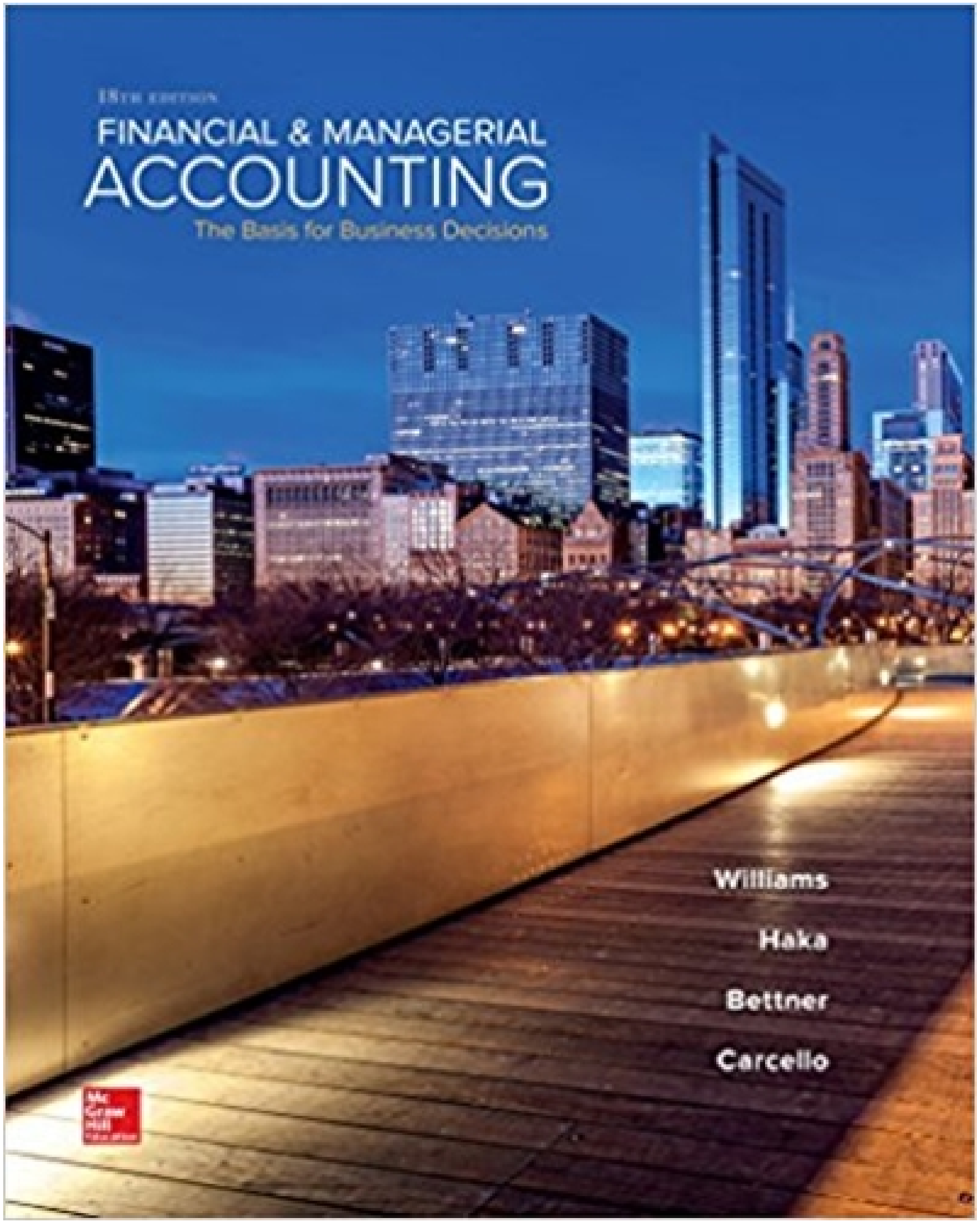
Solutions for Financial and Managerial Accounting The Basis for Business Decisions 18th Edition by Williams



Solutions

2 BASIC FINANCIAL STATEMENTS

Chapter Summary

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

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

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

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

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

Learning Objectives

1. Explain the nature and general purposes of financial statements.

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

3. Demonstrate how certain business transactions affect the elements of the accounting equation: Assets = Liabilities + Owners' Equity.

4. Explain how the statement of financial position, often referred to as the balance sheet, is an expansion of the basic accounting equation.

5. Explain how the income statement reports an enterprise's financial performance for a period of time in terms of the relationship of revenues and expenses.

6. Explain how the statement of cash flows presents the change in cash for a period of time in terms of the company's operating, investing, and financing activities.

7. Explain how the statement of financial position (balance sheet), income statement, and statement of cash flows relate to each other.

8. Explain common forms of business ownership—sole proprietorship, partnership, and corporation—and demonstrate how they differ in terms of their statements of financial position.

9. Discuss the importance of financial statements to a company and its investors and creditors and why management may take steps to improve the appearance of the company in its financial statements.

Brief Topical Outline

A. Introduction to financial statements
B. A starting point: statement of financial position
   1. The concept of the business entity
   2. Assets
      a. The cost principle
      b. The going-concern assumption
      c. The objectivity principle—see *Your Turn* (page **46**)
      d. The stable-dollar assumption—see *International Case in Point* (page **46**)
   3. Liabilities
   4. Owners' equity
      a. Increases in owners' equity
      b. Decreases in owners' equity
   5. The accounting equation
   6. The effects of business transactions: an illustration
      a. The business entity
      b. Overnight's accounting policies
      c. The company's first transaction
      d. Purchase of an asset for cash
      e. Purchase of an asset and financing part of the cost
      f. Purchase of an asset on account
      g. Sale of an asset
      h. Collection of an account receivable
      i. Payment of a liability
      j. Earning of revenue
      k. Payment of expenses
   7. Effects of these business transactions on the accounting equation
C. Income statement (illustrated on pages **54 & 55**)
D. Statement of cash flows (illustrated on page **56**)—see *Case in Point* (page **56**)
E. Relationships among financial statements—see *Pathways Connection* and *Your Turn* (page **59**)
F. Forms of business organization
   1. Sole proprietorships
   2. Partnerships
   3. Corporations
   4. Reporting ownership equity in the statement of financial position (illustrated on pages **60 & 61**)

a. Sole proprietorships
b. Partnerships
c. Corporations

G. The use of financial statements by external parties
1. The short run versus the long run
2. Evaluating short-term liquidity
3. The need for adequate disclosure
4. Management's interest in financial statements—see *Ethics, Fraud, & Corporate Governance* (page **63**)

