then categorize them as either current or noncurrent.

ANS: Among your current assets would be cash and any investments you expect to sell in the near future. Your car would be a noncurrent asset.

CURRENT LIABILITIES 3

The definition of a current liability is closely tied to that of a current asset. A **current liability** is an obligation that will be satisfied within the next operating cycle or within one year, if the cycle is shorter than one year. For example, the classification of a note payable on the balance sheet depends on its maturity date. If the note will be paid within the next year, it is classified as current; otherwise, it is classified as a long-term liability. On the other hand, accounts payable, wages payable, and income taxes payable are all short-term or current liabilities.

Most liabilities, such as those for purchases of merchandise on credit, are satisfied by the payment of cash. However, certain liabilities are eliminated from the balance sheet when the company performs services. For example, the liability Subscriptions Received in Advance, which would appear on the balance sheet of a magazine publisher, is satisfied not by the payment of any cash but by the delivery of the magazine to the customers. Finally, it is possible to satisfy one liability by substituting another in its place. For example, a supplier might ask a customer to sign a written promissory note to replace an existing account payable if the customer is unable to pay at the present time.

CURRENT LIABILITY

An obligation that will be satisfied within the next operating cycle or within one year if the cycle is shorter than one year.

LONG-TERM LIABILITIES 4

Any obligation that will not be paid or otherwise satisfied within the next year or the operating cycle, whichever is longer, is classified as a long-term liability, or long-term debt. Notes payable and bonds payable, both promises to pay money in the future, are two common forms of long-term debt. Some bonds have a life as long as 25 or 30 years.

STOCKHOLDERS' EQUITY 5

Recall that stockholders' equity represents the owners' claims on the assets of the business. These claims arise from two sources: *contributed capital* and *earned capital*. Contributed capital appears on the balance sheet in the form of capital stock, and earned capital takes the form of retained earnings. *Capital stock* indicates the owners' investment in the business. *Retained earnings* represents the accumulated earnings, or net income, of the business since its inception less all dividends paid during that time.

Most companies have a single class of capital stock called *common stock*. This is the most basic form of ownership in a business. All other claims against the company, such as

those of *creditors* and *preferred stockholders*, take priority. *Preferred stock* is a form of capital stock that, as the name implies, carries with it certain preferences. For example, the company must pay dividends on preferred stock before it makes any distribution of dividends on common stock. In the event of liquidation, preferred stockholders have priority over common stockholders in the distribution of the entity's assets.

Capital stock may appear as two separate items on the balance sheet: *Par Value* and *Paid-in Capital in Excess of Par Value*. The total of these two items tells us the amount that has been paid by the owners for the stock. We will take a closer look at these items in Chapter 11.

USING A CLASSIFIED BALANCE SHEET

LO 4 Use a classified balance sheet to analyze a company's financial position.

As we have now seen, a classified balance sheet separates both assets and liabilities into those that are current and those that are noncurrent. This distinction is very useful in any analysis of a company's financial position.

WORKING CAPITAL

Investors, bankers, and other interested readers use the balance sheet to evaluate the liquidity of a business. **Liquidity** is a relative term and deals with the ability of a company to pay its debts as they come due. As you might expect, bankers and other creditors are particularly interested in the liquidity of businesses to which they have lent money. A comparison of current assets and current liabilities is a starting point in evaluating the ability of a company to meet its obligations. **Working capital** is the difference between current assets and current liabilities at a point in time. Referring back to Exhibit 2-4, we see that the working capital for Dixon Sporting Goods on December 31, 2001, is as follows:

WORKING CAPITAL

FORMULA	FOR DIXON SPORTING GOODS
Current Assets – Current Liabilities	\$118,000 – \$59,900 = <u>\$58,100</u>

The management of working capital is an important task for any business. A company must continually strive for a *balance* in managing its working capital. For example, too little working capital—or in the extreme, negative working capital—may signal the inability to pay creditors on a timely basis. However, an overabundance of working capital could indicate that the company is not investing enough of its available funds in productive resources, such as new machinery and equipment.

CURRENT RATIO

Because it is an absolute dollar amount, working capital is limited in its informational value. For example, \$1 million may be an inadequate amount of working capital for a large corporation but far too much for a smaller company. In addition, a certain dollar amount of working capital may have been adequate for a company earlier in its life but is inadequate now. However, a related measure of liquidity, the **current ratio**, allows us to *compare* the liquidity of companies of different sizes and of a single company over time. The ratio is computed by dividing current assets by current liabilities. Dixon Sporting goods has a current ratio of just under 2 to 1:

CURRENT RATIO

FORMULA	FOR DIXON SPORTING GOODS
$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	$\frac{\$118,000}{\$59,900} = \underline{\underline{1.97 \text{ to } 1}}$

LIQUIDITY

The ability of a company to pay its debts as they come due.

WORKING CAPITAL

Current assets minus current liabilities.

CURRENT RATIO

Current assets divided by current liabilities.

Some analysts use a rule of thumb of 2 to 1 for the current ratio as a sign of short-term financial health. However, as is always the case, rules of thumb can be dangerous. Historically, companies in certain industries have operated quite efficiently with a current ratio of less than 2 to 1, whereas a ratio much higher than this is necessary to survive in other industries. Consider Tommy Hilfiger Corp., the popular clothing company. At the end of the fiscal year 1998, it had a current ratio of 4.74 to 1. On the other hand, companies in the telephone communication business routinely have current ratios well under 1 to 1. Sprint's current ratio at the end of 1998 was only .80 to 1.

www.tommy.com

www.sprint.com

Unfortunately, neither the amount of working capital nor the current ratio tells us anything about the *composition* of current assets and current liabilities. For example, assume two companies both have total current assets equal to \$100,000. Company A has cash of \$10,000, accounts receivable of \$50,000, and inventory of \$40,000. Company B also has cash of \$10,000 but accounts receivable of \$20,000 and inventory of \$70,000. All other things being equal, Company A is more liquid than Company B because more of its total current assets are in receivables than inventory. Receivables are only one step away from being cash, whereas inventory must be sold and then the receivable collected. Note that Dixon's inventory of \$73,500 makes up a large portion of its total current assets of \$118,000. An examination of the *relative* size of the various current assets for a company may reveal certain strengths and weaknesses not evident in the current ratio.

In addition to the composition of the current assets, the *frequency* with which they are "turned over" is important. For instance, how long does it take to sell an item of inventory? How long is required to collect an account receivable? Many companies could not exist with the current ratio of .52 reported by the McDonald's Corporation at the end of 1998. However, think about the nature of the fast-food business. The frequency of its sales and thus the numerous operating cycles within a single year mean that it can operate with a much lower current ratio than a manufacturing company, for example.

www.mcdonalds.com

THE INCOME STATEMENT

The income statement is used to summarize the results of operations of an entity for a *period of time*. At a minimum, all companies prepare income statements at least once a year. Companies that must report to the Securities and Exchange Commission prepare financial statements, including an income statement, every three months. Monthly income statements are usually prepared for internal use by management.

www.sec.gov

WHAT APPEARS ON THE INCOME STATEMENT?

From an accounting perspective, it is important to understand what transactions of an entity should appear on the income statement. In general, the income statement reports the excess of *revenue over expense*, that is, the *net income*, or in the event of an excess of *expense over revenue*, the *net loss* of the period. As a reference to the "bottom line" on an income statement, it is common to use the terms *profits* or *earnings* as synonyms for *net income*.

As discussed in Chapter 1, *revenue* is the inflow of assets resulting from the sale of products and services. It represents the dollar amount of sales of products and services for a period of time. An *expense* is the outflow of assets resulting from the sale of goods and services for a period of time. The cost of products sold, wages and salaries, and taxes are all examples of expenses.

Certain special types of revenues, called *gains*, are sometimes reported on the income statement, as are certain special types of expenses, called *losses*. For example, assume that Sanders Company holds a parcel of land for a future building site. The company paid \$50,000 for the land 10 years ago. The state pays Sanders \$60,000 for the property to use in a new highway project. Sanders has a special type of revenue from the condemnation of its property. It will recognize a *gain* of \$10,000: the excess of the cash received from the state, \$60,000, over the cost of the land, \$50,000.

FORMAT OF THE INCOME STATEMENT

LO 5 Explain the difference between a single-step and a multiple-step income statement and prepare each type of income statement.

Different formats are used by corporations to present their results. The major choice a company makes is whether to prepare the income statement in a single-step or a multiple-step form. Both forms are generally accepted. According to the AICPA's annual survey of 600 companies, more than twice as many use the multiple-step form than the single-step form. Next, we'll explain the differences between the two forms and their variations.

SINGLE-STEP INCOME STATEMENT

An income statement in which all expenses are added together and subtracted from all revenues.

Single-Step Format for the Income Statement In a **single-step income statement**, all expenses and losses are added together and then are deducted *in a single step* from all revenues and gains to arrive at net income. A single-step format for the income statement of Dixon Sporting Goods is presented in Exhibit 2-5. The primary advantage of the single-step form is its simplicity. No attempt is made to classify either revenues or expenses or to associate any of the expenses with any of the revenues.

MULTIPLE-STEP INCOME STATEMENT

An income statement that shows classifications of revenues and expenses as well as important subtotals.

Multiple-Step Format for the Income Statement The purpose of the **multiple-step income statement** is to subdivide the income statement into specific sections and provide the reader with important subtotals. This format is illustrated for Dixon Sporting Goods in Exhibit 2-6.

GROSS PROFIT

Sales less cost of goods sold.

The multiple-step income statement for Dixon indicates three important subtotals. First, **cost of goods sold** is deducted from sales to arrive at **gross profit**:

$$\text{Gross profit} = \text{Sales} - \text{Cost of goods sold}$$

Sales	\$357,500
Cost of goods sold	<u>218,300</u>
Gross profit	<u>\$139,200</u>

Cost of goods sold, as the name implies, is the cost of the units of inventory sold during the year. It is logical to associate cost of goods sold with the sales revenue for the year because the latter represents the *selling price* of the inventory sold during the period.

EXHIBIT 2-5 Income Statement (Single-Step Format) for Dixon Sporting Goods Inc.

