Chapter 2

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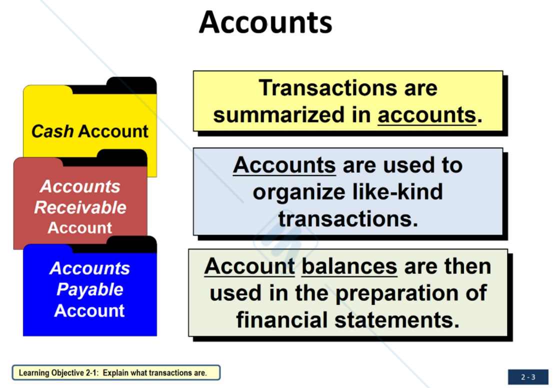
- Explain what transactions are.

The term economic interchange means that something of value has been given up by one entity in exchange for something else of equal value. For example, an organization uses cash to pay for employee wages. The organization gives up cash to pay an employee to produce a product, while the employee gives up time to produce the product and in exchange receives a wage for his or her labour.

Transactions are economic interchanges between entities that are accounted for and reflected in financial statements. Examples include borrowing cash from the bank, sales of merchandise, purchases of inventory, cash receipts for goods sold, and cash payments for supplies and merchandise.

Recording transactions, the economic interchanges between an entity and other organizations and/or individuals, requires both bookkeeping and accounting functions. The flow begins with the bookkeeping function, procedures for sorting, classifying, and presenting the transactions, and continues with an accounting function of selecting among alternative methods of reflecting the effects of those transactions. The entity's financial statements are the end product of these processes.



- Identify and explain the kind of information reported in each financial statement and describe how financial statements are related to each other.

The four financial statements include:

1) the balance sheet that presents the financial position of an entity at the end of an accounting period;

2) the income statement that reports the earnings of an entity for the accounting period;

3) the statement of cash flows that shows the cash inflows and outflows during the period; and

4) the statement of changes in stockholders' equity that reports the investments and distributions to owners during the period.

These financial statements are contained in an annual report that will probably include several notes or explanations of the accounting policies used and detailed information about the amounts and captions shown in the financial statements.

- Explain the meaning and usefulness of the accounting equation.

The balance sheet is a listing of an organization's assets, liabilities, and equity at a point in time.

Assets represent the amount of resources owned by an entity, the probable future economic benefits obtained or controlled by the entity as a result of past transactions or events.

Liabilities are those amounts owed to other entities, the probable future sacrifices of the entity's economic benefits arising from present obligations to transfer assets or provide services to other entities in the future as a result of past transactions or events.

Stockholders' equity is the stockholders' ownership in the assets of an entity that remain after deducting the liabilities. Stockholders' equity is often referred to as net assets.

Assets minus liabilities equal stockholders' equity.

The balance sheet presents the balances in an entity's accounts at a given point in time.

Assets = Liabilities + Stockholders' Equity.

The balance sheet equation must balance. Total assets include current and long-lived assets. Total liabilities include both current and long-term liabilities. Total liabilities combined with stockholders' equity must equal total assets.

- Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

BALANCESHEET

Current assets are those assets that are likely to be converted into cash or used to benefit the entity within one year. Current assets include cash, accounts receivable, and merchandise inventory.

Current liabilities represent amounts borrowed that will be repaid within one year of the balance sheet date. Current liabilities include short-term debt, accounts payable, and other accrued liabilities.

Long-term liabilities are those liabilities that will not be repaid within one year of the balance sheet date.

The income statement shows the net income (or net loss) for the period of time under consideration. The income statement may be called **the statement of earnings, profit and loss statement, or statement of operations**.

The balance sheet presents the balances in an entity's accounts at a given point in time.

The balance sheet reports the ending balances of all assets, liabilities, and stockholders' equity at a specific point in time.

At a minimum, an organization will produce a balance sheet at the end of its accounting year.

However, some organizations will report these results at other intervals throughout the year - typically quarterly. Internally, an organization may decide to produce this report monthly depending on its information requirements.

The **current asset accounts** on the balance sheet include cash, accounts receivable, and merchandise inventory.

Assets are reported at the original cost.

Non-current asset accounts on the balance sheet include equipment and the contra-account to equipment, accumulated depreciation.

The **current liabilities** on a balance sheet include short-term debt, accounts payable, and other accrued liabilities; **long-term liabilities** include long-term debt.

Stockholders' equity accounts on the balance sheet report the residual claims of the owners to the assets, which is also represented as assets minus liabilities.

