CHAPTER

1 Reporting and Interpreting the Financial Results of Business Activities

Toys and Games.

We make the kid in you.

Mattel is a leader in the toys and family games industry.

Understand the basic activities of businesses.

LO1 Distinguish operating, investing, and financing activities.

Study how financial results are reported in financial statements.

LO2 Describe the purpose, setup, and content of the four basic financial statements.

Evaluate results from the perspective of financial statement users.

LO3 Explain the primary goals of financial statement users.

Reconsider how financial statement reporting informs users' decision making.

LO4 Describe the importance of ethics and reputation in accounting.

It's never easy to break bad news to someone. Just how do you tell your best friend that you lost his car keys last night or that his girlfriend is planning to break up with him? You want to convince him that it won't happen again and that things will get better, but that's not going to be easy. It's also difficult to be in your friend's position on the receiving end of bad news, because it's tough to know for sure what happened and who's to blame.

The same thing is true in the business world. Just imagine the problem faced by the executives at **MATTEL,** the maker of Barbie® dolls and Hot Wheels® cars. They had to break the news to investors that their company had lost $431 million during a recent year. That's a $431-million problem. It's tough to convince investors that things aren't so bad when the company just lost more than a million dollars a day. Also imagine yourself on the other side of this news, as one of Mattel's investors. Would you be happy with these results? Would you believe what the executives were telling you? Would you think the sparkle had faded from Barbie's eyes and sell your shares? These are the kinds of questions that come up when reporting and interpreting the financial results of business activities.

In every chapter, we introduce a key accounting decision that is made *inside* a real-world company, and, later in the chapter, we show how people *outside* the company are affected by it. This chapter features Mattel, the company that makes toys and games that everyone has enjoyed at one time in their lives. As you will see in this chapter, this industry isn't child's play—toys are one of the riskiest of all businesses to manage.

COACH'S CORNER

Throughout this course, I'll pass along some advice to you in my Coach's Corner like this. To make effective use of these points, read them after each paragraph that they appear beside. The key terms in the margins contain definitions that will be most useful when you review for a test.

Wait a second. Did you just skip over the inside/outside feature story for Mattel? We suspect that you're used to seeing stories like it in textbooks for other courses and that you may even have developed a habit of skipping them in a rush to get to the "important" part of those courses. We urge you not to do so with the stories in this book because we frequently refer to them throughout the chapters, so skipping over them would be like arriving late to a movie. Plus, you'd miss one of the most interesting parts of accounting. The glimpse inside the company reveals some of the key decisions that accountants make and sets the stage for topics that will be discussed in greater detail in the chapter. The glance outside the company should help you to understand how business people use accounting information and why they consider it so important in their decision making.

To complement this inside/outside approach, the text organizes its Learning Objectives (LO1–LO4) using the framework illustrated on the cover, providing a roadmap to each chapter. This **USER** framework, shown on the first page of each chapter, encourages students to **Understand** the business decisions that managers make on the ground floor, **Study** the accounting methods used on the second floor, **Evaluate** the reported results from the viewpoint of financial statement users on the top floor, and **Reconsider** how accounting and decision-making are linked.

Financial statements are reports that summarize the financial results of business activities.

Financial statement users are people who base their decisions, in part, on information reported in a company's financial statements.

As you read the first part of this chapter, which begins with a look inside Mattel, focus on understanding how and where the financial results of Mattel's business activities are presented in accounting reports called the **financial statements.** In the second part of the chapter, after you have learned about what is reported in the financial statements, we describe how outsiders use Mattel's financial statements to make important business decisions such as determining whether to invest in or lend money to Mattel. In this part, your main goal should be to understand the information these **financial statement users,** as they are often called, use when making their decisions. At the end of the chapter, we'll return to Mattel's $431-million problem to let you test whether you understand how, on the inside, Mattel's managers will deal with this problem in the company's financial statements and how, on the outside, users will use this financial statement information in their decision making.

UNDERSTAND

The Basic Activities of Businesses

THE DEVELOPMENT OF MATTEL'S BUSINESS

Operating activities include day-to-day events involved in running a business.

Investing activities involve buying or selling long-lived items such as land, buildings, and equipment.

Financing activities involve raising money from lenders and owners or paying it back.

Partnerships are business organizations owned by two or more people. Each partner often is personally liable for debts that the partnership cannot pay.

Corporations operate as businesses separate from their owners. Owners of corporations (often called shareholders) are *not* personally responsible for debts of the corporation.

Mattel's history provides an interesting look at how a business can change in form as it grows. Its history also provides a good context for introducing the three main types of business activities: **operating, investing,** and **financing.** You will find that one of the first steps to understanding accounting is to start thinking about business activities in terms of these three main categories. When Mattel started out, its first steps were to raise money (a financing activity) and then buy manufacturing equipment (an investing activity). Only then could it begin to make and sell its toys (its operating activity). Look for the operating, investing, and financing activities in the following paragraph that describe how Mattel developed into an international toy monster.

The toy company that claims to sell a couple of Barbie dolls every second started its business in 1945. Two friends, Harold "Matt" Matson and Elliot Handler, combined their names, money, and artistic skills to form a partnership that initially was in business to produce picture frames and dollhouse furniture. Matt left the business soon after it was started and was replaced by Elliot's wife Ruth. With the picture frame business struggling and opportunities growing in the dollhouse business, the Handlers decided they needed to get serious about toys. They changed their business from a **partnership** to a **corporation** in 1948, and borrowed money from a bank to expand their company. After a decade of satisfactory but not stellar performance, Mattel struck it big in 1959 with the introduction of Barbie. She was an instant success, selling over 350,000 dolls in the first year. The Handlers quickly realized that Mattel needed to expand the production facilities to try to keep up with growing worldwide toy demand. The money for financing the expansion this time didn't come from a bank loan.

exhibit 1.1 **Categorizing Mattel's Business Activities**

Based on the discussion of Mattel's activities in the text, you should have included making and selling picture frames, dollhouse furniture, and toys as operating activities. Investing activities would have included the purchase of production facilities during Mattel's expansion. Mattel's financing activities consisted of borrowing money from the bank and obtaining money from investors in exchange for a share in the ownership of the business.

Instead, Elliot and Ruth decided Mattel should become a **public company,** which attracted hordes of investors who gave money to Mattel in exchange for a share of its ownership.

Like most public companies, Mattel started out small but continually evolved from one type of business organization to another.[1] As the business grew, so did the variety of its activities. Were you able to slot the business activities into their operating, investing, and financing categories? Check whether you were on track by reading Exhibit 1.1.

In reality, companies like Mattel become involved in hundreds of different types of operating, investing, and financing activities. Rather than bombard you with all possible examples in this course, we'll stick to the main business activities that affect about 99 percent of today's companies. Although we'll focus on how these activities affect the company in terms of dollars and cents, we don't want you to get the impression that this financial information is all that matters. In fact, to run a company successfully, business managers also need information about other aspects of their business, such as how much time Mattel's production line takes to roll out a Magic 8 Ball®. To ensure this other information is available, most modern businesses install sophisticated computer systems (called accounting information systems, or more broadly, management information systems) that monitor business activities in both financial and nonfinancial terms. This information then is reported in either the financial statements or other reports.

Exhibit 1.2 shows how these different aspects of **accounting** fit together and what courses you'll take to learn more about them. Accounting Information Systems courses focus on how to design systems to capture and report the information that is needed in financial statements and other accounting reports. Financial Accounting courses (like this one) focus on preparing and using the financial statements that are made available by public companies to anyone who's interested in reading them. Managerial Accounting courses focus on other accounting reports that are not released to the general public, but instead are prepared and used by accountants and managers who run the business.

COACH'S CORNER

Researchers have found that people learn more from exhibits when they look at the pictures in them, then read the explanations in their captions, and then look again at the pictures.

Public companies have their shares bought and sold on stock exchanges. (Private companies' shares are bought and sold privately.)

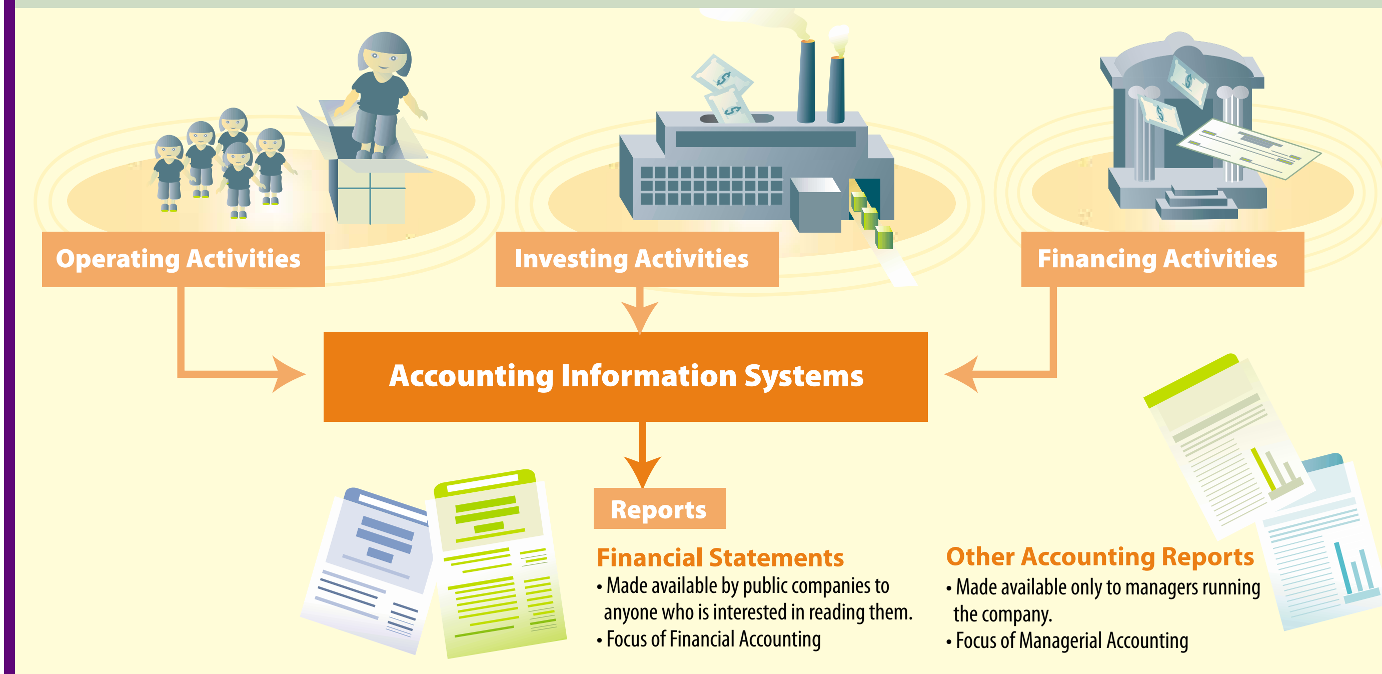
Accounting is the process of capturing and reporting the results of a business's operating, investing, and financing activities.

POINT OF INTEREST

Accounting has been around for over 6,000 years. The ancient civilization of Mesopotamia used clay tablets for recordkeeping.

[1] The only form of business organization not mentioned above is the sole proprietorship, which is like a partnership but with only one owner.

exhibit 1.2 **Accounting for the Results of Business Activities**



The results of a business's operating, investing, and financing activities are captured by accounting information systems, which then produce financial statements and other accounting reports.

The balance sheet is also known as the statement of financial position. The income statement is also known as the **statement of income**, the statement of operations, the statement of earnings, or the statement of profit and loss.

Rather than memorizing detailed definitions for every financial statement item, try to understand the purpose, setup, and content of the four basic financial statements.

STUDY

How Financial Results Are Reported in Financial Statements

FINANCIAL STATEMENTS

The term "financial statements" typically refers to the following four accounting reports:

1. **Balance Sheet**
2. **Income Statement**
3. **Statement of Retained Earnings**
4. **Statement of Cash Flows**

One of the most confusing things for people first learning about accounting (or anything new, for that matter) is that different people use different terms to mean exactly the same thing. We will avoid doing this, but we can't stop others from doing it. So look to the coach for help with interpreting alternative names that people use in accounting.

Financial statements can be prepared at any time during the year, although they are most commonly prepared monthly, every three months (known as *quarterly reports*), and at the end of the year (known as *annual reports*). Companies are allowed to choose any date for the end of their accounting (or *fiscal*) year. Mattel chose a December 31 year-end because this is the start of its slow business period. Fewer toys are sold in January through May than in the first three weeks of December. Hudson's Bay Company (HBC), Canada's oldest corporation and its largest department store chain, ends its financial year on January 31, after its post-holiday clear-out sales are finished.

Each of the four statements has a specific and unique purpose, so we will begin by studying them one at a time. Later you will see how the four statements fit together, but for now just focus on learning what goes into each individual financial statement. Specifically, look for the answers to these questions:

a. ***Purpose.*** What is each statement attempting to explain?
b. ***Setup.*** How is the information on each statement organized?
c. ***Content.*** What kind of information is found on each statement?

Remember that this chapter is intended to provide an overview of financial statements, so focus on the "big picture." You will have the opportunity to learn details about specific financial statement items when we discuss them in depth in Chapters 2 through 5.

1. The Balance Sheet

a. ***Purpose.*** The balance sheet reports *at a point in time* what a business owns (**assets**), what it owes to outsiders (**liabilities**), and what is left over for the owners of the company's shares (**shareholders' equity**). In effect, the balance sheet asks, Does a business have enough resources to pay its bills and still have something left for its owners? The business itself, not the individual shareholders who own the business, is viewed as owning the assets and owing the liabilities on its balance sheet. This is also the idea behind the **separate entity** assumption, which requires that a business's balance sheet include the assets, liabilities, and shareholders' equity of only that business and not those of the shareholders. In accounting language, assets are the resources owned by the business, and liabilities and shareholders' equity represent the claims that interested parties have over the assets. These claims exist because the interested parties have provided the financing for the business to buy the assets.