DIXON SPORTING GOODS INC. INCOME STATEMENT (SINGLE-STEP FORMAT) FOR THE YEAR ENDED DECEMBER 31, 2001		
Revenues		
Sales	\$357,500	
Interest	<u>1,500</u>	
Total revenues		\$359,000
Expenses		
Cost of goods sold	\$218,300	
Depreciation on store furniture and fixtures	4,200	
Advertising	13,750	
Salaries and wages for sales staff	22,000	
Depreciation on buildings and amortization of trademark	6,000	
Salaries and wages for office staff	15,000	
Insurance	3,600	
Supplies	1,050	
Interest	16,900	
Income taxes	<u>17,200</u>	
Total expenses		<u>318,000</u>
Net income		<u>\$ 41,000</u>

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

EXHIBIT 2-6 Income Statement (Multiple-Step Format) for Dixon Sporting Goods

DIXON SPORTING GOODS INC. INCOME STATEMENT (MULTIPLE-STEP FORMAT) FOR THE YEAR ENDED DECEMBER 31, 2001																																																																									
<p>In a multiple-step income statement:</p> <p>Sales and the costs of sales are compared. 1</p> <p>Expenses of the business are detailed.</p> <p>Isolating expenses and revenues by type is useful in analyzing a business.</p> <p>Operating income is highlighted. 2</p> <p>"Nonoperating" revenues and expenses are included here. 3</p> <p>4</p>	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">Sales</td> <td style="width: 20%; text-align: right;">\$357,500</td> <td style="width: 20%;"></td> </tr> <tr> <td>Cost of goods sold</td> <td style="text-align: right;">218,300</td> <td></td> </tr> <tr> <td>Gross profit</td> <td></td> <td style="text-align: right;">\$139,200</td> </tr> <tr> <td colspan="3">Operating expenses</td> </tr> <tr> <td colspan="3">Selling expenses</td> </tr> <tr> <td> Depreciation on store furniture and fixtures</td> <td style="text-align: right;">\$ 4,200</td> <td></td> </tr> <tr> <td> Advertising</td> <td style="text-align: right;">13,750</td> <td></td> </tr> <tr> <td> Salaries and wages</td> <td style="text-align: right;">22,000</td> <td></td> </tr> <tr> <td> Total selling expenses</td> <td></td> <td style="text-align: right;">\$ 39,950</td> </tr> <tr> <td colspan="3">General and administrative expenses</td> </tr> <tr> <td> Depreciation on buildings and amortization of trademark</td> <td style="text-align: right;">\$ 6,000</td> <td></td> </tr> <tr> <td> Salaries and wages</td> <td style="text-align: right;">15,000</td> <td></td> </tr> <tr> <td> Insurance</td> <td style="text-align: right;">3,600</td> <td></td> </tr> <tr> <td> Supplies</td> <td style="text-align: right;">1,050</td> <td></td> </tr> <tr> <td> Total general and administrative expenses</td> <td></td> <td style="text-align: right;">25,650</td> </tr> <tr> <td> Total operating expenses</td> <td></td> <td style="text-align: right;">65,600</td> </tr> <tr> <td>Income from operations</td> <td></td> <td style="text-align: right;">\$ 73,600</td> </tr> <tr> <td colspan="3">Other revenues and expenses</td> </tr> <tr> <td> Interest revenue</td> <td style="text-align: right;">\$ 1,500</td> <td></td> </tr> <tr> <td> Interest expense</td> <td style="text-align: right;">16,900</td> <td></td> </tr> <tr> <td> Excess of other expenses over other revenue</td> <td></td> <td style="text-align: right;">15,400</td> </tr> <tr> <td>Income before taxes</td> <td></td> <td style="text-align: right;">\$ 58,200</td> </tr> <tr> <td>Income tax expense</td> <td></td> <td style="text-align: right;">17,200</td> </tr> <tr> <td>Net income</td> <td></td> <td style="text-align: right;">\$ 41,000</td> </tr> </table>	Sales	\$357,500		Cost of goods sold	218,300		Gross profit		\$139,200	Operating expenses			Selling expenses			Depreciation on store furniture and fixtures	\$ 4,200		Advertising	13,750		Salaries and wages	22,000		Total selling expenses		\$ 39,950	General and administrative expenses			Depreciation on buildings and amortization of trademark	\$ 6,000		Salaries and wages	15,000		Insurance	3,600		Supplies	1,050		Total general and administrative expenses		25,650	Total operating expenses		65,600	Income from operations		\$ 73,600	Other revenues and expenses			Interest revenue	\$ 1,500		Interest expense	16,900		Excess of other expenses over other revenue		15,400	Income before taxes		\$ 58,200	Income tax expense		17,200	Net income		\$ 41,000
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The second important subtotal on Dixon's income statement is **2** *income from operations* of \$73,600. This is found by subtracting *total operating expenses* of \$65,600 from the gross profit of \$139,200. Operating expenses are further subdivided between *selling expenses* and *general and administrative expenses*. For example, note that two depreciation amounts are included in operating expenses. Depreciation on store furniture and fixtures is classified as a selling expense because the store is where sales take place. On the other hand, we will assume that the buildings are offices for the administrative staff and thus depreciation on the buildings is classified as a general and administrative expense.

The third important subtotal on the income statement is **3** *income before taxes* of \$58,200. Interest revenue and interest expense, neither of which is an operating item, are included in *other revenues and expenses*. The excess of interest expense of \$16,900 over interest revenue of \$1,500, which equals \$15,400, is subtracted from income from operations to arrive at income before taxes. Finally, **4** *income tax expense* of \$17,200 is deducted to arrive at *net income* of \$41,000.

Two-Minute Review

1. Give at least two examples of items that would appear on a multiple-step income statement but not a single-step statement.
2. Classify each of the following expenses as either selling or general and administrative: advertising, depreciation on office building, salespersons' commissions and office salaries.

Answers on next page.

Answers:

1. Gross profit, income from operations and income before taxes.
2. Advertising: selling
 Depreciation on office building: general and administrative
 Salespersons' commissions: selling
 Office salaries: general and administrative

USING A MULTIPLE-STEP INCOME STATEMENT

LO 6 Use a multiple-step income statement to analyze a company's operations.

GROSS PROFIT RATIO
 Gross profit divided by sales.

An important advantage of the multiple-step income statement is that it provides additional information to the reader. Although all the amounts needed to calculate certain ratios are available on a single-step statement, such calculations are easier to figure with a multiple-step statement. For example, the deduction of cost of goods sold from sales to arrive at gross profit, or *gross margin* as it is sometimes called, allows us to quickly calculate the **gross profit ratio**. The ratio of Dixon's gross profit to its sales, rounded to the nearest percent, is as follows:

GROSS PROFIT RATIO

FORMULA	FOR DIXON SPORTING GOODS
$\frac{\text{Gross Profit}}{\text{Sales}}$	$\frac{\$139,200}{\$357,500} = 39\%$

The gross profit ratio tells us that after paying for the product, for every dollar of sales, 39¢ is available to cover other expenses and earn a profit. The complement of the gross profit ratio is the ratio of cost of goods sold to sales. For Dixon, this ratio is $1 - .39 = .61$, or 61%. For every dollar of sales, Dixon spends \$.61 on the cost of the product.

PROFIT MARGIN
 Net income divided by sales.

An important use of the income statement is to evaluate the *profitability* of a business. For example, a company's **profit margin** is the ratio of its net income to its sales. Some analysts refer to a company's profit margin as its *return on sales*. Dixon's profit margin is as follows:

PROFIT MARGIN

FORMULA	FOR DIXON SPORTING GOODS
$\frac{\text{Net Income}}{\text{Sales}}$	$\frac{\$41,000}{\$357,500} = 11\%$

For every dollar of sales, Dixon has \$.11 in net income.

Two important factors should be kept in mind in evaluating any financial statement ratio. First, how does this year's ratio differ from ratios of prior years? For example, a decrease in the profit margin may indicate that the company is having trouble this year controlling certain costs. Second, how does the ratio compare with industry norms? For example, in some industries the profit margin is considerably lower than in many others, such as in mass merchandising (Wal-Mart's profit margin was only 3.2% for the year ended January 31, 1999). It is always helpful to compare key ratios, such as the profit margin, with an industry average or with the same ratio for a close competitor of the company.

From *Concept*

TO PRACTICE 2.1

READING BEN & JERRY'S INCOME STATEMENT Which income statement format does Ben & Jerry's use: single-step or multiple-step? Calculate Ben & Jerry's 1998 and 1997 gross profit ratio. Explain what happened from 1997 to 1998.

www.walmart.com

THE STATEMENT OF RETAINED EARNINGS

LO 7 Identify the components of the statement of retained earnings and prepare the statement.

The purpose of a statement of stockholders' equity is to explain the changes in the components of owners' equity during the period. Retained earnings and capital stock are the two primary components of stockholders' equity. If there are no changes during the period in a company's capital stock, it may choose to present a statement of retained earnings instead

EXHIBIT 2-7 Statement of Retained Earnings for Dixon Sporting Goods Inc.

DIXON SPORTING GOODS INC. STATEMENT OF RETAINED EARNINGS FOR THE YEAR ENDED DECEMBER 31, 2001	
Retained earnings, January 1, 2001	\$271,500
Add: Net income for 2001	<u>41,000</u>
	\$312,500
Less: Dividends declared and paid in 2001	<u>(25,000)</u>
Retained earnings, December 31, 2001	<u>\$287,500</u>

of a statement of stockholders' equity.⁹ A statement of retained earnings for Dixon Sporting Goods is shown in Exhibit 2-7.

The statement of retained earnings provides an important link between the income statement and the balance sheet. Dixon's net income of \$41,000, as detailed on the income statement, is an *addition* to retained earnings. Note that the dividends declared and paid of \$25,000 do not appear on the income statement because they are a payout, or *distribution*, of net income to stockholders rather than one of the expenses deducted to arrive at net income. Accordingly, they appear as a direct deduction on the statement of retained earnings. The beginning balance in retained earnings is carried forward from last year's statement of retained earnings.

THE STATEMENT OF CASH FLOWS

All publicly held corporations are required to present a statement of cash flows in their annual reports. The purpose of the statement is to summarize the cash flow effects of a company's operating, investing, and financing activities for the period.

LO 8 Identify the components of the statement of cash flows and prepare the statement.

THE CASH FLOW STATEMENT FOR DIXON SPORTING GOODS

The statement for Dixon Sporting Goods is shown in Exhibit 2-8. The statement consists of three categories: operating activities, investing activities, and financing activities. Each of these three categories can result in a net inflow of cash or a net outflow of cash.

Dixon's *operating activities* generated \$56,100 of cash during the period. Operating activities **1** concern the purchase and sale of a product, in this case the acquisition of sporting goods from distributors and the subsequent sale of those goods. As we can readily see, Dixon had one major source of cash, the collection from its customers of \$362,500. Similarly, Dixon's largest use of cash was the \$217,200 it paid for inventory. In Chapter 12, we will discuss the statement of cash flows in detail and the preparation of this section of the statement.

Financing and investing activities were described in "Getting Started." *Investing activities* **2** involve the acquisition and sale of long-term assets, such as long-term investments, property, plant, and equipment, and intangible assets. *Financing activities* **3** result from the issuance and repayment, or retirement, of long-term liabilities and capital stock. The one investing activity on Dixon's statement of cash flows, the purchase of land for a future office site, required the use of cash and thus is shown as a net outflow of \$150,000. Dixon

⁹According to the AICPA's annual survey, most corporations (almost 85%) present a statement of stockholders' equity. A separate statement of retained earnings, or a combined statement of income and retained earnings, is used by a small minority of companies.

