

Financial Statements for a Corporation

BEFORE
You

READ

What You'll Learn

1. Explain how to record ownership of a corporation.
2. Explain the relationship between the work sheet and the financial statements for a merchandising corporation.
3. Explain how a corporation's financial statements differ from a sole proprietorship's.
4. Prepare an income statement, statement of retained earnings, and balance sheet, and describe the statement of cash flows for a merchandising corporation.
5. Analyze the financial data contained on the statements.
6. Define the accounting terms introduced in this chapter.

Why It's Important

► The corporate form of business and the merchandising operation both have unique financial reporting requirements.



Predict

1. What does the chapter title tell you?
2. What do you already know about this subject from personal experience?
3. What have you learned about this in the earlier chapters?
4. What gaps exist in your knowledge of this subject?

Exploring the *Real World* of Business

ANALYZING CORPORATE FINANCIAL STATEMENTS

99 Cents Only Stores

Do you think it is possible to buy a new 19-inch color TV for 99 cents? It was for the first nine customers at a recent grand opening of a **99 Cents Only Store**. Promoting its 223rd store, **99 Cents Only Stores** tempted customers with all kinds of bargains for 99 cents or less: name-brand and private-label foods, beverages, health and beauty products, toys, and household goods.

How can selling products at such a low price make the company a profit? This retailer focuses on close-out inventory and distressed products purchased at discount prices.

The financial condition and performance of **99 Cents Only Stores** can be examined using statements like the balance sheet and income statement and accompanying notes. Companies also publish growth trends, expansion plans, and financial milestones.

What Do You Think?

In purchasing stock in a company like **99 Cents Only Stores**, what would you review on its financial statements?



Working in the *Real World*

APPLYING YOUR ACCOUNTING KNOWLEDGE

Once the work sheet has been completed, the accounting staff is ready to prepare financial statements. Many corporations are required by law to disclose their financial information to the public. If you have listened to the evening news on television, you might remember an announcer reporting earnings increases or decreases for a large national corporation. This information is found in the financial statements or annual reports of the company.

Personal Connection

1. Is your employer a public corporation?
2. Are the financial statements available for you to review?
3. Can they be found on the Internet or in your local library?

Online Connection

Go to glencoeaccounting.glencoe.com and click on **Student Center**. Click on **Working in the Real World** and select **Chapter 19**.





SECTION 1

BEFORE
You

READ

Main Idea

Owners' equity in a corporation is called **stockholders' equity**.

Read to Learn...

- the accounts used to record ownership of a corporation. (p. 552)
- the qualities expected in financial statements. (p. 554)
- the financial statements of a corporation. (p. 555)

Key Terms

Capital Stock

stockholders' equity
retained earnings
comparability
reliability
relevance
full disclosure
materiality

The Ownership of a Corporation

In Chapter 18 you learned that the work sheet organizes data for preparing financial statements and end-of-period journal entries. In this chapter you will use it to prepare financial statements for a merchandising corporation. This is an important task for all businesses.



Accounting for a Corporation

Who Owns a Corporation?

One person owns a sole proprietorship. A corporation may be owned by one person or by thousands of people. The ownership of a corporation is represented by shares of stock.

Recording the Ownership of a Corporation

As you recall, investments by the owner of a sole proprietorship are recorded in the owner's capital account. A \$25,000 owner's investment in a sole proprietorship is recorded as shown in the T accounts. **Cash in Bank** is debited for \$25,000, and **Maria Sanchez, Capital** is credited for \$25,000.

Cash in Bank		Maria Sanchez, Capital	
Debit	Credit	Debit	Credit
+ 25,000	—	—	+ 25,000

Businesses organized as corporations have a **Capital Stock** account instead of the owner's capital account in a sole proprietorship. **Capital Stock** represents investments in the corporation by its stockholders (owners).

Capital Stock is classified as a stockholders' equity account. **Stockholders' equity** is the value of the stockholders' claims to the corporation. Like the owner's capital account in a sole proprietorship, increases to **Capital Stock** are recorded as credits and decreases are recorded as debits.

Reporting Stockholders' Equity in a Corporation

The form of business organization does not affect the amount of equity in the business. That is, one person may have an ownership interest in a

Business Transaction

On January 1 stockholders invested \$25,000 in exchange for shares of stock of the corporation, Receipt 997.

