Chapter 7

# Accounting Principles

## STUDY OBJECTIVES

*After studying this chapter, you should be able to:*

1. Explain the meaning of GAAP and identify the key items of the conceptual framework.
2. Describe the basic objectives of financial reporting.
3. Discuss the qualitative characteristics of accounting information and elements of financial statements.
4. Identify the basic assumptions used by accountants.
5. Identify the basic principles of accounting.
6. Identify the two constraints in accounting.
7. Understand and analyze classified financial statements.
8. Explain the accounting principles used in international operations.

The Navigator

## The Navigator

| | |
|---|---|
| Scan **Study Objectives** | ☐ |
| Read **Feature Story** | ☐ |
| Read **Preview** | ☐ |
| Read text and answer **Before You Go On** p. 298 ☐ p. 304 ☐ p. 313 ☐ | |
| Work **Demonstration Problems** | ☐ |
| Review **Summary of Study Objectives** | ☐ |
| Answer **Self-Study Questions** | ☐ |
| Complete **Assignments** | ☐ |

## Feature Story

### CERTAINLY WORTH INVESTIGATING!

It is often difficult to determine in what period some revenues and expenses should be reported. There are rules that give guidance, but occasionally these rules are overlooked, misinterpreted, or even intentionally ignored. Consider the following examples.

- Policy Management Systems, which makes insurance software, said that it reported some sales before contracts were signed or products delivered.
- Sunbeam Corporation, while under the control of the (in)famous "Chainsaw" Al Dunlap, prematurely booked revenues and recorded overly large restructuring charges. Ultimately the company had to restate its net income


figures, and Mr. Dunlap lost his job.

- Rent-Way Inc., which owns a large chain of rent-to-own stores, saw its share price plummet from $23.44 to $5 within a week after it disclosed what the company termed "fictitious" accounting entries on its books. These entries included improper accounting for fixed-asset write-offs, and understating the amount of damaged or missing merchandise.

Often in cases such as these, the company's stockholders sue the company because of the decline in the stock price due to the disclosure of the misinformation. In light of this eventuality, why might management want to report revenues or expenses in the wrong period? Company managers are under intense pressure to report higher earnings every year. If actual performance falls short of expectations, management might be tempted to bend the rules.

One analyst suggests that investors and auditors should be suspicious of sharp increases in monthly sales at the end of each quarter or big jumps in fourth-quarter sales. Such events don't always mean management is cheating, but they are certainly worth investigating.

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## Inside Chapter 7

## Preview of Chapter 7

As indicated in the Feature Story, it is important that companies have general guidelines available to resolve accounting issues. Without these basic guidelines, each company would have to develop its own set of accounting practices. If this happened, we would have to become familiar with every company's peculiar accounting and reporting rules in order to understand its financial statements. It would be almost impossible to compare the financial statements of different companies. This chapter explores the basic accounting principles that are followed in developing specific accounting guidelines.

The content and organization of Chapter 7 are as follows.

**Accounting Principles**

| The Conceptual Framework of Accounting | Assumptions | Principles | Constraints in Accounting | Statement Presentation and Analysis |
|---|---|---|---|---|
| • Objectives of reporting<br>• Qualitative characteristics<br>• Elements of financial statements<br>• Operating guidelines | • Monetary unit<br>• Economic entity<br>• Time period<br>• Going concern | • Revenue recognition<br>• Matching<br>• Full disclosure<br>• Cost | • Materiality<br>• Conservatism<br>• Summary of conceptual framework | • Classified balance sheet<br>• Classified income statement<br>• Analyzing financial statements<br>• An international perspective |

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# THE CONCEPTUAL FRAMEWORK OF ACCOUNTING

**STUDY OBJECTIVE 1**

**Explain the meaning of GAAP and identify the key items of the conceptual framework.**

What you have learned up to this point in the book is a process that leads to the preparation of financial reports about a company. These are the company's financial statements. This area of accounting is called **financial accounting**. The accounting profession has established a set of standards and rules that are recognized as a general guide for financial reporting. This recognized set of standards is called **generally accepted accounting principles (GAAP)**. *Generally accepted* means that these principles have "substantial authoritative support." Such support usually comes from two standard-setting bodies: the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC).[1]

Since the early 1970s the business and governmental communities have given the FASB the responsibility for developing accounting principles in this country. This is an ongoing process; accounting principles change to reflect changes in the business environment and in the needs of users of accounting information.

[1]The SEC is an agency of the U.S. government that was established in 1933 to administer laws and regulations relating to the exchange of securities and the publication of financial information by U.S. businesses. The agency has the authority to mandate generally accepted accounting principles for companies under its jurisdiction. However, throughout its history, the SEC has been willing to accept the principles set forth by the FASB and similar bodies.

Prior to the establishment of the FASB, accounting principles were developed on a problem-by-problem basis. Rule-making bodies developed accounting rules and methods to solve specific problems. Critics charged that the problem-by-problem approach led over time to inconsistent rules and practices. No clearly developed conceptual framework of accounting existed to refer to in solving new problems.

In response to these criticisms, the FASB developed a **conceptual framework**. It serves as the basis for resolving accounting and reporting problems. The FASB spent considerable time and effort on this project. The Board views its conceptual framework as "... a constitution, a coherent system of interrelated objectives and fundamentals."[2]

The FASB's conceptual framework consists of the following four items:

1. Objectives of financial reporting.
2. Qualitative characteristics of accounting information.
3. Elements of financial statements.
4. Operating guidelines (assumptions, principles, and constraints).

We will discuss these items on the following pages.

**HELPFUL HINT**

Accounting principles are affected by economic and political conditions which change over time. As a result, accounting principles are not cut into stone like the periodic table in chemistry or a formula in math.

## Objectives of Financial Reporting

**STUDY OBJECTIVE 2**

Describe the basic objectives of financial reporting.

The FASB began to work on the conceptual framework by looking at the objectives of financial reporting. Determining these objectives required answers to such basic questions as: Who uses financial statements? Why? What information do they need? How knowledgeable about business and accounting are financial statement users? How should financial information be reported so that it is best understood?

In answering these questions, the FASB concluded that the objectives of financial reporting are to provide information that:

1. Is useful to those making investment and credit decisions.
2. Is helpful in assessing future cash flows.
3. Identifies the economic resources (assets), the claims to those resources (liabilities), and the changes in those resources and claims.

The FASB then undertook to describe the characteristics that make accounting information useful.

## Qualitative Characteristics of Accounting Information

**STUDY OBJECTIVE 3**

Discuss the qualitative characteristics of accounting information and elements of financial statements.

How does a company like Microsoft decide on the amount of financial information to disclose? In what format should Walt Disney present its financial information? How should it measure assets, liabilities, revenues, and expenses? The FASB concluded that the overriding criterion for such accounting choices is **decision usefulness**. The accounting practice selected should be the one that generates the most useful financial information for making a decision. To be useful, information should possess the following qualitative characteristics: relevance, reliability, comparability, and consistency.

[2]"Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement," *FASB Discussion Memorandum* (Stamford, Conn.: 1976), p. 1.

**HELPFUL HINT**
What makes accounting information relevant? Answer: Relevant accounting information provides feedback, serves as a basis for predictions, and is timely (current).

## RELEVANCE

Accounting information has **relevance** if it makes a difference in a decision. Relevant information has either predictive or feedback value or both. **Predictive value** helps users forecast future events. For example, when ExxonMobil issues financial statements, the information in them is considered relevant because it provides a basis for predicting future earnings. **Feedback value** confirms or corrects prior expectations. When ExxonMobil issues financial statements, it confirms or corrects prior expectations about the financial health of the company.

In addition, accounting information has relevance if it is **timely**. It must be available to decision makers before it loses its capacity to influence decisions. If ExxonMobil reports its financial information only every five years, the information is of limited use in decision-making.

**HELPFUL HINT**
What makes accounting information reliable? Answer: Reliable accounting information is free of error and bias, is factual, verifiable, and neutral.

## RELIABILITY

**Reliability** of information means that the information is free of error and bias. In short, it can be depended on. To be reliable, accounting information must be **verifiable**: We must be able to prove that it is free of error and bias. It also must be a **faithful representation** of what it purports to be: It must be factual. If General Motors' income statement reports sales of $225 billion when it had sales of $193.5 billion, then the statement is not a faithful representation. Finally, accounting information must be **neutral**: It cannot be selected, prepared, or presented to favor one set of interested users over another. To ensure reliability, certified public accountants audit financial statements.

## COMPARABILITY

Accounting information about an enterprise is most useful when it can be compared with accounting information about other enterprises. **Comparability** results when different companies use the same accounting principles. For example, Sears Holdings, L. L. Bean, and The Limited all use the cost principle in reporting plant assets on the balance sheet. Also, each company uses the revenue recognition and matching principles in determining its net income.

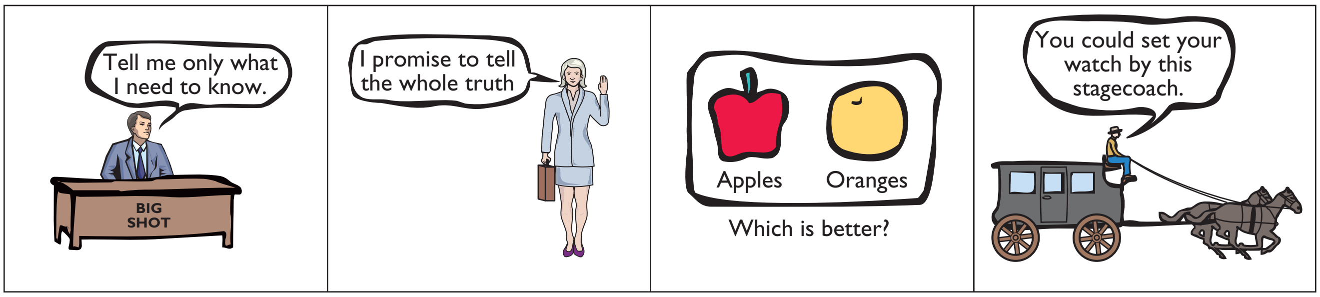
Conceptually, comparability should also extend to the methods used by companies in complying with an accounting principle. Accounting methods include the FIFO and LIFO methods of inventory costing, and various depreciation methods. At this point, comparability of methods is not required, even for companies in the same industry. Thus, Ford, General Motors, and DaimlerChrysler may use different inventory costing and depreciation methods in their financial statements. The only accounting requirement is that each company **must disclose** the accounting methods used. From the disclosures, the external user can determine whether the financial information is comparable.

## CONSISTENCY

**Consistency** means that a company uses the same accounting principles and methods from year to year. If a company selects FIFO as the inventory costing method in the first year of operations, it is expected to use FIFO in succeeding years. When a company reports financial information on a consistent basis, the financial statements permit meaningful analysis of trends within the company.

A company *can* change to a new method of accounting. To do so, management must justify that the new method results in more meaningful financial information. In the year in which the change occurs, the company must disclose the change in the notes to the financial statements. Such disclosure makes users of the financial statements aware of the lack of consistency.

Illustration 7-1 (on page 297) summarizes the characteristics that make accounting information useful.




**Relevance**
1. Provides a basis for forecasts
2. Confirms or corrects prior expectations
3. Is timely

**Reliability**
1. Is verifiable
2. Is a faithful representation
3. Is neutral

**Comparability**
Different companies use similar accounting principles

**Consistency**
Company uses same accounting methods from year to year

**Illustration 7-1**
Characteristics of useful information

## Elements of Financial Statements

An important part of the accounting conceptual framework is a set of definitions that describe the basic terms used in accounting. The FASB refers to this set of definitions as the **elements of financial statements**. They include such terms as assets, liabilities, equity, revenues, and expenses.

Because these elements are so important, it is crucial that they be precisely defined and universally applied. Finding the appropriate definition for many of these elements is not easy. For example, should the value of a company's employees be reported as an asset on a balance sheet? Should the death of the company's president be reported as a loss? A good set of definitions should provide answers to these types of questions. Because you have already encountered most of these definitions in earlier chapters, they are not repeated here.

## Operating Guidelines

The objectives of financial reporting, the qualitative characteristics of accounting information, and the elements of financial statements are very broad. Because practicing accountants must solve practical problems, they need more detailed guidelines. In its conceptual framework, the FASB recognized the need for operating guidelines. We classify these guidelines as assumptions, principles, and constraints. These guidelines are well-established and accepted in accounting.

**Assumptions** provide a foundation for the accounting process. **Principles** are specific rules that indicate how economic events should be reported in the accounting process. **Constraints** on the accounting process allow for a relaxation of the principles under certain circumstances. Illustration 7-2 provides a road-map of the operating guidelines of accounting. These guidelines (some of which you know from earlier chapters) are discussed in more detail in the following sections.

| Assumptions | Principles | Constraints |
| --- | --- | --- |
| Monetary unit<br>Economic entity<br>Time period<br>Going concern | Revenue recognition<br>Matching<br>Full disclosure<br>Cost | Materiality<br>Conservatism |

**Illustration 7-2**
The operating guidelines of accounting

## Before You Go On...

**REVIEW IT**

1. What are generally accepted accounting principles?
2. What is stated about generally accepted accounting principles in the Independent Auditors' Report for PepsiCo? The answer to this question appears on page 336.
3. What are the basic objectives of financial information?
4. What are the qualitative characteristics that make accounting information useful? Identify two elements of the financial statements.

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# ASSUMPTIONS

**STUDY OBJECTIVE 4**

Identify the basic assumptions used by accountants.

As noted above, assumptions provide a foundation for the accounting process. You already know three of the major assumptions—the monetary unit, economic entity, and time period assumptions. The fourth is the going concern assumption.

## Monetary Unit Assumption

The **monetary unit assumption** states that only transaction data that can be expressed in terms of money be included in the accounting records. For example, a company does not report the value of the company president in its financial records because that value cannot be expressed easily in dollars.

An important corollary to the monetary unit assumption is the assumption that the unit of measure remains relatively constant over time. We will discuss this point in more detail later in this chapter.

**ETHICS NOTE**

In an action that sent shock waves through the French business community, the CEO of Alcatel-Alsthom was taken into custody for an apparent violation of the economic entity assumption. Allegedly, the executive improperly used company funds to install an expensive security system in his home.

## Economic Entity Assumption

The **economic entity assumption** states that the activities of the entity be kept separate and distinct from the activities of the owner and of all other economic entities. For example, it is assumed that the activities of IBM can be distinguished from those of other computer companies such as Apple, Dell, and Hewlett-Packard.

## Time Period Assumption

The **time period assumption** states that the economic life of a business can be divided into artificial time periods. Thus, it is assumed that companies such as General Electric, Time Warner, and ExxonMobil, can subdivide their business activities into months, quarters, or a year for meaningful financial reporting purposes.