DIXON SPORTING GOODS INC. STATEMENT OF CASH FLOWS FOR THE YEAR ENDED DECEMBER 31, 2001		
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash collected from customers	\$362,500	
Cash collected in interest	<u>1,500</u>	
Total cash collections		\$364,000
Cash payments for:		
Inventory	\$217,200	
Insurance	4,800	
Store supplies	850	
Salaries and wages	38,500	
Income taxes	15,900	
Interest	16,900	
Advertising	<u>13,750</u>	
Total cash payments		<u>307,900</u>
Net cash provided by operating activities		\$ 56,100
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of land for future office site		(150,000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Dividends declared and paid	\$ (25,000)	
Proceeds from issuance of long-term note	<u>120,000</u>	
Net cash provided by financing activities		<u>95,000</u>
Net increase in cash		\$ 1,100
Cash at beginning of year		<u>3,900</u>
Cash at end of year		<u>\$ 5,000</u>

- 1 Operating activities involve the purchase and sale of products or services.
- 2 Investing activities involve the acquisition and sale of long-term assets.
- 3 Financing activities involve the issuance and repayment of long-term liabilities and stock.

had two financing activities: dividends of \$25,000 required the use of cash, and the issuance of a long-term note generated cash of \$120,000. The balance in cash on the bottom of the statement of \$5,000 must agree with the balance for this item as shown on the balance sheet in Exhibit 2-4.

THE FINANCIAL STATEMENTS FOR GATEWAY

LO 9 Read and use the financial statements and other elements in the annual report of a publicly held company.

www.gateway.com

The financial statements for our hypothetical company, Dixon Sporting Goods Inc., introduced the major categories on each of the statements. We now turn to the financial statements of an actual company, Gateway. These statements are more complex and require additional analysis and a better understanding of accounting to fully appreciate them. However, we will concentrate on certain elements of the statements. At this stage in your study, look for the similarities rather than the differences between these statements and those of Dixon.

Gateway was founded by Ted Waitt in 1985 in an empty farmhouse near Sioux City, Iowa. What began as a mail-order business has grown to the point that sales in 1998 reached nearly \$7.5 billion. Early on, Gateway adopted a cow as its mascot and began to ship all its products in boxes that looked like the markings on a Holstein cow.¹⁰

¹⁰ *International Directory of Company Histories*, vol. 10 (St. James Press, 1995), p. 308.

As we will see later, the notes to a set of financial statements give the reader a variety of information about a company. Like the statements of many other companies, Gateway's financials include a note that describes its business:

Gateway 2000, Inc. (the "Company") is a direct marketer of personal computers ("PCs") and PC-related products. The Company develops, manufactures, markets and supports a broad line of desktop and portable PCs, digital media (convergence) PCs, servers, workstations, and PC-related products used by individuals, families, businesses, government agencies and educational institutions.¹¹

GATEWAY'S BALANCE SHEET

The balance sheets for Gateway at the end of each of two years are shown in Exhibit 2-9. Like most other companies, Gateway chose an accounting or fiscal year that corresponds to the calendar, that is, beginning on January 1 and ending on December 31. However, some companies choose a fiscal year that ends at a point when sales are at their lowest in the annual cycle. For example, Wal-Mart ends its fiscal year on January 31, after the busy holiday season.

www.walmart.com

Gateway releases what are called *consolidated financial statements*, which reflect the position and results of all operations that are controlled by a single entity. Like most other large corporations, Gateway owns other companies. Often these companies are legally separate and are called *subsidiaries*. How a company accounts for its investment in a subsidiary is covered in advanced accounting courses.

Gateway presents comparative balance sheets to indicate its financial position at the end of each of the last two years. As a minimum standard, the Securities and Exchange Commission requires that the annual report include balance sheets as of the two most recent years and income statements for each of the three most recent years. Note that all amounts on the balance sheet are stated in thousands of dollars. This type of rounding is a common practice in the financial statements of large corporations and is justified under the materiality concept. Knowing the exact dollar amount of each asset would not change a decision made by an investor.

The presentation of comparative balance sheets allows the reader to make comparisons between years. For example, Gateway's *working capital* increased significantly during 1998:

WORKING CAPITAL

	December 31, 1997	December 31, 1998
Current Assets – Current Liabilities	\$1,544,683 – \$1,003,906 <u>= \$540,777</u>	\$2,228,186 – \$1,429,674 <u>= \$798,512</u>

Gateway's *current ratio* at each of the two dates follows:

CURRENT RATIO

	December 31, 1997	December 31, 1998
Current Assets	\$1,544,683	\$2,228,186
Current Liabilities	\$1,003,906	\$1,429,674
	<u>= 1.54 to 1</u>	<u>= 1.56 to 1</u>

Although both the amount of working capital and the current ratio increased between 1997 and 1998, the increase in the current ratio was relatively minor. The largest change in the current assets was the increase in cash and cash equivalents, from approximately \$594 million to \$1,170 million.

On the liability side of its balance sheet, Gateway lists two noncurrent liabilities: long-term obligations, net of current maturities, and warranty and other liabilities. Given the nature of the products it sells (PCs), Gateway provides its customers with warranties. (As we will see in Chapter 9, warranties often create a liability for companies. Long-term obligations will be discussed more fully in Chapter 10.)

¹¹ Gateway 1998 Annual Report, p. 29.

EXHIBIT 2-9 Comparative Balance Sheets for Gateway

CONSOLIDATED BALANCE SHEETS

December 31, 1997 and 1998

(in thousands, except per share amounts)

	1997	1998
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 593,601	\$ 1,169,810
Marketable securities	38,648	158,657
Accounts receivable, net	510,679	558,851
Inventory	249,224	167,924
Other	152,531	172,944
Total current assets	1,544,683	2,228,186
Property, plant and equipment, net	376,467	530,988
Intangibles, net	82,590	65,944
Other assets	35,531	65,262
	<u>\$ 2,039,271</u>	<u>\$ 2,890,380</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Notes payable and current maturities of long-term obligations	\$ 13,969	\$ 11,415
Accounts payable	488,717	718,071
Accrued liabilities	271,250	415,265
Accrued royalties	159,418	167,873
Other current liabilities	70,552	117,050
Total current liabilities	1,003,906	1,429,674
Long-term obligations, net of current maturities	7,240	3,360
Warranty and other liabilities	98,081	112,971
Total liabilities	<u>1,109,227</u>	<u>1,546,005</u>
Commitments and Contingencies (Notes 3 and 4)		
Stockholders' equity:		
Preferred stock, \$.01 par value, 5,000 shares authorized; none issued and outstanding	—	—
Class A common stock, nonvoting, \$.01 par value, 1,000 shares authorized; none issued and outstanding	—	—
Common stock, \$.01 par value, 220,000 shares authorized; 154,128 shares and 156,569 shares issued and outstanding, respectively	1,541	1,566
Additional paid-in capital	299,483	365,986
Retained earnings	634,509	980,908
Accumulated other comprehensive loss	(5,489)	(4,085)
Total stockholders' equity	<u>930,044</u>	<u>1,344,375</u>
	<u>\$ 2,039,271</u>	<u>\$ 2,890,380</u>

Use these to find:

- Working capital
- Current ratio

The accompanying notes are an integral part of the consolidated financial statements.

GATEWAY'S INCOME STATEMENT

We have examined two basic formats for the income statement: the single-step format and the multiple-step format. In practice, numerous variations on these two basic formats exist, depending to a large extent on the nature of a company's business. For example, the multiple-step form, with its presentation of gross profit, is not used by service businesses

EXHIBIT 2-10 Consolidated Income Statements for Gateway

CONSOLIDATED INCOME STATEMENTS			
For the years ended December 31, 1996, 1997 and 1998			
(in thousands, except per share amounts)			
	<u>1996</u>	<u>1997</u>	<u>1998</u>
Net sales	\$ 5,035,228	\$ 6,293,680	\$ 7,467,925
Cost of goods sold	4,099,073	5,217,239	5,921,651
Gross profit	<u>936,155</u>	<u>1,076,441</u>	<u>1,546,274</u>
Selling, general and administrative expenses	580,061	786,168	1,052,047
Nonrecurring expenses	—	113,842	—
Operating income	<u>356,094</u>	<u>176,431</u>	<u>494,227</u>
Other income, net	26,622	27,189	47,021
Income before income taxes	<u>382,716</u>	<u>203,620</u>	<u>541,248</u>
Provision for income taxes	132,037	93,823	194,849
Net income	<u>\$ 250,679</u>	<u>\$ 109,797</u>	<u>\$ 346,399</u>
Net income per share:			
Basic	<u>\$ 1.64</u>	<u>\$.71</u>	<u>\$ 2.23</u>
Diluted	<u>\$ 1.60</u>	<u>\$.70</u>	<u>\$ 2.18</u>
Weighted average shares outstanding:			
Basic	<u>152,745</u>	<u>153,840</u>	<u>155,542</u>
Diluted	<u>156,237</u>	<u>156,201</u>	<u>158,929</u>
The accompanying notes are an integral part of the consolidated financial statements.			

Use these to find:
• Gross profit ratio

because they do not sell a product. (Remember that gross profit is sales less cost of goods sold.) As we will see for Gateway, the form of the income statement is a reflection of a company's operations.

Multiple-step income statements for Gateway for a three-year period are presented in Exhibit 2-10. Note the significant increase in Gateway's *gross profit ratio* from 1997 to 1998:

GROSS PROFIT RATIO

	<u>1997</u>	<u>1998</u>
Gross Profit	<u>\$1,076,441</u>	<u>\$1,546,274</u>
Net Sales	<u>\$6,293,680</u>	<u>\$7,467,925</u>
	= 17%	= 21%

Both Gateway's management and its stockholders should be pleased with this improvement in the gross profit ratio. It is a clear sign that the company has successfully increased its sales while controlling the costs to make its products. Also, note the inclusion of net income per share information at the bottom of the statement. The per share information helps users of the statement in various ways and is discussed in more detail in Chapter 13.

From *Concept*

TO PRACTICE 2.2

OTHER ELEMENTS OF AN ANNUAL REPORT

No two annual reports look the same. The appearance of an annual report depends not only on the size of a company but also on the budget devoted to the preparation of the report. Some companies publish "bare-bones" annual reports, whereas others issue a glossy

READING GATEWAY'S INCOME STATEMENT Compute Gateway's profit margin for the past two years. Did it go up or down from the prior year to the current year?

Report of Independent Accountants**To the Stockholders and Board of Directors of Gateway 2000, Inc.**

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, cash flows and changes in stockholders' equity and comprehensive income presents fairly, in all material respects, the consolidated financial position of Gateway 2000, Inc. at December 31, 1997 and 1998, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.



San Diego, California
January 21, 1999

www.starbucks.com
www.walmart.com

report complete with pictures of company products and employees. In recent years, many companies, as a cost-cutting measure, have scaled back the amount spent on the annual report. The creativity in annual reports varies as well. Starbucks' 1998 annual report included a coupon good for a 12-ounce beverage at any of its stores. The 1998 Wal-Mart annual report was designed to give the appearance of a magazine, complete with feature articles and an ad for Sam's Club.

Privately held companies tend to distribute only financial statements, without the additional information normally included in the annual reports of public companies. For the annual reports of public companies, however, certain basic elements are considered standard. A letter to the stockholders from either the president or the chairman of the board of directors appears in the first few pages of most annual reports. A section describing the company's products and markets is usually included. At the heart of any annual report is the financial report or review, which consists of the financial statements accompanied by footnotes to explain various items on the statements. We will now consider these other elements as presented in the 1998 annual report of Gateway.

