

Chapter 01

Financial Statements and Business Decisions

ANSWERS TO QUESTIONS

1. Accounting is a system that collects and processes (analyzes, measures, and records) financial information about an organization and reports that information to decision makers.
2. Financial accounting involves preparation of the four basic financial statements and related disclosures for external decision makers. Managerial accounting involves the preparation of detailed plans, budgets, forecasts, and performance reports for internal decision makers.
3. Financial reports are used by both internal and external groups and individuals. The internal groups are comprised of the various managers of the entity. The external groups include the owners, investors, creditors, governmental agencies, other interested parties, and the public at large.
4. Investors purchase all or part of a business and hope to gain by receiving part of what the company earns and/or selling the company in the future at a higher price than they paid. Creditors lend money to a company for a specific length of time and hope to gain by charging interest on the loan.
5. In a society each organization can be defined as a separate accounting entity. An accounting entity is the organization for which financial data are to be collected. Typical accounting entities are a business, a church, a governmental unit, a university and other nonprofit organizations such as a hospital and a welfare organization. A business typically is defined and treated as a separate entity because the owners, creditors, investors, and other interested parties need to evaluate its performance and its potential separately from other entities and from its owners.
6.

<i>Name of Statement</i>	<i>Alternative Title</i>
(a) Income Statement	(a) Statement of Earnings; Statement of Income; Statement of Operations
(b) Balance Sheet	(b) Statement of Financial Position
(c) Audit Report	(c) Report of Independent Accountants

7. The heading of each of the four required financial statements should include the following:
 - (a) Name of the entity
 - (b) Name of the statement
 - (c) Date of the statement, or the period of time
 - (d) Unit of measure

8.
 - (a) The purpose of the income statement is to present information about the revenues, expenses, and the net income of the entity for a specified period of time.
 - (b) The purpose of the balance sheet is to report the financial position of an entity at a given date, that is, to report information about the assets, obligations and stockholders' equity of the entity as of a specific date.
 - (c) The purpose of the statement of cash flows is to present information about the flow of cash into the entity (sources), the flow of cash out of the entity (uses), and the net increase or decrease in cash during the period.
 - (d) The statement of retained earnings reports the way that net income and distribution of dividends affected the retained earnings of the company during the accounting period.

9. The income statement and the statement of cash flows are dated "For the Year Ended December 31, 2010," because they report the inflows and outflows of resources during a period of time. In contrast, the balance sheet is dated "At December 31, 2010," because it represents the resources, obligations and stockholders' equity at a specific date.

10. Assets are important to creditors and investors because assets provide a basis for judging whether sufficient resources are available to operate the company. Assets are also important because they could be sold for cash in the event the company goes out of business. Liabilities are important to creditors and investors because the company must be able to generate sufficient cash from operations or further borrowing to meet the payments required by debt agreements. If a business does not pay its creditors, the law may give the creditors the right to force the sale of assets sufficient to meet their claims.

11. Net income is the excess of total revenues over total expenses. Net loss is the excess of total expenses over total revenues.

12. The equation for the income statement is $\text{Revenues} - \text{Expenses} = \text{Net Income}$ (or Net Loss if the amount is negative). Thus, the three major items reported on the income statement are (1) revenues, (2) expenses, and (3) net income.

13. The equation for the balance sheet (also known as the basic accounting equation) is: $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$. Assets are the probable (expected) future economic benefits owned by the entity as a result of past transactions. They are the resources owned by the business at a given point in time such as cash, receivables, inventory, machinery, buildings, land, and patents. Liabilities are probable (expected) debts or obligations of the entity as a result of past transactions which will be paid with assets or services in the future. They are the obligations of the entity such as accounts payable, notes payable, and bonds payable. Stockholders' equity is financing provided by owners of the business and operations. It is the claim of the owners to the assets of the business after the creditor claims have been satisfied. It may be thought of as the residual interest because it represents assets minus liabilities.
14. The equation for the statement of cash flows is: $\text{Cash flows from operating activities} + \text{Cash flows from investing activities} + \text{Cash flows from financing activities} = \text{Change in cash for the period}$. The net cash flows for the period represent the increase or decrease in cash that occurred during the period. Cash flows from operating activities are cash flows directly related to earning income (normal business activity including interest paid and income taxes paid). Cash flows from investing activities include cash flows that are related to the acquisition or sale of productive assets used by the company. Cash flows from financing activities are directly related to the financing of the enterprise itself.
15. The equation for the statement of retained earnings is: $\text{Beginning Retained Earnings} + \text{Net Income} - \text{Dividends} = \text{Ending Retained Earnings}$. It begins with beginning-of-the-year Retained Earnings which is the prior year's ending retained earnings reported on the balance sheet. The current year's Net Income reported on the income statement is added and the current year's Dividends are subtracted from this amount. The ending Retained Earnings amount is reported on the end-of-period balance sheet.
16. Marketing managers and credit managers use customers' financial statements to decide whether to extend them credit for their purchases. Purchasing managers use potential suppliers' financial statements to judge whether the suppliers have the resources necessary to meet current and future demand. Human resource managers use financial statements as a basis for contract negotiations, to determine what pay rates the company can afford. The net income figure even serves as a basis to pay bonuses not only to management, but to other employees through profit sharing plans.
17. The Securities and Exchange Commission (SEC) is the U.S. government agency which determines the financial statements that public companies must provide to stockholders and the measurement rules used in producing those statements. The Financial Accounting Standards Board (FASB) is the private sector body given the primary responsibility to work out the detailed rules which become generally accepted accounting principles.

18. Management is responsible for preparing the financial statements and other information contained in the annual report and for the maintenance of a system of internal accounting policies, procedures and controls. These measures are intended to provide reasonable assurance, at appropriate cost, that transactions are processed in accordance with company authorization as well as properly recorded and reported in the financial statements, and that assets are adequately safeguarded. Independent auditors examine the financial reports (prepared by management) and the underlying records to assure that the reports represent what they claim and conform with generally accepted accounting principles (GAAP).
19. A sole proprietorship is an unincorporated business owned by one individual. A partnership is an unincorporated association of two or more individuals to carry on a business. A corporation is a business that is organized under the laws of a particular state whereby a charter is granted and the entity is authorized to issue shares of stock as evidence of ownership by the owners (i.e., stockholders).
20. A CPA firm normally renders three services: auditing, management advisory services, and tax services. Auditing involves examination of the records and financial reports to determine whether they “fairly present” the financial position and results of operations of the entity. Management advisory services involve management advice to the individual business enterprises and other entities. It is like a consulting firm. Tax services involve providing tax planning advice to clients (both individuals and businesses) and preparation of their tax returns.

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ANSWERS TO MULTIPLE CHOICE

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