Assets are the resources (things of value) owned by a business.

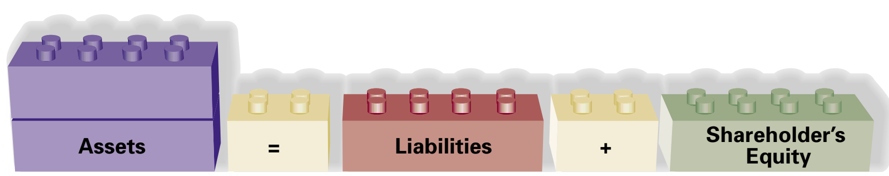
Liabilities are amounts owed by the business.

Shareholders' equity is the amount invested in the business by its owners.

The **separate entity** assumption states that the financial statements of a company are assumed to include the results of only that company's business activities.

b. ***Setup.*** The balance sheet, like the other three basic financial statements, starts with a *heading* that answers three questions: (*i*) who—the name of the company, (*ii*) what—the name of the financial statement, and (*iii*) when—the date of the financial statement. The heading is followed by a *body* that lists dollar amounts for various aspects of the business. The body of every balance sheet contains three interrelated parts: assets, liabilities, and shareholders' equity. The relationship that unites these three parts of the balance sheet is often called the **basic accounting equation** and it is represented by the following:

The **basic accounting equation** is A = L + SE.



The body of the balance sheet always shows that assets equal liabilities plus shareholders' equity. This basic accounting equation is true by definition because each asset on the balance sheet has been financed by either **creditors** or shareholders. Financing provided by creditors creates a liability. Financing provided by shareholders creates shareholders' equity.

Creditors are those to whom a business owes money.

c. ***Content.*** Now that you know the purpose and setup for the balance sheet, you can probably predict its content. The balance sheet should have a heading that is followed by a body, which lists the business's assets, liabilities, and shareholders' equity at a particular point in time. You can learn lots about the balance sheet just by reading it from the top. As you read the following paragraphs, glance at Mattel's balance sheet in Exhibit 1.3, which we have adapted from the "investors" section of Mattel's website at www.mattel.com.

The heading indicates *who* (Mattel, Inc.), *what* (Balance Sheet), and *when* (At December 31, 2004). The balance sheet is like a snapshot indicating the financial position of a company at a particular point in time. Like most big companies, our Mattel example in Exhibit 1.3 rounds to the nearest million dollars, which involves dropping the last six digits.

exhibit 1.3 Sample Balance Sheet and Explanation of Items

MATTEL, INC. Balance Sheet At December 31, 2004		*Who:* Name of the business *What:* Title of the statement *When:* Accounting period (at a point in time)
Assets	(in millions)	
Cash	$1,156	The amount of cash in the company's bank accounts
Accounts Receivable	759	Amounts owed to Mattel by customers for prior credit sales
Inventories	418	Toys being made and finished toys ready to be sold
Property, Plant, and Equipment	586	Land, factories, and production machinery
Other Assets	1,837	Trademarks, brand names, and other assets bought by Mattel
Total Assets	$4,756	Total must equal total liabilities and shareholders' equity below
Liabilities		
Accounts Payable	$1,726	Amounts still owed by Mattel for prior purchases on credit
Notes Payable	644	Amounts owed based on written debt contracts
Total Liabilities	2,370	
Shareholders' Equity		
Contributed Capital	1,293	Amounts invested in the business by shareholders
Retained Earnings	1,093	Past earnings minus past distributions to shareholders
Total Shareholders' Equity	2,386	
Total Liabilities and Shareholders' Equity	$4,756	Total must equal total assets above

Accounts are records that summarize the items a company wants to keep track of, such as its cash.

Let's move on to the body of the balance sheet, focusing first on the Assets section. The five items listed there are common names that many companies use to describe the assets that they own and use in their business activities. If these **accounts,** as they are often called, don't adequately describe the company's assets, then the list would be expanded.

Assets. The first three assets (*Cash, Accounts Receivable,* and *Inventories*) relate to Mattel's main operating activities. The amount shown for the *Cash* account indicates that Mattel has over $1.1 billion in its bank accounts (remember that the amounts in the exhibit are rounded to the nearest million dollars, so $1,156 is actually $1,156,000,000). The second asset account, *Accounts Receivable*, indicates the total amount of money that Mattel expects to collect from its customers for toys it has sold on credit. Think of this as an IOU that gives Mattel the right to collect cash from customers in the future. The third asset account, *Inventories*, reports the cost of all toys that Mattel has made or bought to be sold in the future.

Mattel's remaining asset accounts relate to its investing activities. The fourth asset account listed, *Property, Plant, and Equipment*, indicates that Mattel has invested a great deal of money in the land, factories, and production machinery that are used to make toys. The final asset shown, *Other Assets*, is a catchall that includes a variety of assets, including trademarks and brand names (like View-Master® and Matchbox®) that Mattel has bought from other companies. The figures shown for *Property, Plant, and Equipment* and *Other Assets* are the cost of the assets less an amount for wear and tear and general decline in usefulness. How that amount is calculated is discussed in Chapter 9.

COACH'S CORNER

Assets are listed on the balance sheet in order of how quickly they are used up or converted into cash. This is called order of liquidity.

Liabilities. Financing for Mattel to buy its assets has come from liabilities and shareholders' equity. Under the Liabilities category, Mattel's balance sheet in Exhibit 1.3 lists two items. *Accounts Payable* includes amounts owed to other companies for purchases of goods or services on credit. For example, when Mattel buys the material for Barbie's hair, which is the very same as that used to make Saran Wrap™,[2] it doesn't pay cash upfront. Instead, Mattel promises to pay within a short interest-free period of 60 days or less. The amount owed is included in accounts payable. If Mattel were to need a longer period of time to pay, the accounts payable could be converted to *Notes Payable*—the next liability listed on Mattel's balance sheet. Notes payable are like accounts payable except that they (*a*) are not interest-free, (*b*) will not be paid as soon as accounts payable, and (*c*) are documented using formal written debt contracts known as "notes." So if your friend buys a DVD for you with the understanding that you'll pay her back right away, you would have an account payable. If you arrange and sign for a car loan through your bank, you would have a note payable.

Shareholders' Equity. The Shareholders' Equity section of the balance sheet is called *shareholders'* equity to emphasize that Mattel is a corporation owned by shareholders. This section lists two accounts, both of which represent financing provided by shareholders. *Contributed Capital* reports the amount of cash injected into the business by shareholders who bought shares directly from the company. *Retained Earnings* represents the company's total earnings (and losses) less all **dividends** paid to the shareholders since the formation of the corporation. We'll discuss this account in more detail later in this chapter when we get to the statement of retained earnings.

Dividends are payments a company periodically makes to its shareholders as a return on their investment.

HOW'S IT GOING? A Self-Study Quiz

1. Mattel's *assets* are listed in one section of the balance sheet and *liabilities* and *shareholders' equity* are in other sections. Notice that, according to the basic accounting equation, these sections must balance. In the following chapters, you will learn that this basic accounting equation is the main building block for the entire accounting process. Your task in this quiz is to show that Mattel's reported assets of $4,756 (million) is correct, by using the numbers for liabilities and shareholders' equity presented in Exhibit 1.3. Fill in the blanks in the basic accounting equation:

Assets	=	Liabilities	+	Shareholders' Equity
$4,756	=	______	+	______

(amounts rounded to the nearest million)

2. Learning which items belong in each of the balance sheet categories is an important first step in understanding their meaning. Without referring to Exhibit 1.3, mark each balance sheet item in the following list with letters to show it as an Asset, Liability, or Shareholders' Equity account.

☐ Accounts Payable	☐ Inventories
☐ Accounts Receivable	☐ Property, Plant, and Equipment
☐ Cash	☐ Notes Payable
☐ Contributed Capital	☐ Retained Earnings

When working on these questions, cover up the solutions in the margin with your thumb. After you're done, check the answers in the margin.

If you're thinking of leaving out the self-study quiz just to "get through" the chapter, don't. The best way to know whether you've been reading the chapter carefully enough is to see how well you do on the self-study quiz.

Quiz Answers
1. Assets $4,756 = Liabilities $2,370 + Shareholders' Equity $2,386.
2. Column 1: L, A, A, SE;
Column 2: A, A, L, SE.

[2] "Impressive Tresses: Designing Barbie® Doll's Hair," retrieved June 2, 2004, from www.barbiecollectibles.com/about/design_200104.asp.

2. The Income Statement

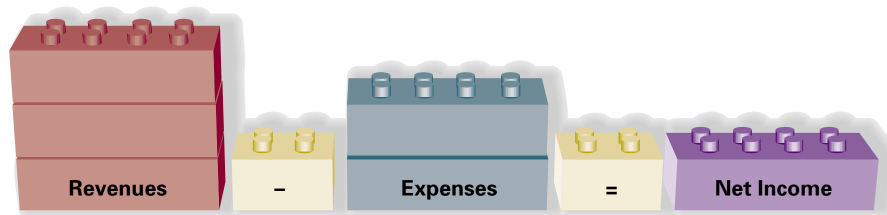
Net income is equal to revenues minus expenses.

Revenue is the money earned from selling goods and services.

Expenses are the costs of running the business.

a. ***Purpose.*** In the same way that your personal tax return shows how much you made during the year, the income statement reports whether a business made a profit (**net income**) from selling goods and providing services (**revenues**) after subtracting the costs of doing business (**expenses**). The income statement summarizes these financial results *over a particular time period*, such as one month, a quarter (three months), or an entire year.

b. ***Setup.*** Like the balance sheet, the income statement starts with a heading that shows *who*, *what*, and *when*. Following this is a body, which reports the various operating activities of the business along with related dollar amounts. These operating activities are classified as revenues or expenses. The amount by which revenues exceed expenses is reported as net income. (It's called a net loss if expenses are greater than revenues.) These three main parts of the income statement are connected through the following relationship:



Unlike the heading of the balance sheet, which says it is prepared at a point in time, the headings of the three other basic financial statements—income statement, statement of retained earnings, and statement of cash flows—indicate that they cover a period of time that ends at the balance sheet date.

c. ***Content.*** As you can see from Exhibit 1.4, the heading of the income statement indicates that it covers a period of time ("For the Year Ended"). This means that the net income of $573 million shown in the body is the amount by which Mattel's revenues exceeded its expenses during the period from January 1 through December 31, 2004. The specific types of revenues and expenses reported in the body of the income statement depend on the nature of the business, as discussed below.

Revenues. Mattel's (adapted) income statement in Exhibit 1.4 reports only one type of revenue (*Sales*), which implies they only sell goods. If you were to look instead at Blockbuster's income statement, you would see three types of revenues: movie rentals, merchandise sales, and the ever-mysterious "other revenues." The main rule of all reported revenues, whether they relate to Blockbuster's DVD rentals or Mattel's sales of Survivor™ games, is that revenues are reported when the product or service is given to a customer *whether or not they are paid for in that period*. Some companies may collect cash at the time a sale is made, like when Blockbuster rents you a video, but others do not (such as when Mattel sells toys to The Bay on credit). Either way, revenues include all sales (cash and credit) made during the period.

When expenses equal revenues, a company is said to "break even." When expenses exceed revenues, the business reports a "net loss." A company is "in the red" when it reports a net loss.

Expenses. In addition to sales revenue, we see from Mattel's income statement in Exhibit 1.4 that its operating activities result in several types of expenses, which are the costs of running the business. The biggest expense is the $2.6 billion cost of making the toys that were sold in 2004 (called *Cost of Goods Sold Expense*). Another big expense for Mattel was the $643 million in *Advertising and Promotion Expenses*. It's pretty easy for Mattel to run up costs like this because it sells about 100 different lines of toys, and a single full-page ad for only one product in *Teen People* costs $75,500.[3] We could go on, but you probably already get the point: companies, like Mattel, have to take on many different kinds of expenses in order to generate revenues. All expenses are reported on the income statement.

Throughout this course, you will learn that some expenses involve immediate cash payments, while others involve payments at a later date. Expenses also can arise from

[3] Mediamark Research Inc. database, retrieved June 2, 2004, from www.mriplus.com.

exhibit 1.4 Sample Income Statement and Explanation of Items

MATTEL, INC. **Income Statement** **For the Year Ended December 31, 2004**		*Who:* Name of the business *What:* Title of the statement *When:* Accounting period (for the year)
	(in millions)	
Revenues		
Sales Revenue	$5,103	Revenue earned from selling toys
Total Revenues	5,103	
Expenses		
Cost of Goods Sold Expense	2,692	Costs to make the toys that were sold
Advertising and Promotion Expenses	643	Expenses to run ads and provide coupons
Other Selling and Administrative Expenses	1,036	Expenses to sell toys and manage the business
Interest Expense	35	Cost of using borrowed funds
Income Tax Expense	124	Cost of taxes charged on income earned
Total Expenses	4,530	Total of all expenses
Net Income	$ 573	Total of all revenues minus all expenses

selling or using assets that have been paid for in a prior period. We'll sort through all of this in Chapters 2–4, but for now you should note that expenses are reported in the same period in which they help to generate revenues *whether or not they are paid for in cash during that period*.

HOW'S IT GOING? A Self-Study Quiz

1. Learning which items belong in each of the income statement categories is an important first step in understanding their meaning. Without referring to Exhibit 1.4, mark each income statement item in the following list with a letter to indicate whether it is a Revenue or an Expense.