H. Concluding remarks

Topical Coverage and Suggested Assignments

Class Meetings on Chapter	Topical Outline Coverage	Discussion Questions*	Brief Exercises*	Exercises*	Problems*	Critical Thinking Cases*
1	A – D	3, 4, 5, 8	1, 3, 4	1, 4, 6	1, 3, 6	1
2	E – I	9, 14, 15	7, 9, 10	11, 12, 13	7, 8, 9	3

*Homework assignment (to be completed prior to class)

Comments and Observations

Teaching Objectives for Chapter 2

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

1. Describe the nature of financial statements. Explain the role of ***generally accepted accounting principles*** in this process.

2. Illustrate and explain a ***balance sheet.*** Define the terms ***assets, liabilities,*** and ***owners' equity***, and discuss the basic accounting principles relating to asset valuation. Discuss the uses and limitations of this financial statement.

3. Introduce the ***accounting equation*** and illustrate the effects of business transactions upon this equation and upon a balance sheet.

4. Introduce the ***income statement***, emphasizing the nature of ***revenues*** and ***expenses***.

5. Introduce the statement of ***cash flows*** and distinguish among ***operating, investing,*** and financing activities.

6. Explain and illustrate the concept of financial statement articulation.

7. Define proprietorship, partnership, and the corporation as forms of business organization, and illustrate the effect of the form of organization on the presentation of owners' equity in the financial statements.

8. Explain the importance of adequate disclosure.

General Comments

Introducing the financial statements. Our overriding objective in this chapter is to introduce students to the balance sheet, income statement, and statement of cash flows. We find Problem 2.***8A*** useful for this purpose. Exercise ***1*** defining assets and liabilities, stimulates student interest when discussed in class. Also, it is short enough that they can be discussed without having been assigned as homework. We also recommend Problem ***9*** or ***10*** for initiating a lively classroom discussion of many of the concepts introduced in this chapter.

In covering Chapter 2, we like to continue the overview of the financial reporting process begun in Chapter 1. Case 2.3 gives students a great opportunity to exercise many of the skills and concepts covered in chapter 2 as they analyze the balance sheets of two separate companies for the purpose of making decisions. Students gain a better understanding of how external users such as investors and creditors may use the information contained in the general purpose financial statements to make better business decisions.

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

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

We also urge instructors to spend some class time examining how various accounting transactions impact the accounting equation. In the textbook, we walk through the transactions of Overnight Auto Service. Subsequent to each transaction, we examine the changes that occurred within the accounting equation. This understanding better prepares students to learn the rules of double-entry bookkeeping, which are introduced in Chapter 3. Instructors may want to present the balance sheet on January 20, 2018 alongside the balance sheet on January 31, 2018. This enables students to see the culmination of all of the recorded transactions. Students can also compare the financial position and liquidity of the company between the two reports.

Supplemental Exercises

Internet Exercise

Case 2-7 introduces students to the EDGAR database on the SEC website. Students learn to retrieve the quarterly report (10Q) from the website. This is a good opportunity for instructors to assist students in navigating the SEC website. When students initially visit the SEC website, they may feel a bit overwhelmed. From the homepage, they should look in the "Information for" section and select "EDGAR Filers." Next, click on "Company Filings Search" in the left menu. At this point, students have the option of searching by company name or ticker symbol if they have that available. After retrieving the filings, they have options to view the documents as well as the Interactive Data. We find this to be a valuable teaching moment in introducing students to those basic financial research skills.

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

CHAPTER 2 **NAME**________________________________#______

10-MINUTE QUIZ A **SECTION**______________________________

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

1 The financial statements of a business entity:
- **a** Include the balance sheet, income statement, and income tax return.
- **b** Provide information about the profitability and financial position of the company.
- **c** Are the first step in the accounting process.
- **d** Are prepared for a fee by the Financial Accounting Standards Board.

2 A balance sheet is designed to show the financial position of an entity:
- **a** At a single point in time.
- **b** Over a period of time such as a year or quarter.
- **c** At December 31 of the current year.
- **d** At January 1 of the coming year.

3 Accounts payable and notes payable are:
- **a** Always less than the amount of cash a business owns.
- **b** Creditors.
- **c** Written promises to pay a certain amount, plus interest, at a definite future date.
- **d** Liabilities.

4 The balance sheet of Dotty Designs includes the following items:

Accounts Receivable	Cash
Capital Stock	Accounts Payable
Equipment	Supplies
Notes Payable	Notes Receivable

This list includes:
- **a** Four assets and three liabilities.
- **b** Five assets and three liabilities.
- **c** Five assets and two liabilities.
- **d** Six assets and two liabilities.

5 An accounting entity may best be described as:
- **a** An individual.
- **b** A particular economic unit.
- **c** A publicly owned corporation.
- **d** Any corporation, regardless of size.

CHAPTER 2 **NAME**__________________________________#_______

10-MINUTE QUIZ B **SECTION**________________________________

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

SABINO FAMILY DENTISTRY
Balance Sheet
January 1, 20__

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

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

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

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

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

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

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

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

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

CHAPTER 2 **NAME**__________________________________#_______

10-MINUTE QUIZ C **SECTION**__________________________________

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

MANHATTAN FAMILY DENTISTRY
Balance Sheet
January 1, 20__

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

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

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

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

MANHATTAN FAMILY DENTISTRY
Balance Sheet
January 4, 20__

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

CHAPTER 2 **NAME**________________________________#______

10-MINUTE QUIZ D **SECTION**______________________________

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

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

COUNTRYWIDE LEGAL SERVICES
Balance Sheet
January 31, 20__

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

SOLUTIONS TO CHAPTER 2 10-MINUTE QUIZZES

QUIZ A

1 B
2 A
3 D
4 C
5 B
Learning Objective 2, 4, 5, 6

QUIZ B

1 B
2 C
3 D
4 A
5 C
Learning Objective 3, 4

QUIZ C

MANHATTAN FAMILY DENTISTRY
Balance Sheet
January 4, 20__

Assets		**Liabilities & Owners' Equity**	
Cash	$ 100,000[a]	Liabilities:	
Accounts receivable	15,000[b]	Notes payable	$ 60,000
Land	190,000	Accounts payable	60,000[e]
Building	225,000	Total liabilities	$ 120,000
Equipment	73,000[c]	Owners' equity:	
		Capital stock	483,000[d]
Total assets	$603,000	Total liabilities and owners' equity	$603,000