Report of Independent Accountants As you see in Exhibit 2-11, Gateway is audited by PricewaterhouseCoopers LLP, one of the largest international accounting firms. Two key phrases should be noted in the first sentence of the independent accountants' report: *in our opinion* and *presents fairly*. The report indicates that responsibility for the statements rests with Gateway and that the auditors' job is to *express an opinion* on the statements, based on certain tests. It would be impossible for an auditing firm to spend the time or money to retrace and verify every single transaction entered into during the year by Gateway. Instead, the auditing firm performs various tests of the accounting records to be able to assure itself that the statements are free of *material misstatement*. Auditors do not "certify" the total accuracy of a set of financial statements but render an opinion as to the reasonableness of those statements. Finally, note that this format for the auditors' report differs from the one for Ben & Jerry's presented in Chapter 1. However, both formats contain the same basic information.

The Ethical Responsibility of Management and the Auditors The management of a company and its auditors share a common purpose: to protect the interests of stockholders. In large corporations, the stockholders are normally removed from the daily affairs of the business. The need for a professional management team to run the business is a practical

"I was familiar with the basic elements of the [annual] report, but the line-by-line specifics were foreign to me."

—Matthew Butler

FOCUS ON USERS

Using Financial Statements Becomes Second Nature

Annual reports reveal a company's financial health. For this reason, all kinds of professionals use reports and their financial statements as a guide in making

business decisions or in helping others make investment decisions.

Matthew Butler, a financial advisor for a large brokerage firm in Washington, D.C., has learned along the way how important the financial statements are in the business world. "I knew what an annual report was to the extent that I knew that every year a company sends a formal accounting of its financial status to shareholders. I was familiar with the basic elements of the report, but the line-by-line specifics were foreign to me," Matthew says. "Then, when I went to get licensed as a financial advisor, I was required to pass a group of financial exams, including the Series 7. Studying for and acing this exam taught me everything I would ever want to know about financial statements and how to interpret them. Now, I use them every day without even thinking about it."

As a financial advisor, Matthew's job is to provide potential investors with opinions about stocks and the companies behind them. "The first thing I do when a client asks me about a particular stock is look at the numbers. On the income statement, I look at the net income and revenues to find out how much the company is making and at the costs to see how much it is spending. From there, I go to the 'earnings per share'—net income divided by the total number of shares outstanding—and to the 'price/earnings ratio'—which is the current price of the stock divided by earnings per share. These calculations are huge in my business. They're the most important numbers I can provide my clients."

By looking at corporate financial statements day to day and doing what is called "fundamental analysis" for his clients, Matthew now has the experience to render, in an instant, an opinion on the financial health of a company. As he says, "It's what I do for a living."



Name: Matthew Butler
Education: B.A., University of Virginia
College Majors: Economics; Psychology
Occupation: Financial advisor in retail sales at a large investment firm
Age: 27

necessity, as is the need for a periodic audit of the company's records. Because stockholders cannot run the business themselves, they need assurances that the business is being operated effectively and efficiently and that the financial statements presented by management are a fair representation of the company's operations and financial position. The management and the auditors have a very important ethical responsibility to their constituents, the stockholders of the company.

Management Discussion and Analysis Preceding the financial statements is a section of Gateway's annual report titled "Management's Discussion and Analysis of Financial Condition and Results of Operations." This report gives management the opportunity to discuss the financial statements and provide the stockholders with explanations for certain amounts reported in the statements. For example, management explains the increase in sales as follows:

Sales. Gateway added over \$1.1 billion in sales in 1998 compared to 1997, achieving annual sales of \$7.47 billion. This represents an increase of 19% over 1997. Sales to the consumer segment represented 53% of total sales while business segment sales were 47% of total sales. Sales were driven by continued strong unit growth of 37% in 1998 compared to unit growth of 35% in 1997. The Company's unit growth outpaced the worldwide market in 1998 by approximately three times the market growth rate, leading to continued gains in market share.¹²

¹² Gateway 1998 Annual Report, p. 20.

Notes to Consolidated Financial Statements The sentence “The accompanying notes are an integral part of the consolidated financial statements” appears at the bottom of each of Gateway’s four financial statements. These comments, or *footnotes*, as they are commonly called, are necessary to satisfy the need for *full disclosure* of all the facts relevant to a company’s results and financial position. The first footnote in all annual reports is a summary of *significant accounting policies*. A company’s policies for valuing inventories, depreciating assets, and recognizing revenue are among the important items contained in this footnote. For example, Gateway describes its policy for depreciating assets as follows: “Depreciation is provided using straight-line and accelerated methods over the assets’ estimated useful lives, ranging from four to forty years.”¹³ In addition to the summary of significant accounting policies, other footnotes discuss such topics as income taxes and retirement savings plans.

This completes our discussion of the makeup of the annual report. By now you should appreciate the flexibility that companies have in assembling the report, aside from the need to follow generally accepted accounting principles in preparing the statements. The accounting standards followed in preparing the statements, as well as the appearance of the annual report itself, differ in other countries. As has been noted elsewhere, although many corporations operate internationally, accounting principles are far from being standardized.

WARMUP EXERCISES

LO 4, 6 Warmup Exercise 2-1 Identifying Ratios

State the equation for each of the following ratios:

1. Current ratio
2. Gross profit ratio
3. Profit margin

Key to the Solution

Review the various ratios as discussed in the chapter.

LO 4, 6 Warmup Exercise 2-2 Calculating Ratios

Bridger reported net income of \$150,000, sales of \$1,000,000 and cost of goods sold of \$800,000.

Required

Compute each of the following ratios for Bridger:

1. Gross profit ratio
2. Profit margin

Key to the Solution

Recall the equation for each of these ratios as presented in the chapter.

LO 4 Warmup Exercise 2-3 Determining Liquidity

Big has current assets of \$500,000 and current liabilities of \$400,000. Small reports current assets of \$80,000 and current liabilities of \$20,000.

Required

Which company is more liquid? Why?

Key to the Solution

Calculate the current ratio for each company and compare them.

¹³ Gateway 1998 Annual Report, p. 29.

SOLUTIONS TO WARMUP EXERCISES

Warmup Exercise 2-1

1. Current ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$
2. Gross profit ratio = $\frac{\text{Gross Profit}}{\text{Sales}}$
3. Profit margin = $\frac{\text{Net income}}{\text{Sales}}$

Warmup Exercise 2-2

1. $\frac{\$1,000,000 - \$800,000}{\$1,000,000} = \frac{\$200,000}{\$1,000,000} = \underline{\underline{20\%}}$
2. $\frac{\$150,000}{\$1,000,000} = \underline{\underline{15\%}}$

Warmup Exercise 2-3

Small Company appears on the surface to be more liquid. Its current ratio of \$80,000/\$20,000 or 4 to 1 is significantly higher than Big's current ratio of \$500,000/\$400,000 or 1.25 to 1.

The following review problem will give you the opportunity to apply what you have learned by preparing both an income statement and a balance sheet.

REVIEW PROBLEM

Shown below, in alphabetical order, are items taken from the records of Grizzly Inc., a chain of outdoor recreational stores in the Northwest. Use the items to prepare two statements. First, prepare an income statement for the year ended December 31, 2001. The income statement should be in multiple-step form. Second, prepare a classified balance sheet at December 31, 2001. All amounts are in thousands of dollars.

Accounts payable	\$ 6,500
Accounts receivable	8,200
Accumulated depreciation—buildings	25,000
Accumulated depreciation—furniture and fixtures	15,000
Advertising expense	3,100
Buildings	80,000
Capital stock, \$1 par, 10,000 shares issued and outstanding	10,000
Cash	2,400
Commissions expense	8,600
Cost of goods sold	110,000
Depreciation on buildings	2,500
Depreciation on furniture and fixtures	1,200
Furniture and fixtures	68,000
Income taxes payable	2,200
Income tax expense	13,000
Insurance expense	2,000
Interest expense	12,000
Interest payable	1,000
Interest revenue	2,000
Land	100,000
Long-term notes payable, due December 31, 2009	120,000
Merchandise inventories	6,000

Office supplies	900
Paid-in capital in excess of par value	40,000
Prepaid rent	3,000
Rent expense for salespersons' autos	9,000
Retained earnings	48,800
Salaries and wages for office staff	11,000
Sales revenue	190,000

Solution to Review Problem

1. Multiple-step income statement:

GRIZZLY INC. INCOME STATEMENT FOR THE YEAR ENDED DECEMBER 31, 2001 (IN THOUSANDS OF DOLLARS)		
Sales revenue		\$190,000
Cost of goods sold		<u>110,000</u>
Gross profit		\$ 80,000
Operating expenses:		
Selling expenses:		
Advertising	\$ 3,100	
Depreciation on furniture and fixtures	1,200	
Rent for salespersons' autos	9,000	
Commissions	<u>8,600</u>	
Total selling expenses		\$ 21,900
General and administrative expenses:		
Depreciation on buildings	\$ 2,500	
Insurance	2,000	
Salaries and wages for office staff	<u>11,000</u>	
Total general and administrative expenses		<u>15,500</u>
Total operating expenses		<u>37,400</u>
Income from operations		\$ 42,600
Other revenues and expenses:		
Interest revenue	\$ 2,000	
Interest expense	<u>12,000</u>	
Excess of other expenses over other revenue		<u>10,000</u>
Income before taxes		\$ 32,600
Income tax expense		<u>13,000</u>
Net income		<u><u>\$ 19,600</u></u>

2. Classified Balance Sheet:

GRIZZLY INC. BALANCE SHEET AT DECEMBER 31, 2001 (IN THOUSANDS OF DOLLARS)		
Assets		
Current assets:		
Cash	\$ 2,400	
Accounts receivable	8,200	
Merchandise inventories	6,000	
Office supplies	900	
Prepaid rent	<u>3,000</u>	
Total current assets		\$ 20,500

Property, plant, and equipment:		
Land		\$100,000
Buildings	\$ 80,000	
Less: Accumulated depreciation	<u>25,000</u>	55,000
Furniture and fixtures	\$ 68,000	
Less: Accumulated depreciation	<u>15,000</u>	53,000
Total property, plant, and equipment		<u>208,000</u>
Total assets		<u>\$228,500</u>

Liabilities

Current liabilities:		
Accounts payable	\$ 6,500	
Income taxes payable	2,200	
Interest payable	<u>1,000</u>	
Total current liabilities		\$ 9,700
Long-term notes payable, due December 31, 2009		<u>120,000</u>
Total liabilities		<u>\$129,700</u>

Stockholders' Equity

Contributed capital:		
Capital stock, \$1 par, 10,000 shares issued and outstanding	\$ 10,000	
Paid-in capital in excess of par value	<u>40,000</u>	
Total contributed capital	\$ 50,000	
Retained earnings	<u>48,800</u>	
Total stockholders' equity		<u>98,800</u>
Total liabilities and stockholders' equity		<u>\$228,500</u>