☐ Cost of goods sold	☐ Sales
☐ Advertising and promotion	☐ Selling and administrative

2. During 2004, Mattel delivered toys for which customers paid or promised to pay amounts totalling $5,103 (million). During the same period, it collected $4,888 (million) in cash from its customers. Without referring to Exhibit 1.4, pick which of these two amounts will be shown on Mattel's income statement as *sales revenue* for 2004. Why did you pick this answer?
3. During 2004, Mattel *produced* toys with a total cost of production of $2,636 (million). During the same period, it *delivered* to customers toys that cost a total of $2,692 (million) to produce. Without referring to Exhibit 1.4, pick which of the two numbers will be shown on Mattel's income statement as *cost of goods sold expense* for 2004. Why did you pick this answer?

After you're done, check your answers with the solutions in the margin.

Quiz Answers

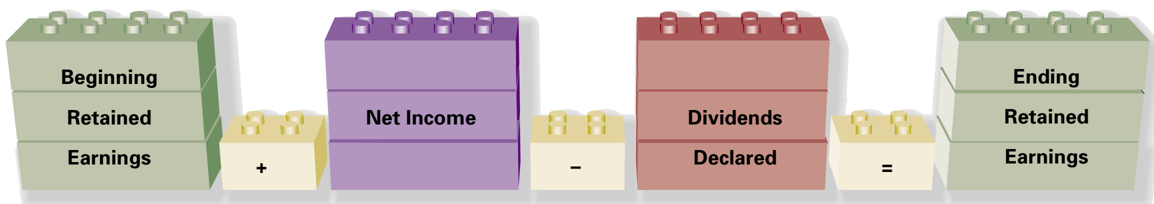
1. Column 1: E, E; Column 2: R, E.
2. Sales revenue in the amount of $5,103 (million) is reported. Sales revenue is normally reported on the income statement when goods or services have been delivered to customers who have either paid or promised to pay for them in the future.
3. Cost of goods sold expense is $2,692 (million). Expenses are the dollar amount of resources used to earn revenues during the period. Only those toys that have been delivered to customers have been used up. Those toys that were produced and are still on hand are part of the asset called inventories.

Net Income. To understand how successful Mattel was in generating a profit from its business operations, we need to consider both the revenues and the expenses at the same time. *Net Income* does this by meshing revenues and expenses into a single number. This combined (or "net") number indicates whether the inflow of resources from making sales (revenues) was greater or less than the outflow of resources (expenses) to generate those sales. In Mattel's case in 2004, the net income (or "bottom line") was $573 million. Nice.

3. The Statement of Retained Earnings

a. ***Purpose.*** The statement of retained earnings shows the amount of earnings that have been retained in the business and the amount of the company's resources paid out to shareholders as dividends.

b. ***Setup.*** As shown in Exhibit 1.5, Mattel's (adapted) statement of retained earnings has the customary heading and is followed by a body that reports the way that net income and dividends affected the company's financial position during the accounting period. The equation for the statement of retained earnings is:



A dividend is said to be **declared** when a company formally promises to pay out some of its resources to its owners.

Net income earned during the period increases the retained earnings balance. When a company **declares** dividends during the period, *Retained Earnings* decreases.

c. ***Content.*** The statement begins with Mattel's beginning-of-year *Retained Earnings* balance of $707 million. This beginning balance indicates the total net income of the company that has not been distributed to shareholders, added up from when the corporation was formed in 1948 to the beginning of the current year. The current year's *Net Income* of $573 million (as we saw earlier on the income statement in Exhibit 1.4) is then added to the beginning retained earnings balance. The next line subtracts *Dividends* totalling $187 million that were declared in 2004 to be paid to shareholders. The last line reports the new end-of-year retained earnings balance, which for Mattel was $1,093 million at December 31, 2004.

exhibit 1.5 **Sample Statement of Retained Earnings and Explanation of Items**

MATTEL, INC.
Statement of Retained Earnings
For the Year Ended December 31, 2004

Who: Name of the business
What: Title of the statement
When: Accounting period (for the year)

	(in millions)	
Retained Earnings, January 1, 2004	$707	Balance carried forward from previous year
Net Income for 2004	573	"Bottom line" from the income statement
Dividends Declared for 2004	(187)	Declared distributions to shareholders
Retained Earnings, December 31, 2004	$1,093	Balance at the end of this year

Notice that the ending retained earnings balance in Exhibit 1.5 is the same as the amount reported for *Retained Earnings* on Mattel's balance sheet in Exhibit 1.3. Thus, the statement of retained earnings shows how the income statement (and net income, in particular) links to the balance sheet (and retained earnings). We'll talk about this link in more detail later in this chapter.

Notice that dividends are reported in the statement of retained earnings *not* the income statement. Dividends are not an expense. They are a distribution of profits to shareholders.

4. The Statement of Cash Flows

a. ***Purpose.*** Most people are keenly interested in monitoring the balance in their own bank accounts, often asking questions such as: Why do I have only $23 left? Didn't my paycheque get deposited? Where did I spend all that money? These are precisely the kinds of questions that a statement of cash flows answers. The purpose of the statement of cash flows is to summarize how a business's operating, investing, and financing activities caused its cash balance to change over a particular period of time.

b. ***Setup.*** The statement of cash flows contains the now-familiar heading and a body. The body, unlike your personal bank statement, classifies cash increases (inflows) and decreases (outflows) into the three categories of business activities (operating, investing, and financing). As you can see from Mattel's (adapted) statement of cash flows in Exhibit 1.6, cash inflows are shown as positive numbers and cash outflows appear as negative numbers (in parentheses). A subtotal (called *net cash flow*) is reported at the bottom of each of the three main categories, and these three subtotals are added together to yield a total *Net Change in Cash*. When this total change is added to the *Beginning-of-Year Cash* balance, an *End-of-Year Cash* balance pops out. This end-of-year cash balance is precisely the amount reported for the asset account *Cash* on the balance sheet.

Negative amounts are reported in parentheses in the financial statements.

exhibit 1.6 **Sample Statement of Cash Flows and Explanation of Items**

MATTEL, INC.
Statement of Cash Flows
For the Year Ended December 31, 2004

Who: Name of the business
What: Title of the statement
When: Accounting period (for the year)
Other: Unit of measure

Cash Flows from Operating Activities	**(in millions)**	
Cash collected from customers	$4,888	Cash flow from making and selling toys
Cash paid to suppliers and employees	(2,636)	
Cash paid for other operating activities	(1,682)	
Net cash flow from operating activities	570	
Cash Flows from Investing Activities		
Cash paid to purchase equipment and other assets	(156)	Cash flow from buying/selling long-lived assets
Cash received from selling equipment and other assets	48	
Net cash flow from investing activities	(108)	
Cash Flows from Financing Activities		
Cash paid on notes payable and other financing	(271)	Cash flow from dealings with lenders/shareholders
Cash paid for dividends	(187)	
Net cash flow from financing activities	(458)	
Net Change in Cash During the Year	4	Change in cash (570 − 108 − 458)
Cash at Beginning of Year	1,152	Last period's ending cash balance
Cash at End of Year	$1,156	This period's ending cash on the balance sheet

c. ***Content.*** *Cash Flows from Operating Activities* are cash flows that are directly related to earning income. For example, when The Bay and other customers pay Mattel for the toys delivered to them, the statement of cash flows lists the amounts collected as "cash collected from customers." From the first line of the operating activities section of the statement of cash flows in Exhibit 1.6, you can see that Mattel received nearly $5 billion in cash from its customers during 2004. When Mattel pays salaries to its employees at its Design Centre, or pays bills received from supply companies like Dow Chemical, the statement of cash flows includes the amounts as "cash paid to suppliers and employees," as shown in the second line of the operating activities section. Other cash outflows for operating activities are shown in a similar manner.

Cash Flows from Investing Activities include cash flows related to the acquisition or sale of the company's long-lived assets. Exhibit 1.6 reports only one cash outflow from investing activities, the purchase of additional manufacturing equipment to meet growing demand for Mattel's toys. The company also reported a cash inflow of $48 million, which it received from selling some equipment and other long-lived assets.

Cash Flows from Financing Activities are directly related to financing the company itself. These cash flows involve receiving money from or paying money back to lenders and shareholders. We see from Exhibit 1.6 that Mattel paid down $271 million of its notes payable and other financing, and it also paid out $187 million in dividends to shareholders in 2004.

HOW'S IT GOING? A Self-Study Quiz

1. During 2004, Mattel delivered toys to customers who paid or promised to pay amounts totalling $5,103 (million). During the same period, Mattel collected $4,888 (million) in cash from its customers. Without referring to Exhibit 1.6, indicate which of the two amounts will be shown on Mattel's cash flow statement for 2004.

2. Learning which items belong in each cash flow statement category is an important first step in understanding their meaning. Without referring to Exhibit 1.6, use a letter to mark each item in the following list as a cash flow from Operating, Investing, or Financing activities. **Put parentheses around the letter if it is a cash *outflow* and use no parentheses if it's an *inflow*.**

☐	Cash paid to suppliers and employees	☐	Cash paid to purchase equipment
☐	Cash paid on note payable	☐	Cash collected from customers
☐	Cash paid for dividends	☐	Cash received from selling equipment

After you're done, check your answers with the solutions in the margin.

Quiz Answers

1. $4,888 (million) will be reported in the cash flow statement because this represents the actual cash collected from customers related to current and prior years' sales.
2. Column 1: (O), (F), (F)
Column 2: (I), O, I

Relationships among the Four Basic Financial Statements

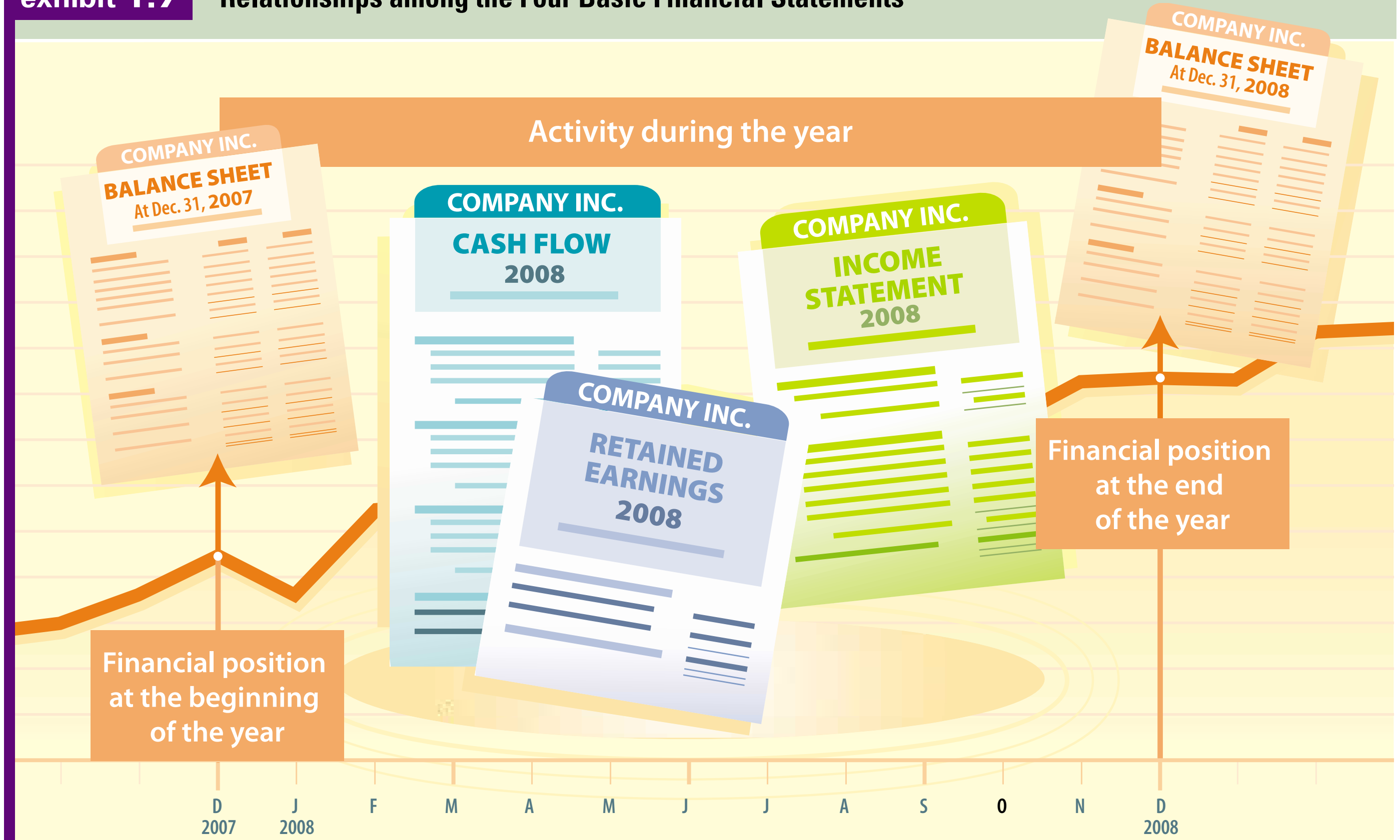
COACH'S CORNER

Learning how the four statements fit together is very important. Slow down and spend a little extra time on the next couple of pages.

The goal for this section is to show how the four statements fit together. Exhibit 1.7 presents one way to picture this, by reminding you that a balance sheet reports a snapshot of the company at a *point* in time whereas the other three statements cover a *period* of time. Think of the balance sheet on December 31, 2003 as the starting point for 2004 and the other three statements as explanations of what happened during the year (2004), ending on December 31, 2004, with a new balance sheet that presents an updated picture of the company.

In the real world, most companies do, in fact, present balance sheets at the two points in time shown in Exhibit 1.7. Rather than create two separate reports, though, they report these balance sheets using two columns of numbers on a single report. One column displays the balances at the end of the previous period (which is the starting point for the current period), and the other displays balances at the end of the current

exhibit 1.7 **Relationships among the Four Basic Financial Statements**



This exhibit shows how the statement of cash flows, statement of retained earnings. and income statement cover a period of time, explaining how the balance sheet changes from one point in time to another point in time.

period. An example of this **comparative** balance sheet format is shown in Exhibit 1.8. This comparative balance sheet acts as our starting point for showing how the financial statements connect together in the real world.