Computations:

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

Learning Objective: 4

QUIZ D

COUNTRYWIDE LEGAL SERVICES
Balance Sheet
January 31, 20__

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

Computations:

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

Learning Objective: 4

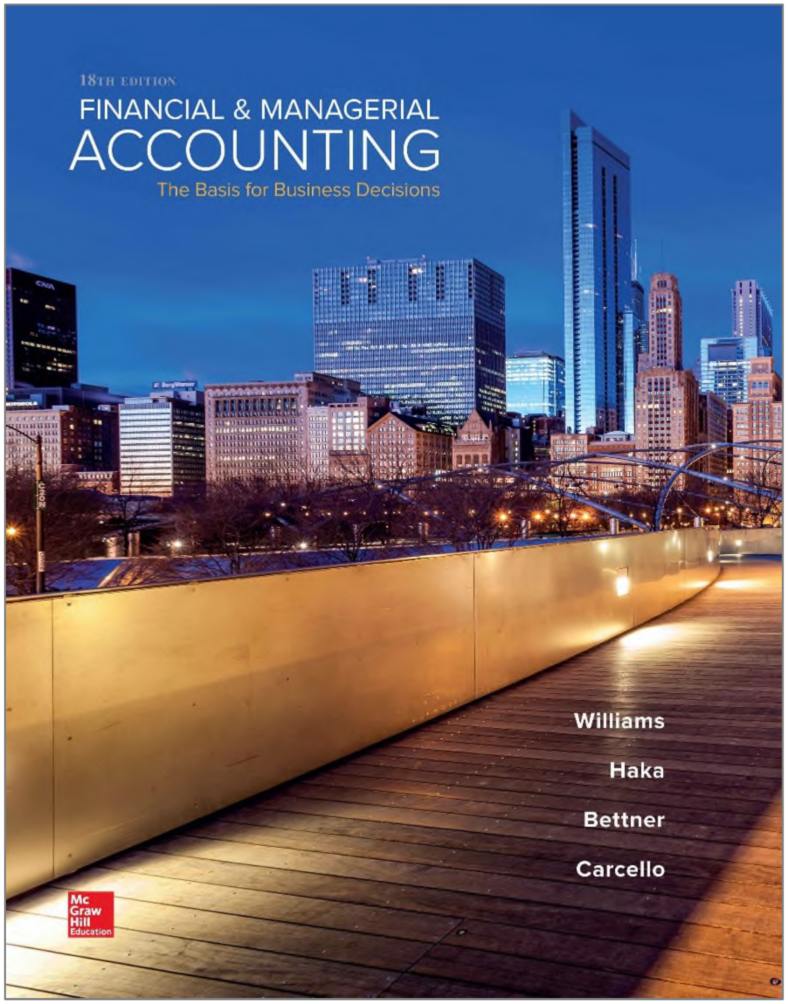
Assignment Guide to Chapter 2

	Brief Exercises	Exercises	Problems										Cases						Net
Item Number	1 – 10	1 – 17	1	2	3	4	5	6	7	8	9	10	1	2	3	4	5	6	7
Time estimate (in minutes)	< 10	< 15	15	15	15	15	20	20	35	40	35	30	30	30	30	30	35	30	25
Difficulty rating	E	E	E	E	M	M	M	M	M	S	S	S	M	S	M	M	M	E	E
Learning Objectives: **1. Explain the nature and general purpose of financial statements.**																			
2. Explain certain accounting principles that are important for an understanding of financial statements and how professional judgment by accountants may affect the application of those principles.		4, 10										√							
3. Demonstrate how certain business transactions affect the elements of the accounting equation: Assets = Liabilities + Owner's Equity.	1, 2	1, 5, 6, 7		√	√	√			√										
4. Explain how the statement of financial position, often referred to as the balance sheet, is an expansion of the basic accounting equation.	3, 4	2, 3, 16	√				√	√	√	√	√	√	√	√	√		√		√
5. Explain how the income statement reports an enterprise's financial performance for a period of time in terms of the relationship of revenues and expenses.	5, 6	12, 13, 16, 17 (M)								√				√					√
6. Explain how the statement of cash flows presents the change in cash for a period of time in terms of the company's operating, investing, and financing activities.	7	11, 14, 16							√	√				√		√			
7. Explain how the statement of financial position (balance sheet), income statement, and statement of cash flows relate to each other.	10																		

	Brief Exercises	Exercises	Problems										Cases						Net
8. Explain common forms of business ownership—sole proprietorship, partnership, and corporation—and demonstrate how they differ in terms of their statements of financial position.	8, 9	8									√								
9. Discuss the importance of financial statements to a company and its investors and creditors and why management may take steps to improve the appearance of the company in its financial statements.		9, 15																√	

Chapter 2

Basic Financial Statements



Introduction to Financial Statements

Investors and creditors are interested in the cash flows that they expect to receive in the future.

- Creditors are interested in the ability of an enterprise, to which they have made loans or sold merchandise on credit, to meet its payment obligations, which may include payment of interest.
- Investors are interested in the market value of their stock holdings, as well as dividends that the enterprise will pay to them while they own the stock.

Financial Statements

- A financial statement is simply a declaration of what is believed to be true about an enterprise, communicated in terms of a monetary unit, such as the dollar.
- When accountants prepare financial statements, they are describing in financial terms certain attributes of the enterprise that they believe fairly represent its financial activities.

Three Primary Financial Statements

- Statement of financial position (often referred to as the balance sheet)
- Income statement
- Statement of cash flows

KEY POINT
While examining the financial statements in this chapter, we will be assuming the corporate form of business ownership.