Account	Definition
Cash	Cash on hand and in the bank
Accounts receivable	Amounts due from customers
Merchandise inventory	Cost of merchandise acquired and not yet sold
Equipment	Cost of equipment purchased and used in business
Accumulated depreciation	Portion of the cost of equipment that is estimated to have been used up in the process of operating the business
Short-term debt	Amounts borrowed that will be repaid within one year of the balance sheet date
Accounts payable	Amounts due to suppliers
Other accrued liabilities	Amounts owed to various creditors
Long-term debt	Amounts borrowed from banks or other creditors that will not be repaid within one year from the balance sheet date
Stockholders' equity	Residual claim of owners, computed as "assets minus liabilities"

INCOME STATEMENT

The income statement reports the revenues that result from the entity's operating activities and deducts the costs and expenses incurred in generating the revenues to arrive at net income, which represents the profit or loss for the period.

The income statement captures revenue and related expenses in generating revenue.

It typically measures profit or loss over a period of time not to exceed one year. Some organizations will generate this statement monthly or quarterly to assess how the organization is performing and/or meeting its objectives.

Income taxes are shown after all the other income statement items have been reported, because income taxes (often captioned as *income tax expense* or *provision for income taxes*) are a function of the firm's income before taxes.

Earnings per share of common stock outstanding is reported as a separate item at the bottom of the income statement because of its significance in evaluating the market value of a share of common stock.

The **income statement captions** include net sales (sales minus returns), cost of goods sold (the cost of merchandise removed from inventory and sold to customers), and gross profit (net sales minus cost of goods sold).

Selling, general, and administrative expenses (also known as operating expenses) are deducted from gross profit to arrive at income from operations (an important measure of the firm's activities).

Interest expense (the cost of borrowing funds) and **income tax expense** (which is calculated after all other items have been reported) are deducted from income from operations to arrive at net income.

Net income per share of common stock outstanding (which is net income earned divided by the average number of shares of the entity's common stock outstanding) is often referred to as earnings per share or EPS.

Captions	Explanation
Net sales	Amount of sales of merchandise to customers, less the amount of customer returns of merchandise
Cost of goods sold	Represents the total cost of merchandise removed from inventory and delivered to customers as a result of sales
Gross profit	Difference between net sales and cost of goods sold; Represents the seller's maximum amount of "cushion" from which all other expenses of the business must be deducted before it is possible to have net income
Selling, general, and administrative expenses	Represents the operating expenses of the entity
Income from operations	Represents one of the most important measures of the firm's activities
Interest expense	Represents the cost of using borrowed funds
Income taxes	Shown after all of the other income statement items have been reported because income taxes are a function of the firm's income before taxes
Net income per share of common stock outstanding	A significant item in evaluating the market value of a share of common stock; Often referred to as "earnings per share" or EPS

STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

The statement of changes in stockholders' equity reports *the details of stockholders' equity and explains the changes that occurred in paid-in capital and retained earnings during the year.* This statement reflects the changes that have occurred over a period of time with stockholders' equity. Also provides the details of the balances reported in the stockholders' equity section of the balance sheet

Each shareholder is considered an "owner" of the organization and therefore has the most interest in this financial statement.

Paid-in capital includes common stock at par value and additional paid-in capital.

Retained earnings include the net income or loss reported by the entity since its inception less any dividends that have been distributed to owners.

The statement of changes in stockholders' equity reports **paid-in capital**, the total amount owners have invested in the entity, which includes **common stock**, the number of shares of authorized, issued, and outstanding (outstanding means the shares still held by the stockholders).

Captions	Explanation
Paid-in capital	Represents the total amount invested in the entity by the owners
Common stock	Reflects the number of shares authorized by the corporation's charter, the number of shares issued to stockholders, and the number of shares still held by the stockholders
Additional paid-in capital	Difference between the total amount invested by the owners and the par value or stated value of the stock
Retained earnings	Represents the cumulative net income of the entity that has been retained for use in the business
Dividends	Distributions of earnings to the owners

The **retained earnings** account reports the cumulative net income of the entity that has been retained for use in the business minus the dividends, which are distributions of earnings to owners.

CASH FLOWS FROM OPERATING ACTIVITIES

The statement of cash flows details *the inflows and outflows of cash during a period of time, which is typically one year.* As an asset, the ending cash balance is reported on the balance sheet. This statement recaps the sources of cash and how cash was used throughout a period of time - typically one year.

The inflows and outflows of cash are separated into three distinct categories:

1) operating activities; 2) investing activities; and 3) financing activities.

Cash flows from **operating activities** consist of inflows and outflows of cash required to operate the business on a day-to-day basis. Inflows result from selling products or services. Outflows result from paying expenses required to generate revenue such as wages, rent, utilities, etc.

Cash flows from **investing activities** result from the organization using cash to purchase long-term assets such as equipment, building factories, or purchasing land. The long- term assets are acquired with the intention of increasing revenue. Inflows typically result from the sale of long-term operational assets.