Comparative financial statements report numbers for two or more periods to make it easy for users to compare account balances from one period to the next.

Think of actually splitting the balance sheet apart to form two points on a timeline, with one end on the far left side of the page and the other on the far right. Imagine that, for *Cash* and *Retained Earnings*, there are lines linking their beginning and ending balance sheet amounts. If you click on the cash link, the statement of cash flows would pop up, showing how the cash balance changed during the year. If you click on the retained earnings link, the statement of retained earnings would pop up, showing how the retained earnings balance changed during the year. If you were to click on the net income number within the statement of retained earnings, the income statement would pop up, explaining how the company's operations improved or harmed Mattel's financial position during the year. Exhibit 1.9 shows the end result of these clicks and pop-ups.

In addition to the four reports that we've just described, the financial statements include two additional parts that you should know about: assurance statements and notes to the financial statements.

Assurance Statements

There are two assurance statements that generally appear directly before the four financial statements in a company's annual report:

1. ***The Management's Statement of Responsibility for Financial Reporting*** states that management is responsible for the integrity of the information contained in the statements and that they have taken steps to ensure that they can stand behind them.

Financial statements are prepared using common formatting styles:

- List assets in order of ease of conversion to cash.
- List liabilities in order of their due dates.
- Place a dollar sign next to the first dollar amount listed.
- Place a single underline below the last item in a group before a subtotal or total (e.g., total shareholders' equity).
- Place a double underline below and a dollar sign beside totals for complete groups (e.g., total assets).

exhibit 1.8 **Comparative Balance Sheet**

MATTEL, INC.
Balance Sheet
At December 31

	(in millions)	
Assets	**2004**	**2003**
Cash	$1,156	$1,153
Accounts Receivable	759	544
Inventories	418	389
Property, Plant, and Equipment	586	626
Other Assets	1,837	1,799
Total Assets	$4,756	$4,511
Liabilities		
Accounts Payable	$1,726	$1,468
Notes Payable	644	827
Total Liabilities	2,370	2,295
Shareholders' Equity		
Contributed Capital	1,293	1,509
Retained Earnings	1,093	707
Total Shareholders' Equity	2,386	2,216
Total Liabilities and Shareholders' Equity	$4,756	$4,511

2. ***The Independent Auditors' Report*** states that external accountants, who are independent of management and are called auditors, have examined the statements and believe that they follow the rules of accounting.

Notes to the Financial Statements

Notes provide additional information about the financial condition of a company, without which the financial statements cannot be fully understood.

The **notes** to the financial statements (or "footnotes") appear on the pages immediately *after* the four financial statements.

There are three types of financial statement notes:

1. ***Accounting policies.*** This type of note describes the accounting decisions that were made when preparing financial statements. For example, Mattel's accounting policy note for advertising and promotion describes how (and when) these costs are reported in Mattel's financial statements.
2. ***Contents included.*** This type of note presents additional detail about what's included in certain financial statement account balances. For example, Mattel's notes tell us that its "other assets" include the costs of trademarks and brand names.
3. ***Additional information.*** The third type of note provides additional financial disclosures about items not listed on the statements themselves. For example, Mattel rents warehouse space and the terms of these rental agreements (also known as leases) are disclosed in a note.

Unlike the footnotes in some articles and books, which you might gloss over, don't overlook the footnotes to the financial statements.

We've covered a lot of material to this point in the chapter. Exhibit 1.10 on page 18 summarizes the main points for each of the four basic financial statements. Notice that the fourth column provides examples of items included in each financial statement. For more formal definitions of these financial statement items, see the key terms presented in the margins of this chapter.

exhibit 1.9 Linking the Four Basic Statements

MATTEL, INC.
Statement of Cash Flows
For the Year Ended December 31, 2004
(in millions)

Cash Flows from Operating Activities	
Cash collected from customers	$4,888
Cash paid to suppliers and employees	(2,636)
Cash paid for other operating activities	(1,682)
Net cash flow from operating activities	570
Cash Flows from Investing Activities	
Cash paid to purchase equipment and other assets	(156)
Cash received from selling equipment	48
Net cash flow from investing activities	(108)
Cash Flows from Financing Activities	
Cash paid on notes payable and other financing	(271)
Cash paid for dividends	(187)
Net cash flow from financing activities	(458)
Net Change in Cash During the Year	4
Cash at Beginning of Year	1,152
Cash at End of Year	$1,156

MATTEL, INC.
Balance Sheet
At December 31
(in millions)

	2003	*2004*
Assets		
Cash	$1,153	$1,156
Accounts Receivable	544	759
Inventories	389	418
Property, Plant, and Equipment	626	586
Other Assets	1,799	1,837
Total Assets	$4,511	$4,756
Liabilities		
Accounts Payable	$1,468	$1,726
Notes Payable	827	644
Total Liabilities	2,295	2,370
Shareholders' Equity		
Contributed Capital	1,509	1,293
Retained Earnings	707	1,093
Total Shareholders' Equity	2,216	2,386
Total Liabilities and Shareholders' Equity	$4,511	$4,756

MATTEL, INC.
Statement of Retained Earnings
For the Year Ended December 31, 2004
(in millions)

Retained Earnings, January 1, 2004	$707
Net Income for 2004	**573**
Dividends Declared for 2004	(187)
Retained Earnings, December 31, 2004	$1,093

MATTEL, INC.
Income Statement
For the Year Ended December 31, 2004
(in millions)

Revenues	
Sales Revenue	$5,103
Total Revenues	5,103
Expenses	
Cost of Goods Sold Expense	2,692
Advertising and Promotion Expenses	643
Other Selling and Administrative Expenses	1,036
Interest Expense	35
Income Tax Expense	124
Total Expenses	4,530
Net Income	$ 573

exhibit 1.10 **Summary of Key Points**

Financial Statement	*Purpose: To report . . .*	*Setup*	*Examples of Content*
1. Balance sheet (also called the statement of financial position)	. . . what the business owns *at a particular point in time* and whether the financing for these items came from creditors or shareholders.	Assets = Liabilities + Shareholders' Equity	*Assets* include Mattel's cash in the bank, production equipment, and toys Mattel has made but not yet sold. *Liabilities* include amounts owed but not yet paid. *Shareholders' Equity* shows the amount owners have invested in the company.
2. Income statement (also called the statement of income, statement of operations, statement of earnings, statement of profit and loss)	. . . what the business has earned from its operating activities *over a period of time.*	Revenues − Expenses = Net Income	*Revenues* include what Mattel earns from selling toys. *Expenses* include Mattel's costs of running its business.
3. Statement of retained earnings	. . . the accumulated earnings retained in the business *over a period of time.*	Beginning Retained Earnings + Net Income (this period) − Dividends Declared (this period) = Ending Retained Earnings	*Net Income* is the net amount earned by the business during the period. *Dividends* indicate how much is distributed to the business's shareholders during the period.
4. Statement of cash flows	. . . the cash received and paid out by the business *over a period of time.*	Operating Activities Cash Flow + Investing Activities Cash Flow + Financing Activities Cash Flow = Change in Cash Balance + Beginning Cash Balance = Ending Cash Balance	*Operating* cash flow includes cash received from customers and cash paid to suppliers during the period. *Investing* cash flow includes cash used to buy factory buildings during the period. *Financing* cash flow includes exchanges of cash with lenders and owners during the period.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

GAAP (generally accepted accounting principles) are the rules for financial reporting

GAAS (generally accepted auditing standards) are the rules used by **auditors,** who report on whether a public company's financial statements are, in fact, prepared following GAAP.

Just as the inventors of Monopoly® had to come up with rules for that game, someone has to determine the rules for financial reporting, and for ensuring that the accounting rules keep up with the ever-changing nature of business. As it turns out, the system of financial statement reporting in use today has a long history—all the way back to a publication in 1494 by an Italian monk and mathematician, Luca Pacioli. Despite this long history, few hard-and-fast accounting rules existed until the 1930s. Until that time, most companies decided for themselves how and what to report in their financial statements. Following the dramatic stock market crash of 1929, the governments of both Canada and the United States enacted legislation designed to improve financial reporting and to protect investors. Since that time, rules called **generally accepted accounting principles,** or **GAAP** for short (pronounced like the name of the clothing store) have developed. To ensure accountants follow GAAP when preparing their company's financial statements, securities legislation requires that each public company hire independent **auditors** to scrutinize its financial records. Following rules called **generally accepted auditing standards (GAAS)**, the Auditors' Report discussed on page 16 states whether, in their opinion, the financial statements represent what they claim to represent and whether they comply with GAAP. In a sense, GAAP are to auditors and accountants what the criminal code is to lawyers and the public.

Who sets these accounting rules? Well, that depends on where your company operates. Most industrialized companies have their own national organization for setting accounting rules. In Canada, the Canadian Institute of Chartered Accountants (CICA) has this responsibility.[4] In the United States, it is the Financial Accounting Standards Board (FASB). Because so many companies operate internationally, there is also an International Accounting Standards Board (IASB) that has been instrumental in harmonizing accounting rules around the world. In 2005, the CICA declared its intention to phase out Canadian-made accounting rules for public companies over the next five years and to adopt the IASB rules. The CICA will, however, continue to set accounting rules for non-public entities in Canada.

POINT OF INTEREST

Harmonization does not mean accounting rules are identical across countries. Investors who want to compare the financial statements of an American company to those of a Canadian company, for example, have to be aware of differences that exist between the two sets of accounting rules.

EVALUATE

Results from the Perspective of Financial Statement Users

WHO CARES?

Now that you see what goes into financial statements, it's time to ask *who cares?* As Exhibit 1.11 shows, lots of people care. Financial statements are used by people inside the company and those outside it. In this course, we focus on decisions made by two important groups of external financial statement users: *investors* and *creditors*.

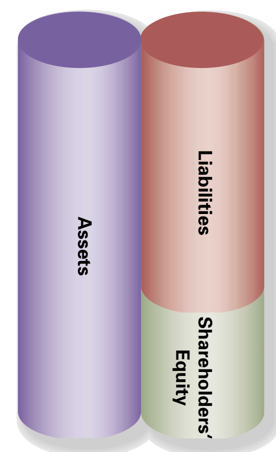
In general, investors and creditors use the four basic financial statements (and notes) to

1. ***Understand the current state of the business.***
2. ***Predict how the business is likely to do in the future.***

1. Using the Balance Sheet

Investors and creditors look at the balance sheet to see whether the company owns enough (assets) to pay all that it owes to creditors (liabilities) and still have enough left to distribute as dividends to shareholders and fund future operations (shareholders' equity). If assets are barely enough to cover liabilities, the company's future is at risk because if it does not pay its creditors on time, it can be forced to sell its assets to pay its liabilities. When this happens, the law requires that creditors be paid before investors receive any money, as illustrated in Exhibit 1.12.

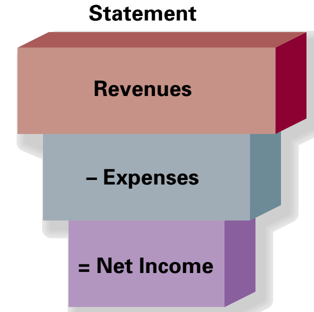
Balance sheet



2. Using the Income Statement

Investors and creditors are eager to analyze the income statement because it indicates whether a company made a profit during the current period. Also, by looking for a trend in a company's net income from year to year, users can get clues about the company's future earnings. Estimated future earnings are important to investors because they buy shares when they believe that future earnings will improve and lead to higher dividends and/or share prices. These estimates also are important to creditors because future earnings provide the resources to repay loans.