CHAPTER HIGHLIGHTS

1. **LO 1** The primary objective of financial reporting is to provide information that is useful in making investment, credit, and similar decisions.
2. **LO 1** Investors and creditors are ultimately interested in their own prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Because these expected cash flows are related to the expected cash flows to the company, its cash flows are of interest to investors and creditors. The entity's economic resources, claims to them, and the effects of transactions that change resources and claims to those resources are also of interest.
3. **LO 2** Financial information should be understandable to those who are willing to spend the time to understand it. To be useful, the information should be relevant and reliable. Relevant information has the capacity to make a difference in a decision. Reliable information can be depended on to represent the economic events that it purports to represent.
4. **LO 2** *Comparability* is the quality that allows for comparisons to be made between two or more companies, whereas *consistency* is the quality that allows for comparisons to be made within a single company from one period to the next. These two qualities of useful accounting information are aided by full disclosure—in the footnotes to the financial statements—of all relevant information.
5. **LO 3** The operating cycle depends to a large extent on the nature of a company's business. For a retailer, it encompasses the period of time from the investment of cash in inventory to the collection of any account receivable from sale of the product. The operating cycle for a manufacturer is expanded to include the period of time required to convert raw materials into finished products.
6. **LO 3** Current assets will be realized in cash or sold or consumed during the operating cycle or within one year if the cycle is shorter than one year. Because most businesses have numerous operating cycles within a year, the cutoff for classification as a current asset is usually one year. Cash, accounts receivable, inventory, and pre-paid expenses are all examples of current assets.
7. **LO 3** The definition of *current liability* is related to that of *current asset*. A current liability is an obligation that will be satisfied within the operating cycle or within one year if the cycle is shorter than one year. Many liabilities are satisfied by making a cash payment. However, some obligations are settled by rendering a service.
8. **LO 4** A classified balance sheet is helpful in evaluating the liquidity of a business. Working capital, the difference between current assets and current liabilities, indicates the buffer of protection for creditors. The current ratio, current assets divided by current liabilities, provides the reader with a relative measure of liquidity.
9. **LO 5, 6** All expenses are added together and subtracted from all revenues in a single-step income statement. The multiple-step income statement provides the reader with classifications of revenues and expenses as well as with important subtotals. Cost of goods sold is subtracted from sales revenue on a multiple-step

statement, with the result reported as gross profit. Profitability analysis includes such measures as the gross profit ratio (the ratio of gross profit to sales) and the profit margin (the ratio of net income to sales).

10. **LO 7, 8** If there are no changes in the capital stock accounts, some companies present a statement of retained earnings or a combined statement of income and retained earnings in lieu of a statement of stockholders' equity. The statement of cash flows

summarizes the operating, investing, and financing activities of an entity for the period.

11. **LO 9** No two annual reports are the same. However, certain basic elements are included in most of them. In addition to the financial statements, annual reports include, among other items, the independent accountants' report, management's discussion of the amounts appearing in the statements, and footnotes to the statements.

KEY TERMS QUIZ

Read each definition below and then write the number of that definition in the blank beside the appropriate term it defines. The solution appears at the end of the chapter.

- ___ Understandability
- ___ Relevance
- ___ Reliability
- ___ Comparability
- ___ Depreciation
- ___ Consistency
- ___ Materiality
- ___ Conservatism
- ___ Operating cycle
- ___ Current asset

- ___ Current liability
- ___ Liquidity
- ___ Working capital
- ___ Current ratio
- ___ Single-step income statement
- ___ Multiple-step income statement
- ___ Gross profit
- ___ Gross profit ratio
- ___ Profit margin

1. An income statement in which all expenses are added together and subtracted from all revenues.
2. The magnitude of an omission or misstatement in accounting information that will affect the judgment of someone relying on the information.
3. The capacity of information to make a difference in a decision.
4. An income statement that provides the reader with classifications of revenues and expenses as well as with important subtotals.
5. The practice of using the least optimistic estimate when two estimates of amounts are about equally likely.
6. The quality of accounting information that makes it comprehensible to those willing to spend the necessary time.
7. Gross profit divided by sales.
8. Current assets divided by current liabilities.
9. The quality of accounting information that makes it dependable in representing the events that it purports to represent.
10. An obligation that will be satisfied within the next operating cycle or within one year if the cycle is shorter than one year.
11. The period of time between the purchase of inventory and the collection of any receivable from the sale of the inventory.
12. Current assets minus current liabilities.
13. Net income divided by sales.
14. The quality of accounting information that allows a user to analyze two or more companies and look for similarities and differences.
15. An asset that is expected to be realized in cash or sold or consumed during the operating cycle or within one year if the cycle is shorter than one year.
16. The ability of a company to pay its debts as they come due.
17. The quality of accounting information that allows a user to compare two or more accounting periods for a single company.
18. Sales less cost of goods sold.
19. The allocation of the cost of a tangible, long-term asset over its useful life.

ALTERNATE TERMS

Balance sheet Statement of financial position or condition

Capital stock Contributed capital

Cost of goods sold Cost of sales

Gross profit Gross margin

Income statement Statement of income

Income tax expense Provision for income taxes

Long-term assets Noncurrent assets

Long-term liability Long-term debt

Net income Profits or earnings

Report of independent accountants Auditors' report

Retained earnings Earned capital

Stockholders' Equity Shareholders' equity

QUESTIONS

1. How would you evaluate the following statement: “The cash flows to a company are irrelevant to an investor; all the investor cares about is the potential for receiving dividends on the investment”?
2. A key characteristic of useful financial information is understandability. How does this qualitative characteristic relate to the background of the user of the information?
3. What does *relevance* mean with regard to the use of accounting information?
4. What is the qualitative characteristic of comparability, and why is it important in preparing financial statements?
5. What is the difference between comparability and consistency as they relate to the use of accounting information?
6. How does the concept of materiality relate to the size of a company?
7. How does the operating cycle of a retailer differ from that of a service company?
8. How does the concept of the operating cycle relate to the definition of a current asset?
9. What are two examples of the way a company’s intent in using an asset affects classification of the asset on the balance sheet?
10. How would you evaluate the following statement: “A note payable with an original maturity of five years will be classified on the balance sheet as a long-term liability until it matures”?
11. How do the two basic forms of owners’ equity items for a corporation—capital stock and retained earnings—differ?
12. What are the limitations of working capital as a measure of the liquidity of a business as opposed to the current ratio?
13. What is meant by a company’s capital structure?
14. What is the major weakness of the single-step form for the income statement?
15. Why might a company’s gross profit ratio increase from one year to the next but its profit margin ratio decrease?
16. How does a statement of retained earnings act as a link between an income statement and a balance sheet?
17. In auditing the financial statements of a company, does a certified public accountant *certify* that the statements are totally accurate and without errors of any size or variety?
18. What is the first footnote in the annual report of all publicly held companies, and what is its purpose?

EXERCISES

LO 2 Exercise 2-1 Characteristics of Useful Accounting Information

Fill in the blank with the qualitative characteristic for each of the following descriptions:

- | | |
|-------|---|
| _____ | 1. Information that users can depend on to represent the events that it purports to represent |
| _____ | 2. Information that has the capacity to make a difference in a decision |
| _____ | 3. Information that is valid, that indicates an agreement between the underlying data and the events represented |
| _____ | 4. Information that allows for comparisons to be made from one accounting period to the next |
| _____ | 5. Information that is free from error |
| _____ | 6. Information that is meaningful to those who are willing to learn to use it properly |
| _____ | 7. Information that is not slanted to portray a company’s position any better or worse than the circumstances warrant |
| _____ | 8. Information that allows for comparisons to be made between or among companies |

LO 3 Exercise 2-2 Classification of Assets and Liabilities

Indicate the appropriate classification of each of the following as a current asset (CA), noncurrent asset (NCA), current liability (CL), or long-term liability (LTL):

- | | |
|-------|--|
| _____ | 1. Inventory |
| _____ | 2. Accounts payable |
| _____ | 3. Cash |
| _____ | 4. Patents |
| _____ | 5. Notes payable, due in six months |
| _____ | 6. Taxes payable |
| _____ | 7. Prepaid rent (for the next nine months) |
| _____ | 8. Bonds payable, due in 10 years |
| _____ | 9. Machinery |

LO 5 Exercise 2-3 Selling Expenses and General and Administrative Expenses

Operating expenses are subdivided between selling expenses and general and administrative expenses when a multiple-step income statement is prepared. From the following list, identify each item as a selling expense (S) or general and administrative expense (G&A):

- _____ 1. Advertising expense
- _____ 2. Depreciation expense—store furniture and fixtures
- _____ 3. Office rent expense
- _____ 4. Office salaries expense
- _____ 5. Store rent expense
- _____ 6. Store salaries expense
- _____ 7. Insurance expense
- _____ 8. Supplies expense
- _____ 9. Utilities expense

LO 5 Exercise 2-4 Missing Income Statement Amounts

For each of the following independent cases, fill in the blank with the appropriate dollar amount:

	Sara's Coffee Shop	Amy's Deli	Jane's Bagels
Net sales	\$35,000	\$ _____	\$78,000
Cost of goods sold	_____	45,000	_____
Gross profit	7,000	18,000	_____
Selling expenses	3,000	_____	9,000
General and administrative expenses	1,500	2,800	_____
Total operating expenses	_____	8,800	13,600
Net income	\$ 2,500	\$ 9,200	\$25,400

LO 6 Exercise 2-5 Income Statement Ratios

The 2001 income statement of Holly Enterprises shows net income of \$45,000, comprising net sales of \$134,800, cost of goods sold of \$53,920, selling expenses of \$18,310, general and administrative expenses of \$16,990, and interest expense of \$580. Holly's stockholders' equity was \$280,000 at the beginning of the year and \$320,000 at the end of the year. The company has 20,000 shares of stock outstanding at December 31, 2001.

Required

Compute Holly's (1) gross profit ratio and (2) profit margin. What other information would you need to be able to comment on whether these ratios are favorable?

LO 7 Exercise 2-6 Statement of Retained Earnings

Landon Corporation was organized on January 2, 1999, with the investment of \$100,000 by each of its two stockholders. Net income for its first year of business was \$85,200. Net income increased during 2000 to \$125,320 and to \$145,480 during 2001. Landon paid \$20,000 in dividends to each of the two stockholders in each of the three years.

Required

Prepare a statement of retained earnings for the year ended December 31, 2001.

LO 8 Exercise 2-7 Components of the Statement of Cash Flows

From the following list, identify each item as operating (O), investing (I), financing (F), or not on the statement of cash flows (N):

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

LO 9 Exercise 2-8 Basic Elements of Financial Statements

Most financial reports contain the following list of basic elements. For each element, identify the person(s) who prepared the element and describe the information a user would expect to find in each element. Some information is verifiable; other information is subjectively chosen by management. Comment on the verifiability of information in each element.

1. Letter from the president
2. Product/markets of company
3. Financial statements
4. Notes to financial statements
5. Independent accountants' report

Multi-Concept Exercises

LO 3, 5, 7 Exercise 2-9 Financial Statement Classification

Potential stockholders and lenders are interested in a company's financial statements. For the list below, identify the statement—balance sheet (BS), income statement (IS), retained earnings statement (RE)—on which each item would appear.