## Going Concern Assumption

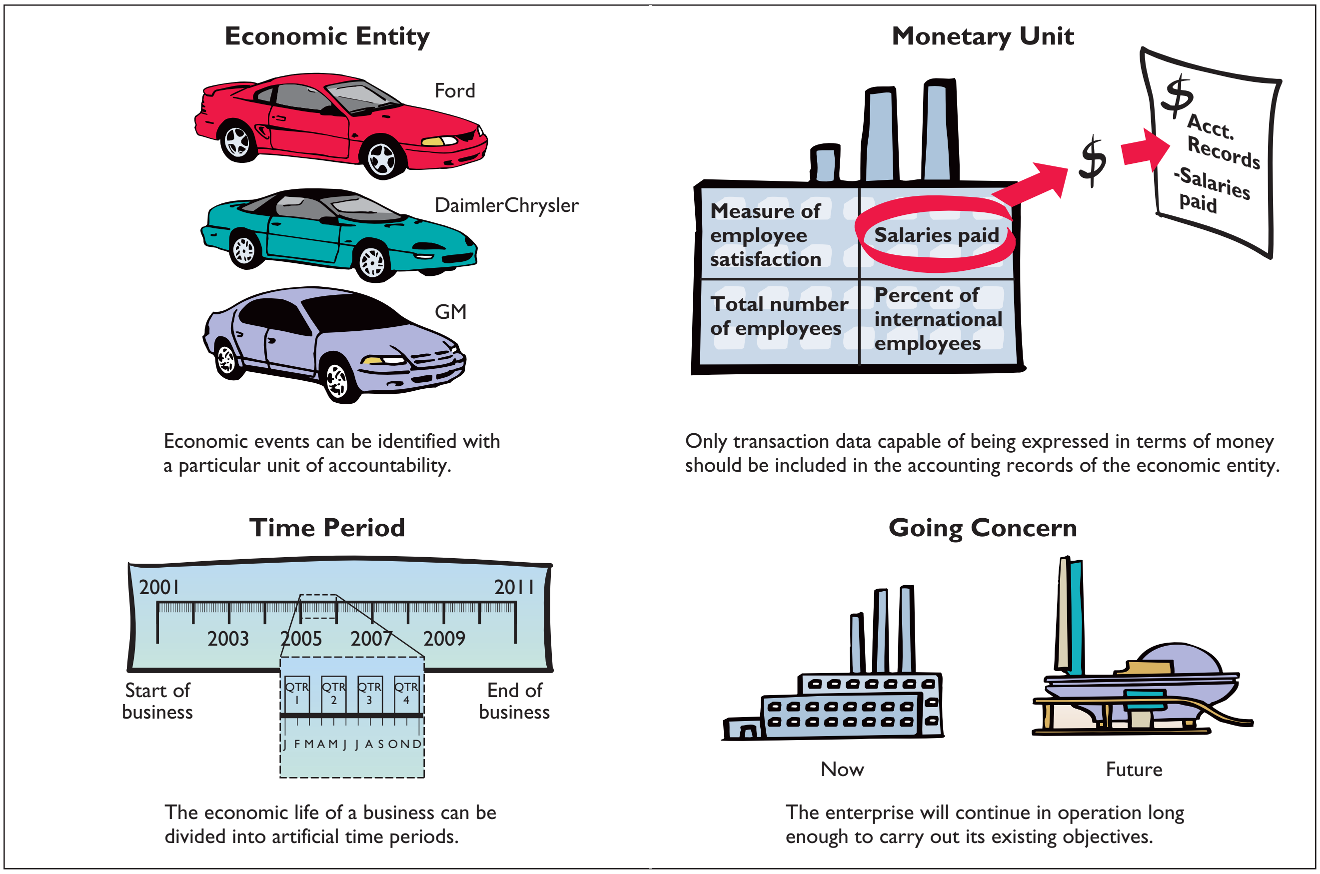
The **going concern assumption** assumes that the company will continue in operation long enough to carry out its existing objectives. Despite numerous business failures, companies have a fairly high continuance rate. It has proved useful to adopt a going-concern assumption for accounting purposes.

This assumption has significant implications. If a going concern assumption is not used, then plant assets should be stated at their liquidation value (selling price less cost of disposal)—not at their cost. In that case, depreciation of these assets is not needed. Each period, companies would simply report these assets at their liquidation value. Also, without this assumption, the current–noncurrent classification of assets and liabilities would not matter. Labeling anything as long-term would be difficult to justify.

Acceptance of the going-concern assumption gives credibility to the cost principle. Only when liquidation appears imminent is the going concern assumption inapplicable. In that case, assets would be better stated at liquidation value than at cost.

These basic accounting assumptions are illustrated graphically in Illustration 7-3 below.

**Illustration 7-3**
Assumptions used in accounting




## PRINCIPLES

**STUDY OBJECTIVE 5**
**Identify the basic principles of accounting.**

On the basis of the fundamental assumptions of accounting, the accounting profession has developed principles that dictate how economic events should be recorded and reported. In earlier chapters we discussed the cost principle (Chapter 1) and the revenue recognition and matching principles (Chapter 3). Here we now examine a number of reporting issues related to these principles. In addition, we introduce another principle, the full disclosure principle.

### Revenue Recognition Principle

The **revenue recognition principle** dictates that companies should recognize revenue in the accounting period in which it is earned. But applying this general principle in practice can be difficult. For example, some companies improperly recognize revenue on goods that have not been shipped to customers. Similarly, financial institutions at one time immediately recorded a large portion of their fees for granting a loan as revenue rather than spreading those fees over the life of the loan.

**HELPFUL HINT**
Companies should recognize revenue in the accounting period in which it is earned. This may not be the period in which the company receives the related cash.

When a sale is involved, companies recognize revenue at the point of sale. This **sales basis** involves an exchange transaction between the seller and buyer. The sales price is an objective measure of the amount of revenue realized. However, there are two exceptions to the sales basis for revenue recognition that have become generally accepted. These methods are left for more advanced courses.

## Matching Principle (Expense Recognition)

Expense recognition is traditionally tied to revenue recognition: "Let the expense follow the revenue." As you learned in Chapter 3, this practice is referred to as the **matching principle**. It dictates that companies match expenses with revenues in the period in which efforts are made to generate revenues. Expenses are not recognized when cash is paid, or when the work is performed, or when the product is produced. Rather, they are recognized when the labor (service) or the product actually makes its contribution to revenue.

**HELPFUL HINT**
Costs become expenses when they are charged against revenue.

But, it is sometimes difficult to determine the accounting period in which the expense contributed to revenues. Several approaches have therefore been devised for matching expenses and revenues on the income statement.

To understand these approaches, you need to understand the nature of expenses. Costs are the source of expenses. Companies immediately expense costs that will generate revenues only in the current accounting period. They report these costs as **operating expenses** in the income statement. Examples include costs for advertising, sales salaries, and repairs. These expenses are often called **expired costs**.

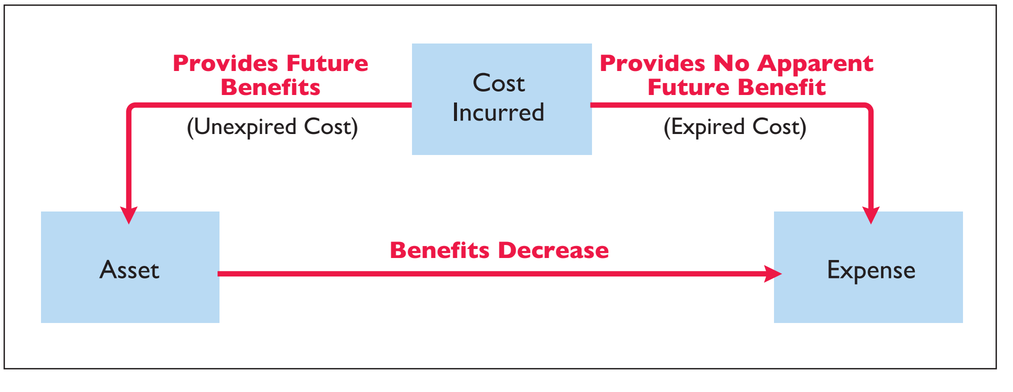
Companies recognize as assets costs that will generate revenues in future accounting periods. Examples include merchandise inventory, prepaid expenses, and plant assets. These costs represent **unexpired costs**. Unexpired costs become expenses in two ways:

**ETHICS NOTE**
Many appear to do it, but few like to discuss it: It's *earnings management*, and it's a clear violation of the revenue recognition and matching principles. Banks sometimes time the sale of investments or the expensing of bad debts to accomplish earnings objectives. Prominent companies have been accused of matching one-time gains with one-time charge-offs so that current-period earnings are not so high that they can't be surpassed next period.

1. **Cost of goods sold.** Costs carried as merchandise inventory become expenses when the inventory is sold. Companies expense these costs as cost of goods sold in the period when the sale occurs. Thus, there is a direct matching of expenses with revenues.
2. **Operating expenses.** Other unexpired costs become operating expenses through use or consumption (as in the case of store supplies) or through the passage of time (as in the case of prepaid insurance). Companies expense the costs of plant assets and other long-lived resources through rational and systematic allocation methods—that is, through periodic depreciation. Operating expenses contribute to the revenues for the period, but their association with revenues is less direct than for cost of goods sold.

Illustration 7-4 summarizes these points about expense recognition.

**Illustration 7-4**
Expense recognition pattern



## ACCOUNTING ACROSS THE ORGANIZATION


### *When to Account for the Winning Handle Pull*

Implementing expense recognition guidelines can be difficult. Consider, for example, Harold's Club (a gambling casino) in Reno, Nevada. How should it report expenses related to the payoff of its progressive slot machines? Progressive slot machines, which generally have no ceiling on their jackpots, provide a lucky winner with all the money that many losers had previously put in. Payoffs tend to be huge, but infrequent. At Harold's, the progressive slots pay off on average every 4½ months.

The basic accounting question is: Can Harold's deduct the millions of dollars sitting in its progressive slot machines from the revenue recognized at the end of the accounting period? One might argue that no, you cannot deduct the money until the "winning handle pull." However, a winning handle pull might not occur for many months or even years. Although an estimate would have to be used, the better answer is to match these costs with the revenue recognized, assuming that an average 4½ months' payout is well documented.

What accounting principles are applicable to the Harold's Club progressive slot machines? If Harold's fails to use an estimate for expenses, what effect will this have on financial statements in a period when no payouts occur?

## Full Disclosure Principle

The **full disclosure principle** requires that companies disclose circumstances and events that make a difference to financial statement users. For example, investors who lost money in Enron, WorldCom, and Global Crossing have complained that the lack of full disclosure regarding some of the companies' transactions caused the financial statements to be misleading. Investors want to be made aware of events that can affect the financial health of a company.

Compliance with the full disclosure principle occurs through the data in the financial statements and the information in the notes that accompany the statements. The first note in most cases is a **summary of significant accounting policies**. It includes, among others, the methods used for inventory costing and depreciation of plant assets.

Deciding how much disclosure is enough can be difficult. Accountants could disclose every financial event that occurs and every contingency that exists. But the benefits of providing additional information in some cases may be less than the costs of doing so. Many companies complain of an accounting standards overload. They also object to requirements that force them to disclose confidential information. Determining where to draw the line on disclosure is not easy.

One thing is certain: Financial statements were much simpler years ago. In 1930, General Electric had no notes to its financial statements. Today it has numerous pages of notes! Why this change? A major reason is that the objectives of financial statements have changed. In the past, information was generally presented on what the business had done. Today, the objectives of financial reporting are more future-oriented. The goal is to provide information that makes it possible to predict the amounts, timing, and uncertainty of future cash flows.

# ACCOUNTING ACROSS THE ORGANIZATION

### *How About Instant Access?*

Some accountants are reconsidering the current means of financial reporting. They propose a database concept of financial reporting. In such a system, a computerized database would store all the information from transactions. Various user groups could instantly access the information. The main benefit of such a system is the ability to tailor the information requested to the needs of each user on a real-time basis.

What makes this idea controversial? Discussion currently revolves around access and aggregation issues. Questions abound: "Who should be allowed to make inquiries of the system?" "What is the lowest/smallest level of information to be provided?" "Will such a system necessarily improve on the current means of disclosure?" Such questions must be answered before database financial accounting can be implemented on a large scale.

Would instant access to financial information provide more relevant information? Do you think such an approach would do away with the need for annual reports?

## Cost Principle

As you know, the **cost principle** dictates that companies record assets at their cost. Cost is used because it is both relevant and reliable. Cost is **relevant** because it represents the price paid, the assets sacrificed, or the commitment made at date of acquisition. Cost is **reliable** because it is objectively measurable, factual, and verifiable. It is the result of an exchange transaction. Cost is the basis used in preparing financial statements.

The cost principle, however, has come under criticism. Some criticize it as irrelevant. After acquisition, the argument goes, the cost of an asset is not equivalent to market value or current value. Also, as the purchasing power of the dollar changes, so does the meaning associated with the dollar used as the basis of measurement. Consider the classic story about the individual who went to sleep and woke up 10 years later. Hurrying to a telephone, he called his broker and asked what his formerly modest stock portfolio was worth. The broker told him that he was a multimillionaire. His General Motors stock was worth $5 million, and his Microsoft stock was up to $10 million. Elated, he was about to inquire about his other holdings, when the telephone operator cut in with "Your time is up. Please deposit $100,000 for the next three minutes."[3]

**HELPFUL HINT**

**Are you a winner or loser when you hold cash in a period of inflation? Answer: A loser, because the value of the cash declines as inflation climbs.**

Despite the inevitability of changing prices due to inflation, the accounting profession still follows the stable monetary unit assumption in preparing the primary financial statements. While admitting that some changes in prices do occur, the profession believes the unit of measure—the dollar—has remained sufficiently constant over time to provide meaningful financial information. Sometimes, the **disclosure of price-level adjusted data is in the form of supplemental information** that accompanies the financial statements.

Illustration 7-5 (page 303) summarizes the basic principles of accounting.

[3] Adapted from *Barron's*, January 28, 1980, p. 27.

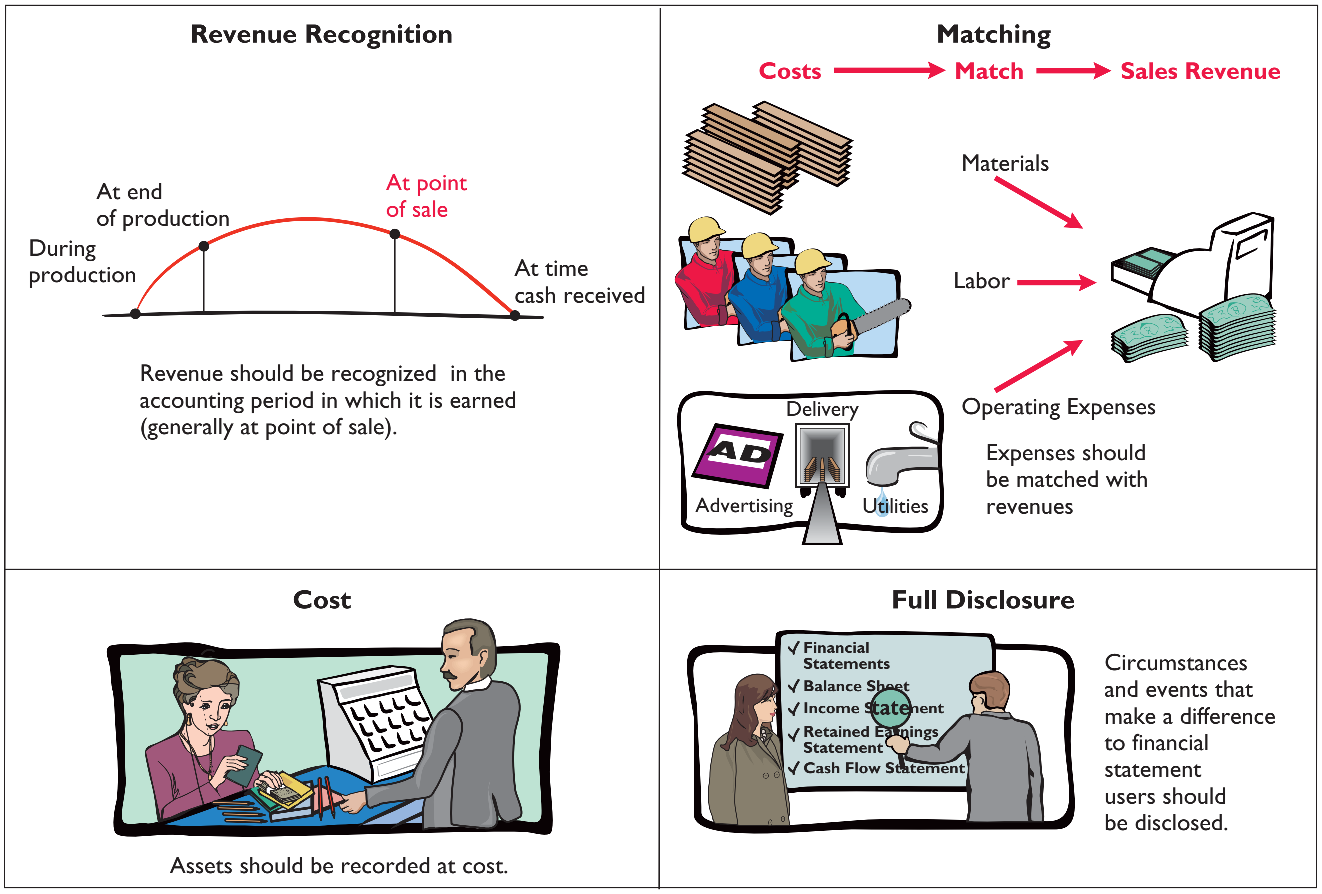



**Illustration 7-5**
Basic principles used in accounting

## CONSTRAINTS IN ACCOUNTING

**STUDY OBJECTIVE 6**
**Identify the two constraints in accounting.**

**Constraints** permit a company to modify generally accepted accounting principles without reducing the usefulness of the reported information. The constraints are materiality and conservatism.