Income Statement



3. Using the Statement of Retained Earnings

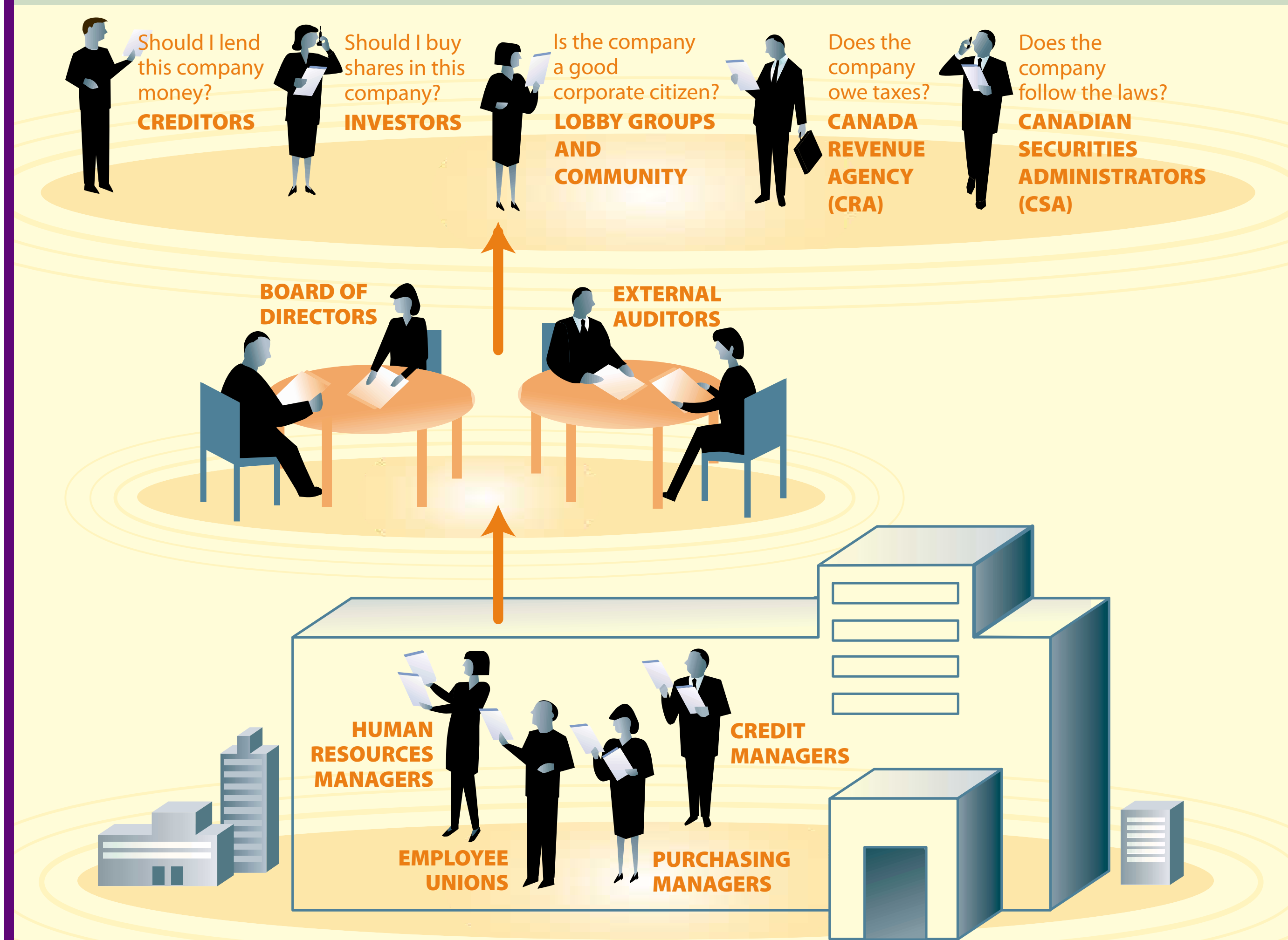
Creditors closely monitor the retained earnings statement because a company's policy on dividend payments to shareholders affects its ability to repay its debts. Every dollar from earnings that Mattel pays to shareholders as dividends is not available to use in paying back its debt to banks and other creditors. Investors, on the other hand, use the statement of retained earnings to evaluate whether the company favours paying out dividends or retaining its earnings to support future growth. There are two ways that an investor can make money owning shares in a company: (1) the company can pay dividends to the in-

Statement of Retained Earnings

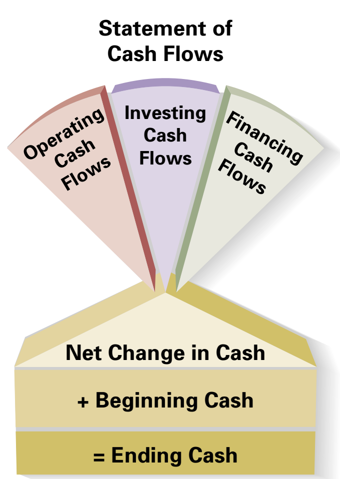
	Retained earnings, 1/1/07
+	Net income (2007)
−	Dividends declared (2007)
=	Retained earnings, 12/31/07

[4] The CICA receives input from a variety of interested groups in making these decisions and is further overseen by various boards set up to protect the public interest.

exhibit 1.11 **Financial Statement Users**



Financial statements are used by a variety of people, including managers inside the company and several groups outside the company.



vestors, or (2) if the company keeps profits in the business instead and uses them wisely, this should cause the company's share price to increase, and the investor can sell the shares for more than the purchase price. Some investors, perhaps your grandparents, prefer steady dividends, whereas others prefer that every dollar that Mattel makes in profit is kept for investing in additional factories and the latest manufacturing equipment.

4. Using the Statement of Cash Flows

The statement of cash flows indicates to investors and creditors how the company obtained and spent its money during the accounting period. The Operating Activities section indicates the company's ability to generate cash from sales to meet its current cash needs, and the Investing and Financing Activities sections indicate whether any money left over from operations was used to expand the company, pay back the bank debt, or pay dividends to shareholders. By comparing Mattel's statement of cash flows from year to year, users can find that Mattel generates plenty of cash from operations but has reduced its dividends in recent years.

exhibit 1.12 **Creditor and Shareholder Claims**

When a company goes out of business, creditors have the first claim to the company's assets. Assets are distributed to the shareholders only after satisfying the creditors' claims. In this sense shareholders stand in line behind the creditors.

Using the Notes and Other Reports

All financial statement users need to understand the rules used in computing the numbers on the financial statements. A swim coach would never try to evaluate a swimmer's time in the 100 freestyle without first asking if the time was for a race in metres or in yards. Likewise, a financial statement user should never attempt to use accounting information without reading the notes that describe the rules used to prepare the financial statements. Information in the notes can dramatically influence your interpretation of the main statements. Consider them the equivalent of Health Canada's warning on a package of cigarettes.

In addition to reading the notes to the financial statements, users also consider the information reported in the auditors' report. This report describes whether the financial statements present a fair picture of the company, and whether they are prepared using methods allowed by GAAP. The purpose of the auditors' report isn't to tell you if a company is about to go broke, but it is the best protection against having a company's accountants and executives unintentionally or intentionally prepare misleading financial reports.

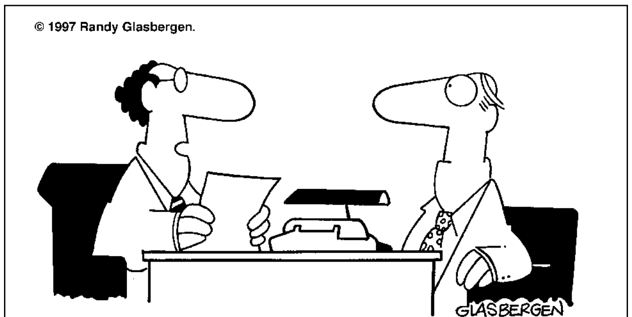
RECONSIDER

How Financial Statement Reporting Informs Users

ETHICAL ISSUES

THE GLIMPSE INSIDE

Do you remember Mattel's problem from the opening of this chapter? Its managers had to tell investors and creditors that the company lost $431 million (in 2000) without alarming them. They needed to be ethical and report the bad news about the loss honestly and, at the same time, convey to users good news that Mattel was still strong. By being honest with the bad news, Mattel's managers could begin to develop a reputation for honest reporting. This reputation could help in the long run because it would make users more likely to believe Mattel's managers when they have good news to report in the future.



"The bad news is, you do less work than anyone in this office. The good news is, you make the fewest mistakes."

POINT OF INTEREST

Mattel executives have learned the importance of honest financial reporting. Three decades earlier, six Mattel executives were charged with including fictitious sales in the company's financial statements. The fun and games ended with the Mattel execs paying over $30 million to settle lawsuits filed by angry investors and creditors. As the saying goes, today's good decisions come from experience, which itself comes from yesterday's bad decisions.

Fortunately for Mattel, the $431-million loss in 2000 wasn't caused by poor toy sales. Instead, it was a result of a failed attempt to get into the software entertainment industry. Mattel had bought The Learning Company (TLC)—a business that produced kids' computer software under the Reader Rabbit® brand name. At the time of Mattel's purchase, TLC seemed to be doing well, having generated sales increases of 25 percent in each of the last three quarters leading up to the purchase. In the quarter after the purchase, however, Mattel ran into big losses from TLC. Mattel stuck with TLC for a year and a half, trying to make it profitable. But the longer Mattel tried, the more the losses mounted. Finally, Mattel admitted defeat and decided to get rid of TLC, confirming what some analysts had been calling one of the biggest acquisition failures of all time.

A GLANCE OUTSIDE

How did users take the news when Mattel announced the losses from TLC? Not well. Mattel's stock price fell about 30 percent. In addition to selling their Mattel stock, shareholders filed a lawsuit claiming that TLC's financial statements, which led Mattel to buy TLC, were fraudulently misstated. In an ironic turn of events, Mattel was named as a defendant in this lawsuit as TLC's former owner.[5] Mattel has since settled the lawsuit for $122 million.

WHAT'S COMING UP

In this chapter, you studied the basic financial statements that give external users an idea of how things are doing inside the company. The next chapter will take you deep inside a company to learn about the detailed steps involved in determining the amounts reported in each financial statement. To get ready for Chapter 2, use the materials in the following sections to review and practise what we covered in this chapter.

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[5] U.S. District Court Class Action Complaint 99-CV-10619, retrieved June 2, 2004, from http://securities.stanford.edu/1009/MAT99/003.html.

FOR YOUR REVIEW

DEMONSTRATION CASE

The introductory case presented here reviews the items reported on the income statement and balance sheet, using the financial statements of Tim Hortons. Tim Hortons® opened its first coffee and doughnut shop in Ontario in 1964. Founded by NHL hockey player Tim Horton, and expanded under the direction of Ron Joyce, the highly successful chain was sold to Wendy's International in 1995. Wendy's subsequently sold off 18 percent of Tim Hortons in a red-hot stock offering to the public in March 2006. Tim Hortons currently has almost 3,000 stores and has passed McDonald's to become Canada's favourite fast-food operator. Following is a list of the financial statement items and amounts adapted from a recent Tim Hortons Inc. balance sheet and income statement. The numbers are presented in millions of dollars for the year ended December 31, 2005.

Accounts payable	$ 110
Accounts receivable	86
Cash	186
Contributed capital	39
Income tax expense	84
Inventories	39
Net income	191
Notes payable	1,137
Operating expenses	1,192
Other assets	224
Other expenses	15
Other liabilities	311
Property and equipment	1,062
Retained earnings	0
Sales revenues	960
Total assets	1,597
Total expenses	1,291
Total liabilities	1,558
Total liabilities and shareholders' equity	1,597
Franchise revenues	522
Total shareholders' equity	39

Required:

1. Prepare a balance sheet and an income statement for the year, following the formats in Exhibits 1.3 and 1.4.
2. Describe the content of these two statements.
3. Name the other two statements that Tim Hortons would include in its financial statements.
4. Did financing for Tim Hortons' assets come primarily from liabilities or shareholders' equity?
5. Explain why Tim Hortons would subject its statements to an independent audit.

eXcel

COACH'S CORNER

At the end of most chapters, one or more demonstration cases are presented. These cases show you how to apply the material from the chapter to a problem similar to what you are likely to be asked to do as homework. It's worth your effort to do the demo case before studying the suggested solution.

Suggested Solution

1.

TIM HORTONS INC.
Balance Sheet
At December 31, 2005
(in millions of dollars)

Assets	
Cash	$ 186
Accounts receivable	86
Inventories	39
Property and equipment	1,062
Other assets	224
Total assets	**$ 1,597**
Liabilities	
Accounts payable	$ 110
Notes payable	1,137
Other liabilities	311
Total liabilities	1,558
Shareholders' Equity	
Contributed capital	39
Retained earnings	0
Total shareholders' equity	39
Total liabilities and shareholders' equity	**$ 1,597**

COACH'S CORNER

It is odd for a company as old and as profitable as Tim Hortons to have $0 in retained earnings. If we had prepared a statement of retained earnings for 2005, it would have shown how this occured.

TIM HORTONS INC.
Income Statement
For the Year Ended December 31, 2005
(in millions of dollars)

Revenues	
Sales revenues	$ 960
Franchise revenues	522
Total revenues	1,482
Expenses	
Operating expenses	1,192
Income tax expense	84
Other expenses	15
Total expenses	1,291
Net income	**$ 191**

2. The balance sheet reports the amount of assets, liabilities, and shareholders' equity of a business at a point in time. The income statement reports the most common measure of financial performance for a business: net income (revenues minus expenses during the accounting period).
3. Tim Hortons would also present a statement of retained earnings and a statement of cash flows.
4. Financing for Tim Hortons' assets is provided almost entirely from liabilities ($1,558) rather than shareholders' equity ($39).
5. Users will have greater confidence in the accuracy of financial statement information if they know that it has been audited, particularly because the people who audited the statements are required to meet professional standards of ethics and competence.

CHAPTER SUMMARY

Distinguish operating, investing, and financing activities. p. 4 — LO1

- *Operating activities* include day-to-day events involved in making and delivering goods and services.
- *Investing activities* involve buying or selling longer-term assets such as land and buildings.
- *Financing activities* are related to exchanging money with lenders or owners.

Describe the purpose, setup, and content of the four basic financial statements. p. 6 — LO2

- The *balance sheet* reports what the business owns (reported as assets) at a particular point in time and whether the financing for these assets came from creditors (reported as liabilities) or shareholders (reported as shareholders' equity).
- The *income statement* reports the net amount that a business earned (net income) over a period of time by subtracting the costs of running the business (expenses) from the total amount earned (revenues).
- The *statement of retained earnings* explains changes in the retained earnings account over a period of time by considering increases (from net income) and decreases (from dividends to shareholders).
- The *statement of cash flows* explains changes in the cash account over a period of time by reporting inflows and outflows of cash from the business's operating, investing, and financing activities.

Explain the primary goals of financial statement users. p. 19 — LO3

- Although the particular interests of the various financial statement users differ somewhat, they ultimately are interested in using the financial statements to
  1. Understand the current state of the business.
  2. Predict how the business is likely to do in the future.

Describe the importance of ethics and reputation in accounting. p. 22 — LO4

- Users have confidence in the accuracy of financial statement numbers when the people associated with their preparation and audit have reputations for ethical behaviour and competence.