Financial Statements: Balance Sheet

1. Statement of Financial Position (Balance Sheet)
   a. Describes where the enterprise stands at a specific date.
   b. A snapshot of the business in financial or dollar terms that shows what the enterprise looks like at a specific date.

Financial Statements: Income Statement

2. Income Statement
   a. An activity statement that shows the revenues and expenses for a designated period of time.
   b. Revenues have resulted or are expected to result in positive cash flows through transactions with customers.
   c. Expenses result in negative cash flows (outflows of cash) through business activities.

Financial Statements: Statement of Cash Flows

3. Statement of Cash Flows
   a. Details the company's sources and uses of cash during an accounting period.
   b. Enables the financial statement user to better understand the change in the cash balance shown on the comparative balance sheet.

A Starting Point: Statement of Financial Position

VAGABOND TRAVEL AGENCY STATEMENT OF FINANCIAL POSITION DECEMBER 31, 2018			
Assets		**Liabilities & Owners' Equity**	
Cash	$ 22,500	Liabilities:	
Notes Receivable	10,000	Notes Payable	$ 41,000
Accounts Receivable	60,500	Accounts Payable	36,000
Supplies	2,000	Salaries Payable	3,000
Office Equipment	15,000	Total Liabilities	$ 80,000
Building	90,000	Owners' Equity:	
Land	100,000	Capital Stock	150,000
		Retained Earnings	70,000
Total	$ 300,000	Total	$ 300,000

Features of the Balance Sheet

1. Heading
   a. Names of the business
   b. Name of the financial statement
   c. Date
2. Assets: Generally listed in order of expected liquidity beginning with cash.
3. Liabilities: Listed on the other side of the balance sheet before owners' equity.
4. Equity: Divided into the categories of capital stock and retained earnings.

Business Entity Concept

Business Entity

- An economic unit that engages in identifiable business activities.
- For accounting purposes, the activities of the entity is separate from the personal activities of its owners.
- Should only include items related to the operation of the business.

Assets

Assets have three basic characteristics:

1. Economic resources
2. Owned by the business
3. Expected to benefit future operations*

**The expected future benefit may come directly as the asset is converted into cash or indirectly as the asset is used in operating the business to create other assets that result in positive future cash flows.*

The Cost Principle

- *Historical cost* refers to the original amount the entity paid to acquire the asset.
- Examples of assets reported at historical cost include merchandise inventory, land, buildings, and equipment.
- Examples of assets reported at net realizable value, or fair value, include accounts receivable and investments.

The Going-Concern Assumption

- The going-concern assumption indicates that we assume that a business will be a continuing enterprise which will operate for an indefinite period.
- This assumption supports the principle of historical cost as most long-term assets are not intended for resale but meant to assist the business in continuing their core operations.

The Objectivity Principle

- *Objective* describes information that is factual, definite, and verifiable.
- Objective information lacks subjectivity.
- Objectivity is a primary reason for reporting long-term assets at historical cost as that value is verifiable.

Your Turn: You as a Home Owner

First, assume you have owned your home for 10 years and need to report the value of your home to the city assessor for real estate tax assessment purposes. What information would you provide? Second, assume you are planning to sell your home. What type of information would you provide to potential buyers? What ethical issues arise in these two situations that the objectivity principle helps address?

The Stable-Dollar Assumption

A limitation of measuring assets at historical cost is that the value of the monetary unit or dollar is not always stable.

- *Inflation* is a term used to describe the situation where the value of the monetary unit decreases, meaning that it will purchase less than it did previously.
- *Deflation*, on the other hand, is the opposite situation in which the value of the monetary unit increases, meaning that it will purchase more than it did previously.

The Stable-Dollar Assumption (cont.)

- Accountants in the United States prepare financial statements under an assumption that the dollar is a stable unit of measurement, as is the gallon, the acre, or the mile.

International Case in Point

Many countries experience prolonged and serious inflation. Inflation can undermine the stable-currency assumption. Accounting rules have been designed in some foreign countries to address the impact of inflation on a company's financial position. For example, Mexican corporate law requires Mexican companies to adjust their balance sheets to current purchasing power by using indexes provided by the government. Because inflation is significant, the indexes are used to devalue the Mexican currency (pesos) to provide a more transparent representation of the company's financial condition.

Liabilities

Liabilities:

- Financial obligations or debts.
- Represent negative future cash flows.
- The person or organization to whom the debt is owed is called a creditor.
- Usually listed on the balance sheet in the order in which they are expected to be repaid.
- Represents claims against the borrower's assets.

Owners' Equity

Owners' Equity:

- Represents the owners' claims on the assets of the business.
- Indicates a residual amount as creditors have legal priority over owners.
- Entitles owners to the residual assets once creditors have been paid in full.
- Always equal to total assets minus total liabilities.

Increases in Owners' Equity

The owners' equity in a business comes from two primary sources:

1. Investments of cash or other assets by owners.
2. Earnings from profitable operation of the business.

Decreases in Owners' Equity

Decreases in owners' equity also are caused in two ways:

1. Payments of cash or transfers of other assets to owners.
2. Losses from unprofitable operation of the business.

The Accounting Equation

Assets = Liabilities + Owners' Equity

Example:

Assets = Liabilities + Owners' Equity

$360,000 = $96,000 + $264,000

The Effects of Business Transactions

How does a statement of financial position come about? What has occurred in the past for it to exist at any point in time?

- The statement of financial position is a picture of the results of past business transactions that has been captured by the company's information system and organized into a concise financial description of where the company stands at a point in time.
- The specific items and dollar amounts are the direct results of the transactions in which the company has engaged.

Illustration: Introduction

To illustrate how a balance sheet comes about, and later to show how the income statement and statement of cash flows relate to the balance sheet, we use an example of a small auto repair business, Overnight Auto Service.

Illustration: Business Entity Background

Assume that Michael McBryan, an experienced auto mechanic, opens his own automotive repair business, Overnight Auto Service. A distinctive feature of Overnight's operations is that all repair work is done at night. This strategy offers customers the convenience of dropping off their cars in the evening and picking them up the following morning.