### Materiality

**Materiality** relates to an item's impact on a firm's overall financial condition and operations. An item is **material** when it is likely to influence the decision of a reasonably prudent investor or creditor. It is **immaterial** if its inclusion or omission has no impact on a decision maker. In short, if the item does not make a difference in decision making, GAAP does not have to be followed. To determine the materiality of an amount, the accountant usually compares it with such items as total assets, total liabilities, and net income.

To illustrate application of the materiality constraint, assume that Rodriguez Co. purchases a number of low-cost plant assets, such as wastepaper baskets. Although the proper accounting would appear to be to depreciate these wastepaper baskets over their useful life, they usually are expensed immediately. This practice is justified because these costs are considered immaterial. Establishing depreciation schedules for these assets is costly and time-consuming and will not make a material difference on total assets and net income. Another application of the materiality constraint would be the expensing of small tools. Some companies expense any plant assets under a specified dollar amount.

**HELPFUL HINT**
In other words, if two methods are otherwise equally appropriate, choose the one that will least likely overstate assets and income.

## Conservatism

The **conservatism** constraint dictates that when in doubt, choose the method that will be least likely to overstate assets and income. **It does not mean understating assets or income**. Conservatism provides a reasonable guide in difficult situations: Do not overstate assets and income.

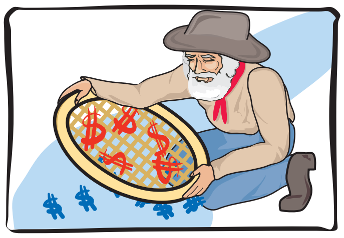
A common application of the conservatism constraint is the use of the lower-of-cost-or-market method for inventories. As indicated in Chapter 6, companies report inventories at market value if market value is below cost. This practice results in a higher cost of goods sold and lower net income. In addition, inventory on the balance sheet is stated at a lower amount.

Other examples of conservatism in accounting are the use of the LIFO method for inventory valuation when prices are rising and the use of accelerated depreciation methods for plant assets (faster write-off in earlier years). Both these methods result in lower asset carrying values and lower net income than alternative methods.

Illustration 7-6 depicts the two constraints in accounting.

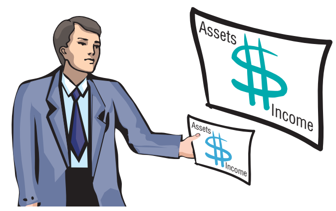
**Illustration 7-6**
Constraints in accounting

**Materiality**



For small amounts, GAAP does not have to be followed.

**Conservatism**




When in doubt, choose the solution that will be least likely to overstate assets and income.

## Summary of Conceptual Framework

As we have seen, the conceptual framework for developing sound reporting practices starts with a set of objectives for financial reporting. It follows with the description of qualities that make information useful. In addition, it defines elements of financial statements and then provides more detailed operating guidelines. These guidelines take the form of assumptions and principles. The conceptual framework also recognizes that constraints exist on the reporting environment. Illustration 7-7 (page 305) shows the conceptual framework.

### *Before You Go On...*

**REVIEW IT**

1. What are the monetary unit assumption, the economic entity assumption, the time period assumption, and the going concern assumption?
2. What are the revenue recognition principle, the matching principle, the full disclosure principle, and the cost principle?
3. What are the materiality constraint and the conservatism constraint?

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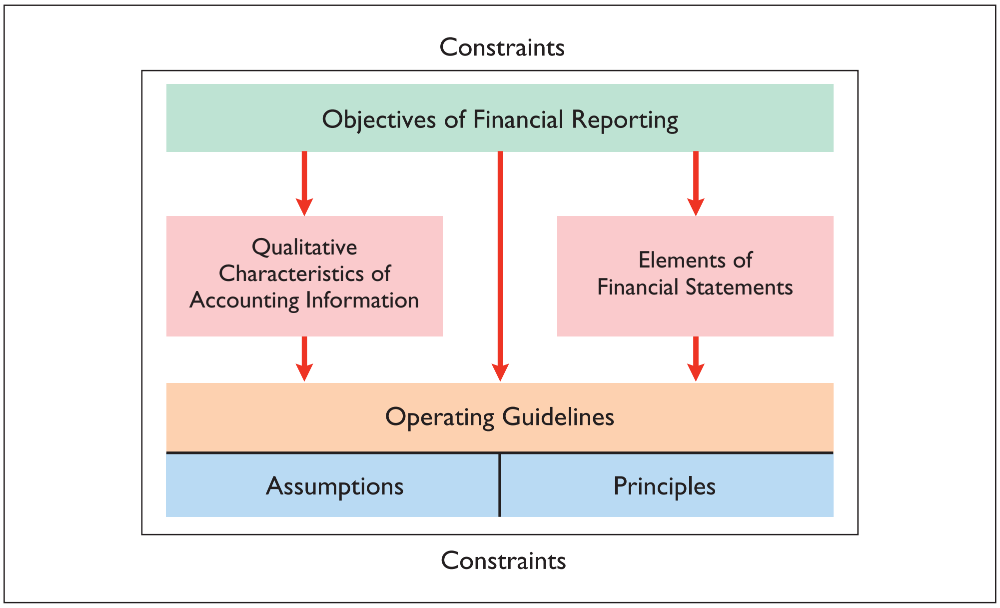



**Illustration 7-7**
Conceptual framework

## STATEMENT PRESENTATION AND ANALYSIS

**STUDY OBJECTIVE 7**
**Understand and analyze classified financial statements.**

Financial statements play an important role in attempting to meet the objectives of financial reporting. "Bottom line" information such as total assets and net income are useful to investors, but these single numbers lack sufficient detail for serious analysis. Investors and creditors generally find the parts of a financial statement more useful than the whole. Proper classification within the financial statements is therefore extremely important.

### Classified Balance Sheet

The balance sheet is composed of three major elements: assets, liabilities, and stockholders' equity. Additional segregation within these groups, however, is considered useful to financial statement readers. As indicated in Chapter 4, the following classification is generally found.

| Assets | Liabilities and Stockholders' Equity |
|---|---|
| Current assets | Current liabilities |
| Long-term investments | Long-term liabilities |
| Property, plant, and equipment | Stockholders' equity |
| Intangible assets | |

**Illustration 7-8**
Standard classification of balance sheet

If the form of organization is a proprietorship, the balance sheet uses the term "Owner's equity" instead of "Stockholders' equity" to describe that section. An account called Capital is reported in the owner's equity section of the balance sheet for a proprietorship. **Capital** is the owner's investment in the business.

To illustrate, assume that Sally Field invests $90,000 on July 10, 2008, to start up Med/Waste Company. The company's balance sheet immediately after the investment is shown in Illustration 7-9 on the next page.

**Illustration 7-9**
Proprietorship balance sheet

**MED/WASTE COMPANY**
Balance Sheet
July 10, 2008

| | | | |
|---|---|---|---|
| Cash | $90,000 | Sally Field, Capital | $90,000 |

**HELPFUL HINT**
**Note "Owners' equity" instead of "Owner's equity" is used for a partnership to indicate multiple owners.**

Because Sally Field owns the business and has chosen not to incorporate, common stock is not issued and net income (net loss) belongs to her. Therefore, the company does not need common stock and retained earnings accounts. Instead, the owner's capital account is increased by investments and by net income. It is decreased by withdrawals of assets for personal use and by net losses. The capital account represents Sally Field's claim to the net assets (assets less liabilities) of the company.

If the form of organization is a partnership, each partner has a separate capital account, and the owners' equity section shows the capital accounts of all the partners. For example, assume that A. Roy and B. Siegfried form a partnership on December 11, 2008, at which time Roy and Siegfried each invest $60,000. The balance sheet immediately after their investments is as follows.

**Illustration 7-10**
Partnership balance sheet

**ROY AND SIEGFRIED**
Balance Sheet
December 11, 2008

| | | | |
|---|---|---|---|
| Cash | $120,000 | A. Roy, Capital | $ 60,000 |
| | | B. Siegfried, Capital | 60,000 |
| | | | $120,000 |

## Classified Income Statement

Chapter 5 presented a multiple-step income statement for PW Audio Supply, Inc. The multiple-step income statement included the following.

**Sales revenue section**—Presents the sales, discounts, allowances, and other related information to arrive at the net amount of sales revenue.

**Cost of goods sold**—Indicates the cost of goods sold to produce sales.

**Operating expenses**—Provides information on both selling and administrative expenses.

**Other revenues and gains**—Indicates revenues earned or gains resulting from nonoperating transactions.

**Other expenses and losses**—Indicates expenses or losses incurred from nonoperating transactions.

Two additional items are income tax expense and earnings per share.

### INCOME TAX EXPENSE

Because a corporation is a legal entity separate and distinct from its owners, corporations must pay and report income taxes. Proprietorships and partnerships are not separate legal entities; owners are therefore taxed directly on their business income. Stockholders are taxed only on the dividends they receive.

Companies report corporate **income taxes** (or **income tax expense)** in a separate section of the income statement, before net income. The condensed income statement for Leads Inc. in Illustration 7-11 shows a typical presentation. Note that "Income before income taxes" is reported before "Income tax expense."

**Illustration 7-11**
Income statement with income taxes

**LEADS INC.**
Income Statement
For the Year Ended December 31, 2008

| | |
|---|---|
| Sales | $800,000 |
| Cost of goods sold | 600,000 |
| Gross profit | 200,000 |
| Operating expenses | 50,000 |
| Income from operations | 150,000 |
| Other revenues and gains | 10,000 |
| Other expenses and losses | 4,000 |
| **Income before income taxes** | **156,000** |
| **Income tax expense** | **46,800** |
| Net income | $109,200 |

**HELPFUL HINT**
**Corporations may also use the single-step form of income statements discussed in Chapter 5.**

Income tax expense and the related liability for income taxes payable are recorded as part of the adjusting process, preceding financial statement preparation. Using the data in Illustration 7-11 for Leads Inc., the adjusting entry for income tax expense at December 31, 2008, would be as follows.

| | | |
|---|---|---|
| Income Tax Expense | 46,800 | |
| Income Taxes Payable | | 46,800 |
| (To record income taxes for 2008) | | |

| A | = | L | + | SE |
|---|---|---|---|---|
| | | | | −46,800 |
| | | +46,800 | | |

**Cash Flows**
no effect

Other examples of income tax presentation appear in the Demonstration Problem income statement of Chapter 15 and the income statement of **PepsiCo** in Appendix A.

## EARNINGS PER SHARE

The financial press frequently reports earnings per share data and stockholders and potential investors widely use EPS data in evaluating the profitability of a company. Investors, especially, attempt to link earnings per share to the market price per share.[4] **Earnings per share (EPS)** indicates the net income earned by each share of outstanding common stock. Thus, **earnings per share is reported only for common stock**. The formula for computing earnings per share when there has been no change in outstanding shares during the year is as follows.

$$\text{Net Income} \div \text{Number of Common Shares Outstanding} = \text{Earnings per Share}$$

**Illustration 7-12**
Earnings per share formula—no change in outstanding shares

[4]The ratio of the market price per share to the earnings per share is referred to as the *price-earnings (P-E) ratio*. This ratio is reported in the *Wall Street Journal* and other newspapers for common stocks listed on major stock exchanges.

For example, Leads Inc. (Illustration 7-11) has net income of $109,200. Assuming that it has 54,600 shares of common stock outstanding for the year, earnings per share is $2 ($109,200 ÷ 54,600).[5]

Because of the importance of earnings per share, most companies are required to report it on the face of the income statement. Generally this amount is simply reported below net income on the statement. For Leads Inc. the presentation would be as follows.

**Illustration 7-13**
Basic earnings per share disclosure

**LEADS INC.**
Income Statement (partial)
For the Year Ended December 31, 2008

| | |
|---|---|
| Net income | $109,200 |
| **Earnings per share** | **$2.00** |

## Analyzing Financial Statements

The financial statements should provide financial information that is useful for helping readers make sound investment and credit decisions. Illustrations 7-14 below and 7-15 (page 309) present the condensed balance sheet and income statement of Genlyte Inc. for 2008.

**Illustration 7-14**
Balance sheet—Genlyte Inc.

**GENLYTE INC.**
Balance Sheet
December 31, 2008

| Assets | | Liabilities and Stockholders' Equity | |
|---|---|---|---|
| Current assets | $156,000 | Current liabilities | $ 70,000 |
| Plant and equipment (net) | 74,000 | Long-term liabilities | 114,000 |
| Intangible assets | 14,000 | Stockholders' equity | 60,000 |
| Total assets | $244,000 | Total liabilities and stockholders' equity | $244,000 |

In analyzing and interpreting financial statement information, three major characteristics are generally used: **liquidity**, **profitability**, and **solvency**. A **short-term debtholder**, for example, is primarily interested in the ability of a borrower to pay obligations when they become due. The liquidity of the borrower in such a case is extremely important in assessing the safety of a loan. A **long-term debtholder**, however, looks to indicators such as profitability and solvency that point to the firm's ability to survive over a long period of time. Long-term debtholders analyze earnings per share, the relationship of income to total assets invested, and the amount of debt in relation to total assets to determine whether money should be

[5]Whenever the number of outstanding shares changes during the year, the calculation of EPS becomes more complicated. These computations are covered in Chapter 15.