ANALYSIS

Identify Classify

+/-

1. The accounts affected are **Cash in Bank** and **Capital Stock**.
2. **Cash in Bank** is an asset account. **Capital Stock** is a stockholders' equity account.
3. **Cash in Bank** is increased by \$25,000. **Capital Stock** is increased by \$25,000.

DEBIT-CREDIT RULE

4. Increases to asset accounts are recorded as debits. Debit **Cash in Bank** for \$25,000.
5. Increases to stockholders' equity accounts are recorded as credits. Credit **Capital Stock** for \$25,000.

T ACCOUNTS

6. Cash in Bank		Capital Stock	
Debit	Credit	Debit	Credit
+ 25,000	-	-	+ 25,000

JOURNAL ENTRY

7. GENERAL JOURNAL					PAGE <u>1</u>
	DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT
1	20--				
2	Jan. 1	Cash in Bank		25 000 00	
3		Capital Stock			25 000 00
4		Receipt 997			

sole proprietorship worth \$80,000, or 10 people may have shares of stock in a corporation worth a total of \$80,000. The difference is in the way these two amounts are reported on the balance sheet.

A sole proprietorship reports the balance of the owner's capital account in the owner's equity section of the balance sheet. For a corporation the owner's equity section of the balance sheet is called stockholders' equity. The law requires that stockholders' equity be reported in two parts: (1) equity contributed by stockholders and (2) equity earned through business profits.

Equity Contributed by Stockholders

The first part of stockholders' equity is the amount of money invested by stockholders. This amount is comparable to the investments made by the owner in a sole proprietorship. In a corporation stockholders contribute to equity by buying shares of stock issued by the corporation. Stockholders' investments are recorded in the **Capital Stock** account.

Equity Earned Through Business Profits

The second part of stockholders' equity is the amount of accumulated net income earned and retained by the corporation. This amount is comparable to the amount of net income less any withdrawals by the owner in a sole proprietorship. In a corporation this amount, called **retained earnings**, represents the increase in stockholders' equity from the portion of net income not distributed to the stockholders.

Retained Earnings	
Debit	Credit
-	+
Decrease Side	Increase Side
	Normal Balance

Earnings retained by a corporation are recorded in the **Retained Earnings** account. **Retained Earnings** is classified as a stockholders' equity account. Like the **Capital Stock** account, it is increased by credits and decreased by debits. **Retained Earnings** has a normal credit balance.

In a sole proprietorship, net income increases owner's capital. This increase in owner's capital represents an increase in the assets of the business. In a corporation net income increases retained earnings, which represents the growth, or increase, in the assets of the corporation.

Balance Sheet Presentation

A comparison of the capital section of the balance sheet for a sole proprietorship and for a corporation follows:

Sole Proprietorship

Owner's Equity:

Owner's Capital

Corporation

Stockholders' Equity:

Capital Stock

Retained Earnings

Characteristics of Financial Information

What Qualities Are Required in Financial Statements?

At the end of a period, a business prepares various financial statements. These statements summarize the changes that have taken place during the period and report the financial condition of the business at the end of the period. Financial statements are used by many groups:

- Managers analyze financial statements to evaluate past performance and to make informed decisions and predictions for future operations.
- Stockholders are interested in the performance, potential future growth, and success of the business.
- Creditors want to know a company's ability to pay its debts in a timely manner and the amount of credit that should be extended to the company.
- Government agencies, employees, consumers, and the general public are also interested in the financial position of the business.

Comparability

For accounting information to be useful, it must be understandable and comparable. The data must be presented in a way that lets users recognize similarities, differences, and trends from one period to another.

Comparability allows accounting information to be compared from one

As You READ

Key Point

The Accounting Equation The basic accounting equation applies to any business regardless of the form of business organization:
Assets = Liabilities + Stockholders' Equity

fiscal period to another. The same types of statements, therefore, are prepared at the end of each period for the same length of time (for example, one month or one year). By comparing financial statements in different periods of equal length, financial patterns and relationships can be identified and analyzed, and the information from the analysis can be used to make decisions regarding business operations. Comparability also allows the comparison of financial information between businesses.

Reliability

The users of accounting data assume that the data is reliable. **Reliability** refers to the confidence users have that the financial information is reasonably free from bias and error.

Relevance

Relevance is the requirement that all information that would affect the decisions of financial statement users be disclosed in the financial reports.

Full Disclosure

“To disclose” means “to uncover or to make known.” **Full disclosure** means that financial reports include enough information to be complete.

Materiality

If something is “material,” it is important. In accounting, **materiality** means that relevant information should be included in financial reports.