Operating at night also enables Overnight to minimize labor costs. Instead of hiring full-time employees, Overnight offers part-time work to mechanics who already have day jobs at major automobile dealerships. This eliminates the need for costly employee training programs and for such payroll fringe benefits as group health insurance and employees' pension plans, benefits usually associated with full-time employment.

Illustration: Overnight's Accounting Policies

McBryan has taken several courses in accounting and maintains Overnight's accounting records himself. He knows that small businesses such as his are not required to prepare formal financial statements, but he prepares them anyway. He believes they will be useful to him in running the business. In addition, if Overnight is successful, McBryan plans to open more locations. He anticipates needing to raise substantial amounts of capital from investors and creditors. He believes that the financial history provided by a series of monthly financial statements will be helpful in obtaining investment capital.

Overnight: Transaction 1

On January 20, Michael McBryan started Overnight Auto Service. He and his family invested $80,000 and received 8,000 shares of stock at $10 per share.

OVERNIGHT AUTO SERVICE
BALANCE SHEET
JANUARY 20, 2018

Assets		Owners' Equity	
Cash	$ 80,000	Capital Stock	$ 80,000
Total	$ 80,000	Total	$ 80,000

Overnight: Transaction 2

On January 21, Overnight purchased the land from the city for $52,000 cash.

OVERNIGHT AUTO SERVICE
BALANCE SHEET
JANUARY 21, 2018

Assets		Owners' Equity	
Cash	$ 28,000	Capital Stock	$ 80,000
Land	52,000		
Total	$ 80,000	Total	$ 80,000

Overnight: Transaction 3

On January 22, Overnight purchased an old garage for $36,000. Overnight paid $6,000 down in cash and issued a 90-day note payable for the remaining $30,000 owed.

OVERNIGHT AUTO SERVICE BALANCE SHEET JANUARY 22, 2018			
Assets		**Liabilities and Owners' Equity**	
Cash	$ 22,000	Liabilities:	
Building	36,000	Notes Payable	$ 30,000
Land	52,000	Owners' Equity:	
		Capital Stock	80,000
Total	$ 110,000	Total	$ 110,000

Overnight: Transaction 4

On January 23, Overnight purchased tools and automotive repair equipment for $13,800 on account, due within 60 days.

OVERNIGHT AUTO SERVICE
BALANCE SHEET
JANUARY 23, 2018

Assets		Liabilities and Owners' Equity	
Cash	$ 22,000	Liabilities:	
Tools & Equipment	13,800	Notes Payable	$ 30,000
Building	36,000	Accounts Payable	13,800
Land	52,000	Total Liabilities	$ 43,800
		Owners' Equity:	
		Capital Stock	80,000
Total	$123,800	Total	$123,800

Overnight: Transaction 5

Overnight realized that the company had purchased more tools and equipment than it needed.
On January 24, Overnight sold some of the new tools to Ace Towing for $1,800, a price equal to Overnight's cost. Ace agreed to pay the amount within 45 days.

OVERNIGHT AUTO SERVICE
BALANCE SHEET
JANUARY 24, 2018

Assets		Liabilities and Owners' Equity	
Cash	$ 22,000	Liabilities:	
Accounts Receivable	1,800	Notes Payable	$ 30,000
Tools & Equipment	12,000	Accounts Payable	13,800
Building	36,000	Total Liabilities	$ 43,800
Land	52,000	Owners' Equity:	
		Capital Stock	80,000
Total	$123,800	Total	$123,800

Overnight: Transaction 6

On January 26, Ace Towing pays Overnight $600 as a partial settlement of its accounts receivable.

OVERNIGHT AUTO SERVICE
BALANCE SHEET
JANUARY 26, 2018

Assets		Liabilities and Owners' Equity	
Cash	$ 22,600	Liabilities:	
Accounts Receivable	1,200	Notes Payable	$ 30,000
Tools & Equipment	12,000	Accounts Payable	13,800
Building	36,000	Total Liabilities	$ 43,800
Land	52,000	Owners' Equity:	
		Capital Stock	80,000
Total	$123,800	Total	$123,800

Overnight: Transaction 7

On January 27, Overnight made a partial payment of $6,800 on its account payable to Snappy Tools.

OVERNIGHT AUTO SERVICE BALANCE SHEET JANUARY 27, 2018			
Assets		**Liabilities and Owners' Equity**	
Cash	$ 15,800	Liabilities:	
Accounts Receivable	1,200	Notes Payable	$ 30,000
Tools & Equipment	12,000	Accounts Payable	7,000
Building	36,000	Total Liabilities	37,000
Land	52,000	Owners' Equity:	
		Capital Stock	80,000
Total	$117,000	Total	$117,000

Overnight: Transaction 8

On January 31, Overnight recorded auto repair services provided for the last week of January of $2,200, received in cash.

OVERNIGHT AUTO SERVICE
BALANCE SHEET
JANUARY 31, 2018

Assets		Liabilities and Owners' Equity	
Cash	$ 18,000	Liabilities:	
Accounts Receivable	1,200	Notes Payable	$ 30,000
Tools & Equipment	12,000	Accounts Payable	7,000
Building	36,000	Total Liabilities	37,000
Land	52,000	Owners' Equity:	
		Capital Stock	80,000
		Retained Earnings	2,200
Total	$119,200	Total	$119,200

Overnight: Transaction 9

On January 31, Overnight paid operating expenses of $1,400 in cash.