Cash flows from **financing activities** typically include the borrowing or repayment of monies. Cash **inflows** from financing activities may come from investments from stockholders or the borrowing of funds from bondholders or a financial institution such as a bank. **Outflows** from financing activities may result from the repayment of previously borrowed funds or the payment of cash dividends.

The statement of cash flows includes three captions (referred to as activities).

The first caption, cash flows **from operating activities**, begins with net income from the income statement, then 1) adds back depreciation expense because it is subtracted to arrive at net income but does not require the use of cash, 2) deducts an increase in accounts receivable because it reflects sales revenues that are included in net income but not yet received in cash, 3) deducts an increase in merchandise inventory because cash was spent to acquire the increase in inventory, and 4) adds an increase in current liabilities because cash has not yet been paid for the products and services that have been received during the current fiscal period.

The caption, cash flows **from investing activities**, shows the cash sources and uses related to long-lived assets. The caption, cash flows **from financing activities**, shows the cash sources and uses related to transactions with creditors and stockholders.

One key number to watch on this statement is whether the cash flows from operating activities are generating positive or negative results. Over time an organization should have a positive cash inflow from operating activities.

If an organization consistently generates a negative cash inflow from operating activities, it is an indicator of trouble. Cash is mandatory to continue operations. When cash flow from operating activities is consistently negative, it translates to financing activities. Consistent borrowing to fund day-to-day operations will ultimately cause an organization to go bankrupt.

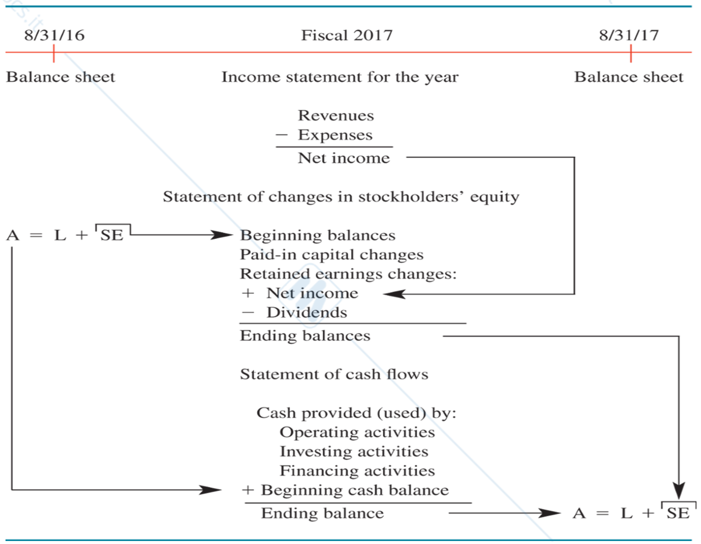
Captions	Explanation
Cash flows from operating activities	Shown first; Net income is the starting point for this measure of cash generation
Depreciation expense	Added back to net income because it is subtracted to arrive at net income, but does not require the use of cash
Increase in accounts receivable	Deducted because it reflects sales revenues, included in net income, but not yet received in cash
Increase in merchandise inventory	Deducted because cash was spent to acquire the increase in inventory
Increase in current liabilities	Added because cash has not yet been paid for the products and services that have been received during the current fiscal period
Cash flows from investing activities	Shows the cash sources and uses related to long-lived assets
Cash flows from financing activities	Shows the cash sources and uses related to transactions with creditors and stockholders

The beginning balance sheet reports the assets, liabilities, and stockholders' equity account balances as the accounting period begins.

The income statement reports the revenue earned and expenses incurred during the year. The net income is calculated and reported in the changes in stockholders' equity and the net income is added to the beginning balance in retained earnings. Dividends are deducted at this time as well.

The ending balance in stockholders' equity is reported on the end-of-year balance sheet.

In addition, the statement of cash flows shows the increase or decrease in the cash account, which is combined with the beginning balance, then the calculated balance is reported in the asset account, cash, in the ending balance sheet.



Earning revenue always increases Stockholders' Equity.

Incurring expenses will always decrease Stockholders' Equity.

Expenses are necessary in order to generate revenue.

Dividends will also decrease Stockholders' Equity, however, they are never treated as an expense. Dividends are never considered an expense because they reflect a distribution of profits from the organization to the investors.

The payment of dividends to investors has no correlation to the generation of revenue.

Expenses are defined as costs associated with generating revenue.

ANNUAL REPORT

A corporation distributes an annual report to its shareholders. The annual report contains the financial statements, together with the report of the external auditor's examination of the financial statements. It also contains Management's Discussion and Analysis (MD&A).