KEY TERMS TO KNOW

Accounting p. 5
Accounts p. 8
Assets p. 7
Auditors p. 18
Basic Accounting Equation p. 7
Comparative Information p. 15
Corporations p. 4
Creditors p. 7
Declaration Date p. 12
Dividends p. 9
Expenses p. 10
Financial Statements p. 4
Financial Statement Users p. 4
Financing Activities p. 4
Generally Accepted Accounting Principles (GAAP) p. 18
Generally Accepted Auditing Standards (GAAS) p. 18
Income Statement (Statement of Income, Statement of Earnings, Statement of Operations, or Statement of Profit and Loss) p. 6
Investing Activities p. 4
Liabilities p. 7
Net Income p. 10
Notes (Footnotes) p. 16
Operating Activities p. 4
Partnerships p. 4
Public Companies p. 5
Revenues p. 10
Separate-Entity Concept p. 7
Shareholders' Equity p. 7

FOR YOUR PRACTICE

QUESTIONS

1. Define *accounting*.
2. Briefly distinguish financial accounting from managerial accounting.
3. The accounting process generates financial reports for both internal and external users. Describe some of the specific groups of internal and external users.
4. Briefly distinguish investors from creditors.
5. Explain what the separate entity concept means when it says a business is treated as separate from its owners for accounting purposes.
6. Complete the following:

	Name of Statement		Alternative Title
a.	Income statement	*a.*	____________
b.	Balance sheet	*b.*	____________

7. What information should be included in the heading of each of the four primary financial statements?
8. What are the purposes of (*a*) the balance sheet, (*b*) the income statement, (*c*) the statement of retained earnings, and (*d*) the statement of cash flows?
9. Explain why the income statement, statement of retained earnings, and statement of cash flows would be dated "For the Year Ended December 31, 2007," whereas the balance sheet would be dated "At December 31, 2007."
10. Briefly explain the importance of assets and liabilities to the decisions of investors and creditors.
11. Briefly define the following: *net income* and *net loss*.
12. Describe the basic accounting equation that underlies the balance sheet. Define the three major components reported on the balance sheet.
13. Describe the equation that underlies the income statement. Explain the three major items reported on the income statement.
14. Describe the equation that underlies the statement of retained earnings. Explain the four major items reported on the statement of retained earnings.
15. Describe the equation that underlies the statement of cash flows. Explain the three major types of activities reported on the statement.
16. Who is responsible for developing accounting rules (generally accepted accounting principles) in Canada?

MULTIPLE CHOICE

Select the one alternative that best answers the question or completes the sentence.

1. Which of the following is *not* one of the four basic financial statements?
   a. The balance sheet
   b. The audit report
   c. The income statement
   d. The statement of cash flows
2. Which of the following is true regarding the income statement?
   a. The income statement is sometimes called the statement of earnings.
   b. The income statement reports revenues, expenses, and liabilities.
   c. The income statement only reports revenue for which cash was received at the point of sale.
   d. The income statement reports the financial position of a business at a particular point in time.
3. Which of the following is false regarding the balance sheet?
   a. The accounts shown on a balance sheet represent the basic accounting equation for a particular business.
   b. The retained earnings balance shown on the balance sheet must agree to the ending retained earnings balance shown on the statement of retained earnings.
   c. The balance sheet summarizes the net changes in specific account balances over a period of time.
   d. The balance sheet reports the amount of assets, liabilities, and shareholders' equity of a business at a point in time.

4. Which of the following regarding retained earnings is false?
- *a.* Retained earnings is increased by net income.
- *b.* Retained earnings is a component of shareholders' equity on the balance sheet.
- *c.* Retained earnings is an asset on the balance sheet.
- *d.* Retained earnings represents earnings not distributed to shareholders in the form of dividends.

5. Which of the following is not one of the items required to be shown in the heading of a financial statement?
- *a.* The financial statement preparer's name.
- *b.* The title of the financial statement.
- *c.* The financial reporting date or period.
- *d.* The name of the business entity.

6. How many of the following statements regarding the statement of cash flows are true?
- The statement of cash flows separates cash inflows and outflows into three major categories: operating, investing, and financing.
- The ending cash balance shown on the statement of cash flows must agree with the amount shown on the balance sheet at the end of the same period.
- The total increase or decrease in cash shown on the statement of cash flows must agree to the "bottom line" (net income or net loss) reported on the income statement.

- *a.* None
- *b.* One
- *c.* Two
- *d.* Three

7. Which of the following is not a typical footnote included in an annual report?
- *a.* A note describing the auditors' opinion of the management's past and future financial planning for the business.
- *b.* A note providing more detail about a specific item shown in the financial statements.
- *c.* A note describing the accounting rules applied in the financial statements.
- *d.* A note describing financial disclosures about items not appearing in the financial statements.

8. Which of the following regarding GAAP is true?
- *a.* GAAP is an abbreviation for goodie, another accounting problem.
- *b.* Changes in GAAP do not affect the amount of income reported by a company.
- *c.* GAAP is the abbreviation for generally accepted accounting principles.
- *d.* Changes to GAAP must be approved by the federal government.

9. Which of the following is true?
- *a.* CICA creates IASB.
- *b.* GAAP creates CICA.
- *c.* GAAP creates CRA.
- *d.* CICA creates GAAP.

10. Which of the following would *not* be a goal of external users reading a company's financial statements?
- *a.* Understanding the current financial state of the company.
- *b.* Assessing the company's contribution to social and environmental policies.
- *c.* Predicting the company's future financial performance.
- *d.* Evaluating the company's ability to generate cash from sales.

Solutions to Multiple-Choice Questions
1. b 2. a 3. c 4. c 5. a 6. c 7. a 8. c 9. d 10. b

MINI-EXERCISES

M1-1 Identifying Definitions with Abbreviations

LO3

The following is a list of important abbreviations used in the chapter. These abbreviations also are used widely in business. For each abbreviation, give the full name. The first one is an example.

	Abbreviation	Full Name
1.	IASB	International Accounting Standards Board
2.	GAAP	______________
3.	CICA	______________
4.	CSA	______________

LO1–LO3 M1-2 Matching Definitions with Terms or Abbreviations

Match each definition with its related term or abbreviation by entering the appropriate letter in the space provided.

Term or Abbreviation

____ 1. Investing activities
____ 2. Private company
____ 3. Corporation
____ 4. Accounting
____ 5. Audit report
____ 6. Partnership
____ 7. CICA
____ 8. Financing activities
____ 9. Separate entity
____ 10. GAAP
____ 11. Public company
____ 12. Operating activities

Definition

A. A system that collects and processes financial information about an organization and reports that information to decision makers.
B. The financial statements of a company include only the results of that company's business activities.
C. An unincorporated business owned by two or more persons.
D. A company that sells its shares privately and does not release its financial statements to the public.
E. An incorporated business that issues shares as evidence of ownership.
F. Purchases and disposals of long-term assets.
G. Transactions with lenders (borrowing and repaying cash) and shareholders (selling company shares and paying dividends).
H. Day-to-day activities related to a company's core business.
I. A report that describes the auditors' opinion of the fairness of the financial statement presentations and the evidence gathered to support that opinion.
J. Canadian Institute of Chartered Accountants.
K. A company that has its shares bought and sold by investors on established stock exchanges.
L. Generally accepted accounting principles.

LO2 M1-3 Matching Items to Balance Sheet and Income Statement Categories

According to its website, Sun-Rype Products Ltd. is a leading Canadian manufacturer and marketer of juice-based beverages and all-natural fruit snacks, including Blue Label Apple Juice and Fruit to Go snacks. Based in the Okanagan Valley of British Columbia, Sun-Rype operates one of the most sophisticated processing plants in North America. The following are items taken from its recent balance sheet and income statement. Mark each item in the following list with letters to indicate whether it would be reported as an Asset, Liability, or Shareholders' Equity account on the balance sheet or a Revenue or Expense account on the income statement.

____ 1. Accounts payable
____ 2. Accounts receivable
____ 3. Cash
____ 4. Cost of goods sold expense
____ 5. Property, plant, and equipment
____ 6. Income tax expense
____ 7. Interest expense
____ 8. Inventories
____ 9. Selling and administrative expenses
____ 10. Sales revenue
____ 11. Notes payable
____ 12. Retained earnings

LO2 M1-4 Matching Financial Statement Items to Balance Sheet and Income Statement Categories

Mark each item in the following list with letters to indicate whether it would be reported as an Asset, Liability, or Shareholders' Equity account on the balance sheet or a Revenue or Expense account on the income statement.

____ 1. Retained earnings
____ 2. Accounts receivable
____ 3. Sales revenue
____ 4. Property, plant, and equipment
____ 5. Cost of goods sold expense
____ 6. Inventories
____ 7. Advertising expense
____ 8. Accounts payable

M1-5 Matching Financial Statement Items to Balance Sheet and Income Statement Categories
LO2

McCain Foods is the number one French fry maker in the world, processing about a million pounds of French fries and other potato products per hour. The McCain family began producing French fries in 1957 and they still own the New Brunswick company. For the following items, mark each item from the balance sheet as an Asset, Liability, or Shareholders' Equity and each item from the income statement as a Revenue or Expense.

____ 1.	Accounts payable	____ 7.	Cash
____ 2.	Accounts receivable	____ 8.	Machinery
____ 3.	Cost of goods sold expense	____ 9.	Promotion and advertising expenses
____ 4.	Selling and administrative expenses	____ 10.	Sales revenue
____ 5.	Income tax expense	____ 11.	Notes payable to banks
____ 6.	Inventories	____ 12.	Retained earnings

M1-6 Matching Financial Statement Items to Balance Sheet and Income Statement Categories
LO2

Maple Leaf Foods is a Canadian manufacturer of food products, operating under the Maple Leaf, Schneider, and Dempster's brands. The following items were presented in the company's financial statements. Mark each item from the balance sheet as an Asset, Liability, or Shareholders' Equity and each item from the income statement as a Revenue or Expense.

____ 1.	Inventories	____ 7.	Cash
____ 2.	Accounts payable	____ 8.	Retained earnings
____ 3.	Contributed capital	____ 9.	Operating expenses
____ 4.	Property, plant, and equipment	____ 10.	Interest expense
____ 5.	Accounts receivable	____ 11.	Income tax expense
____ 6.	Notes payable	____ 12.	Sales revenue

M1-7 Matching Financial Statement Items to Balance Sheet and Income Statement Categories
LO2

Shell Canada is one of the largest integrated petroleum companies in Canada. The following items were presented in the company's financial statements. Mark each item from the balance sheet as an Asset, Liability, or Shareholders' Equity and each item from the income statement as a Revenue or Expense.

____ 1.	Accounts payable	____ 7.	Contributed capital
____ 2.	Inventories	____ 8.	Accounts receivable
____ 3.	Cash	____ 9.	Sales revenue
____ 4.	Retained earnings	____ 10.	Selling and administration expenses
____ 5.	Property, plant, and equipment	____ 11.	Exploration expense
____ 6.	Notes payable	____ 12.	Cost of goods sold expense

M1-8 Matching Financial Statement Items to the Four Basic Financial Statements
LO1, LO2

Match each element with its financial statement by entering the appropriate letter in the space provided.

	Element		Financial Statement
____ 1.	Expenses	A.	Balance sheet
____ 2.	Cash flows from investing activities	B.	Income statement
____ 3.	Assets	C.	Statement of retained earnings
____ 4.	Dividends declared	D.	Statement of cash flows
____ 5.	Revenues		
____ 6.	Cash flows from operating activities		
____ 7.	Liabilities		
____ 8.	Cash flows from financing activities		

LO1, LO2 **M1-9 Matching Financial Statement Items to the Four Basic Financial Statements**

Oakley, Inc., manufactures sunglasses, goggles, shoes, watches, footwear, and clothing. Recently, the company reported the following items in its financial statements. Indicate whether these items appeared on the balance sheet (B/S), income statement (I/S), statement of retained earnings (SRE), or statement of cash flows (SCF).

________ 1. Total shareholders' equity
________ 2. Sales revenue
________ 3. Total assets
________ 4. Cash flows from operating activities
________ 5. Total liabilities
________ 6. Net income
________ 7. Cash flows from financing activities
________ 8. Dividends declared

LO2 **M1-10 Reporting Amounts on the Income Statement**

During a recent year, Maple Leaf delivered boxes of hot dogs, buns, and other products for which customers paid or promised to pay amounts totalling $6,364,983,000. During the same period, it collected $6,314,827,000 in cash from its customers. Indicate which of these two amounts will be shown on Maple Leaf's income statement as *sales revenue*.

LO2 **M1-11 Reporting Amounts on the Income Statement**

During a recent year, Shell Canada delivered gas, oil, and other products for which customers paid or promised to pay amounts totalling $11,228,000,000. During the same period, it collected $10,510,000,000 in cash from its customers. Indicate which of these two amounts will be shown on Shell Canada's income statement as *sales revenue*.

LO2 **M1-12 Reporting Amounts on the Income Statement**

During a recent year, assume that Maple Leaf *produced* sliced meats, bread, and other products with a total cost of production of $5,568,231,000. During the same period, it *delivered* to customers sliced meats, bread, and other products that cost a total of $5,574,034,000 to produce. Indicate which of the two numbers will be shown on Maple Leaf's income statement as *cost of goods sold expense*.

LO2 **M1-13 Reporting Amounts on the Income Statement**

During a recent year, Shell Canada *produced* petroleum products with a total cost of production of $6,590,000,000. During the same period, it *delivered* to customers petroleum products that cost a total of $6,068,000,000 to produce. Indicate which of the two numbers will be shown on Shell Canada's income statement as *cost of goods sold expense*.

LO1 **M1-14 Reporting Amounts on the Statement of Cash Flows**

During a recent year, Maple Leaf delivered hot dogs, buns, and other products to customers who paid or promised to pay amounts totalling $6,364,983,000. During the same period, Maple Leaf collected $6,314,827,000 in cash from its customers. Indicate which of the two amounts will be shown on Maple Leaf's cash flow statement.

LO1 **M1-15 Reporting Amounts on the Statement of Cash Flows**

During a recent year, Shell Canada delivered gas, oil and other products to customers who paid or promised to pay amounts totalling $11,228,000,000. During the same period, Shell Canada collected $10,510,000,000 in cash from its customers. Indicate which of the two amounts will be shown on Shell Canada's cash flow statement.

