## MBO 102-Financial Reporting and Statement Analysis

1. Define accounting.

   SOLUTION:

   Accounting is a system of analyzing, recording, and summarizing the results of a business's activities and then reporting them to decision makers.

2. Valeri is opening a hair salon, but she does not know what business form it should take. What can you tell her about the advantages and disadvantages of operating as a sole proprietorship versus a corporation?

   SOLUTION:

   An advantage of operating as a sole proprietorship, rather than a corporation, is that it is easy to establish. Another advantage is that income from a sole proprietorship is taxed only once in the hands of the individual proprietor (income from a corporation is taxed in the corporation and then again in the hands of the individual shareholder). A disadvantage of operating as a sole proprietorship, rather than a corporation, is that the individual proprietor can be held responsible for the debts of the business.

3. Briefly distinguish financial accounting from managerial accounting.

   SOLUTION:

   Financial accounting focuses on preparing and using the financial statements that are made available to owners and external users such as customers, creditors, and potential investors who are interested in reading them. Managerial accounting focuses on other accounting reports that are not released to the general public, but instead are prepared for internal decision making and used by employees, supervisors, and managers who run the company.

4. The accounting process generates financial reports for both internal and external users. Describe some of the specific groups of internal and external users.

   SOLUTION:

   Financial reports are used by both internal and external groups and individuals. The internal groups are comprised of the various managers of the business. The external groups include investors, creditors, governmental agencies, other interested parties, and the public at large.

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5. Explain what the separate entity assumption means when it says a business is treated as separate from its owners for accounting purposes.

SOLUTION:

The business itself, not the individual stockholders who own the business, is viewed as owning the assets and owing the liabilities on its balance sheet. A business's balance sheet includes the assets, liabilities, and stockholders' equity of only that business and not the personal assets, liabilities, and equity of the stockholders. The financial statements of a company show the results of the business activities of only that company.

6. List the three main types of business activities on the statement of cash flows and give an example of each.

SOLUTION:

(a) Operating – These activities are directly related to earning profits. They include buying supplies, making products, serving customers, cleaning the premises, advertising, renting a building, repairing equipment, and obtaining insurance coverage.

(b) Investing – These activities involve buying and selling productive resources with long lives (such as buildings, land, equipment, and tools), purchasing investments, and lending to others.

(c) Financing – Any borrowing from banks, repaying bank loans, receiving contributions from stockholders, or paying dividends to stockholders are considered financing activities.

7. What information should be included in the heading of each of the four primary financial statements?

SOLUTION:

The heading of each of the four primary financial statements should include the following:

(a) Name of the business

(b) Name of the statement

(c) Date of the statement, or the period of time that the statement covers

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?

SOLUTION:

(a) The purpose of the balance sheet is to report the financial position (assets, liabilities and stockholders' equity) of a business at a point in time.

(b) The purpose of the income statement is to present information about the revenues, expenses, and net income of a business for a specified period of time.

(c) The statement of retained earnings reports the way that net income and the distribution of dividends affected the financial position of the company during the period.

(d) 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.

9. Explain why the income statement, statement of retained earnings, and statement of cash flows would be dated "For the Year Ended December 31, 2015," whereas the balance sheet would be dated "At December 31, 2015."

SOLUTION:

The income statement, statement of retained earnings, and statement of cash flows would be dated "For the Year Ended December 31, 2015," because they report the inflows and outflows of resources over a period of time. In contrast, the balance sheet would be dated "At December 31, 2015," because it represents the assets, liabilities and stockholders' equity at a specific date.

10. Briefly explain the difference between net income and net loss.

SOLUTION:

Net income is the excess of total revenues over total expenses. A net loss occurs if total expenses exceed total revenues.

11. Describe the basic accounting equation that provides the structure for the balance sheet. Define the three major components reported on the balance sheet.

SOLUTION:

The accounting equation for the balance sheet is: Assets = Liabilities + Stockholders' Equity. Assets are the economic resources controlled by the company. Liabilities are amounts owed by the business. Stockholders' equity is the owners' claims to the business. It includes amounts contributed to the business (by investors through purchasing the company's stock) and the amounts earned and accumulated through profitable business operations.

12. Describe the equation that provides the structure for the income statement. Explain the three major items reported on the income statement.

SOLUTION:

The equation for the income statement is Revenues – Expenses = Net Income. Revenues are increases in a company's resources, arising primarily from its operating activities. Expenses are decreases in a company’s resources, arising primarily from its operating activities. Net Income is equal to revenues minus expenses. (If expenses are greater than revenues, the company has a Net Loss.)

13. Describe the equation that provides the structure for the statement of retained earnings. Explain the four major items reported on the statement of retained earnings.