OVERNIGHT AUTO SERVICE
BALANCE SHEET
JANUARY 31, 2018

Assets		Liabilities and Owners' Equity	
Cash	$ 16,600	Liabilities:	
Accounts Receivable	1,200	Notes Payable	$ 30,000
Tools & Equipment	12,000	Accounts Payable	7,000
Building	36,000	Total Liabilities	37,000
Land	52,000	Owners' Equity:	
		Capital Stock	80,000
		Retained Earnings	800
Total	$117,800	Total	$117,800

Overnight: Expanded Accounting Equation

OVERNIGHT AUTO SERVICE
EXPANDED ACCOUNTING EQUATION
JANUARY 20–31, 2018

	Assets					=	Liabilities	+	Owners' Equity	
	Cash	+ Accounts Receivable	+ Tools and Equipment	+ Building	+ Land	=	Notes Payable	+ Accounts Payable	+ Capital Stock	Retained Earnings
Jan. 20	$80,000					=			$80,000	
Balances	$80,000					=			$80,000	
Jan. 21	–52,000				+$52,000	=				
Balances	$28,000				$52,000	=			$80,000	
Jan. 22	–6,000			+$36,000		=	+$30,000			
Balances	$22,000			$36,000	$52,000	=	$30,000		$80,000	
Jan. 23			+$13,800			=		+$13,800		
Balances	$22,000		$13,800	$36,000	$52,000	=	$30,000	$13,800	$80,000	
Jan. 24		+$1,800	–1,800			=				
Balances	$22,000	$1,800	$12,000	$36,000	$52,000	=	$30,000	$13,800	$80,000	
Jan. 26	+600	–600				=				
Balances	$22,600	$1,200	$12,000	$36,000	$52,000	=	$30,000	$13,800	$80,000	
Jan. 27	–6,800					=		–6,800		
Balances	$15,800	$1,200	$12,000	$36,000	$52,000	=	$30,000	$7,000	$80,000	
Jan. 31	+2,200					=				+$2,200
Jan. 31	–1,400					=				–1,400
Balances	$16,600	$1,200	$12,000	$36,000	$52,000	=	$30,000	$7,000	$80,000	$ 800

Statement of Cash Flows

Income Statement

Overnight: Expanded Accounting Equation (cont.)

OVERNIGHT AUTO SERVICE
EXPANDED ACCOUNTING EQUATION
JANUARY 20–31, 2018

	Asset…							+	Owners' Equity	
	Cash +	Accounts Receivable +	Tools an… Equipme…				…ounts …able	+	Capital Stock	Retained Earnings
Jan. 20	$80,000								$80,000	
Balances	$80,000								$80,000	
Jan. 21	−52,000									
Balances	$28,000								$80,000	
Jan. 22	−6,000									
Balances	$22,000								$80,000	
Jan. 23			+$13,800			=	+$13,800			
Balances	$22,000		$13,800	$36,000	$52,000	= $30,000	$13,800		$80,000	
Jan. 24		+$1,800	−1,800			=				
Balances	$22,000	$1,800	$12,000	$36,000	$52,000	= $30,000	$13,800		$80,000	
Jan. 26	+600	−600				=				
Balances	$22,600	$1,200	$12,000	$36,000	$52,000	= $30,000	$13,800		$80,000	
Jan. 27	−6,800					=	−6,800			
Balances	$15,800	$1,200	$12,000						$80,000	
Jan. 31	+2,200									+$2,200
Jan. 31	−1,400									−1,400
Balances	$16,600	$1,200	$12,000						$80,000	$ 800

Statement of Cash Flows

These transactions impact the Statement of Cash Flows.

These transactions impact the Income Statement.

Income Statement

The income statement is a summarization of the company's revenue and expense transactions for a period of time.

Revenues

- Increases in the company's assets from its profit-directed activities.
- Result in positive cash flows.

Income Statement (cont.)

<u>Expenses</u>

- Decreases in the company's assets from its profit-directed activities.
- Result in negative cash flows.

Net income is the difference between revenues and expenses for a specified period of time.

Net Income = Revenues − Expenses

Overnight's Income Statement

OVERNIGHT AUTO SERVICE INCOME STATEMENT FOR THE PERIOD JANUARY 20–31, 2018		
Sales Revenues		$ 2,200
Operating Expenses:		
Wages	$ 1,200	
Utilities	200	$ 1,400
Net Income		$ 800

Investments by and payments to the owners are **not** included on the Income Statement.

Statement of Cash Flows

Classifies cash flows into three categories:

1. Operating activities: the cash effects of revenue and expense transactions that are included on the income statement.
2. Investing activities: the cash effects of purchasing and selling assets, such as land and buildings.
3. Financing activities: the cash effects of the owners investing in the company and creditors loaning money to the company and the repayment of either or both.

Overnight's Statement of Cash Flows

OVERNIGHT AUTO SERVICE STATEMENT OF CASH FLOWS FOR THE PERIOD JANUARY 20–31, 2018				
Cash flows from operating activities:				
Cash received from revenue transactions	$	2,200		
Cash paid for expenses		(1,400)		
Net cash provided by operating activities			$	800
Cash flows from investing activities:				
Purchase of land	$	(52,000)		
Purchase of building		(6,000)		
Purchase of tools		(6,800)		
Sale of tools		600		
Net cash used by investing activities				(64,200)
Cash flows from financing activities:				
Sale of Capital Stock				80,000
Increase in cash for the period			$	16,600
Cash balance, January 20, 2018				-
Cash balance, January 31, 2018			$	16,600

Overnight: Operating Activities

OVERNIGHT AUTO SERVICE
STATEMENT OF CASH FLOWS
FOR THE PERIOD JANUARY 20-31, 2018

Cash flows from operating activities:		
Cash received from revenue transactions	$ 2,200	
Cash paid for expenses	(1,400)	
Net cash provided by operating activities		$ 800
Ca		
Pu		
Pu		
Pu		
Sa		
N		(64,200)
Cash flows from financing activities:		
Sale of Capital Stock		80,000
Increase in cash for the period		$ 16,600
Cash balance, January 20, 2018		-
Cash balance, January 31, 2018		$ 16,600

Operating activities include the cash effects of revenue and expense transactions.

Overnight: Investing Activities

OVERNIGHT AUTO SERVICE STATEMENT OF CASH FLOWS FOR THE PERIOD JANUARY 20–31, 2018				
Cash flows from operating activities:				
Cash received from revenue transactions	$	2,200		
Cash paid for expenses		(1,400)		
Net cash provided by operating activities			$	800
Cash flows from investing activities:				
Purchase of land	$	(52,000)		
Purchase of building		(6,000)		
Purchase of tools		(6,800)		
Sale of tools		600		
Net cash used by investing activities				(64,200)
Cash flows from financing activities:				
S				80,000
Inc			$	16,600
Cash balance, January 20, 2018				-
Cash balance, January 31, 2018			$	16,600

Investing activities include the cash effects of purchasing and selling assets.