A Corporation’s Financial Statements

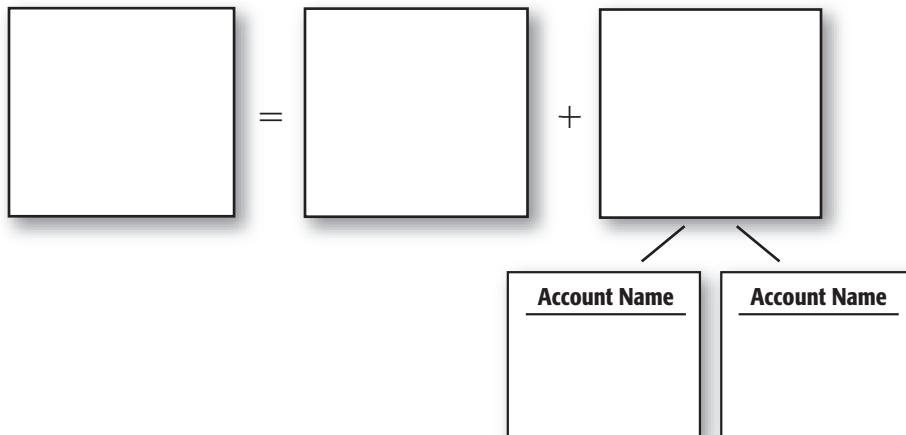
What Financial Statements Does a Merchandising Corporation Prepare?

On Your Mark Athletic Wear, a merchandising corporation, prepares four financial statements: the income statement, the statement of retained earnings, the balance sheet, and the statement of cash flows. Three statements report the changes that have taken place over the period. One statement, the balance sheet, shows the financial position of the business on a specific date—the last day of the period. The work sheet provides most of the information needed to complete all four statements.

Today most businesses rely on automated equipment or computers to maintain the general and subsidiary ledgers and to prepare the end-of-period financial statements. Computers offer the advantages of speed and accuracy. The impact of a change in an estimate, operating procedure, or accounting method can be seen instantaneously. For example, electronic spreadsheets allow *what-if analysis*, which is when one or more variables are changed to see how the final outcome would be affected.

Reinforce the Main Idea

Use a diagram like this one to describe the basic accounting equation for a corporation. Use three key terms from Section 1.

**Do the Math**

Stock in Middlewood Corporation sells for \$20 per share. The balance in the **Capital Stock** account at the beginning of the period was \$72,400. The amount entered in the Balance Sheet section of the end-of-period work sheet is \$83,100. How many shares of stock were sold during the fiscal period?

**Problem 19-1 Analyzing Stockholders' Equity Accounts**

1. An investment of \$60,000 by Kevin Cleary in his sole proprietorship is recorded as a credit to which account?
2. The sale of 100 shares of stock for \$8,500 by the Sims Corporation is recorded as a credit to which account?
3. Stockholders' equity consists of which two accounts?

**Problem 19-2 Analyzing a Source Document**

A sales slip for Cindy's Curtains is presented at right. The accountant noticed errors in the calculations.

Instructions Check all calculations and recalculate the sales tax using a rate of 4 percent.

		Cindy's Curtains	
432 Meadowbrook Street		Wilcoxson, Georgia 30345-8417	
404-555-2488			
DATE: June 26, 20--		NO. 1441	
SOLD TO	Rachel C. Washington		
	59 Priscilla Drive		
	Park Ridge, IL 60068		
CLERK	CASH	CHARGE	TERMS
K.C.	✓		
QTY.	DESCRIPTION	UNIT PRICE	AMOUNT
2	Curtain Rods #21847	\$ 14.95	\$ 29 09
4	Anchor Pieces #23104	6.75	27 00
15	Feet of ribbon per ft.	0.89	13 00
		SUBTOTAL	\$ 69 09
		SALES TAX	2 76
		TOTAL	\$ 71 85

Thank You!



SECTION 2

The Income Statement

In Section 1 you learned that corporations prepare four financial statements at the end of each period. In this section you will learn how to prepare and analyze the income statement.

The Income Statement

How Is a Merchandising Business Income Statement Different from a Service Business Income Statement?