- | | |
|---|--|
| <p>_____ 1. Accounts payable</p> <p>_____ 2. Accounts receivable</p> <p>_____ 3. Advertising expense</p> <p>_____ 4. Bad debt expense</p> <p>_____ 5. Bonds payable</p> <p>_____ 6. Buildings</p> <p>_____ 7. Cash</p> <p>_____ 8. Common stock</p> <p>_____ 9. Deferred income taxes</p> <p>_____ 10. Depreciation expense</p> | <p>_____ 11. Dividends</p> <p>_____ 12. Land held for future expansion</p> <p>_____ 13. Loss on the sale of equipment</p> <p>_____ 14. Office supplies</p> <p>_____ 15. Organizational costs</p> <p>_____ 16. Patent amortization expense</p> <p>_____ 17. Retained earnings</p> <p>_____ 18. Sales</p> <p>_____ 19. Unearned revenue</p> <p>_____ 20. Utilities expense</p> |
|---|--|

LO 5, 6 Exercise 2-10 Single- and Multiple-Step Income Statement

Some headings and/or items are used on either the single-step or the multiple-step income statement. Some are used on both. For the list below, indicate the following: single-step (S), multiple-step (M), both formats (B), or not used on either income statement (N).

- _____ 1. Sales
- _____ 2. Cost of goods sold
- _____ 3. Selling expenses
- _____ 4. Total revenues
- _____ 5. Utilities expense
- _____ 6. Administrative expense
- _____ 7. Net loss
- _____ 8. Supplies on hand
- _____ 9. Accumulated depreciation
- _____ 10. Gross profit

LO 5, 6 Exercise 2-11 Multiple-Step Income Statement

Gaynor Corporation's partial income statement follows:

Sales	\$1,200,000
Cost of sales	450,000
Selling expenses	60,800
General and administrative expenses	75,000

Required

Determine the gross profit ratio and profit margin. Would you consider investing in Gaynor Corporation? Explain your answer.

LO 2 Problem 2-1 Materiality

Joseph Knapp, a newly hired accountant, wanted to impress his boss, so he stayed late one night to analyze the office supplies expense. He determined the cost by month, for the past 12 months, of each of the following: computer paper, copy paper, fax paper, pencils and pens, note pads, postage, stationery, and miscellaneous items.

1. What did Joseph think his boss would learn from this information? What action might be taken as a result of knowing it?
2. Would this information be more relevant if Joseph worked for a hardware store or for a real estate company? Discuss.

LO 2 Problem 2-2 Costs and Expenses

The following costs are incurred by a retailer:

1. Display fixtures in a retail store
2. Advertising
3. Merchandise for sale
4. Incorporation (i.e., legal costs, stock issue costs)
5. Cost of a franchise
6. Office supplies
7. Wages in a restaurant
8. Computer software
9. Computer hardware

Required

For each of these costs, explain whether all of the cost or only a portion of the cost would appear as an expense on the income statement for the period in which the cost was incurred. If not all of the cost would appear on the income statement for that period, explain why not.

LO 3 Problem 2-3 Classified Balance Sheet

The following balance sheet items, listed in alphabetical order, are available from the records of Ruth Corporation at December 31, 2001:

Accounts payable	\$ 18,255
Accounts receivable	23,450
Accumulated depreciation—automobiles	22,500
Accumulated depreciation—buildings	40,000
Automobiles	112,500
Bonds payable, due December 31, 2005	160,000
Buildings	200,000
Capital stock, \$10 par value	150,000
Cash	13,230
Income taxes payable	6,200
Interest payable	1,500
Inventory	45,730
Land	250,000
Long-term investments	85,000
Notes payable, due June 30, 2002	10,000
Office supplies	2,340
Paid-in capital in excess of par value	50,000
Patents	40,000
Prepaid rent	1,500
Retained earnings	311,095
Salaries and wages payable	4,200

Required

1. Prepare in good form a classified balance sheet as of December 31, 2001.
2. Compute Ruth's current ratio.
3. On the basis of your answer to requirement 2, does Ruth appear to be *liquid*? What other information do you need to fully answer this question?

LO 4 Problem 2-4 Financial Statement Ratios

The following items, in alphabetical order, are available from the records of Walker Corporation as of December 31, 2001 and 2000:

	December 31, 2001	December 31, 2000
Accounts payable	\$ 8,400	\$ 5,200
Accounts receivable	13,230	19,570
Cash	10,200	9,450
Cleaning supplies	450	700
Interest payable	-0-	1,200
Inventory	24,600	26,200
Marketable securities	6,250	5,020
Note payable, due in six months	-0-	12,000
Prepaid rent	3,600	4,800
Taxes payable	1,450	1,230
Wages payable	1,200	1,600

Required

1. Calculate the following, as of December 31, 2001, and December 31, 2000:
 - a. Working capital
 - b. Current ratio
2. On the basis of your answers to 1, comment on the relative liquidity of the company at the beginning and the end of the year. As part of your answer, explain the change in the company's liquidity from the beginning to the end of 2001.

LO 4 Problem 2-5 Working Capital and Current Ratio

The balance sheet of Stevenson Inc. includes the following items:

Cash	\$ 23,000
Accounts receivable	13,000
Inventory	45,000
Prepaid insurance	800
Land	80,000
Accounts payable	54,900
Salaries payable	1,200
Capital stock	100,000
Retained earnings	5,700

Required

1. Determine the current ratio and working capital.
2. Beyond the information provided in your answers to 1, what does the composition of the current assets tell you about Stevenson's liquidity?
3. What other information do you need to fully assess Stevenson's liquidity?

LO 5 Problem 2-6 Single-Step Income Statement

The following income statement items, arranged in alphabetical order, are taken from the records of Shaw Corporation for the year ended December 31, 2001:

Advertising expense	\$ 1,500
Commissions expense	2,415
Cost of goods sold	29,200
Depreciation expense—office building	2,900
Income tax expense	1,540
Insurance expense—salesperson's auto	2,250
Interest expense	1,400
Interest revenue	1,340
Rent revenue	6,700
Salaries and wages expense—office	12,560
Sales revenue	48,300
Supplies expense—office	890

Required

1. Prepare a single-step income statement for the year ended December 31, 2001.
2. What weaknesses do you see in this form for the income statement?

LO 5 Problem 2-7 Multiple-Step Income Statement

Refer to the list of income statement items in Problem 2-6. Assume that Shaw Corporation classifies all operating expenses into two categories: (1) selling and (2) general and administrative.

1. Prepare a multiple-step income statement for the year ended December 31, 2001.
2. Compute Shaw's gross profit percentage.
3. What does this percentage tell you about Shaw's markup on its products?

LO 6 Problem 2-8 Albertsons' Gross Profit Ratio

www.albertsons.com

Albertsons Inc. is a large, retail food and drug chain, with nearly 1,000 stores throughout the western, midwestern, and southern states. The following items appeared in the company's 1998 annual report (all amounts are in thousands of dollars):

	52 Weeks January 28, 1999	52 Weeks January 29, 1998	52 Weeks January 30, 1997
Sales	\$16,005,115	\$14,689,511	\$13,776,678
Cost of sales	11,622,026	10,807,687	10,211,348

Required

1. Note that Albertsons' fiscal year ends toward the end of January (actually, on the Thursday nearest to January 31 each year). Why do you think this particular company would choose this time, rather than December 31, to end its accounting year?
2. Compute Albertsons' gross profit and its gross profit ratio for each of the three years.
3. Comment on the *change* in the gross profit ratio over the three-year period. What possible explanations are there for the change?

LO 8 Problem 2-9 Statement of Cash Flows

Colorado Corporation was organized on January 1, 2001, with the investment of \$250,000 in cash by its stockholders. The company immediately purchased an office building for \$300,000, paying \$210,000 in cash and signing a three-year promissory note for the balance. Colorado signed a five-year, \$60,000 promissory note at a local bank during 2001 and received cash in the same amount. During its first year, Colorado collected \$93,970 from its customers. It paid \$65,600 for inventory, \$20,400 in salaries and wages, and another \$3,100 in taxes. Colorado paid \$5,600 in cash dividends.

1. Prepare a statement of cash flows for the year ended December 31, 2001.
2. What does this statement tell you that an income statement does not?

LO 9 Problem 2-10 Basic Elements of Financial Reports

Comparative income statements for Grammar Inc. are presented on the following page.

	2001	2000
Sales	\$1,000,000	\$500,000
Cost of sales	<u>500,000</u>	<u>300,000</u>
Gross margin	\$ 500,000	\$200,000
Operating expenses	<u>120,000</u>	<u>100,000</u>
Operating income	\$ 380,000	\$100,000
Loss on sale of subsidiary	(400,000)	—
Net income	<u>\$ (20,000)</u>	<u>\$100,000</u>

Required

The president and management believe that the company performed better in 2001 than it did in 2000. Write the president's letter to be included in the 2001 annual report. Explain why the company is financially sound and why shareholders should not be alarmed by the \$20,000 loss in a year when sales have doubled.

Multi-Concept Problems

LO 2, 4 Problem 2-11 Comparing Coca-Cola and PepsiCo

The following current items, listed in alphabetical order, are taken from the consolidated balance sheets of Coca-Cola and PepsiCo as of December 31, 1998, and December 26, 1998, respectively (all amounts are in millions of dollars):

www.cocacola.com

www.pepsico.com

Coca-Cola

Accounts payable and accrued expenses	\$3,141
Accrued income taxes	1,037
Cash and cash equivalents	1,648
Current maturities of long-term debt	3
Inventories	890
Loans and notes payable	4,459
Marketable securities	159
Prepaid expenses and other assets	2,017
Trade accounts receivable, less allowance of \$10	1,666



PepsiCo

Accounts and notes receivable, less allowance of \$127	\$2,453
Accounts payable and other current liabilities	3,870
Cash and cash equivalents	311
Income taxes payable	123
Inventories	1,016
Prepaid expenses, deferred income taxes, and other current assets	499
Short-term borrowings	3,921
Short-term investments, at cost	83

Required

1. Compute working capital and the current ratio for both companies.
2. On the basis of your answers to 1 above, which company appears to be more liquid?
3. As you know, other factors affect a company's liquidity in addition to its working capital and current ratio. Comment on the *composition* of each company's current assets and how this composition affects its liquidity.

LO 2, 5 Problem 2-12 Comparability and Consistency in Income Statements

The following income statements were provided by Gleeson Company, a retailer:

2001 Income Statement		2000 Income Statement	
Sales	\$1,700,000	Sales	\$1,500,000
Cost of sales	520,000	Cost of sales	450,000
Gross profit	\$1,180,000	Sales salaries	398,000
Selling expense	702,000	Advertising	175,000
Administrative expense	95,000	Office supplies	54,000
Total selling and administrative expense	\$ 797,000	Depreciation—building	40,000
		Delivery expense	20,000
		Total expenses	\$1,137,000
Net income	\$ 383,000	Net income	\$ 363,000

Required

1. Identify each income statement as either single-step or multiple-step format.
2. Convert the 2000 income statement to the same format as the 2001 income statement.