**Illustration 7-15**
Income statement—Genlyte Inc.

| GENLYTE INC.<br>Income Statement<br>For the Year Ended December 31, 2008 | |
|---|---|
| Net sales | $430,000 |
| Cost of sales | 295,000 |
| Gross profit | 135,000 |
| Selling and administrative expenses | 109,000 |
| Income from operations | 26,000 |
| Other expenses and losses | 5,000 |
| Income before income taxes | 21,000 |
| Income tax expense | 7,000 |
| Net income | $ 14,000 |
| Earnings per share | $0.35 |

lent and at what interest rate. Similarly, when assessing the likelihood of dividends and the growth potential of the common stock, **stockholders** are interested in the profitability and solvency of a company.

## LIQUIDITY

What is Genlyte's ability to pay its maturing obligations and meet unexpected needs for cash? The relationship between current assets and current liabilities is critical to helping answer this question. These relationships are expressed as a ratio, called the **current ratio**, and as a dollar amount, called **working capital**.

**Current Ratio.** The **current ratio** is current assets divided by current liabilities. For Genlyte Inc., the ratio is 2.23:1, computed as follows.

**Illustration 7-16**
Current ratio formula and computation

| Current Assets | ÷ | Current Liabilities | = | Current Ratio |
|---|---|---|---|---|
| $156,000 | ÷ | $70,000 | = | 2.23:1 |

This ratio means that current assets are more than two times greater than current liabilities. Bankers, other creditors, and agencies such as Dun & Bradstreet use this ratio to determine whether the company is a good credit risk. Traditionally, a ratio of 2:1 is considered to be the standard for a good credit rating. Today, however, many sound companies have current ratios of less than 2:1. With its 2.23:1 ratio, Genlyte's short-term debt-paying ability appears to be very favorable.

From the foregoing, you might at first assume that the higher the current ratio, the better. This is not necessarily true. A very high current ratio may indicate that the company is holding more current assets than it currently needs in the business. It is possible, therefore, that the excess resources might be directed to more profitable investment opportunities.

**Working Capital.** The excess of current assets over current liabilities is called **working capital**. For Genlyte Inc., working capital is $86,000, as shown on page 310.

**Illustration 7-17**
Working capital formula and computation

| Current Assets | − | Current Liabilities | = | Working Capital |
|---|---|---|---|---|
| $156,000 | − | $70,000 | = | $86,000 |

The amount of working capital provides some indication of the company's ability to meet its existing current obligations. A large amount of working capital generally means a company can meet its current liabilities as they fall due and, if desired, pay dividends. Although no set standards exist for the level of working capital a company should maintain, analysts often determine the general adequacy of a company's working capital by comparing data from prior periods and from similar companies of comparable size. Genlyte's working capital appears adequate.

## PROFITABILITY

Profitability ratios measure the income or operating success of a company for a given period of time. Income, or the lack of it, affects the company's ability to obtain debt or equity financing and the company's ability to grow.

**Profit Margin Percentage.** One important profitability ratio is the **profit margin percentage** (or rate of return on sales). It measures the percentage of each dollar of sales that results in net income. It is calculated by dividing net income by net sales for the period. Genlyte Inc.'s profit margin percentage is 3.3 percent, computed as follows.

**Illustration 7-18**
Profit margin formula and computation

| Net Income | ÷ | Net Sales | = | Profit Margin Percentage |
|---|---|---|---|---|
| $14,000 | ÷ | $430,000 | = | 3.3% |

This ratio seems low. Much, however, depends on the type of industry. High-volume retailers, such as grocery stores (Safeway or Kroger) or discount stores (Wal-Mart or Kmart), generally have a low profit margin. They make a small profit on each sale but have many sales.

## INVESTOR INSIGHT

### *How High Is Your Profit Margin?*

The type of industry can make a difference in the profit margin percentage investors and creditors expect. Profit margins among service companies—from airlines and banks to telecommunications companies and utilities—have traditionally been lower than those among manufacturers. Verizon Communications, for example, showed a profit margin percentage of 7 percent which is high for a telecommunications company. Qwest's profit margin percentage was 4.6 percent. By contrast, the top three pharmaceutical firms—Johnson & Johnson, Pfizer, and Merck—had profit margin percentages of 20.7 percent, 39.9 percent, and 19.6 percent, respectively. Before using a ratio like the profit margin percentage to evaluate company performance, you need to know what is reasonable performance for the industry.

? If service companies have a profit margin much lower than manufacturers (a third as large), why would anyone invest in a service company over a manufacturer?

**Return on Assets.** In making an investment, an investor wants to know what rate of return to expect and what risks are associated with that rate of return. The greater the risk, the higher the rate of return the investor will demand on the investment.

One overall measure of profitability of a company is its rate of **return on assets**. It is calculated by dividing net income by total assets.[6] Genlyte Inc.'s rate of return is 5.7 percent, computed as follows.

| Net Income | ÷ | Total Assets | = | Return on Assets |
|---|---|---|---|---|
| $14,000 | ÷ | $244,000 | = | 5.7% |

**Illustration 7-19**
Return on assets formula and computation

The rate of return on assets is relatively low, which suggests that Genlyte may not be using its assets effectively.

**Return on Common Stockholders' Equity.** Another widely used rate that measures profitability from the common stockholders' viewpoint is **return on common stockholders' equity**. This rate shows the percentage of net income earned for each dollar of owners' investment. It is calculated by dividing net income by common stockholders' equity. In Genlyte Inc.'s case, the rate of return is 23.3 percent (or 23.3 cents per dollar), computed as follows.

| Net Income | ÷ | Common Equity | = | Return on Common Stockholders' Equity |
|---|---|---|---|---|
| $14,000 | ÷ | $60,000 | = | 23.3% |

**Illustration 7-20**
Return on common stockholders' equity formula and computation

Genlyte's return on common stockholders' equity is quite good. The reason for this high rate of return is that Genlyte's assets are earning a return higher than the borrowing costs the company incurs.

## SOLVENCY

Solvency measures the ability of an enterprise to survive over a long period of time. Long-term debtholders and stockholders are interested in a company's ability to pay periodic interest and to repay the face value of the debt at maturity.

**Debt to Total Assets.** One useful measure of solvency is the **debt to total assets ratio**. It measures the percentage of total assets that creditors, as opposed to stockholders, provide. It is calculated by dividing total debt (liabilities) by total assets, normally expressed as a percentage. Genlyte Inc.'s debt to total assets ratio is 75.4 percent, computed as follows.

| Total Debt | ÷ | Total Assets | = | Debt to Total Assets Ratio |
|---|---|---|---|---|
| $184,000 | ÷ | $244,000 | = | 75.4% |

**Illustration 7-21**
Debt to total assets formula and computation

[6] For simplicity, we've based the rate of return calculations on end-of-year total amounts. The more conceptually correct *average* total assets and *average* common stockholders' equity are used in later chapters.

Debt to total assets of 75.4 percent means that Genlyte's creditors have provided approximately three-quarters of its total assets. The higher the percentage of debt to total assets, the greater the risk that the company may be unable to meet its maturing obligations. The lower the percentage, the greater the "buffer" available to creditors should the company become insolvent. In Genlyte Inc.'s case, unless earnings are positive and very stable, the company may have too much debt.

Analysts and other financial statement readers often use these percentage and ratio relationships in comparison with (1) expected results, (2) prior year results, and (3) published results of other companies in the same line of business. Conclusions based on a single year's results are hazardous at best. Chapter 15 provides more detailed consideration of the analysis of financial statements.

## Financial Statement Presentation—An International Perspective

**STUDY OBJECTIVE 8**

**Explain the accounting principles used in international operations.**

World markets are increasingly intertwined. Foreigners use American computers, eat American breakfast cereals, read American magazines, listen to American rock music, watch American movies and TV shows, and drink American soda. Americans drive Japanese cars, wear Italian shoes and Scottish woolens, drink Brazilian coffee and Indian tea, eat Swiss chocolate bars, sit on Danish furniture, and use Arabian oil. The variety and volume of exported and imported goods indicates the extensive involvement of U.S. business in international trade. Many U.S. companies consider the world their market.

Companies that conduct operations in more than one country through subsidiaries, divisions, or branches in foreign countries are referred to as **multinational corporations (MNCs)**. The accounting for such corporations is complicated because foreign currencies are involved. These international transactions must be translated into U.S. dollars.

## INTERNATIONAL INSIGHT

### *And the Correct Answer Is . . .?*

Research and development costs are an example of different international accounting standards. Compare how four countries once accounted for research and development (R&D):

| Country | Accounting Treatment |
|---|---|
| United States | Expenditures are expensed. |
| United Kingdom | Certain expenditures may be capitalized. |
| Germany | Expenditures are expensed. |
| Japan | Expenditures may be capitalized and written off over 5 years. |

Thus, an R&D expenditure of $100 million is charged totally to expense in the current period in the United States and Germany. This same expense could range from zero to $100 million in the United Kingdom and from $20 million to $100 million in Japan!

? What would be the advantage of similar accounting standards for all countries? How can the financial and operating performance of international companies be compared?

### DIFFERENCES IN STANDARDS

In the new global economy many investment and credit decisions require the analysis of foreign financial statements. As indicated in Chapter 1, accounting standards are not always uniform from country to country. This lack of uniformity results from differences in legal systems, in processes for developing accounting standards, in governmental requirements, and in economic environments.

### UNIFORMITY IN STANDARDS

The **International Accounting Standards Board (IASB)** is working toward the development of a single set of high-quality global accounting standards. Its purpose is to formulate international accounting standards and to promote their acceptance worldwide.

The FASB is a willing partner in trying to achieve the goal of the IASB. For example, the FASB and IASB are undertaking several joint projects. One joint project is development of a common conceptual framework for financial reporting. The goal of this project is to build a framework that both the FASB and IASB can use when developing new and revised accounting standards.

Over 7,000 listed companies in the European Union and over 100 countries around the world now use IASB standards. There may be many bumps in the road to achieve one set of worldwide standards, but progress to date is remarkable. We are optimistic that the goal of worldwide standards can be achieved, which will be of value to all.

## *Before You Go On...*

### REVIEW IT

1. What is the major difference in the equity section of the balance sheet between a corporation and proprietorship?
2. Where are income tax expense and earnings per share reported on the income statement? How is earnings per share computed?
3. How are the current ratio, working capital, profit margin percentage, return on assets, return on common stockholders' equity, and debt to total assets computed?
4. Explain how these ratios are useful in financial statement analysis.
5. What is the purpose of the International Accounting Standards Board?

*The Navigator*

Be sure to read **ALL ABOUT YOU: *Corporations Have Governance Structures—Do You?*** on page 314 for information on how topics in this chapter apply to you.

all about YOU

# Corporations Have Governance Structures—Do You?

As discussed previously in this text, the scandals and bankruptcies at Enron, WorldCom, and other companies brought many changes to the way America does business. One of the primary lessons has been that companies need to take corporate governance and management oversight more seriously. In a sense, they have to set up a conceptual framework to run their companies.

As part of this effort, many companies have developed a code of ethics. The purpose of a code of ethics is to clearly specify standards of conduct to deter wrongdoing and promote honest and ethical conduct. It also is intended to be an expression by top management of its "tone at the top" —that is, to indicate that top management takes ethics seriously. Many other organizations, including university student groups, also have formulated ethics codes.

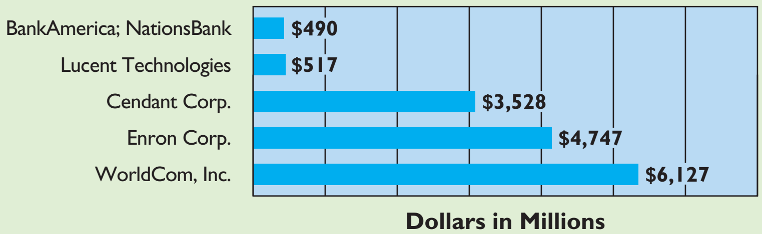
## Some Facts

* Under Sarbanes-Oxley, a company must disclose in its annual report whether it has a code of ethics. It must also disclose any changes to or waivers of the code of ethics.
* Enron had a code of ethics. In a number of instances, Enron's board of directors knowingly waived requirements of the code so that the CFO could set up and run special purpose entities. Ultimately these waivers contributed to Enron's downfall.
* In some instances U.S. federal prosecutors have pressured companies to not pay the legal-defense bills of employees accused of wrong-doing, thus making it harder for the employees to defend themselves.
* In a recent survey of 1,436 workers, 34% said that they have seen unethical activities at their workplace, but only 47% said they are likely to report these activities. Many cited fear of retaliation by their bosses as the reason for not reporting.

## About the Numbers

Stockholders often lose money as a result of unethical behavior by management. When they do, they often file lawsuits against the company in an effort to recoup these losses. The graph below shows just how expensive these class-action lawsuits can be for companies.

**Top Class-Action Securities Settlements**




**Source:** Elaine Buckberg, Todd Foster, and Ronald I. Miller, "Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard?" NERA Economic Consulting, *www.nera.com* (accessed June 26, 2006).

## What Do You Think

Many universities have become concerned about student cheating. In particular, the prevalence of digital documents on the Internet has made it very easy to plagiarize. Many schools now have student ethics codes. Do you think that these ethics codes serve a useful purpose?

**YES:** Anything that will reduce unethical behavior is a good thing. An ethics code establishes what is and is not acceptable behavior, which helps universities maintain ethical standards for academic work and weed out those students who try to get ahead by non-ethical means.

**NO:** The existence of an ethics code won't affect student behavior. If students have a propensity to cheat, a document that tells them what is and is not good behavior is not going to be a deterrent. Students already know what cheating is, and that it is wrong.

**Sources:** "Whistleblowing Workers: Becoming an Endangered Species?" *HR Focus,* June 2006, p. 9; Lauren Etter, "The Enron Trial Finally Begins," *Wall Street Journal,* February 4, 2006, p. A7.



The authors' comments on this situation appear on page 335.

## Demonstration Problem 1

Presented below are a number of operational guidelines and practices that have developed over time.

### Instructions

Identify the accounting assumption, accounting principle, or reporting constraint that most appropriately justifies these procedures and practices. Use only one item per description.

**(a)** The first note, "Summary of Significant Accounting Policies," presents information on the subclassification of plant assets and discusses the company's depreciation methods.
**(b)** The local hamburger restaurant expenses all spatulas, french fry baskets, and other cooking utensils when purchased.
**(c)** Retailers recognize revenue at the point of sale.
**(d)** Green-Grow Lawn Mowers, Inc. includes an estimate of warranty expense in the year in which it sells its lawn mowers, which carry a 2-year warranty.
**(e)** Companies present sufficient financial information so that creditors and reasonably prudent investors will not be misled.
**(f)** Companies listed on U.S. stock exchanges report audited financial information annually and report unaudited information quarterly.
**(g)** Beach Resorts, Inc. does not record the 2008 value of $1.5 million for a piece of beachfront property it purchased in 1995 for $500,000.
**(h)** Office Systems, Inc. takes a $32,000 loss on a number of older microcomputers in its inventory; it paid the manufacturer $107,000 for them but can sell them for only $75,000.
**(i)** Frito Lay is a wholly owned subsidiary of PepsiCo, Inc., and Frito Lay's operating results and financial condition are included in the consolidated financial statements of PepsiCo. (Do not use full disclosure.)

### action plan

Remember that:
- ✔ The four principles are cost, revenue recognition, matching, and full disclosure.
- ✔ The two constraints are materiality and conservatism.
- ✔ Full disclosure relates generally to the item; materiality to the amount.