Overnight: Financing Activities

OVERNIGHT AUTO SERVICE STATEMENT OF CASH FLOWS FOR THE PERIOD JANUARY 20–31, 2018		
Cash flows from operating activities:		
Cash received from revenue transactions	$ 2,200	
Cash paid for expenses	(1,400)	
Net cash provided by operating activities		$ 800
Cash flows from investing activities:		
Purchase of land	$ (52,000)	
Purchase of building	(6,000)	
Pu		
Sa		
Ne		(64,200)
Cash flows from financing activities:		
Sale of Capital Stock		80,000
Increase in cash for the period		$ 16,600
Cash balance, January 20, 2018		-
Cash balance, January 31, 2018		$ 16,600

Financing activities include the cash effects of transactions with the owners and creditors.

Case in Point: Statement of Cash Flows

It is not unusual for a company to report an increase in cash from operating activities, but a decrease in the total amount of cash. This outcome results when more cash is used for investing and financing activities than is generated from operations. For example, in 2014 **Carnival Corporation**, which owns and operates cruise lines, reported cash provided by operating activities of over $3.4 billion but a decrease in total cash of $131 million. This was due primarily to large expenditures for property and equipment, such as cruise ships, which are presented as investing activities in the company's statement of cash flows. In addition, Carnival used a large amount of cash to reduce its debt, and made a substantial dividend payment.

Overnight: Balance Sheet

Now, let's prepare the Balance Sheet for Overnight Auto Service for January 20–31, 2018.

OVERNIGHT AUTO SERVICE
EXPANDED ACCOUNTING EQUATION
JANUARY 20–31, 2018

	Assets					=	Liabilities		+ Owners' Equity	
	Cash +	Accounts Receivable +	Tools and Equipment +	Building +	Land	=	Notes Payable +	Accounts Payable +	Capital Stock	Retained Earnings
Jan. 20	$80,000					=			$80,000	
Balances	$80,000					=			$80,000	
Jan. 21	−52,000				+$52,000	=				
Balances	$28,000				$52,000	=			$80,000	
Jan. 22	−6,000			[illegible]			[illegible]			
Balances	$22,000								$80,000	
Jan. 23			+$13					13,800		
Balances	$22,000		$13					13,800	$80,000	
Jan. 24		+$1,800	−1							
Balances	$22,000	$1,800	$12					13,800	$80,000	
Jan. 26	+600	−600								
Balances	$22,600	$1,200	$12					13,800	$80,000	
Jan. 27	−6,800					=		−6,800		
Balances	$15,800	$1,200	$12,000	$36,000	$52,000	=	$30,000	$7,000	$80,000	
Jan. 31	+2,200					=				+$2,200
Jan. 31	−1,400					=				−1,400
Balances	$16,600	$1,200	$12,000	$36,000	$52,000	=	$30,000	$7,000	$80,000	$ 800

Statement of Cash Flows

Income Statement

These balances will appear on the Balance Sheet.

Overnight: Balance Sheet (cont.)

OVERNIGHT AUTO SERVICE BALANCE SHEET JANUARY 31, 2018					
Assets			**Liabilities**		
Cash	$	16,600	Notes Payable	$	30,000
Accounts Receivable		1,200	Accounts Payable		7,000
Tools & Equipment		12,000	**Owners' Equity**		
Building		36,000	Capital Stock		80,000
Land		52,000	Retained Earnings		800
Total assets	$	117,800	Total liabilities & equity	$	117,800

Assets = Liabilities + Owners' Equity

$117,800 = $37,000 + $80,800

Relationships Among Financial Statements

Date at beginning of period

Time

Date at end of period

Statement of financial position (Balance sheet)

Statement of financial position (Balance sheet)

Income statement
Statement of cash flows

Financial Statement Articulation

OVERNIGHT AUTO SERVICE
STATEMENT OF CASH FLOWS
FOR THE PERIOD JANUARY 20-31, 2018

Cash flows from operating activities:		
Cash received from revenue transactions	$ 2,200	
Cash paid for expenses	(1,400)	
Net cash provided by operating activities		$ 800
Cash flows from investing activities:		
Purchase of land	$ (52,000)	
Purchase of building	(6,000)	
Purchase of tools	(6,800)	
Sale of tools	600	
Net cash used by investing activities		(64,200)
Cash flows from financing activities:		
Sale of Capital Stock		80,000
Increase in cash for the period		$ 16,600
Cash balance, January 20, 2018		-
Cash balance, January 31, 2018		$ 16,600

OVERNIGHT AUTO SERVICE
INCOME STATEMENT
FOR THE PERIOD JANUARY 20–31, 2018

Sales Revenues		**$ 2,200**
Operating Expenses:		
Wages	**$ 1,200**	
Utilities	**200**	**$ 1,400**
Net Income		**$ 800**

OVERNIGHT AUTO SERVICE
BALANCE SHEET
JANUARY 31, 2018

Assets		**Liabilities**	
Cash	$ 16,600	Notes payable	$ 30,000
Accounts receivable	1,200	Accounts payable	7,000
Tools & equipment	12,000	**Owners' Equity**	
Building	36,000	Capital stock	80,000
Land	52,000	Retained earnings	800
Total assets	$ 117,800	Total liabilities & equity	$ 117,800

Your Turn: You as a Creditor

Assume that you are a financial analyst for a potential supplier to Overnight Auto Service. Overnight wants to buy goods from your company on credit. What factors might you consider in deciding whether to extend credit to Overnight?

Forms of Business Organization

1. Sole Proprietorship
   a. An unincorporated business owned by one person.
   b. Often the owner also acts as the manager.
   c. Common for small retail stores, farms, service businesses, and professional practices in law, medicine, and accounting.
   d. Most common form of business organization in our economy.

Forms of Business: Partnership

2. Partnership
   a. An unincorporated business owned by two or more persons voluntarily acting as partners (co-owners).
   b. Widely used for small businesses as well as some large professional practices, including CPA firms and law firms.
   c. Owners of a partnership are personally responsible for all debts of the business.
   d. From an accounting standpoint, a partnership is viewed as a business entity separate from the personal affairs of its owners.

Forms of Business: Corporation

3. Corporations
   a. Recognized under the law as an entity separate from its owners.
   b. Owners of a corporation are *not* personally liable for the debts of the business.
   c. These owners can lose no more than the amounts they have invested in the business—a concept known as *limited liability*.