    SOLUTION:

    The equation for the statement of retained earnings is: Beginning Retained Earnings + Net Income - Dividends = Ending Retained Earnings. It begins with beginning-of-the-year retained earnings which is the prior year’s ending retained earnings reported on the prior year’s 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-year balance sheet.

14. Describe the equation that provides the structure for the statement of cash flows. Explain the three major types of activities reported on the statement.

    SOLUTION:

    The equation for the statement of cash flows is: Cash flows from operating activities + Cash flows from investing activities + Cash flows from financing activities = Change in cash for the period. Change in cash for the period + Beginning cash balance = Ending cash balance. 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). Cash flows from investing activities include cash flows that are related to the acquisition or sale of the company’s long-term assets. Cash flows from financing activities are directly related to the financing of the company.

15. Briefly describe the organization that is responsible for developing accounting measurement rules (generally accepted accounting principles) in the United States.

    SOLUTION:

    Currently, the Financial Accounting Standards Board (FASB) is given the primary responsibility for setting the detailed rules that become Generally Accepted Accounting Principles (GAAP) in the United States. (Internationally, the International Accounting Standards Board (IASB) has the responsibility for setting accounting rules known as International Financial Reporting Standards (IFRS).)

16. What is the main goal for accounting rules in the United States and around the world? What characteristics must financial information possess to reach that goal?

    SOLUTION:

    The main goal of accounting rules is to ensure that companies produce useful financial information for present and potential investors, lenders, and other creditors in making decisions in their capacity as capital providers. Financial information must show relevance and faithful representation, as well as be comparable, verifiable, timely, and understandable

17. Briefly define what an ethical dilemma is and describe the steps to consider when evaluating ethical dilemmas.

    SOLUTION:

    An ethical dilemma is a situation where following one moral principle would result in violating another. Three steps that should be considered when evaluating ethical dilemmas are:

    (a) Identify who will benefit from the situation (often, the manager or employee) and how others will be harmed (other employees, the company's reputation, owners, creditors, and the public in general).

    (b) Identify the alternative courses of action.

    (c) Choose the alternative that is the most ethical – that which you would be proud to have reported in the news media. Often, there is no one right answer and hard choices will need to be made. Following strong ethical practices is a key part of ensuring good financial reporting by businesses of all sizes.

18. In what ways might accounting frauds be similar to cases of academic dishonesty?

    SOLUTION:

    Accounting frauds and cases involving academic dishonesty are similar in many respects. Both involve deceiving others in an attempt to influence their actions or decisions, often resulting in temporary personal gain for the deceiver. For example, when an accounting fraud is committed, financial statement users may be misled into making decisions they wouldn't have made had the fraud not occurred (e.g., creditors might loan money to the company, investors might invest in the company, or stockholders might reward top managers with big bonuses). When academic dishonesty is committed, instructors might assign a higher grade than is warranted by the student's individual contribution.

Another similarity is that, as a consequence of the deception, innocent bystanders may be adversely affected by fraud and academic dishonesty. Fraud may require the company to charge higher prices to customers to cover costs incurred as a result of the fraud. Academic dishonesty may lead to stricter grading standards, with significant deductions taken for inadequate documentation of sources referenced. A final similarity is that if fraud and academic dishonesty are ultimately uncovered, both are likely to lead to adverse long-term consequences for the perpetrator. Fraudsters may be fined, imprisoned, and encounter an abrupt end to their careers. Students who cheat may be penalized through lower course grades or expulsion, and might find it impossible to obtain academic references for employment applications.

MULTIPLE CHOICE

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 operations.**
   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 with 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 stockholders' 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 stockholders' equity on the balance sheet.
   c. **Retained earnings is an asset on the balance sheet.**
   d. Retained earnings represents earnings not distributed to stockholders in the form of dividends.

Segment 1: Financial Reporting

5. Which of the following is <u>NOT</u> 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. Which of the following statements regarding the statement of cash flows is <u>FALSE</u>?

a. The statement of cash flows separates cash inflows and outflows into three major categories: operating, investing, and financing.

b. 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.

**c. The total increase or decrease in cash shown on the statement of cash flows must agree with the "bottom line" (net income or net loss) reported on the income statement.**

d. The statement of cash flows covers a period of time.

7. Which of the following regarding GAAP is <u>TRUE</u>?

a. GAAP is an abbreviation for generally applied accounting principles.

b. Changes in GAAP always 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 Senate Finance Committee.

8. Which of the following is <u>TRUE</u>?

a. FASB creates SEC.

b. GAAP creates FASB.

c. SEC creates CPA.