### Solution

**(a)** Full disclosure principle
**(b)** Materiality constraint
**(c)** Revenue recognition principle
**(d)** Matching principle
**(e)** Full disclosure principle
**(f)** Time period assumption
**(g)** Cost principle
**(h)** Conservatism constraint
**(i)** Economic entity assumption

The Navigator

## Demonstration Problem 2

Presented below is financial information related to Notting Hill Corporation for the year 2008. All balances are ending balances unless stated otherwise.

| | |
|---|---|
| Accounts payable | $ 868,000 |
| Accounts receivable | 700,000 |
| Accumulated depreciation—equipment | 100,000 |
| Administrative expenses | 280,000 |
| Bonds payable | 1,600,000 |
| Cash | 800,000 |
| Common stock | 500,000 |
| Cost of goods sold | 1,600,000 |
| Dividends | 60,000 |
| Equipment | 1,100,000 |

## action plan

- ✔ Review the format in Chapter 5, page 216, for a multiple-step income statement. Note the multiple-step income statement reports gross profit and income from operations. A single-step income statement does not report these items.
- ✔ Remember that income tax expense is reported immediately after "Income before income taxes" for both a multiple-step and single-step income statement.
- ✔ Report earnings per share on both a multiple-step and a single-step income statement.
- ✔ Disclose net income and dividends on a retained earnings statement.
- ✔ Refer to Chapter 4, page 166, for examples of a classified balance sheet.

| | |
|---|---|
| Income tax expense | 83,000 |
| Interest expense | 60,000 |
| Interest revenue | 120,000 |
| Inventories | 500,000 |
| Loss on the sale of equipment | 35,000 |
| Marketable (trading) securities | 400,000 |
| Net sales | 2,400,000 |
| Notes payable (short-term) | 800,000 |
| Other long-term debt | 387,000 |
| Patents and other intangibles | 900,000 |
| Prepaid expenses | 200,000 |
| Retained earnings (January 1, 2008) | 80,000 |
| Selling expenses | 220,000 |
| Taxes payable | 83,000 |

Notting Hill Corporation had 88,000 shares of common stock outstanding for the entire year.

### Instructions

**(a)** Prepare a multiple-step income statement.
**(b)** Prepare a single-step income statement.
**(c)** Prepare a retained earnings statement.
**(d)** Prepare a classified balance sheet.
**(e)** Compute the following balance sheet relationships.
  **(1)** Current ratio.
  **(2)** The amount of working capital.
  **(3)** Debt to total assets ratio.
  What insights do these relationships provide to the reader of the financial statements?
**(f)** Compute three measures of profitability from the income statement and balance sheet information. What insights do these relationships provide to the reader of the financial statements?

### *Solution*

**(a)** Multiple-step income statement

NOTTING HILL CORPORATION
Income Statement
For the Year Ended December 31, 2008

| | | |
|---|---|---|
| Net sales | | $2,400,000 |
| Cost of goods sold | | 1,600,000 |
| Gross profit | | 800,000 |
| Selling expenses | $220,000 | |
| Administrative expenses | 280,000 | 500,000 |
| Income from operations | | 300,000 |
| Other revenues and gains | | |
| Interest revenue | | 120,000 |
| Other expenses and losses | | |
| Loss on sale of equipment | 35,000 | |
| Interest expense | 60,000 | 95,000 |
| Income before income taxes | | 325,000 |
| Income tax expense | | 83,000 |
| Net income | | $ 242,000 |
| Earnings per share | | $2.75 |

**(b)** Single-step income statement

NOTTING HILL CORPORATION
Income Statement
For the Year Ended December 31, 2008

| | | |
|---|---|---|
| Revenues | | |
| Net sales | | $2,400,000 |
| Interest revenue | | 120,000 |
| Total revenues | | 2,520,000 |
| Expenses | | |
| Cost of goods sold | $1,600,000 | |
| Selling expenses | 220,000 | |
| Administrative expenses | 280,000 | |
| Interest expense | 60,000 | |
| Loss on the sale of equipment | 35,000 | 2,195,000 |
| Income before income taxes | | 325,000 |
| Income tax expense | | 83,000 |
| Net income | | $ 242,000 |
| Earnings per share | | $2.75 |

**(c)** Retained earnings statement

NOTTING HILL CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2008

| | |
|---|---|
| Retained earnings, January 1 | $ 80,000 |
| Add: Net income | 242,000 |
| | 322,000 |
| Less: Dividends | 60,000 |
| Retained earnings, December 31 | $262,000 |

**(d)** Classified balance sheet

NOTTING HILL CORPORATION
Balance Sheet
December 31, 2008

| | | |
|---|---|---|
| Current assets | | |
| Cash | | $ 800,000 |
| Marketable (trading) securities | | 400,000 |
| Accounts receivable | | 700,000 |
| Inventories | | 500,000 |
| Prepaid expenses | | 200,000 |
| Total current assets | | 2,600,000 |
| Property, plant, and equipment | | |
| Equipment | $1,100,000 | |
| Less: Accumulated depreciation | 100,000 | 1,000,000 |
| Intangible assets | | |
| Patents and other intangible assets | | 900,000 |
| Total assets | | $4,500,000 |
| Current liabilities | | |
| Notes payable | | $ 800,000 |
| Accounts payable | | 868,000 |
| Taxes payable | | 83,000 |
| Total current liabilities | | 1,751,000 |

| | | |
|---|---|---|
| Long-term liabilities | | |
| Bonds payable | $1,600,000 | |
| Other long-term debt | 387,000 | 1,987,000 |
| Total liabilities | | 3,738,000 |
| Stockholders' equity | | |
| Common stock | 500,000 | |
| Retained earnings | 262,000 | 762,000 |
| Total liabilities and stockholders' equity | | $4,500,000 |

**(e)** Balance sheet relationships

(1) $$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{\$2,600,000}{\$1,751,000} = 1.48:1$$

(2) Working capital = Current assets − Current liabilities

| | |
|---|---|
| Current assets | $2,600,000 |
| Current liabilities | 1,751,000 |
| Working capital | $ 849,000 |

(3) $$\text{Debt to total assets} = \frac{\text{Debt}}{\text{Total assets}} = \frac{\$3,738,000}{\$4,500,000} = 83.07\%$$

Notting Hill's liquidity and solvency are of mixed quality. The current ratio is satisfactory with its working capital healthy, i.e., current assets well in excess of current liabilities. However, its debt to total assets, at well over 80%, is too high. Given the company's relatively low profitability (see below), its creditors might be concerned.

**(f)** Profitability relationships

$$\text{Profit margin percentage} = \frac{\text{Net income}}{\text{Net sales}} = \frac{\$242,000}{\$2,400,000} = 10.08\%$$

$$\text{Return on assets} = \frac{\text{Net income}}{\text{Total assets}} = \frac{\$242,000}{\$4,500,000} = 5.38\%$$

$$\text{Return on common stockholders' equity} = \frac{\text{Net income}}{\text{Common stockholders' equity}} = \frac{\$242,000}{\$762,000} = 31.76\%$$

The profit margin percentage (return on sales) for Notting Hill seems adequate. Given the company's large asset base, however, it should probably generate a higher profit. The company's overall financial picture, then, could be better.

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# SUMMARY OF STUDY OBJECTIVES

WILEY PLUS

1 **Explain the meaning of GAAP and identify the key items of the conceptual framework.** Generally accepted accounting principles (GAAP) are a set of rules and practices that are recognized as a general guide for financial reporting purposes. *Generally accepted* means that these principles must have "substantial authoritative support." The key items of the conceptual framework are: (1) objectives of financial reporting; (2) qualitative characteristics of accounting information; (3) elements of financial statements; and (4) operating guidelines (assumptions, principles, and constraints).

2 **Describe the basic objectives of financial reporting.** The basic objectives of financial reporting are to provide information that is (1) useful to those making investment and credit decisions; (2) helpful in assessing future cash flows; and (3) helpful in identifying economic resources (assets), the claims to those resources (liabilities), and the changes in those resources and claims.

3 **Discuss the qualitative characteristics of accounting information and elements of financial statements.** To be judged useful, information should possess the following qualitative characteristics: relevance, reliability, comparability, and consistency. The elements of financial statements are a set of definitions that can be used to describe the basic terms used in accounting.

4 **Identify the basic assumptions used by accountants.** The major assumptions are: monetary unit, economic entity, time period, and going concern.

5 **Identify the basic principles of accounting.** The major principles are revenue recognition, matching, full disclosure, and cost.

6 **Identify the two constraints in accounting.** The major constraints are materiality and conservatism.

7 **Understand and analyze classified financial statements.** We presented classified balance sheets and classified (multiple-step) income statements in Chapters 4 and 5, respectively. Two new items added to the classified income statement in this chapter are income taxes and earnings per share. Three items used to analyze the balance sheet are the current ratio, working capital, and debt to total assets. Earnings per share, profit margin percentage (return on sales), return on assets, and return on common stockholders' equity are used to analyze profitability.

8 **Explain the accounting principles used in international operations.** There are few recognized worldwide accounting standards. The International Accounting Standards Board (IASB), of which the United States is a member, is working to obtain conformity in international accounting practices.

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# GLOSSARY

**Comparability** Ability to compare accounting information of different companies because they use the same accounting principles. (p. 296).

**Conceptual framework** A coherent system of interrelated objectives and fundamentals that can lead to consistent standards. (p. 295).

**Conservatism** The approach of choosing an accounting method when in doubt that will least likely overstate assets and net income. (p. 304).

**Consistency** Use of the same accounting principles and methods from year to year within a company. (p. 296).

**Cost principle** Accounting principle that assets should be recorded at their historical cost. (p. 302).

**Current ratio** A measure that expresses the relationship of current assets to current liabilities by dividing current assets by current liabilities. (p. 309).

**Debt to total assets ratio** Solvency measure that indicates the percentage of total assets provided by creditors; calculated as total debt divided by total assets. (p. 311).

**Earnings per share (EPS)** The net income earned by each share of outstanding common stock. (p. 307).

**Economic entity assumption** Accounting assumption that economic events can be identified with a particular unit of accountability. (p. 298).

**Elements of financial statements** Definitions of basic terms used in accounting. (p. 297).

**Full disclosure principle** Accounting principle that circumstances and events that make a difference to financial statement users should be disclosed. (p. 301).

**Generally accepted accounting principles (GAAP)** A set of rules and practices, having substantial authoritative support, that are recognized as a general guide for financial reporting purposes. (p. 294).

**Going concern assumption** The assumption that the enterprise will continue in operation long enough to carry out its existing objectives and commitments. (p. 298).

**International Accounting Standards Board (IASB)** An accounting organization whose purpose is to formulate and publish international accounting standards and to promote their acceptance worldwide. (p. 313).

**Matching principle** Accounting principle that expenses should be matched with revenues in the period when efforts are expended to generate revenues. (p. 300).

**Materiality** The constraint of determining if an item is important enough to likely influence the decision of a reasonably prudent investor or creditor. (p. 303).

**Monetary unit assumption** Accounting assumption that only transaction data capable of being expressed in monetary terms should be included in accounting records. (p. 298).

**Profit margin percentage** Profitability measure that indicates the percentage of each dollar of sales that results in net income; calculated as net income divided by net sales. Also called *rate of return on sales.* (p. 310).

**Relevance** The quality of information that indicates the information makes a difference in a decision. (p. 296).

**Reliability** The quality of information that gives assurance that it is free of error and bias. (p. 296).

**Return on assets** An overall measure of a company's profitability; calculated as net income divided by total assets. (p. 311).

**Return on common stockholders' equity** Profitability measure that shows the rate of net income earned for each dollar of owners' investment; calculated as net income divided by common stockholders' equity. (p. 311).

**Revenue recognition principle** Accounting principle that revenue should be recognized in the accounting period in which it is earned (generally at the point of sale). (p. 299).

**Time period assumption** Accounting assumption that the economic life of a business can be divided into artificial time periods. (p. 298).

**Working capital** The excess of current assets over current liabilities. (p. 309).

## SELF-STUDY QUESTIONS

*Answers are at the end of the chapter.*

(SO 1) **1.** Generally accepted accounting principles are:
- **a.** a set of standards and rules that are recognized as a general guide for financial reporting.
- **b.** usually established by the Internal Revenue Service.
- **c.** the guidelines used to resolve ethical dilemmas.
- **d.** fundamental truths that can be derived from the laws of nature.

(SO 2) **2.** Which of the following is *not* an objective of financial reporting?
- **a.** Provide information that is useful in investment and credit decisions.
- **b.** Provide information about economic resources, claims to those resources, and changes in them.
- **c.** Provide information that is useful in assessing future cash flows.
- **d.** Provide information on the liquidation value of a business.

(SO 3) **3.** The primary criterion by which accounting information can be judged is:
- **a.** consistency.
- **b.** predictive value.
- **c.** decision-usefulness.
- **d.** comparability.

(SO 3) **4.** Verifiable is an ingredient of:

| | Reliability | Relevance |
|---|---|---|
| **a.** | Yes | Yes |
| **b.** | No | No |
| **c.** | Yes | No |
| **d.** | No | Yes |

(SO 4, 5, 6) **5.** Valuing assets at their liquidation value rather than their cost is *inconsistent* with the:
- **a.** time period assumption.
- **b.** matching principle.
- **c.** going concern assumption.
- **d.** materiality constraint.

**6.** The accounting constraint that says that when in doubt the accountant should choose the method that will be least likely to overstate assets and income is called: (SO 4, 5, 6)
- **a.** matching principle.
- **b.** materiality.
- **c.** conservatism.
- **d.** monetary unit assumption.

**7.** Erika Pechacek Inc. has current assets of $90,000 and current liabilities of $30,000. Its current ratio and working capital are: (SO 7)
- **a.** .33:1; $60,000.
- **b.** 3:1; $60,000.
- **c.** .33:1; $90,000.
- **d.** 3:1; $90,000.

**8.** Suster Company has a retained earnings balance of $170,000 at the beginning of the period. At the end of the period, the retained earnings balance was $222,000. Assuming a dividend of $25,000 was declared and paid during the period, the net income for the period was: (SO 7)
- **a.** $27,000.
- **b.** $52,000.
- **c.** $77,000.
- **d.** $197,000.

**9.** The basic formula for computing earnings per share is net income divided by: (SO 7)
- **a.** common shares authorized.
- **b.** common shares issued.
- **c.** common shares outstanding.
- **d.** common stock purchased.

**10.** Phish Corp. has total liabilities of $1,200,000, total stockholders' equity of $1,800,000, current assets of $800,000, and current liabilities of $400,000. Phish's debt to total assets ratio is: (SO 7)
- **a.** 50%.
- **b.** 40%.
- **c.** 33.3%.
- **d.** 26.6%.

Go to the book's website, **www.wiley.com/college/weygandt**, for Additional Self-Study questions.

The Navigator

## QUESTIONS

**1.** **(a)** What are generally accepted accounting principles (GAAP)? **(b)** What bodies provide authoritative support for GAAP?

**2.** What elements comprise the FASB's conceptual framework?

**3.** **(a)** What are the objectives of financial reporting? **(b)** Identify the qualitative characteristics of accounting information.

**4.** Henrik Stenson, the president of Spartan Company, is pleased. Spartan substantially increased its net income in 2008 while keeping the number of **units** in its inventory relatively the same. Brett Quiney, chief accountant, cautions Stenson, however. Quiney says that since Spartan changed its method of inventory **valuation**, there is a consistency problem and it would be difficult to determine if Spartan is better off. Is Quiney correct? Why?