LO 3, 5, 7 Problem 2-13 Classified Balance Sheet, Multiple-Step Income Statement, and Statement of Retained Earnings for Kellogg's

www.kelloggs.com

Shown below, in alphabetical order, are items taken from Kellogg's 1998 consolidated financial statements:



	(in millions)
Accounts payable	\$ 386.9
Accounts receivable, less allowance of \$12.9	693.0
Accumulated other comprehensive income (reduction of owners' equity listed after treasury stock)	(292.4)
Capital in excess of par value	105.0
Cash and cash equivalents	136.4
Cash dividends	375.3
Common stock	103.8
Cost of goods sold	3,282.6
Current maturities of long-term debt	1.1
Income taxes (expense)	279.9
Interest expense	119.5
Inventories	451.4
Long-term debt	1,614.5
Net sales	6,762.1
Non-recurring charges (operating expense)	70.5
Notes payable (current liability)	620.4
Other assets (long-term assets)	666.2
Other current assets	215.7
Other current liabilities	710.1
Other income (expense), net	6.9
Other liabilities (long-term liabilities)	828.7
Property, net	2,888.8
Retained earnings, beginning of year	1,240.4
Selling and administrative expense	2,513.9
Treasury stock (reduction of owners' equity listed after retained earnings)	(394.3)

(NOTE: The descriptions in parentheses are not part of the items but have been added to provide you with hints as you complete this problem.)

Required

1. Prepare a multiple-step income statement for Kellogg's for the year ended December 31, 1998.
2. Prepare a statement of retained earnings for Kellogg's for the year ended December 31, 1998.
3. Prepare a classified balance sheet for Kellogg's at December 31, 1998.

LO 4, 6 Problem 2-14 Using Kellogg's Classified Balance Sheet and Multiple-Step Income Statement

(**Note:** Consider completing this problem after Problem 2-13 to ensure that you have the various items on the financial statements properly classified.)

www.kelloggs.com

Refer to the information set forth in Problem 2-13.

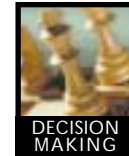
Required

1. Compute Kellogg's working capital and its current ratio at December 31, 1998.
2. Does Kellogg's appear to be liquid? What other factors need to be considered in answering this question?
3. Compute Kellogg's gross profit ratio and its profit margin for 1998.
4. As a Kellogg's stockholder, would you be satisfied with the company's gross profit ratio and its profit margin? What other factors need to be considered in answering this question?



LO 1, 4, 8 Problem 2-15 Cash Flow

Franklin Co., a specialty retailer, has a history of paying quarterly dividends of \$.50 per share. Management is trying to determine whether the company will have adequate cash on December 31, 2001, to pay a dividend if one is declared by the board of directors. The following additional information is available:



- All sales are on account, and accounts receivable are collected one month after the sale. Sales volume has been increasing 5% each month.
- All purchases of merchandise are on account, and accounts payable are paid one month after the purchase. Cost of sales is 40% of the sales price. Inventory levels are maintained at \$75,000.
- Operating expenses in addition to the mortgage are paid in cash. They amount to \$3,000 per month and are paid as they are incurred.

**FRANKLIN CO.
BALANCE SHEET
SEPTEMBER 30, 2001**

Cash	\$ 5,000	Accounts payable	\$ 5,000
Accounts receivable	12,500	Mortgage note†	150,000
Inventory	75,000	Common stock—\$1 par	50,000
Note receivable*	10,000	Retained earnings	<u>66,500</u>
Building/Land	<u>169,000</u>	Total liabilities	
Total assets	<u>\$271,500</u>	and stockholders' equity	<u>\$271,500</u>

*Note receivable represents a one-year, 5% interest-bearing note, due November 1, 2001.

†Mortgage note is a 30-year, 7% note due in monthly installments of \$1,200.

Required

Determine the cash that Franklin will have available to pay a dividend on December 31, 2001. Round all amounts to the nearest dollar. What can Franklin's management do to increase the cash available? Should management recommend that the board of directors declare a dividend?

ALTERNATE PROBLEMS

LO 2 Problem 2-1A Materiality

Jane Erving, a newly hired accountant, wanted to impress her boss, so she stayed late one night to analyze the long-distance calls by area code and time of day placed. She determined the monthly cost, for the past 12 months, by hour and area code called.

Required

1. What did Jane think her boss would learn from this information? What action might be taken as a result of knowing it?
2. Would this information be more relevant if Jane worked for a hardware store or for a real estate company? Discuss.

LO 2 Problem 2-2A Costs and Expenses

The following costs are incurred by a retailer:

1. Point-of-sale systems in a retail store
2. An ad in the yellow pages
3. An inventory-control computer software system
4. Shipping merchandise for resale to chain outlets

For each of these costs, explain whether all of the cost or only a portion of the cost would appear as an expense on the income statement for the period in which the cost is incurred. If not all of the cost would appear on the income statement for that period, explain why not.

LO 3 Problem 2-3A Classified Balance Sheet

The following balance sheet items, listed in alphabetical order, are available from the records of Singer Company at December 31, 2001:

Accounts payable	\$ 34,280
Accounts receivable	26,700
Accumulated depreciation—buildings	40,000
Accumulated depreciation—equipment	12,500
Bonds payable, due December 31, 2007	250,000
Buildings	150,000
Capital stock, \$1 par value	200,000
Cash	60,790
Equipment	84,500
Income taxes payable	7,500
Interest payable	2,200
Land	250,000
Marketable securities	15,000
Merchandise inventory	112,900
Notes payable, due April 15, 2002	6,500
Office supplies	400
Paid-in capital in excess of par value	75,000
Patents	45,000
Prepaid rent	3,600
Retained earnings	113,510
Salaries payable	7,400

Required

1. Prepare a classified balance sheet as of December 31, 2001.
2. Compute Singer's current ratio.
3. On the basis of your answer to **2**, does Singer appear to be *liquid*? What other information do you need to fully answer this question?

LO 4 Problem 2-4A Financial Statement Ratios

The following items, in alphabetical order, are available from the records of Quinn Corporation as of December 31, 2001 and 2000:

	December 31, 2001	December 31, 2000
Accounts payable	\$10,500	\$ 6,500
Accounts receivable	16,500	26,000
Cash	12,750	11,800
Interest receivable	200	-0-
Note receivable, due 12/31/2003	12,000	12,000
Office supplies	900	1,100
Prepaid insurance	400	250
Salaries payable	1,800	800
Taxes payable	10,000	5,800

Required

1. Calculate the following, as of December 31, 2001, and December 31, 2000:
 - a. Working capital
 - b. Current ratio
2. On the basis of your answers to **1**, comment on the relative liquidity of the company at the beginning and the end of the year. As part of your answer, explain the change in the company's liquidity from the beginning to the end of 2001.

LO 4 Problem 2-5A Working Capital and Current Ratio

The balance sheet of Kapinski Inc. includes the following items:

Cash	\$ 23,000
Accounts receivable	43,000
Inventory	75,000
Prepaid insurance	2,800
Land	80,000
Accounts payable	84,900
Salaries payable	3,200
Capital stock	100,000
Retained earnings	35,700

Required

1. Determine the current ratio and working capital.
2. Kapinski appears to have a positive current ratio and a large net working capital. Why would it have trouble paying bills as they come due?
3. Suggest three things that Kapinski can do to help pay its bills on time.

LO 5 Problem 2-6A Single-Step Income Statement

The following income statement items, arranged in alphabetical order, are taken from the records of Corbin Enterprises, a software sales firm, for the year ended December 31, 2001:

Advertising expense	\$ 9,000
Cost of goods sold	150,000
Depreciation expense—computer	4,500
Dividend revenue	2,700
Income tax expense	30,700
Interest expense	1,900
Rent expense—office	26,400
Rent expense—salesperson's car	18,000
Sales revenue	350,000
Supplies expense—office	1,300
Utilities expense	6,750
Wages expense—office	45,600

Required

1. Prepare a single-step income statement for the year ended December 31, 2001.
2. What weaknesses do you see in this form for the income statement?

LO 5 Problem 2-7A Multiple-Step Income Statement

Refer to the list of income statement items in Problem 2-6A. Assume that Corbin Enterprises classifies all operating expenses into two categories: (1) selling and (2) general and administrative.

Required

1. Prepare a multiple-step income statement for the year ended December 31, 2001.
2. Compute Corbin's gross profit percentage.
3. What does this percentage tell you about Corbin's markup on its products?

LO 6 Problem 2-8A Saks Gross Profit Ratio

Saks Incorporated is a national retailer operating department stores under various names, with the most recognizable being Saks Fifth Avenue. The following items appeared in the company's 1998 annual report (all amounts are in thousands of dollars):

	Year Ended		
	January 30, 1999	January 31, 1998	February 1, 1997
Net sales	\$6,219,893	\$5,726,346	\$4,926,862
Cost of sales	4,093,467	3,731,293	3,208,989

Required

1. Note that Saks' fiscal year ends toward the end of January (actually, on the Saturday closest to January 31 each year). Why do you think this particular company would choose this time to end its accounting year rather than December 31?
2. Compute Saks' gross profit and its gross profit ratio for each of the three years.
3. Comment on any *change* in the gross profit ratio over the three-year period. What possible explanations are there for the change?

LO 8 Problem 2-9A Statement of Cash Flows

Wisconsin Corporation was organized on January 1, 2001, with the investment of \$400,000 in cash by its stockholders. The company immediately purchased a manufacturing facility for \$300,000, paying \$150,000 in cash and signing a five-year promissory note for the balance. Wisconsin signed another five-year note at the bank for \$50,000 during 2001 and received cash for the same amount. During its first year, Wisconsin collected \$310,000 from its customers. It paid \$185,000 for inventory, \$30,100 in salaries and wages, and another \$40,000 in taxes. Wisconsin paid \$4,000 in cash dividends.

Required

1. Prepare a statement of cash flows for the year ended December 31, 2001.
2. What does this statement tell you that an income statement does not?

LO 9 Problem 2-10A Basic Elements of Financial Reports

Comparative income statements for Thesaurus Inc. are presented below:

	2001	2000
Sales	\$1,000,000	\$500,000
Cost of sales	500,000	300,000
Gross margin	\$ 500,000	\$200,000
Operating expenses	120,000	100,000
Operating income	\$ 380,000	\$100,000
Gain on the sale of subsidiary	—	400,000
Net income	\$ 380,000	\$500,000

Required

The president and management believe that the company performed better in 2001 than it did in 2000. Write the president's letter to be included in the 2001 annual report. Explain why the company is financially sound and why shareholders should not be alarmed by the reduction in income in a year when sales have doubled.

Alternate Multi-Concept Problems

LO 2, 4 Problem 2-11A Comparing Compaq and Dell

The following current items, listed in alphabetical order, are taken from the consolidated balance sheets of Compaq Computer Corporation and Dell Computer Corporation as of December 31, 1998, and February 1, 1998, respectively (all amounts are in millions of dollars):

Compaq	
Accounts payable	\$4,237
Accounts receivable, less allowance of \$318	6,998
Accrued restructuring costs	1,110

Cash and cash equivalents	4,091
Deferred income taxes (asset)	1,602
Income taxes payable	282
Inventories	2,005
Other current assets	471
Other current liabilities	5,104

Dell

Accounts payable	\$1,643
Accounts receivable, net	1,486
Accrued and other (liabilities)	1,054
Cash	320
Inventories	233
Marketable securities	1,524
Other (assets)	349

(NOTE: the descriptions in parentheses are not part of the items but have been added to provide you with assistance as you complete this problem.)

Required

1. Compute working capital and the current ratio for both companies.
2. On the basis of your answers to 1 above, which company appears to be more liquid?
3. As you know, other factors affect a company's liquidity in addition to its working capital and current ratio. Comment on the *composition* of each company's current assets and how this composition affects its liquidity.