Corporations (cont.)

d. Ownership of a corporation is divided into transferable shares of capital stock.

e. Owners are called stockholders or shareholders.

f. Stockholders are generally free to sell some or all of these shares to other investors at any time.

g. Corporations are the dominant form of business organization in terms of the dollar volume of business activity.

Reporting Ownership Equity in the Statement of Financial Position

Sole Proprietorships

Owner's equity:		
Michael McBryan, Capital	$	80,800

Partnerships

Partners' equity:		
Michael McBryan, Capital	$ 40,400	
Rebecca McBryan, Capital	40,400	
Total partners' equity		$80,800

Corporations

Owners' equity:		
Capital Stock	$80,000	
Retained Earnings	800	
Total stockholders' equity		$80,800

Liquidity and Profitability

Liquidity is the ability of the business to pay its debts as they come due.

- Critical to the survival of the business.
- A business that is not liquid may be forced into bankruptcy by its creditors.

Profitability refers to a company's ability to generate net income from the business.

- Profitable operations increase owner's equity.

Short-Run vs. Long-Run

- In the short-run, liquidity and profitability may be independent of each other.
- Over the long term, liquidity and profitability go hand in hand.
- A key indicator of a company's short-term liquidity is the relationship between an entity's liquid assets and the liabilities requiring payment in the near future.

Adequate Disclosure

- Adequate disclosure means that users of financial statements are informed of all information necessary for the proper interpretation of the statements.
- Disclosures are made in the body of the financial statements and in the notes accompanying the statements.
- It is common for the notes to the financial statements to be longer than the statements themselves.

Adequate Disclosure (cont.)

Items that may require disclosure include but are not limited to:

- Significant accounting policies
- Subsequent events
- Contingencies
- Contractual commitments
- Assets pledged as collateral

Management's Interest in Financial Statements

- Creditors are more likely to extend credit if financial statements show a strong statement of financial position—that is, relatively little debt and large amounts of liquid assets.
- Window dressing occurs when management takes measures to make the company appear as strong as possible in its financial statements.

Learning Objective Summary LO2-1

LO2-1: **Explain the nature and general purposes of financial statements.** Financial statements are presentations of information in financial terms about an enterprise that are believed to be fair and accurate. They describe certain attributes of the enterprise that are important for decision makers, particularly investors (owners) and creditors.

Learning Objective Summary LO2-2

LO2-2: **Explain certain accounting principles that are important for an understanding of financial statements and how professional judgment by accountants may affect the application of those principles.** Accountants prepare financial statements by applying a set of standards or rules referred to as generally accepted accounting principles. Consistent application of these standards permits comparisons between companies and between years of a single company. Generally accepted accounting principles allow for significant latitude in how certain transactions should be accounted for, meaning that professional judgment is particularly important.

Learning Objective Summary LO2-3

LO2-3: **Demonstrate how certain business transactions affect the elements of the accounting equation: Assets = Liabilities + Owners' Equity.** Business transactions result in changes in the three elements of the basic accounting equation. A transaction that increases total assets must also increase total liabilities and owners' equity. Similarly, a transaction that decreases total assets must simultaneously decrease total liabilities and owners' equity. Some transactions increase one asset and reduce another. Regardless of the nature of the specific transaction, the accounting equation must stay in balance at all times.

Learning Objective Summary LO2-4

LO2-4: **Explain how the statement of financial position, often referred to as the balance sheet, is an expansion of the basic accounting equation.**

The statement of financial position, or balance sheet, presents in detail the elements of the basic accounting equation. Various types of assets are listed and totaled. The enterprise's liabilities are listed, totaled, and added to the owners' equity. The balancing feature of this financial statement is one of its dominant characteristics because the statement is simply an expansion of the basic accounting equation.

Learning Objective Summary LO2-5

LO2-5: **Explain how the income statement reports an enterprise's financial performance for a period of time in terms of the relationship of revenues and expenses.** Revenues are created as the enterprise provides goods and services for its customers. Many expenses are required to be able to provide those goods and services. The difference between the revenues and expenses is net income or net loss.

Learning Objective Summary LO2-6

LO2-6: **Explain how the statement of cash flows presents the change in cash for a period of time in terms of the company's operating, investing, and financing activities.** Cash is one of the most important assets, and the statement of cash flows shows in detail how the enterprise's cash balance changed between the beginning and end of the accounting period. Operating activities relate to ongoing revenue and expense transactions. Investing activities relate to the purchase and sale of various types of assets (for example, land, buildings, and equipment). Financing activities describe where the enterprise has received its debt and equity financing. The statement of cash flows combines information about all of these activities into a concise statement of changes in cash that reconciles the beginning and ending cash balances.

Learning Objective Summary LO2-7

LO2-7: **Explain how the statement of financial position (balance sheet), income statement, and statement of cash flows relate to each other.** The three primary financial statements are based on the same underlying transactions. They are not alternatives to each other, but rather represent three different ways of looking at the financial activities of the reporting enterprise. Because they are based on the same transactions, they "articulate" with each other.

Learning Objective Summary LO2-8

LO2-8: **Explain common forms of business ownership—sole proprietorship, partnership, and corporation—and demonstrate how they differ in terms of their statements of financial position.**

Owners' equity is one of three major elements in the basic accounting equation. Regardless of the form of organization, owners' equity represents the interest of the owners in the assets of the reporting enterprise. For a sole proprietorship, owner's equity consists of the interest of a single owner. For a partnership, the ownership interests of all partners are added together to determine the total owners' equity of the enterprise. For a corporation, which may have many owners, the total contribution to the enterprise represents its owners' equity. In all cases, the enterprise's net income is added to owners' equity.

Learning Objective Summary LO2-9

LO2-9: **Discuss the importance of financial statements to a company and its investors and creditors and why management may take steps to improve the appearance of the company in its financial statements.** Financial statements are particularly important for investors and creditors in their attempts to evaluate future cash flows from the enterprise to them. Management is interested in the enterprise looking as positive as possible in its financial statements and may take certain steps to improve the overall appearance of the enterprise. A fine line, however, exists between the steps management can take and the steps that are unethical, or even illegal.

End of Chapter 2