**5.** What is the distinction between comparability and consistency?

**6.** Why is it necessary for accountants to assume that an economic entity will remain a going concern?

**7.** When should revenue be recognized? Why has the date of sale been chosen as the point at which to recognize the revenue resulting from the entire producing and selling process?

**8.** Distinguish between expired costs and unexpired costs.

**9.** **(a)** Where does the accountant disclose information about an entity's financial position, operations, and cash flows? **(b)** The full disclosure principle recognizes that the nature and amount of information included in financial reports reflects a series of judgmental trade-offs. What are the objectives of these trade-offs?

**10.** Betsy McCall is the president of Brew News. She has no accounting background. McCall cannot understand why current cost is not used as the basis for accounting measurement and reporting. Explain what basis is used and why.

**11.** Describe the two constraints inherent in the presentation of accounting information.

**12.** In February 2008, Matt Osterhaus invested an additional $5,000 in his business, Osterhaus Pharmacy, which is organized as a corporation. Osterhaus' accountant, Kate Mulgrew, recorded this receipt as an increase in cash and revenues. Is this treatment appropriate? Why or why not?

**13.** Identify three financial relationships that are useful in analyzing the profitability of a company. Why might we want more than one measure of profitability?

**14.** Natasha Company has current assets of $60,000 and current liabilities of $20,000. What is its (a) working capital and (b) current ratio?

**15.** If current assets are less than current liabilities, will working capital be positive or negative? Will the current ratio be greater than or less than 1:1?

**16.** Bozeman Inc.'s debt to total asset ratio stands at 62 percent. If you were a banker, would you be comfortable about extending additional credit to Bozeman? Why or why not?

**17.** Your roommate believes that international accounting standards are uniform throughout the world. Is your roommate correct? Explain.

**18.** What organization establishes international accounting standards?

## BRIEF EXERCISES

WILEY PLUS

**BE7-1** Indicate whether each of the following statements is true or false.

*Identify generally accepted accounting principles.*
(SO 1)

**(a)** ____ "*Generally accepted*" means that these principles must have "substantial authoritative support."
**(b)** ____ Substantial authoritative support for GAAP usually comes from two standard-setting bodies: the FASB and the IRS.
**(c)** ____ GAAP is a set of rules and practices established by the accounting profession to serve as a general guide for financial reporting purposes.

**BE7-2** Indicate which of the following items is(are) included in the FASB's conceptual framework. (Use "Yes" or "No" to answer this question.)

*Identify items included in conceptual framework.*
(SO 1)

**(a)** ____ Analysis of financial statement ratios.
**(b)** ____ Objectives of financial reporting.
**(c)** ____ Qualitative characteristics of accounting information.

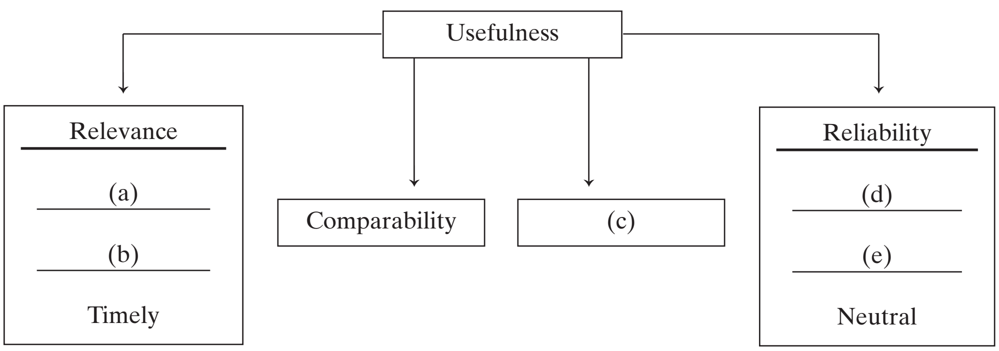
**BE7-3** According to the FASB's conceptual framework, which of the following are objectives of financial reporting? (Use "Yes" or "No" to answer this question.)

*Identify objectives of financial reporting.*
(SO 2)

**(a)** ____ Provide information that is helpful in assessing past cash flows and stock prices.
**(b)** ____ Provide information that is useful to those making investment and credit decisions.
**(c)** ____ Provide information that identifies the economic resources (assets), the claims to those resources (liabilities), and the changes in those resources and claims.

**BE7-4** Presented below is a chart of the qualitative characteristics of accounting information. Fill in the blanks from (a) to (e).

*Identify qualitative characteristics.*
(SO 3)



*Identify qualitative characteristics.*
(SO 3)

**BE7-5** Given the *qualitative characteristics* of accounting established by the FASB's conceptual framework, complete each of the following statements:

**(a)** For information to be ____, it should have predictive or feedback value, and it must be presented on a timely basis.
**(b)** ____ is the quality of information that gives assurance that it is free of error and bias; it can be depended on.
**(c)** ____ means using the same accounting principles and methods from year to year within a company.

*Identify qualitative characteristics.*
(SO 3)

**BE7-6** Presented below is a set of qualitative characteristics of accounting information.

**1.** Predictive value
**2.** Neutral
**3.** Verifiable
**4.** Timely

Match these qualitative characteristics to the following statements, using numbers 1 through 4.

**(a)** ____ Accounting information should help users make predictions about the outcome of past, present, and future events.
**(b)** ____ Accounting information cannot be selected, prepared, or presented to favor one set of interested users over another.
**(c)** ____ Accounting information must be proved to be free of error and bias.
**(d)** ____ Accounting information must be available to decision makers before it loses its capacity to influence their decisions.

*Identify operating guidelines.*
(SO 4, 5, 6)

**BE7-7** Presented below are four concepts discussed in this chapter.

**1.** Time period assumption
**2.** Cost principle
**3.** Full disclosure principle
**4.** Conservatism

Match these concepts to the following accounting practices. Each number can be used only once.

**(a)** ____ Recording inventory at its purchase price.
**(b)** ____ Using notes and supplementary schedules in the financial statements.
**(c)** ____ Preparing financial statements on an annual basis.
**(d)** ____ Using the lower of cost or market method for inventory valuation.

*Identify the constraints that have been violated.*
(SO 6)

**BE7-8** Fast Forward Company uses the following accounting practices.

**(a)** Inventory is reported at cost when market value is lower.
**(b)** The alternative accounting methods are selected in order to avoid reporting a higher net income.
**(c)** Small tools are recorded as plant assets and depreciated.
**(d)** The income statement shows paper clips expense of $10.

Indicate the accounting constraint, if any, that has been violated by each practice.

*Perform balance sheet analysis.*
(SO 7)

**BE7-9** The following data are taken from the balance sheet of Ortiz, Inc. The data are arranged in alphabetical order (in millions).

| | | | |
|---|---|---|---|
| Accounts payable | $ 584,600 | Income taxes payable | $ 25,900 |
| Accounts receivable | 1,674,400 | Other current liabilities | 608,500 |
| Cash | 110,600 | Retained earnings | 3,043,400 |

Compute Ortiz's (a) current ratio and (b) working capital.

*Compute income statement relationships.*
(SO 7)

**BE7-10** The following information, presented in alphabetical order, is taken from the financial statements of Palpatine Inc.

| | | | |
|---|---|---|---|
| Gross profit | $907,000 | Net income | $ 179,400 |
| Income before income taxes | 276,000 | Net sales | 1,652,000 |
| Income from operations | 240,000 | Other revenues and gains | 36,000 |

Compute Palpatine's (a) operating expenses and (b) income tax expense for the period.

*Compute earnings per share.*
(SO 7)

**BE7-11** Additional information for Palpatine Inc. (BE7-10) is as follows.

| | | | |
|---|---|---|---|
| Common shares outstanding for the entire year | 46,000 | Dividends on common stock paid during the year | $34,500 |

Given the information above and in BE7-10, compute Palpatine's earnings per share.

# EXERCISES

*Identify the assumption, principle, or constraint that has been violated.*

(SO 4, 5, 6)

**E7-1** A number of accounting reporting situations are described below.

1. Church Company recognizes revenue at the end of the production cycle, but before sale. The price of the product, as well as the amount that can be sold, is not certain.
2. In preparing its financial statements, Leask Company omitted information concerning its method of accounting for inventories.
3. Zareena Corp. charges the entire premium on a 2-year insurance policy to the first year.
4. Whitney Hospital Supply Corporation reports only current assets and current liabilities on its balance sheet. Property, plant, and equipment and bonds payable are reported as current assets and current liabilities, respectively. Liquidation of the company is unlikely.
5. Dean Inc. is carrying inventory at its current market value of $100,000. Inventory had an original cost of $110,000.
6. Hot Shot Company is in its fifth year of operation and has yet to issue financial statements. (Do not use full disclosure principle.)
7. Silas Rupe Co. has inventory on hand that cost $400,000. Rupe Co. reports inventory on its balance sheet at its current market value of $425,000.
8. Charlotte Webb, president and owner of the Always Music Company, bought a computer for her personal use. She paid for the computer by using company funds and debited the "Computers" account.

**Instructions**

For each of the above, list the assumption, principle, or constraint that has been violated, if any. List only one term for each case.

*Identify the assumption, principle, or constraint that has been violated and prepare correct entries.*

(SO 4, 5, 6)

**E7-2** Presented below are some business transactions that occurred during 2008 for Vicki Prowitz Company.

**(a)** Merchandise inventory with a cost of $208,000 is reported at its market value of $260,000. The following entry was made.

| | | |
|---|---|---|
| Merchandise Inventory | 52,000 | |
| Gain | | 52,000 |

**(b)** Equipment worth $62,000 was acquired at a cost of $41,000 from a company that had water damage in a flood. The following entry was made.

| | | |
|---|---|---|
| Equipment | 62,000 | |
| Cash | | 41,000 |
| Gain on Purchase of Equipment | | 21,000 |

**(c)** The president of Vicki Prowitz Company, Mark Nabke, purchased a truck for personal use and charged it to his expense account. The following entry was made.

| | | |
|---|---|---|
| Travel Expense | 18,000 | |
| Cash | | 18,000 |

**(d)** An electric pencil sharpener costing $50 is being depreciated over 5 years. The following entry was made.

| | | |
|---|---|---|
| Depreciation Expense—Pencil Sharpener | 10 | |
| Accumulated Depreciation—Pencil Sharpener | | 10 |

**Instructions**

In each of the situations above, identify the assumption, principle, or constraint that has been violated, if any. Discuss the appropriateness of the journal entries, and give the correct journal entry, if necessary.

*Identify accounting assumptions, principles, and constraints.*

(SO 4, 5, 6)

**E7-3** Presented below are the assumptions, principles, and constraints discussed in this chapter.

1. Economic entity assumption
2. Going concern assumption
3. Monetary unit assumption
4. Time period assumption
5. Cost principle
6. Matching principle
7. Full disclosure principle
8. Revenue recognition principle
9. Materiality
10. Conservatism

**Instructions**

Identify by number the accounting assumption, principle, or constraint on page 323 that describes each situation below. Do not use a number more than once.

**(a)** Is the rationale for why plant assets are not reported at liquidation value. (Do not use historical cost principle.)
**(b)** Indicates that personal and business record-keeping should be separately maintained.
**(c)** Ensures that all relevant financial information is reported.
**(d)** Assumes that the dollar is the "measuring stick" used to report on financial performance.
**(e)** Requires that the operational guidelines be followed for all significant items.
**(f)** Separates financial information into time periods for reporting purpose.
**(g)** Requires recognition of expenses in the same period as related revenues.
**(h)** Indicates that market value changes subsequent to purchase are not recorded in the accounts.

*Determine the amount of revenue to be recognized.*
(SO 5)

**E7-4** Consider the following transactions of Parolini Company for 2008.

1. Sold a 6-month insurance policy to Orosco Corporation for $9,000 on March 1.
2. Leased office space to Easley Supplies for a 1-year period beginning September 1. The rent of $30,000 was paid in advance.
3. A sales order for merchandise costing $9,000 that had a sales price of $14,000 was received on December 28 from Guiterrez Company. The goods were shipped FOB shipping point on December 31 and Guiterrez received them on January 3, 2009.
4. Merchandise inventory on hand at year-end amounted to $160,000. Parolini expects to sell the inventory in 2009 for $180,000.

**Instructions**

For each item above, indicate the amount of revenue Parolini should recognize in calendar year 2008. Explain.

*Compute earnings per share.*
(SO 7)

**E7-5** The ledger of Jean Sartre Corporation at December 31, 2008, contains the following summary information.

| | | | |
|---|---|---|---|
| Administrative expenses | $116,000 | Other expenses and losses | $34,700 |
| Cost of goods sold | 409,200 | Other revenues and gains | 17,500 |
| Net sales | 696,000 | Selling expenses | 98,600 |

The income tax rate for all items is 30%. Sartre Corp. had 10,000 shares of common stock outstanding throughout the year, and the company paid $15,000 in dividends during 2008.

**Instructions**

Compute earnings per share for 2008.

*Prepare an income statement and calculate related information.*
(SO 7)

**E7-6** Presented below, in alphabetical order, is information related to Wilkinson Corporation for the year 2008.

| | |
|---|---|
| Cost of goods sold | $1,499,900 |
| Dividends on common stock | 140,000 |
| Gain on the sale of equipment | 80,000 |
| Income tax expense | 150,000 |
| Interest expense | 90,000 |
| Interest revenue | 300,000 |
| Net sales | 2,156,900 |
| Selling and administrative expenses | 340,750 |

Wilkinson had 35,500 shares outstanding for the entire year.

**Instructions**

**(a)** Prepare in good form a single-step income statement for Wilkinson Corporation for 2008.
**(b)** Assuming a multiple-step income statement was prepared instead, compute:
  **(1)** Gross profit.
  **(2)** Income from operations.
  **(3)** Net income.
**(c)** Calculate Wilkinson Corporation's profit margin percentage (rate of return on sales).

**E7-7** Net sales, net income, total assets, and total common stockholders' equity information for a recent year is available for the following three companies.

*Calculate and analyze profitability and solvency relationships.*

(SO 7)

| Company | Net Sales (in millions) | Net Income (in millions) | Total Assets (in millions) | Total Common Equity (in millions) |
|---|---|---|---|---|
| Intel Corporation | $30,141 | $5,641 | $47,143 | $37,846 |
| Johnson & Johnson | $41,862 | $7,197 | $48,263 | $26,869 |
| Motorola, Inc. | $27,058 | $ 893 | $32,098 | $12,689 |

**Instructions**

**(a)** Compute the following relationships for each company.
  **(1)** Debt to total assets ratio.
  **(2)** Profit margin percentage (rate of return on sales).
  **(3)** Return on assets.
  **(4)** Return on common stockholders' equity.

**(b)** What reasons might there be for the differing relationships among these three companies? In your answer, consider the different kinds of industries these companies represent. Do any similarities or differences in the type of business help account for the differences you see?

**E7-8** Net sales, net income, total assets, and total common stockholders' equity information for a recent year is available for the following three companies.

*Calculate and analyze profitability and solvency relationships.*

(SO 7)

| Company | Net Sales (in millions) | Net Income (in millions) | Total Assets (in millions) | Total Common Equity (in millions) |
|---|---|---|---|---|
| Southern Company | $11,251 | $1,474 | $35,045 | $ 9,648 |
| Toys "R" Us, Inc. | $11,305 | $ 229 | $10,218 | $ 4,222 |
| Intel Corp. | $30,141 | $5,641 | $47,143 | $37,846 |

**Instructions**

**(a)** Compute the following relationships for each company.
  **(1)** Debt to total assets ratio.
  **(2)** Profit margin percentage (rate of return on sales).
  **(3)** Return on assets.
  **(4)** Return on common stockholders' equity.