LO 2, 5 Problem 2-12A Comparability and Consistency in Income Statements

The following income statements were provided by Chisholm Company, a wholesale food distributor:

	2001	2000
Sales	\$1,700,000	\$1,500,000
Cost of sales	612,000	450,000
Sales salaries	427,000	398,000
Delivery expense	180,000	175,000
Office supplies	55,000	54,000
Depreciation—truck	40,000	40,000
Computer line expense	23,000	20,000
Total expenses	<u>\$1,337,000</u>	<u>\$1,137,000</u>
Net income	<u>\$ 363,000</u>	<u>\$ 363,000</u>

Required

1. Identify each income statement as either single-step or multiple-step format.
2. Restate each item in the income statements as a percentage of sales. Why did net income remain unchanged when sales increased in 2001?

LO 3, 5, 7 Problem 2-13A Classified Balance Sheet, Multiple-Step Income Statement, and Statement of Retained Earnings for Walgreen's

Shown below, in alphabetical order, are items taken from Walgreen's 1998 consolidated financial statements. Walgreen Co. has a fiscal year ending August 31.

www.walgreens.com

	(in millions)
Accounts receivable, net	\$ 373
Accrued expenses and other liabilities (current liability)	618
Cash and cash equivalents	144
Cash dividends declared	124
Common stock	78
Cost of sales	11,140

Cumulative effect of accounting change for system development costs (last item, deduction on income statement before net income)	26
Deferred income taxes (long-term liabilities)	89
Gain on sale of long-term care pharmacies (other income)	37
Income taxes (current liability)	55
Income tax provision (expense)	340
Interest expense	1
Interest income	6
Inventories	2,027
Net sales	15,307
Other current assets	79
Other non-current assets	135
Other non-current liabilities	384
Paid-in capital	118
Property and equipment, net	2,144
Retained earnings, beginning of year	2,266
Selling, occupancy, and administration (expense)	3,332
Trade accounts payable	907

(NOTE: the descriptions in parentheses are not part of the items but have been added to provide you with hints as you complete this problem.)

Required

1. Prepare a multiple-step income statement for Walgreen's for the year ended August 31, 1998.
2. Prepare a statement of retained earnings for Walgreen's for the year ended August 31, 1998.
3. Prepare a classified balance sheet for Walgreen's at August 31, 1998.

LO 4, 6 Problem 2-14A Using Walgreen's Classified Balance Sheet and Multiple-Step Income Statement

www.walgreens.com

(Note: Consider completing this problem after Problem 2-13A to ensure that you have the various items on the financial statements properly classified.)

Refer to the information set forth in Problem 2-13A.



Required

1. Compute Walgreen's working capital and its current ratio at August 31, 1998.
2. Does Walgreen's appear to be liquid? What other factors need to be considered in answering this question?
3. Compute Walgreen's gross profit ratio and its profit margin for the year ended August 31, 1998.
4. As a Walgreen's stockholder, would you be satisfied with the company's gross profit ratio and its profit margin? What other factors need to be considered in answering this question?

LO 1, 4, 8 Problem 2-15A Cash Flow

Roosevelt Inc., a consulting service, has a history of paying annual dividends of \$1 per share. Management is trying to determine whether the company will have adequate cash on December 31, 2001, to pay a dividend if one is declared by the board of directors. The following additional information is available:

- All sales are on account, and accounts receivable are collected one month after the sale. Sales volume has been decreasing 5% each month.
- Operating expenses are paid in cash in the month incurred. Average monthly expenses are \$10,000 (excluding the biweekly payroll).
- Biweekly payroll is \$4,500, and it will be paid December 15 and December 31.
- Unearned revenue is expected to be earned in December. This amount was taken into consideration in the expected sales volume.

ROOSEVELT INC.
BALANCE SHEET
DECEMBER 1, 2001

Cash	\$ 15,000	Unearned Revenue	\$ 2,000
Accounts receivable	40,000	Note payable*	30,000
Computer equipment	120,000	Common stock—\$2 par	50,000
		Retained earnings	\$ 93,000
		Total liabilities and	
Total assets	\$175,000	stockholder's equity	\$175,000

*The note payable plus 3% interest for six months is due January 15, 2002.

Required

Determine the cash that Roosevelt will have available to pay a dividend on December 31, 2001. Round all amounts to the nearest dollar. Should management recommend that the board of directors declare a dividend?

CASES

Reading and Interpreting Financial Statements

LO 3 Case 2-1 Boeing's Operating Cycle

In Boeing's annual report, footnote 1, "Summary of Significant Accounting Policies," includes the following explanation of Boeing's Inventories:

www.boeing.com

Inventories

Inventoried costs on commercial aircraft programs and long-term contracts include direct engineering, production and tooling costs, and applicable overhead, not in excess of estimated realizable value. In accordance with industry practice, inventoried costs include amounts relating to programs and contracts with long production cycles, a portion of which is not expected to be realized within one year. Commercial spare parts and general stock materials are stated at average cost not in excess of realizable cost.¹⁴

Required

1. Based on the note above, describe Boeing's inventory. That is, what types of items would you expect to find in the inventory of this type of company?
2. Why would Boeing expect that a portion of its inventoried costs would *not* be realized within one year?
3. Based on your answer to 2 above, should Boeing classify its inventories as current or as non-current assets? Explain your answer.

LO 4 Case 2-2 Ben & Jerry's Current Assets and Current Liabilities

Refer to Ben & Jerry's balance sheets as of December 26, 1998 and December 27, 1997.

www.benjerry.com

Required

1. Compute Ben & Jerry's working capital as of each of the two balance sheet dates. Also, compute the change in working capital from the end of 1997 to the end of 1998.
2. Compute Ben & Jerry's current ratio as of each of the two balance sheet dates. Compute the percentage change in the ratio from the end of 1997 to the end of 1998.
3. Assume that you are a dairy farmer and are considering whether to sell milk to Ben & Jerry's in return for their promise to pay any amounts owed within sixty days. On the basis of your answers to 1 and 2 above, what would your decision be? Justify your decision.



LO 3, 4 Case 2-3 Interpreting Gateway's Liabilities

Refer to Gateway's balance sheet as of December 31, 1998.

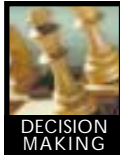
www.gateway.com

¹⁴Boeing Company 1998 Annual Report, p. 59.

Required

1. The first current liability Gateway reports is titled “Notes payable and current maturities of long-term obligations.” Explain *why* a long-term obligation would be classified as a current liability.
2. Directly below the current liabilities is an account titled “Long-term obligations, net of current maturities.” Explain the meaning of this account, specifically what Gateway means by the phrase *net*.
3. The last liability reported on the balance sheet is titled “Warranty and other liabilities.” Explain why warranties result in the recognition of a liability to Gateway.

Making Financial Decisions



LO 8 Case 2-4 Analysis of Cash Flow for a Small Business

Charles, a financial consultant, has been self-employed for two years. His list of clients has grown, and he is earning a reputation as a shrewd investor. Charles rents a small office, uses the pool secretarial services, and has purchased a car that he is depreciating over three years. The following income statements cover Charles's first two years of business:

	Year 1	Year 2
Commissions revenue	\$ 25,000	\$65,000
Rent	12,000	12,000
Secretarial services	3,000	9,000
Car expenses, gas, insurance	6,000	6,500
Depreciation	15,000	15,000
Net income	<u><u>\$(11,000)</u></u>	<u><u>\$22,500</u></u>

Charles believes that he should earn more than \$11,500 for working very hard for two years. He is thinking about going to work for an investment firm where he can earn \$40,000 per year. What would you advise Charles to do?



LO 9 Case 2-5 Factors Involved in an Investment Decision

As an investor, you are considering purchasing stock in a fast-food restaurant chain. The annual reports of several companies are available for comparison.

Required

Prepare an outline of the steps you would follow to make your comparison. Start by listing the first section that you would read in the financial reports. What would you expect to find there, and why did you choose that section to read first? Continue with the other sections of the financial report.

Many fast-food chains are owned by large conglomerates. What limitation does this create in your comparison? How would you solve it?

Accounting and Ethics: What Would You Do?

LO 2 Case 2-6 The Expenditure Approval Process

Roberto is the plant superintendent of a small manufacturing company that is owned by a large corporation. The corporation has a policy that any expenditure over \$1,000 must be approved by the chief financial officer in the corporate headquarters. The approval process takes a minimum of three weeks. Roberto would like to order a new labeling machine that is expected to reduce costs and pay for itself in six months. The machine costs \$2,200, but Roberto can buy the sales rep's demo for \$1,800. Roberto has asked the sales rep to send two separate bills for \$900 each.

What would you do if you were the sales rep? Do you agree or disagree with Roberto's actions? What do you think about the corporate policy?

LO 4, 6 Case 2-7 Barbara Applies For a Loan

Barbara Bites, owner of Bites of Bagels, a drive-through bagel shop, would like to expand her business from its current one location to a chain of bagel shops. Sales in the bagel shop have been increasing an average of 8% each quarter. Profits have been increasing accordingly. Barbara is conservative in spending and a very hard worker. She has an appointment with a banker to apply for a loan to expand the business. To prepare for the appointment, she instructs you, as the chief

financial officer and payroll clerk, to copy the quarterly income statements for the past two years but not to include a balance sheet. Barbara already has a substantial loan from another bank. In fact, she has very little of her own money invested in the business.

What should you do? Do you think the banker will lend Barbara more money?

INTERNET RESEARCH CASE

Case 2-8 Gateway

You can probably do this from your everyday knowledge, but this is good practice in researching a company using the internet. Find a WWW site or a source of information that will list the competitors to Gateway. Choose the top two competitors and answer the following questions:

1. Looking at their balance sheets, what are their total current assets and their total current liabilities? From these numbers, calculate each company's working capital and current ratio. How do they compare to these ratios for Gateway, shown on page 65?
2. From their income statements, calculate their profit margins for the latest year available. How do they compare to those of Gateway, which you were asked to calculate in the From Concept to Practice box on page 67?

Optional Research: From the financial information available on their WWW sites, what other comparisons can you make about these companies? Based on your research, are the companies themselves comparable, in such areas as size, products, assets, liabilities, net income? If not, explain five ways in which they differ. Is the financial information itself comparable for the three companies? Explain.



Fill in your source for industry information:

www.com

Gateway and its main competitors:

www.gateway.com

www.com

www.com

SOLUTION TO KEY TERMS QUIZ

6 Understandability (p. 48)

3 Relevance (p. 48)

9 Reliability (p. 49)

14 Comparability (p. 50)

19 Depreciation (p. 50)

17 Consistency (p. 50)

2 Materiality (p. 51)

5 Conservatism (p. 51)

11 Operating cycle (p. 53)

15 Current asset (p. 54)

10 Current liability (p. 57)

16 Liquidity (p. 58)

12 Working capital (p. 58)

8 Current ratio (p. 58)

1 Single-step income statement (p. 60)

4 Multiple-step income statement (p. 60)

18 Gross profit (p. 60)

7 Gross profit ratio (p. 62)

13 Profit margin (p. 62)