LO1 **M1-16 Reporting Amounts on the Statement of Cash Flows**

Learning which items belong in each cash flow statement category is an important first step in understanding their meaning. Use a letter to mark each item in the following list as a cash flow from Operating, Investing, or Financing activities. **Put parentheses around the letter if it is a cash *outflow* and use no parentheses if it's an *inflow*.**

____ 1. Cash paid for dividends
____ 2. Cash collected from customers
____ 3. Cash received from notes payable
____ 4. Cash paid to suppliers and employees
____ 5. Cash paid to purchase equipment
____ 6. Cash received from issuing shares

M1-17 Reporting Amounts on the Statement of Cash Flows — LO1

Learning which items belong in each category of the statement of cash flows is an important first step in understanding their meaning. Use a letter to mark each item in the following list as a cash flow from Operating, Investing, or Financing activities. **Put parentheses around the letter if it is a cash *outflow* and use no parentheses if it's an *inflow*.**

____ 1. Cash paid to purchase equipment
____ 2. Cash collected from customers
____ 3. Cash received from selling equipment
____ 4. Cash paid for dividends
____ 5. Cash paid to suppliers and employees
____ 6. Cash received from issuing shares

EXERCISES

E1-1 Reporting Amounts on the Four Basic Financial Statements — LO2

Using the figures listed in the table below and the equations underlying each of the four basic financial statements, show (*a*) that the balance sheet is in balance, (*b*) that net income is properly calculated, (*c*) what caused changes in the retained earnings account, and (*d*) what caused changes in the cash account.

Assets	$18,200	Beginning Retained Earnings	$3,500
Liabilities	13,750	Ending Retained Earnings	4,300
Shareholders' Equity	4,450	Cash Flows from Operating Activities	1,600
Revenue	10,500	Cash Flows from Investing Activities	(1,000)
Expenses	9,200	Cash Flows from Financing Activities	(900)
Net Income	1,300	Beginning Cash	1,000
Dividends	500	Ending Cash	700

E1-2 Reporting Amounts on the Four Basic Financial Statements — LO2

Using the figures listed in the table below and the equations underlying each of the four basic financial statements, show (*a*) that the balance sheet is in balance, (*b*) that net income is properly calculated, (*c*) what caused changes in the retained earnings account, and (*d*) what caused changes in the cash account.

Assets	$79,500	Beginning Retained Earnings	$20,500
Liabilities	18,500	Ending Retained Earnings	28,750
Shareholders' Equity	61,000	Cash Flows from Operating Activities	15,700
Revenue	32,100	Cash Flows from Investing Activities	(7,200)
Expenses	18,950	Cash Flows from Financing Activities	(5,300)
Net Income	13,150	Beginning Cash	3,200
Dividends	4,900	Ending Cash	6,400

E1-3 Preparing a Balance Sheet — LO2, LO3

Dave & Buster's Inc. is a restaurant/entertainment company. Founded in 1982, D&B provides high-quality food and beverage items, combined with an extensive array of interactive entertainment attractions such as pocket billiards, shuffleboard, state-of-the-art simulators, and virtual reality and traditional carnival-style amusements and games of skill. A recent November 3 balance sheet contained the following items (in thousands).

Cash	$ 5,841
Contributed capital	114,969
Accounts payable	42,948
Inventories	26,249
Notes payable	94,550
Property and equipment	255,252
Other assets	15,974
Retained earnings	50,849
Total assets	303,316
Total liabilities and shareholders' equity	?

Required:

1. Prepare the balance sheet as of November 3, solving for the missing amount.
2. What is Dave & Buster's biggest asset?
3. As of November 3, did most of the financing for assets come from creditors or shareholders?

LO2, LO3

E1-4 Completing a Balance Sheet and Inferring Net Income

Terry Lloyd and Jean Dupuis organized Read More Store as a corporation; each contributed $50,000 cash to start the business and received 4,000 shares. The store completed its first year of operations on December 31, 2007. On that date, the following financial items for the year were determined: December 31, 2007, cash on hand and in the bank, $48,900; December 31, 2007, amounts due from customers from sales of books, $26,000; property and equipment, $48,000; December 31, 2007, amounts owed to publishers for books purchased, $8,000; one-year note payable to a local bank for $2,120. No dividends were declared or paid to the shareholders during the year.

Required:

1. Complete the following balance sheet as of the end of 2007.

____

____

____

Assets		**Liabilities**		
Cash	$ ______	Accounts payable	$ ______	
Accounts receivable	______	Note payable	______	
Property plant, and equipment	______	Total liabilities		$ ______
		Shareholders' Equity		
		Contributed capital	______	
		Retained earnings	12,780	
		Total shareholders' equity		______
Total assets	**$** ______	**Total liabilities and shareholders' equity**		**$** ______

2. Using the retained earnings equation and an opening balance of $0, compute the amount of net income for the year.
3. As of December 31, 2007, did most of the financing for assets come from creditors or shareholders?

LO2

E1-5 Analyzing Revenues and Expenses and Preparing an Income Statement

Assume that you are the owner of The Sports Shop, which specializes in selling sports T-shirts and caps. At the end of January 2007, you find (for January only) this information:

a. Sales, per the cash register tapes, of $120,000, plus one sale on credit (a special situation) of $1,000.

b. With the help of a friend, you determined that all of the goods sold during January had cost $40,000 to purchase.

c. During the month, according to the chequebook, you paid $38,000 for selling, administration, interest, and other expenses; however, you have not yet paid the $600 monthly advertising expense for January.

Required:

On the basis of the data given (and ignoring income taxes), what was the amount of income for January? Show computations.

E1-6 Preparing an Income Statement and Inferring Missing Values

LO2, LO3

Leon's Furniture, which sells home furnishings, major appliances, and home entertainment items in nine provinces, was founded in 1909 in Weston, Ontario. It is still owned and operated by the Leon family. Its recent annual income statement contained the following items (in millions):

Cost of goods sold expense	$206.5
Net income	?
Sales revenue	352.5
Selling and administrative expenses	98.9
Income tax expense	17.1
Total expenses	?

Hint: First put the items in the order they would appear on the income statement and then solve for the missing values.

Required:

1. Solve for the missing amounts and prepare an income statement for the year ended December 31.
2. What is Leon's biggest expense?
3. What is Leon's markup percentage? (Markup is the difference between what an item costs Leon's to buy and what it sells the item for. This is also called the gross profit or gross margin percentage. [Hint: Use Leon's numbers above to determine the percentage. Express the markup as a percentage of cost.])

E1-7 Analyzing Revenues and Expenses and Completing an Income Statement

LO2

Home Realty, Incorporated, has been operating for three years and is owned by three investors. J. Doe owns 60 percent of the total stock of 9,000 shares outstanding and is the managing executive in charge. On December 31, 2007, the following financial items for the entire year were determined: sales revenue earned and collected in cash, $150,000, plus $16,000 not yet collected; selling expenses paid, $97,000; interest expense paid, $5,775 (not including December interest of $525 yet to be paid); promotion and advertising expenses paid, $9,025; and income tax expense paid, $18,500. There were no other unpaid expenses at December 31. Also during the year, the company declared and paid the owners dividends amounting to $12,000. Complete the following income statement:

____

____

____

Revenues		
Sales revenue		$ ______
Expenses		
Selling expenses	$ ______	
Interest expense	______	
Promotion and advertising expenses	______	
Income tax expense	______	
Total expenses		______
Net income		$ 35,175

LO2

E1-8 Inferring Values Using the Income Statement and Balance Sheet Equations

Review the chapter explanations of the income statement and the balance sheet equations. Apply these equations in each of the following independent cases to compute the two missing amounts for each case. Assume that it is the end of 2007, the first full year of operations for the company.

COACH'S CORNER

Hint: In E1-8, first identify the numerical relations among the columns using the balance sheet and income statement equations. Then compute the missing amounts.

Independent Cases	*Total Revenues*	*Total Expenses*	*Net Income (Loss)*	*Total Assets*	*Total Liabilities*	*Shareholders' Equity*
A	$100,000	$82,000	$______	$150,000	$70,000	$______
B	______	80,000	12,000	112,000	______	60,000
C	80,000	86,000	______	104,000	26,000	______
D	50,000	______	13,000	______	22,000	77,000
E	______	81,000	(6,000)	______	73,000	28,000

LO2, LO3

E1-9 Preparing an Income Statement and Balance Sheet

Five individuals organized Clay Corporation on January 1, 2007. At the end of January 2007, the following monthly financial data are available:

Total revenues	$130,000
Other expenses (excluding income taxes)	80,000
Income tax expense (all paid as of January 31)	15,000
Cash balance, January 31, 2007	30,000
Accounts receivable from customers (all considered collectible)	15,000
Inventory (by inventory count at cost)	42,000
Accounts payable to suppliers for merchandise purchased from them (will be paid during February 2007)	26,000
Contributed capital (2,600 shares)	26,000

No dividends were declared or paid during January.

Required:

1. Complete the following balance sheet and income statement for the month of January.

CLAY CORPORATION
Income Statement
For the Month of January 2007

Total revenues	$ ______
Other expenses (excluding income tax)	______
Income tax expense	______
Net income	$ ______

CLAY CORPORATION
Balance Sheet
At January 31, 2007

Assets	
Cash	$ ______
Accounts receivable	______
Inventory	______
Total assets	**$ ______**
Liabilities	
Accounts payable	$ ______
Total liabilities	______

Shareholders' Equity	
Contributed capital	______
Retained earnings	______
Total shareholders' equity	______
Total liabilities and shareholders' equity	**$** ______

2. Discuss whether Clay Corporation will be able to pay its liabilities.

E1-10 Analyzing and Interpreting an Income Statement — LO3

Three individuals organized Pest Away Corporation on January 1, 2007, to provide insect extermination services. At the end of 2007, the following income statement was prepared:

PEST AWAY CORPORATION
Income Statement
For the Year Ended December 31, 2007

Revenues		
Sales revenue (cash)	$192,000	
Sales revenue (credit)	24,000	
Total revenues		$216,000
Expenses		
Cost of goods sold expense	$ 76,000	
Selling expense	33,000	
Advertising expense	14,000	
Interest expense	8,000	
Income tax expense	21,000	
Other expenses	25,000	
Total expenses		177,000
Net income		$ 39,000

Required:

1. What was the amount of average monthly revenue?
2. What was the average amount of monthly selling expense?
3. Explain why cost of goods sold is reported as an expense.
4. Explain why interest is reported as an expense.
5. Can you determine how much cash the company had on December 31, 2007? Answer yes or no, and explain your reasoning.

E1-11 Matching Cash Flow Statement Items to Business-Activity Categories — LO1

Tech Data Corporation is a leading distributor of computer peripherals and network solutions, and recently was ranked by *Fortune* as the second most admired company in its industry category. The following items were taken from its recent cash flow statement. Mark each item in the following list with a letter to indicate whether it is a cash flow from Operating, Investing, or Financing activities. **Put parentheses around the letter if it is a cash *outflow* and use no parentheses if it's an *inflow.***

____ 1. Cash paid to suppliers and employees
____ 2. Cash received from customers
____ 3. Cash received from borrowing long-term debt
____ 4. Cash received from issuing shares
____ 5. Cash paid to purchase equipment

LO1 E1-12 Matching Cash Flow Statement Items to Business-Activity Categories

Clearly Canadian Beverage, headquartered in West Vancouver, B.C., is a producer of premium beverages. It is best known for its sparkling flavoured water and was among the first to tap the alternative beverage craze. Mark each item in the following list with a letter to indicate whether it is a cash flow from Operating, Investing, or Financing activities. **Put parentheses around the letter if it is a cash *outflow* and use no parentheses if it's an *inflow*.**

____ 1. Purchases of property, plant, and equipment
____ 2. Cash received from customers
____ 3. Cash received from issuing shares
____ 4. Cash paid to suppliers and employees
____ 5. Cash paid on notes payable
____ 6. Cash received from selling equipment

SIMPLIFY WITH SPREADSHEETS

LO2 SS1-1 Preparing an Income Statement and Balance Sheet

Electronic Arts is the world's leading developer and publisher of interactive entertainment software for personal computers and advanced entertainment systems made by Sony, Nintendo, and Microsoft. Assume that the company is revising its methods for displaying its financial statements, and the controller in the accounting department has asked you to create electronic worksheets that they can use as their standard format for financial statement reporting. The controller has provided you with an alphabetical list of statement categories and account names (below), with corresponding balances as of September 30. She has asked you to use a spreadsheet program to create two worksheets that organize the accounts into a properly formatted balance sheet and income statement, and use formulas to compute amounts marked by a ? below.

Accounts Payable	$120,200	Other Liabilities	333,600
Accounts Receivable	139,300	Promotion Expense	55,500
Assets		Property, Plant, and Equipment	307,100
Cash	920,800	Retained Earnings	660,600
Contributed Capital	731,200	Revenue	
Cost of Goods Sold Expense	198,900	Sales Revenue	450,500
Expenses		Selling Expense	98,100
Income Tax Expense	22,500	Shareholders' Equity	
Inventories	36,800	Total Assets	?
Liabilities		Total Expenses	?
Net Income	?	Total Liabilities	?
Notes Payable	1,400	Total Liabilities and Shareholders' Equity	?
Other Assets	443,000		
Other Expenses	29,600	Total Shareholders' Equity	?

Not knowing quite where to start, you e-mailed your friend Billy for advice on using a spreadsheet. Billy is an extreme Type A personality, which explains his very detailed reply, as shown below.