**(b)** What reasons might there be for the differing relationships among these three companies? In your answer, consider the different kinds of industries these companies represent. Do any similarities or differences in the type of business help account for the differences you see?

**E7-9** As of December 31, 2008, Aruba Corporation has a current ratio of 2.6:1 and working capital of $800,000. Aruba's total debt is 60% of its total assets. All of Aruba's long-term assets, which are exactly half of total assets, are properly categorized as property, plant, and equipment.

*Use balance sheet relationships to prepare a balance sheet.*

(SO 7)

**Instructions**

Prepare a summary classified balance sheet for Aruba Corporation at year-end 2008. (*Hint:* First calculate Aruba's current asset and current liability amounts.)

**E7-10** Presented on page 326 is partial balance sheet information related to Batten Ltd., a United Kingdom company at December 31. All financial information has been translated from pounds to dollars.

*Restate foreign financial statements.*

(SO 8)

BATTEN LTD.
Balance Sheet (partial)
(in thousands)

| | | |
|---|---|---|
| Fixed assets | | |
| Tangible assets | | $ 900,000 |
| Current assets | | |
| Stocks (inventory) | $300,000 | |
| Debtors | 121,000 | |
| Investments | 53,000 | |
| Cash | 62,000 | |
| | 536,000 | |
| Creditors | | |
| Amount falling due within one year | 100,000 | |
| Net current assets | | 436,000 |
| Total assets less current liabilities | | 1,336,000 |
| Creditors | | |
| Amounts falling due after one year | | 240,000 |
| Total net assets | | $1,096,000 |

**Instructions**

**(a)** Restate the asset side of the balance sheet in accordance with generally accepted accounting principles in the United States.

**(b)** What is the amount of total stockholders' equity?

## EXERCISES: SET B

Visit the book's website at **www.wiley.com/college/weygandt,** and choose the Student Companion site, to access Exercise Set B.

## PROBLEMS: SET A

*Analyze transactions to identify accounting principle or assumption violated, and prepare correct entries.*

(SO 4, 5)

**P7-1A** Scott and Quick are accountants for Millenium Computers. They disagree over the following transactions that occurred during the calendar year 2008.

1. Scott suggests that equipment should be reported on the balance sheet at its liquidation value, which is $15,000 less than its cost.
2. Millenium bought a custom-made piece of equipment for $36,000. This equipment has a useful life of 6 years. Millenium depreciates equipment using the straight-line method. "Since the equipment is custom-made, it will have no resale value. Therefore, it shouldn't be depreciated but instead should be expensed immediately," argues Scott. "Besides, it provides for lower net income."
3. Depreciation for the year was $18,000. Since net income is expected to be lower this year, Scott suggests deferring depreciation to a year when there is more net income.
4. Land costing $60,000 was appraised at $90,000. Scott suggests the following journal entry.

| | | |
|---|---|---|
| Land | 30,000 | |
| Gain on Appreciation of Land | | 30,000 |

5. Millenium purchased equipment for $35,000 at a going-out-of-business sale. The equipment was worth $45,000. Scott believes that the following entry should be made.

| | | |
|---|---|---|
| Equipment | 45,000 | |
| Cash | | 35,000 |
| Gain on Purchase of Equipment | | 10,000 |

Quick disagrees with Scott on each of the above situations.

**Instructions**

For each transaction, indicate why Quick disagrees. Identify the accounting principle or assumption that Scott would be violating if his suggestions were used. Prepare the correct journal entry for each transaction, if any.

*Determine the appropriateness of journal entries in terms of generally accepted accounting principles or assumptions.*

(SO 4, 5)

**P7-2A** Presented below are a number of business transactions that occurred during the current year for Yerkes, Inc.

**1.** Because the general level of prices increased during the current year, Yerkes, Inc. determined that there was a $10,000 understatement of depreciation expense on its equipment and decided to record it in its accounts. The following entry was made.

| | | |
|---|---|---|
| Depreciation Expense | 10,000 | |
| Accumulated Depreciation | | 10,000 |

**2.** Because of a "flood sale," equipment obviously worth $250,000 was acquired at a cost of $200,000. The following entry was made.

| | | |
|---|---|---|
| Equipment | 250,000 | |
| Cash | | 200,000 |
| Gain on Purchase of Equipment | | 50,000 |

**3.** The president of Yerkes, Inc. used his expense account to purchase a new Saab 9000 solely for personal use. The following entry was made.

| | | |
|---|---|---|
| Miscellaneous Expense | 34,000 | |
| Cash | | 34,000 |

**4.** An order for $30,000 has been received from a customer for products on hand. This order is to be shipped on January 9 next year. The following entry was made.

| | | |
|---|---|---|
| Accounts Receivable | 30,000 | |
| Sales | | 30,000 |

**5.** Materials were purchased on March 31 for $65,000. This amount was entered in the Inventory account. On December 31, the materials would have cost $80,000, so the following entry was made.

| | | |
|---|---|---|
| Inventory | 15,000 | |
| Gain on Inventories | | 15,000 |

**Instructions**

In each situation, discuss the appropriateness of the journal entries in terms of generally accepted accounting principles.

*Identify accounting assumptions, principles, and constraints.*

(SO 4, 5, 6)

**P7-3A** Presented below are the assumptions, principles, and constraints used in this chapter.

**1.** Economic entity assumption
**2.** Going concern assumption
**3.** Monetary unit assumption
**4.** Time period assumption
**5.** Full disclosure principle
**6.** Revenue recognition principle
**7.** Matching principle
**8.** Cost principle
**9.** Materiality
**10.** Conservatism

Identify by number the accounting assumption, principle, or constraint that matches each description below. Do not use a number more than once.

**(a)** Assets are not stated at their liquidation value. (Do not use cost principle.)
**(b)** The death of the president is not recorded in the accounts.
**(c)** Pencil sharpeners are expensed when purchased.
**(d)** Depreciation is recorded in the accounts over the life of an asset. (Do not use the going concern assumption.)
**(e)** Each entity is kept as a unit distinct from its owner or owners.
**(f)** Reporting must be done at defined intervals.
**(g)** Revenue is recorded at the point of sale.
**(h)** When in doubt, it is better to understate rather than overstate net income.
**(i)** All important information related to inventories is presented in the footnotes or in the financial statements.

*Prepare a classified balance sheet and analyze financial position.*

(SO 7)

**P7-4A** The adjusted trial balance of Quad Cities Tours Inc. as of October 31, 2008 (its year-end) contains the following information.

| | |
|---|---|
| Accounts payable | $170,000 |
| Accounts receivable | 15,000 |
| Accumulated depreciation—Buildings | 144,000 |
| Accumulated depreciation—Equipment | 715,000 |
| Bonds payable | 600,000 |
| Buildings—Offices and cabins | 660,000 |
| Cash | 36,000 |
| Common stock | 300,000 |
| Equipment | 840,000 |
| Income taxes payable | 56,250 |
| Interest payable | 30,000 |
| Inventories | 485,000 |
| Investment in Iowa Trading Post, Inc. (trading—short-term) | 140,000 |
| Land | 653,000 |
| Mortgage payable (on fishing cabins—long-term) | 247,750 |
| Notes payable (short-term) | 164,000 |
| Prepaid advertising | 17,000 |
| Prepaid insurance | 9,000 |
| Retained earnings (October 31, 2008) | 440,000 |
| Supplies | 12,000 |

**Instructions**

(a) Total current liabilities $420,250

**(a)** Prepare in good form a classified balance sheet for Quad Cities Tours Inc.

**(b)** Calculate the following balance sheet relationships: current ratio, debt to total assets ratio, and working capital.

**(c)** Assume that Quad Cities has come to you, as the senior loan officer of Big Woods Credit Union, seeking a $500,000 loan to help defray the costs of replacing much of its rental camping gear and canoes. Would you be willing to approve the loan? Is there any additional information you would like to have before making your decision?

*Prepare a multiple-step income statement and analyze profitability.*

(SO 7)

**P7-5A** The ledgers of Mid City Galleries Inc. contain the following balances as of December 31, 2008.

| | | | |
|---|---|---|---|
| Advertising expense | $ 123,000 | Miscellaneous administrative expenses | 53,200 |
| Commissions expense on art sales | 1,200,000 | Miscellaneous selling expenses | 39,000 |
| Depreciation expense (administrative) | 98,000 | Net purchases | 3,200,000 |
| Dividend revenue | 50,000 | Net sales | 9,275,000 |
| Insurance expense | 600,000 | Rent expense | 808,000 |
| Interest expense | 98,000 | Freight-in | 232,000 |
| Inventory, January 1 | 1,650,000 | Freight-out | 82,500 |
| Inventory, December 31 | 1,424,000 | Utilities expense | 117,000 |
| Loss on the sale of office equipment | 21,300 | Wages and salaries | 1,264,000 |

Income taxes are calculated at 30 percent of income. Mid City Galleries had 90,000 shares of common stock outstanding for the entire year. Total assets amounted to $7,509,000, and common stockholder's equity was $3,975,400.

**Instructions**

(a) Net income $814,100

**(a)** Prepare in good form a multiple-step income statement for Mid City Galleries.

**(b)** Calculate three measures of profitability and one ratio of solvency.

**(c)** Assume that you are considering supplying Mid City Galleries with a line of miniature replicas of fine arts sculptures for sale in its gift shops. Is this a company for which you would like to be a supplier? What additional information would you like to have before deciding to become a major supplier for Mid City Galleries?

# PROBLEMS: SET B

*Analyze transactions to identify accounting principle or assumption violated, and prepare correct entries.*

(SO 4, 5)

**P7-1B** Mary Kate and Ashley are accountants for Olsen Printers. They disagree over the following transactions that occurred during the year.

1. Land costing $41,000 was appraised at $49,000. Mary Kate suggests the following journal entry.

| | | |
|---|---|---|
| Land | 8,000 | |
| Gain on Appreciation of Land | | 8,000 |

2. Olsen bought equipment for $60,000, including installation costs. The equipment has a useful life of 5 years. Olsen depreciates equipment using the straight-line method. "Since the equipment as installed into our system cannot be removed without considerable damage, it will have no resale value. Therefore, it should not be depreciated, but instead should be expensed immediately," argues Mary Kate. "Besides, it lowers net income."
3. Depreciation for the year was $26,000. Since net income is expected to be lower this year, Mary Kate suggests deferring depreciation to a year when there is more net income.
4. Olsen purchased equipment at a fire sale for $18,000. The equipment was worth $26,000. Mary Kate believes that the following entry should be made.

| | | |
|---|---|---|
| Equipment | 26,000 | |
| Cash | | 18,000 |
| Gain on Purchase of Equipment | | 8,000 |

5. Mary Kate suggests that Olsen should carry equipment on the balance sheet at its liquidation value, which is $20,000 less than its cost.
6. Olsen rented office space for 1 year starting October 1, 2008. The total amount of $24,000 was paid in advance. Mary Kate believes that the following entry should be made on October 1.

| | | |
|---|---|---|
| Rent Expense | 24,000 | |
| Cash | | 24,000 |

Ashley disagrees with Mary Kate on each of the situations above.

**Instructions**

For each transaction, indicate why Ashley disagrees. Identify the accounting principle or assumption that Mary Kate would be violating if her suggestions were used. Prepare the correct journal entry for each transaction, if any.

*Determine the appropriateness of journal entries in terms of generally accepted accounting principles or assumptions.*

(SO 4, 5)

**P7-2B** Presented below are a number of business transactions that occurred during the current year for Renteria, Inc.

1. Because the general level of prices increased during the current year, Renteria, Inc. determined that there was a $40,000 understatement of depreciation expense on its equipment and decided to record it in its accounts. The following entry was made.

| | | |
|---|---|---|
| Depreciation Expense | 40,000 | |
| Accumulated Depreciation | | 40,000 |

2. Because of a "flood sale," equipment obviously worth $300,000 was acquired at a cost of $225,000. The following entry was made.

| | | |
|---|---|---|
| Equipment | 300,000 | |
| Cash | | 225,000 |
| Gain on Purchase of Equipment | | 75,000 |

3. An order for $60,000 has been received from a customer for products on hand. This order is to be shipped on January 9 next year. The following entry was made.

| | | |
|---|---|---|
| Accounts Receivable | 60,000 | |
| Sales | | 60,000 |

4. Land was purchased on April 30 for $200,000. This amount was entered in the Land account. On December 31, the land would have cost $240,000, so the following entry was made.

| | | |
|---|---|---|
| Land | 40,000 | |
| Gain on Land | | 40,000 |

**5.** The president of Renteria, Inc. used his expense account to purchase a pre-owned Mercedes-Benz E420 solely for personal use. The following entry was made.

| | | |
|---|---|---|
| Miscellaneous Expense | 54,000 | |
| Cash | | 54,000 |

**Instructions**

In each situation, discuss the appropriateness of the journal entries in terms of generally accepted accounting principles.

*Identify accounting assumptions, principles, and constraints.*

(SO 4, 5, 6)

**P7-3B** Presented below are the assumptions, principles, and constraints used in this chapter.

**1.** Economic entity assumption
**2.** Going concern assumption
**3.** Monetary unit assumption
**4.** Time period assumption
**5.** Full disclosure principle
**6.** Revenue recognition principle
**7.** Matching principle
**8.** Cost principle
**9.** Materiality
**10.** Conservatism

Identify by number the accounting assumption, principle, or constraint that matches each description below. Do not use a number more than once.

**(a)** Repair tools are expensed when purchased. (Do not use conservatism.)
**(b)** Allocates expenses to revenues in proper period.
**(c)** Assumes that the dollar is the measuring stick used to report financial information.
**(d)** Separates financial information into time periods for reporting purposes.
**(e)** Market value changes subsequent to purchase are not recorded in the accounts. (Do not use revenue recognition principle.)
**(f)** Indicates that personal and business record keeping should be separately maintained.
**(g)** Ensures that all relevant financial information is reported.
**(h)** Lower of cost or market is used to value inventories.

*Prepare a classified balance sheet and analyze financial position.*

(SO 7)

**P7-4B** The adjusted trial balance of Gabelli Equipment, Inc., as of June 30, 2008 (its year-end) contains the following information.

| | |
|---|---|
| Accounts payable | $ 486,000 |
| Accounts receivable | 420,000 |
| Accumulated depreciation—Buildings | 180,000 |
| Accumulated depreciation—Equipment | 577,500 |
| Bonds payable | 1,750,000 |
| Buildings—Manufacturing plant and offices | 680,000 |
| Cash | 87,000 |
| Common stock | 500,000 |
| Equipment | 1,650,000 |
| Income taxes payable | 47,000 |
| Interest payable | 70,000 |
| Interest receivable | 21,000 |
| Inventories | 845,000 |
| Investment in Spartan, Inc. bonds (held-to-maturity—long-term) | 600,000 |
| Land | 212,000 |
| Mortgage payable (on manufacturing plant—long-term) | 310,000 |
| Notes payable (short-term) | 210,000 |
| Prepaid advertising | 9,500 |
| Prepaid insurance | 21,000 |
| Retained earnings (June 30, 2008) | 447,000 |
| Supplies | 32,000 |

**Instructions**

(a) Total current assets $1,435,500

**(a)** Prepare in good form a classified balance sheet for Gabelli Equipment.
**(b)** Calculate the following balance sheet relationships: current ratio, debt to total assets ratio, and working capital.
**(c)** Assume that Gabelli has come to you, as vice president of Illinois National Bank, seeking a $450,000 loan to help defray the costs of upgrading some of its machinery. Would you be willing to approve the loan? Is there any additional information you would like to have before making your decision?