**d. FASB creates GAAP.**

9. Which of the following would <u>NOT</u> 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.

10. Which of the following is <u>NOT</u> required by the Sarbanes- Oxley Act?

a. Top managers of public companies must sign a report certifying their responsibilities for the financial statements.

b. Public companies must maintain an audited system of internal control to ensure accuracy in accounting reports.

c. Public companies must maintain an independent committee to meet with the company's independent auditors.

**d. Top managers of public companies must be members of the American Institute of Certified Public Accountants.**

## MINI-EXERCISES

LO 1-4

### M1-1 Identifying Definitions with Abbreviations

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 designation. The first one is an example.

| Abbreviation | Full Designation |
|---|---|
| 1. CPA | Certified Public Accountant |
| 2. GAAP | ________________________________ |
| 3. FASB | ________________________________ |
| 4. SEC | ________________________________ |
| 5. IFRS | ________________________________ |

SOLUTION:

| Abbreviation | | Full Designation |
|---|---|---|
| (1) | CPA | Certified Public Accountant |
| (2) | GAAP | Generally Accepted Accounting Principles |
| (3) | FASB | Financial Accounting Standards Board |
| (4) | SEC | Securities and Exchange Commission |
| (5) | IFRS | International Financial Reporting Standards |

LO 1-1, 1-2, 1-4

### 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. SEC
2. Investing activities
3. Private company
4. Corporation
5. Accounting
6. Partnership
7. FASB
8. Financing activities
9. Unit of measure
10. GAAP
11. Public company
12. Operating activities

**Definition**

B. Measurement of information about a business in the monetary unit (dollars or other national currency).

C. An unincorporated business owned by two or more persons.

D. A company that sells shares of its stock privately and is not required to release its financial statements to the public.

E. An incorporated business that issues shares of stock as evidence of ownership.

F. Buying and selling productive resources with long lives.

G. Transactions with lenders (borrowing and repaying cash) and stockholders (selling company stock and paying dividends).

H. Activities directly related to running the business to earn profit.

I. Securities and Exchange Commission.

J. Financial Accounting Standards Board.

K. A company that has its stock bought and sold by investors on established stock exchanges.

L. Generally accepted accounting principles.

A. A system that collects and processes financial information about an organization and reports that information to decision makers.

SOLUTION:

| Term or Abbreviation | | Definition |
|---|---|---|
| (1) | SEC | I. Securities and Exchange Commission. |
| (2) | Investing activities | F. Buying and selling productive resources with long lives. |
| (3) | Private company | D. A company that sells shares of its stock privately and is not required to release its financial statements to the public. |
| (4) | Corporation | E. An incorporated business that issues shares of stock as evidence of ownership. |
| (5) | Accounting | A. A system that collects and processes financial information about an organization and reports that information to decision makers. |
| (6) | Partnership | C. An unincorporated business owned by two or more persons. |
| (7) | FASB | J. Financial Accounting Standards Board. |
| (8) | Financing activities | G. Transactions with lenders (borrowing and repaying cash) and stockholders (selling company stock and paying dividends). |
| (9) | Unit of measure | B. Measurement of information about a business in the monetary unit (dollars or other national currency). |
| (10) | GAAP | L. Generally accepted accounting principles. Activities directly related to running the business to earn profit. |
| (11) | Public company | K. A company that has its stock bought and sold by investors on established stock exchanges. |
| (12) | Operating activities | H. Activities directly related to running the business to earn profit. |

LO 1-2, 1-4

## M1-3 Matching Definitions with Terms

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

**Term**

1. Relevance
2. Faithful Representation
3. Expenses
4. Separate Entity
5. Assets
6. Liabilities
7. Stockholders' Equity
8. Revenues

**Definition**

A. The financial reports of a business are assumed to include the results of only that business's activities.
B. The resources owned by a business.
C. Financial information that depicts the economic substance of business activities.
D. The total amounts invested and reinvested in the business by its owners.
E. The costs of business necessary to earn revenues.
F. A feature of financial information that allows it to influence a decision.
G. Earned by selling goods or services to customers.
H. The amounts owed by the business.

SOLUTION:

| | Term | Definition |
|---|---|---|
| (1) | Relevance | F. A feature of financial information that allows it to influence a decision. |
| (2) | Faithful Representation | C. Financial information that depicts the economic substance of business activities. |
| (3) | Expenses | E. The costs of business necessary to earn revenues. |
| (4) | Separate Entity | A. The financial reports of a business are assumed to include the results of only that business's activities. |
| (5) | Assets | B. The resources owned by a business. |
| (6) | Liabilities | H. The amounts owed by the business. |
| (7) | Stockholders' Equity | D. The total amounts invested and reinvested in the business by its owners. |
| (8) | Revenues | Earned by selling goods or services to customers. |