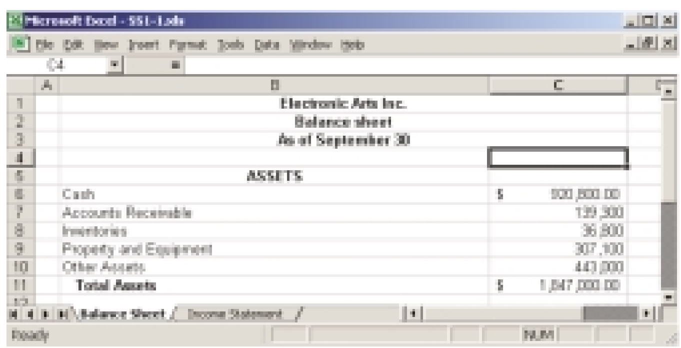
Required:

Follow Billy's advice to create a balance sheet and income statement, with each statement saved on a separate worksheet in a file called *me*EA.xls where the *me* part of the filename uniquely identifies you.

From: BillyTheTutor@yahoo.com
To: Overwhelmed@hotmail.com
Cc:
Subject: Excel Help

Hey pal. Long time, no chat. Here's the scoop on creating those worksheets, with a screenshot that shows how to go. If you need more help, let me know and I'll submit an application for your position there. ☺

1. Start-up Excel to open a new spreadsheet file. You'll need only two worksheets for this assignment, so delete the third worksheet by clicking on the *Sheet3* tab at the bottom of the worksheet and selecting Edit/Delete Sheet in the pull-down menu. While you're at it, rename *Sheet1* and *Sheet2* to *Balance Sheet* and *Income Statement* by double-clicking on the worksheet tabs and typing in the new names.
2. Plan the layout for your reports. Use the first column as a blank margin, the second column for account names and their headings, and the third column for the numbers corresponding to each account name or total. If you want to apply the same format to all worksheets, begin by right-clicking on the tab at the bottom of a worksheet and choosing Select All Sheets. Next, resize the first column by clicking on the A at the top of that column, selecting Format/Column/Width . . . from the pull-down menu, and choosing a width of 2. Using this same procedure, resize columns B and C to 50 and 15, respectively.
3. Starting with cell B1, enter the company's name. Enter the report name and date in cells B2 and B3. To merge cells so these headings span more than one column, select the cells to be merged and then click on . Continue with the body of the report in cell B5, entering any necessary amounts in column C.
4. To use formulas to compute subtotals and totals, the equals sign = is entered first into the cell and is followed immediately by the formula. So, to subtract cell C16 from C13, enter =C16-C13. To add a series of amounts, say C6 through C10, use a formula like =SUM(C6:C10), as shown in the screenshot below.
5. After you get all the data entered and totals calculated, be sure to save the file. To do this, just click on File/Save As . . . and enter the filename.
6. If you need to print the worksheets, it might be best to highlight what you want printed, then click File/Print . . . and choose Selection in the dialog box that pops up.
7. Go to it, you accounting guru!



To apply different formats (such as dollar signs, centre alignment, single- or double-underlined borders, boldface), select the cell(s), click on Format/Cells . . . in the pull-down menu, and choose the desired options.

COACHED PROBLEMS

CP1-1 Preparing an Income Statement and Balance Sheet

LO2

Assume that you are the president of Nuclear Company. At the end of the first year of operations (December 31, 2007), the following financial data for the company are available:

Cash	$ 25,000
Accounts receivable from customers	12,000
Inventories	90,000
Equipment owned	45,000
Accounts payable to suppliers	47,370
Notes payable	2,000
Total sales revenue	140,000
Expenses, including the cost of goods sold (excluding income taxes)	89,100
Income tax expense	15,270
Contributed capital, 7,000 shares outstanding	87,000
No dividends were declared or paid during 2007.	

Required (show computations):

1. Prepare an income statement for the year 2007.
2. Prepare a balance sheet at December 31, 2007.

1. Begin by classifying each account as asset, liability, shareholders' equity, revenue, or expense. Then use the formats shown in the chapter for presenting an income statement and balance sheet. You'll need the net income of the current year to calculate the retained earnings at the end of the year, so do the income statement first.
2. Because this is the first year of operations and there were no dividends, the balance in retained earnings will include only the current year's net income.

LO2

GROUP A PROBLEMS

eXcel

PA1-1 Preparing an Income Statement and Balance Sheet

Assume that you are the president of McClaren Corporation. At the end of the first year of operations (June 30, 2007), the following financial data for the company are available:

Cash	$13,150
Accounts receivable from customers	9,500
Inventories	57,000
Equipment owned	36,000
Accounts payable to suppliers	31,500
Notes payable	1,500
Total sales revenue	90,000
Expenses, including the cost of goods sold (excluding income taxes)	60,500
Income tax expense	8,850
Contributed capital, 5,000 shares outstanding	62,000
No dividends were declared or paid during 2007.	

Required (show computations):

1. Prepare an income statement for the year ended June 30, 2007.
2. Prepare a balance sheet at June 30, 2007.

LO2

PA1-2 Preparing a Balance Sheet and Income Statement

Canadian Tire started out in Toronto in 1922, and now operates almost 500 stores across the country. It is Canada's largest independent gasoline retailer and recently bought Mark's Work Wearhouse. More than 60 percent of this company is still owned by the daughter of one of its original founders. Below is a list of the financial statement items and amounts adapted from a recent Canadian Tire Corporation balance sheet and income statement.

Accounts payable	$ 1,438
Accounts receivable	963
Cash	802
Contributed capital	704
Interest expense	78
Income tax expense	163
Inventories	620
Net income	292
Notes payable	1,088
Operating expenses	6,621
Other assets	248
Other liabilities	441
Property and equipment	2,585
Retained earnings	1,547
Sales revenues	7,154
Total assets	5,218
Total expenses	6,862
Total liabilities	2,967
Total liabilities and shareholders' equity	5,218
Total revenues	7,154
Total shareholders' equity	2,251

Required:

1. Prepare a balance sheet and income statement for the year, following the formats in Exhibits 1.3 and 1.4.
2. What other two statements would Canadian Tire include in its financial statements?
3. Does Canadian Tire rely more or less on shareholders for financing than does Tim Hortons? (See the Demonstration Case on page 23.)

GROUP B PROBLEMS

PB1-1 Preparing an Income Statement and Balance Sheet — LO2

Assume that you are the president of Riterong Corporation. At the end of the first year of operations (April 30, 2007), the following financial data for the company are available:

Cash	$ 39,150
Accounts receivable from customers	27,500
Inventories	135,000
Equipment owned	108,000
Accounts payable to suppliers	57,800
Notes payable	3,500
Total sales revenue	270,000
Expenses, including the cost of goods sold (excluding income taxes)	180,500
Income tax expense	27,150
Contributed capital, 5,000 shares outstanding	186,000
No dividends were declared or paid during 2007.	

Required (show computations):

1. Prepare an income statement for the year ended April 30, 2007.
2. Prepare a balance sheet at April 30, 2007.

CASES & DISCUSSION STARTERS

FINANCIAL REPORTING AND ANALYSIS CASES

C&DS1-1 Finding Financial Information — LO1–LO3

Refer to the financial statements of High Liner Foods in Appendix A at the end of this book, or download the annual report from the *Cases* section of the text's website at www.mcgrawhill.ca/college/phillips. (High Liner's year-end is January 1, 2005, referred to as "the end of 2004" below.)

Required:

1. What is the amount of net income for 2004?
2. What amount of revenue was earned in 2004?
3. How much inventory does the company have at the end of 2004?
4. How much cash is on hand at the end of 2004?
5. High Liner's shares are traded on the Toronto Stock Exchange under the symbol HLF. What kind of company does this make High Liner?
6. Which public accounting firm signed High Liner's Auditors' Report?

C&DS1-2 Comparing Financial Information — LO1–LO3

Refer to the financial statements of Sun-Rype Products by downloading the annual report from the *Cases* section of the text's website at www.mcgrawhill.ca/college/phillips. Note that High Liner ends its fiscal year on January 1, 2005, which doesn't perfectly match Sun Rype's year ended December 31, 2004. In the questions that follow, assume both financial statements are for the year ended December 31, 2004. (This is a reasonable assumption since there is only a one-day difference.)

Required:

1. Was Sun-Rype net income for 2004 greater or less than High Liner?
2. Was Sun-Rype revenue for 2004 greater or less than High Liner?
3. Did Sun-Rype have more or less inventories than High Liner at the end of 2004?
4. Did Sun-Rype have more or less cash than High Liner at the end of 2004?

5. Is Sun-Rype the same type of business organization as High Liner? Does it use the same firm of external auditors?
6. On an overall basis, was Sun-Rype or High Liner more successful in 2004?

LO1–LO3

C&DS1-3 Internet-Based Team Research: Examining an Annual Report

As a team, select an industry to analyze. Go to the website for the System for Electronic Document Analysis and Retrieval (SEDAR) at www.SEDAR.com to search for information about Canadian public companies. The Canadian Securities Administrators (CSA) and CDS INC, a subsidiary of The Canadian Depository for Securities Limited, have operated the SEDAR website since 1997 to make Canadian public securities filings easily accessible. Click on Search Database and Public Company and run your search by industry group to find companies in your chosen industry. Each group member should acquire the annual report for one Canadian publicly traded company in the industry, with each member selecting a different company. In addition to SEDAR's and the company's own websites, corporate and industry information can be found on a number of other websites, such as www.hoovers.com and www.fin-info.com. The United States runs a service similar to SEDAR called EDGAR. For American company data, go to www.edgarscan.pwcglobal.com.

Required:

1. On an individual basis, each team member should write a short report that lists the following information:
   a. What type of business organization is it?
   b. What types of products or services does it sell?
   c. On what day of the year does its fiscal year end?
   d. For how many years does it present complete balance sheets? Income statements? Cash flow statements?
   e. Are its financial statements audited by independent auditors? If so, by whom?
   f. Did its total assets increase or decrease over the last year?
   g. Did its net income increase or decrease over the last year?
2. Then, as a team, write a short report comparing and contrasting your companies using these attributes. Discuss any patterns across the companies that you as a team observe and, in particular, compare the level of reporting detail. Provide potential explanations for any differences discovered.

ETHICS AND CRITICAL THINKING CASES

LO2–LO4

C&DS1-4 Ethical Decision Making: A Real-Life Example

In January 2004, Lord Conrad Black and other executives at Hollinger International Inc (HII) were hit with a lawsuit that accuses them of defrauding investors and lenders of over $1.25 billion. To understand the charges, let's look a bit at HII's and Black's history. Conrad Black, born in Montreal and educated at Carleton and McGill, began buying newspapers after graduation and built a publishing empire that included the *Daily Telegraph* in London and the *Chicago Sun-Times*. Black and his wife became well-known for their love of the good life, owning lavish homes worth close to $100 million in London, Palm Beach, Toronto, and New York. Black gave up his Canadian citizenship in 2001 so that he could be inducted into England's House of Lords under the sponsorship of then-British Prime Minister Margaret Thatcher. A percentage of HII's shares traded publicly on the Toronto and New York Stock Exchanges, but Black still controlled the company through his holdings. The lawsuit claims that HII executives took money from HII in a conspiracy to improperly enrich themselves at the expense of the other shareholders. It alleges that during the late 1990s when HII was selling off many of its assets, HII paid part of the money received from the sale to insiders and then falsified the accounting records to hide what they had done. For example, in 2000 HII sold Canadian newspaper assets to CanWest Global for $1.8 billion. On top of this, CanWest paid $28 million to Black and three other executives plus another $25 million to a Toronto-based company controlled by Black. In 2005, U.S. law enforcement authorities filed criminal charges against Conrad Black and a number of HII executives.[6]

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[6] *The Globe and Mail*, May 8, 2004; *Ottawa Citizen*, August 20, 2005; *Canadian Business*, Nov. 21–Dec. 4, 2005.

1. What is the accounting concept that Lord Black is accused of violating?
2. Based on the information provided above, can you determine which of HII's dealings are clearly inappropriate and which are clearly appropriate?
3. As a shareholder, how might you attempt to ensure that this kind of behaviour does not occur or, at least, does not occur without you knowing about it?
4. Aside from HII's shareholders, who else might be harmed by these actions allegedly committed by HII executives?

C&DS1-5 Ethical Decision Making: A Mini-Case LO4

You are one of three partners who own and operate Mary's Maid Service. The company has been operating for seven years. One of the other partners has always prepared the company's annual financial statements. Recently, you proposed that the statements be audited each year because it would benefit the partners and prevent possible disagreements about the division of profits. The partner who prepares the statements proposed that his Uncle Ray, who has a lot of financial experience, can do the job and at little cost. Your other partner remained silent.

Required:

1. What position would you take on the proposal? Justify your response.
2. What would you strongly recommend? Give the basis for your recommendation.

C&DS1-6 Critical Thinking: Developing a Balance Sheet and Income Statement LO2, LO3

On September 30, Jill and Jack started arguing about who is better off. Jack said he was better off because he had the latest PlayStation console that he bought last year for $350. Jill, on the other hand, argued that she was better off because she had $1,000 and a '75 Mustang that she bought two years ago for $800. Jack countered that Jill still owed $250 on her car and that Jack's dad promised to buy him a Porsche if he gets a great grade in his accounting class. Jill pointed out that she inherited a collection of trading cards that she figured she could sell for about $250. Jack said he had $6,000 in his bank account right now because he just received a $4,800 student loan. Jill knows that Jack still owes an instalment of $800 on this term's tuition.

Jill and Jack met again in early November. They asked how each other was doing. Jill claimed that she'd become much more successful than Jack. She had a part-time job, where she earned $500 per month. Jack laughed at Jill because he had won $950 on a lottery ticket he bought in October, and that was merely for the "work" of standing in line for a minute. It was just what he needed because his apartment costs $450 each month. Jill, on the other hand, pays $120 for her share of the rent. Both Jill and Jack have other normal living costs that total $300 each month.

1. Prepare a report that compares what Jill and Jack each own and owe on September 30. Note any decisions you had to make when preparing your report. Which of the two is better off?
2. Prepare a report that compares what Jill and Jack each earned during October. Note any decisions you had to make when preparing your report. Which of the two is more successful?