*Prepare a multiple-step income statement and analyze profitability.*

(SO 7)

**P7-5B** The ledgers of Campo Leathers Inc. contain the following balances as of January 31, 2008 (its year-end).

| | | | |
|---|---|---|---|
| Advertising expense | $ 130,000 | Inventory, January 31, 2008 | 303,400 |
| Depreciation expense (administrative) | 53,000 | Managerial salaries | 129,800 |
| Freight-in | 27,900 | Miscellaneous administrative expenses | 22,200 |
| Freight-out | 6,800 | Miscellaneous selling expenses | 39,000 |
| Gain on the sale of equipment | 8,500 | Net purchases | 1,697,000 |
| Insurance expense | 57,000 | Net sales | 2,660,000 |
| Interest expense | 13,600 | Rent expense | 81,000 |
| Interest revenue | 7,000 | Sales staff wages | 155,000 |
| Inventory, February 1, 2007 | 296,400 | Utilities expense | 30,300 |

Income taxes are calculated at 30 percent of income. Campo had 84,000 shares of common stock outstanding for the entire year. Total assets amounted to $5,460,000, and common stockholders' equity was $1,966,200 at year end.

**Instructions**

**(a)** Prepare in good form a multiple-step income statement for Campo Leathers Inc.

(a) Net income $167,930

**(b)** Calculate three measures of profitability and one ratio of solvency.

**(c)** Assume that you are considering supplying Campo Leathers with a line of wallets, key holders, and other small leather goods for sale in its two stores. Is this a company for which you would like to be a supplier? What additional information would you like to have before deciding to become a supplier for Campo Leathers?

## PROBLEMS: SET C

Visit the book's website at **www.wiley.com/college/weygandt,** and choose the Student Companion site, to access Problem Set C.

## COMPREHENSIVE PROBLEM: CHAPTERS 2 TO 7

Presented below is financial information related to Nu Wood Corporation for the year 2008. Unless otherwise stated, all balances are ending balances.

| | | | |
|---|---|---|---|
| Accounts payable | $ 874,200 | Interest revenue | 99,000 |
| Accounts receivable | 1,000,800 | Inventories | 984,000 |
| Accumulated depreciation—Equipment | 1,560,000 | Marketable securities (short-term) | 1,175,000 |
| Administrative expenses | 420,000 | Net sales | 3,590,000 |
| Bonds payable | 3,300,000 | Notes payable (short-term) | 1,136,500 |
| Cash | 165,000 | Other long-term debt | 401,300 |
| Common stock | 2,200,000 | Patents and other intangibles | 1,150,100 |
| Cost of goods sold | 2,285,000 | Prepaid expenses | 356,100 |
| Dividends | 250,000 | Retained earnings (January 1, 2008) | 877,200 |
| Equipment | 5,894,000 | Selling expenses | 361,000 |
| Gain on the sale of land | 87,000 | Taxes payable | 234,500 |
| Interest expense | 108,000 | | |

Nu Wood Corporation had 80,000 shares of common stock outstanding for the entire year. Its effective income tax rate for state and federal income taxes combined is 35 percent.

**Instructions**

**(a)** Prepare a multiple-step income statement.

(a) Net income $391,300

**(b)** Prepare a single-step income statement.

(c) Retained earnings, Dec. 31 $1,018,500

**(c)** Prepare a retained earnings statement.
**(d)** Prepare a classified balance sheet.
**(e)** Compute the following balance sheet relationships:
 **(1)** current ratio.
 **(2)** the amount of working capital.
 **(3)** debt to total assets ratio.
 What insights do these relationships provide to the reader of the financial statements?
**(f)** Compute three measures of profitability. What insights do these relationships provide to the reader of the financial statements?
**(g)** Compare the results for Nu Wood Corporation, calculated here, and the results for Notting Hill Corporation in Demonstration Problem 2. As an investor, which corporation seems more attractive to you? Why?

## CONTINUING COOKIE CHRONICLE

(Note: This is a continuation of the Cookie Chronicle from Chapters 1 through 6.)

**CCC7** Natalie's biggest competitor is Trial Appliances. Trial Appliances sells a fine European mixer similar to the one that customers are able to buy from Cookie Creations. Natalie estimates that Trial Appliances sells twice as many mixers as she does. Trial Appliances also sells other appliances. Natalie believes that one of the major reasons Trial Appliances sells the number of mixers that it does is because it sells all of its appliances on an extended payment plan. She would really like to generate more sales revenues and cash flow. Natalie comes to you to ask about the accounting for revenues when mixers are sold on an extended payment plan.

*Go to the book's website,* ***www.wiley.com/college/weygandt****,* *to see the completion of this problem.*

# BROADENING YOUR PERSPECTIVE

## FINANCIAL REPORTING AND ANALYSIS

### Financial Reporting Problem

**BYP7-1** Marcey Leuck successfully completed her first accounting course during the spring semester. She is now working as a management trainee for Midwest Bank, N.A. during the summer. One of her fellow management trainees, Reed LaDue, is taking the same accounting course this summer and has been having a "lot of trouble." On the second exam, for example, Reed became confused about inventory valuation methods. He completely missed all the points on a problem involving LIFO and FIFO.

Reed's instructor recently indicated that the third exam will probably have a number of essay questions dealing with accounting principles issues. Reed is quite concerned about the third exam for two reasons. First, he has never taken an accounting exam in which essay answers were required. Second, Reed feels he must do well on this exam to get an acceptable grade in the course.

Reed has asked Marcey to help him prepare for the next exam. She agrees, and suggests that Reed develop a set of possible questions on the accounting principles material that they might discuss.

**Instructions**
Answer the following questions that were developed by Reed.

**(a)** What is a conceptual framework?
**(b)** Why is there a need for a conceptual framework?
**(c)** What are the objectives of financial reporting?
**(d)** If you had to explain generally accepted accounting principles to a nonaccountant, what essential characteristics would you include in your explanation?

**(e)** What are the qualitative characteristics of accounting? Explain each one.
**(f)** Identify the basic assumptions used in accounting.
**(g)** What are two major constraints involved in financial reporting? Explain both of them.

# Comparative Analysis Problem

## PepsiCo vs. Coca-Cola

**BYP7-2** PepsiCo's financial statements are presented in Appendix A. Coca-Cola's financial statements are presented in Appendix B.

**Instructions**

**(a)** Based on the information contained in these financial statements, compute the following 2005 ratios for each company.
  **(1)** Current ratio.
  **(2)** Working capital.
  **(3)** Profit margin percentage.
  **(4)** Return on assets.
  **(5)** Return on common stockholders' equity.
  **(6)** Debt to total assets ratio.

**(b)** Compare and evaluate the liquidity, profitability, and solvency of the two companies.

# Exploring the Web

**BYP7-3** The Financial Accounting Standards Board (FASB) is a private organization established to improve accounting standards and financial reporting. The FASB conducts extensive research before issuing a "Statement of Financial Accounting Standards," which represents an authoritative expression of generally accepted accounting principles.

***Address:*** **www.accounting.rutgers.edu/accounting,** or go to **www.wiley.com/college/weygandt**

**Steps**

**1.** Choose **FASB**.
**2.** Choose **Facts about FASB**.

**Instructions**

Answer the following questions.

**(a)** What is the mission of the FASB?
**(b)** How are topics added to the FASB technical agenda?
**(c)** What characteristics make the FASB's procedures an "open" decision-making process?

# CRITICAL THINKING

## Decision Making Across the Organization

**BYP7-4** Presented below are key figures and relationships from the financial statements of a prominent company in each of three different industries for two recent fiscal years.

| | Manufacturing | | Mining/Oil | | Merchandising | |
|---|---|---|---|---|---|---|
| | Prior Year | Current Year | Prior Year | Current Year | Prior Year | Current Year |
| **From the balance sheets:** | | | | | | |
| Total assets (millions) | $11,079 | $11,083 | $33,884 | $35,089 | $8,524 | $9,485 |
| Current ratio | 1.72 | 1.73 | 1.14 | 1.12 | 1.51 | 1.56 |
| Working capital (millions) | $2,390 | $2,349 | $1,037 | $1,072 | $1,236 | $1,452 |
| Debt to total assets ratio | 0.45 | 0.43 | 0.59 | 0.58 | 0.72 | 0.72 |
| **Profitability:** | | | | | | |
| Total sales (millions) | $13,021 | $13,340 | $31,916 | $41,540 | $14,739 | $16,115 |
| Profit margin percentage | 10.0% | 8.7% | 0.8% | 5.2% | 2.8% | 1.9% |
| Return on assets | 11.8% | 10.4% | 0.7% | 6.1% | 4.8% | 3.2% |
| Return on common equity | 21.4% | 18.3% | 1.8% | 15.0% | 20.1% | 13.5% |
| Earnings per common share | $5.91 | $5.26 | $0.73 | $6.10 | $5.20 | $3.72 |
| **From the annual reports:** | | | | | | |
| End-of-year stock price | $67.75 | $72.63 | $85.75 | $95.25 | $56.50 | $62.00 |

**Instructions**
With the class divided into groups, answer the following.

**(a)** The benchmark for the current ratio is generally 2:1. None of these companies has a ratio that high, yet all three are well regarded firms. Why might a current ratio less than 2:1 *not* signal a problem?
**(b)** The merchandising company acquired a chain of well-known department stores two years ago. Apart from such major acquisitions, what else might contribute to differing debt to total assets ratios? Consider industry-specific as well as company-specific considerations.
**(c)** For all three companies, the ratio of debt to total assets changed little from the prior year to the current year, yet for two of the three companies return on common stockholders' equity decreased. What might cause this pattern?
**(d)** The profitability relationships and earnings per share for both the manufacturing and the merchandising companies decreased from the prior year to the current year, yet the price per share of stock for each company increased. Why might investors have been willing to pay more for these companies in the current year?

## Communication Activity

**BYP7-5** If you go on to advanced accounting courses, you'll study the differences between accounting in the business world and university accounting. You'll find that there's one major similarity: both depend heavily on the matching principle.

At Long Beach City College, a two-year community college with 30,000 students, most of the revenues come from the state of California and the federal government. As a condition of receiving these grants, "we must match expenses against revenues in the right fiscal year," says the school's accounting manager.

For example, the college receives federal funding under the Job Training Partnership Act. "We receive funding from the federal government, which allows us to offer classes to students for job preparation. The government specifies the grant periods, for instance, from July 1 to June 30. We therefore have to ensure that all transactions for that project are completed within that fiscal year." Another project is the amnesty program, the federal government's legalization of foreign nationals. Expenses to offset the grant money are mostly teaching salaries and instructional materials.

By year-end, the goal is to break even. Excess funds, if any, have to be returned. But program managers do not want a deficit, either, because these projects are accountable to the college administration and any overspending will come from the college's general fund.

**Instructions**
Write a letter to your instructor covering the following points.

1. Why is the matching principle important in accounting for government grants?
2. Give some examples of grant or special programs to which the matching principle might be applied at your college or university.
3. What are some examples of costs that Long Beach City College might properly charge to its grant or special programs?

## Ethics Case

**BYP7-6** When the Financial Accounting Standards Board issues new standards, the required implementation date is usually 12 months or more from the date of issuance, with early implementation encouraged. Michael Peeples, accountant at Bruno Corporation, discusses with his financial vice president the need for early implementation of a recently issued standard that would result in a much fairer presentation of the company's financial condition and earnings. When the financial vice president determines that early implementation of the standard will adversely affect reported net income for the year, he strongly discourages Michael from implementing the standard until it is required.

**Instructions**

**(a)** Who are the stakeholders in this situation?
**(b)** What, if any, are the ethical considerations in this situation?
**(c)** What does Michael have to gain by advocating early implementation? Who might be affected by the decision against early implementation?

## "All About You" Activity

**BYP7-7** In the "All About You" feature in this chapter (page 314), you learned that in response to the Sarbanes-Oxley Act, many companies have implemented formal ethics codes. Many other organizations also have ethics codes.

**Instructions**

Obtain the ethics code from an organization that you belong to (e.g., student organization, business school, employer, or a volunteer organization). Evaluate the ethics code based on how clearly it identifies proper and improper behavior. Discuss its strengths, and how it might be improved.

## Answers to Insight and Accounting Across the Organization Questions

**When to Account for the Winning Handle Pull, p. 301**

Q: What accounting principles are applicable to the Harold's Club progressive slot machines?
A: *The revenue recognition and the matching principles are applicable.*
Q: If Harold's fails to use an estimate for expenses, what effect will this have on financial statements in a period when no payouts occur?
A: *In periods without a payout, revenues will be very high, expenses will be too low, and income will be overstated. In a subsequent period, when a payout occurs, expenses will be very high and net income very low.*

**How About Instant Access?, p. 302**

Q: Would instant access to financial information provide more relevant information?
A: *Such access should be more relevant since it would be more timely.*
Q: Do you think such an approach would do away with the need for annual reports?
A: *No. To ensure compliance with GAAP and various regulatory agencies, it will still be necessary to have audited financial statements and regulatory filings. Reports based upon a consistent time period will be necessary to allow for comparison with prior years and with other companies.*

**How High Is Your Profit Margin?, p. 310**

Q: If service companies have a profit margin much lower than manufacturers (a third as large), why would anyone invest in a service company over a manufacturer?
A: *The profit margin is only a percentage, not an absolute amount. A service company may have a profit margin only a third that of a manufacturer but have a greater amount of net profit in total dollars and per-share amount.*

**And the Correct Answer Is . . .?, p. 312**

Q: What would be the advantage of similar accounting standards for all countries?
A: *Similar accounting standards would make comparable the financial statements of companies from all countries.*
Q: How can the financial and operating performance of international companies be compared?
A: *Adjustments must be made to the reported financial data to make analysis and ratios comparable.*

## Authors' Comments on *All About You:* Corporations Have Governance Structures—Do You?, p. 314

Before we address the usefulness of a student code of ethics, let's first ask whether a corporate code of ethics will ensure that employees no longer commit fraud. The answer is, "Clearly not." Does that mean a code of ethics is a waste of time? No. A code of ethics is a useful statement by the leaders of an organization about what kind of behavior is expected of the members of that organization. It provides a concrete reference point by which wrongdoing can be identified and evaluated.

Now, suppose that you were taking an exam and that you observed a number of people cheating. It would be very frustrating if you thought that your instructor, the school administrators, and other students didn't care that people were cheating. Ultimately this would encourage even more people to cheat. But if the school has defined unethical behavior, stated that it won't be tolerated, and created the necessary mechanisms for detecting and punishing unethical behavior, then it has begun the first steps in creating a more ethical environment. For an example of an ethics code for university students, see the ethics section of the Student Resources at **www.bus.wisc.edu/accounting.**

## Answer to PepsiCo Review It Question 2, p. 298

The Report of Independent Auditors indicates that PepsiCo's financial statements (balance sheet and statements of income, cash flows, and common shareholders' equity) are presented fairly, in conformity with accounting principles generally accepted in the U.S.A.

## Answers to Self-Study Questions

**1.** a **2.** d **3.** c **4.** c **5.** c **6.** c **7.** b **8.** c **9.** c **10.** b

*Remember to go back to the Navigator box on the chapter-opening page and check off your completed work.*