As you know, the income statement reports the net income or loss earned by a business. In Chapter 9 you prepared an income statement for Roadrunner Delivery Service, a service business organized as a sole proprietorship. You subtracted total expenses from revenue to find the period's net income or loss. When preparing the income statement, whether for a service or merchandising business, the *revenue realization* principle is applied. Revenue for a credit sale is recorded at the time of the sale because the account receivable is expected to be converted to cash. The matching principle is also applied when preparing the income statement. Expenses are matched with revenue earned during the same period.

Merchandising businesses have an additional cost—the cost of the merchandise that is purchased and then resold to customers. The income statement for a merchandising business is thus expanded to include the cost of merchandise sold.

An income statement for a merchandising business has five sections:

• Revenue	• Operating Expenses
• Cost of Merchandise Sold	• Net Income (or Loss)
• Gross Profit on Sales	

A comparison of the income statements for a service business and for a merchandising business follows:

Service Business	
<i>Roadrunner Delivery Service</i>	
Revenue	
– Expenses	
Net Income (Loss)	

Merchandising Business	
<i>On Your Mark Athletic Wear</i>	
Revenue	
– Cost of Merchandise Sold	
Gross Profit on Sales	
– Operating Expenses	
Net Income (Loss)	

On Your Mark's income statement has four amount columns (see **Figure 19–1**). Totals are entered in the far right column. Balances that are added or subtracted are entered in the other columns. The format of a computer-generated income statement can vary from the format of an

**BEFORE
You**

READ

Main Idea

A merchandiser's income statement has a Cost of Merchandise Sold section, and a corporation's income statement shows income tax expense.

Read to Learn...

- ▶ how to prepare an income statement for a merchandising business organized as a corporation. (p. 557)
- ▶ how to apply vertical analysis to a financial statement. (p. 562)

Key Terms

net sales
net purchases
gross profit on sales
operating expenses
selling expenses
administrative expenses
operating income
vertical analysis

On Your Mark Athletic Wear						
Income Statement						
For the Year Ended December 31, 20--						
<i>Revenue:</i>						
<i>Sales</i>					320	450 00
<i>Less: Sales Discounts</i>				730 00		
<i>Sales Returns and Allowances</i>			2000 00		2730 00	
<i>Net Sales</i>						317720 00

Figure 19–1 The Heading and Revenue Section of the Income Statement

income statement prepared manually on accounting stationery. Regardless of how an income statement is prepared, the formats are very similar.

All information needed to prepare the income statement comes from the work sheet, particularly the Income Statement section. As with all other financial statements, the income statement begins with a three-line heading. The income statement for On Your Mark is prepared for the year ended December 31.

The Revenue Section

The first section on the income statement is the revenue section. This section reports the net sales for the period. The balances of the **Sales** revenue account and the **Sales Discounts** and **Sales Returns and Allowances** contra revenue accounts are reported in this section. Remember that contra revenue accounts *decrease* the revenue account. Therefore, **net sales** is the amount of sales for the period less any sales discounts, returns, and allowances. Refer to **Figure 19–1** as you learn how to complete the revenue section.

1. On the first line, enter the classification *Revenue:* at the left edge of the stationery.
2. On the second line, enter the name of the revenue account *Sales*, indented about half an inch. Enter the balance of the account in the *third* amount column.
3. On the next lines, enter the deductions from **Sales**. Write the word *Less:* followed by the names and balances of the two contra revenue accounts. (You may have to abbreviate the account names.) Enter the balances of the accounts in the *second* amount column.
4. Add the balances of the two contra revenue accounts. Write the total below the **Sales** balance on the fourth line, in the *third* amount column.
5. On the next line, enter the words *Net Sales*, indented about an inch. Subtract the total of the two contra accounts from the balance of the **Sales** account. Enter the amount in the *fourth* amount column.

On Your Mark's net sales for the year are \$317,720.

The Cost of Merchandise Sold Section

The cost of merchandise sold section follows the revenue section. As the words indicate, the *cost of merchandise sold* is the actual cost to the business of the merchandise it sold to customers during the period.

The cost of merchandise sold is calculated as follows:

$$\begin{array}{r} \text{Beginning Merchandise Inventory} \\ + \text{Net Purchases During the Period} \\ \hline \text{Cost of Merchandise Available for Sale} \\ - \text{Ending Merchandise Inventory} \\ \hline \text{Cost of Merchandise Sold} \end{array}$$

Computing the cost of merchandise sold requires two steps:

1. Determine the cost of all merchandise available for sale.
2. Calculate the cost of merchandise sold.



Calculating Cost of Merchandise Available for Sale. To calculate the cost of merchandise available for sale, add net purchases to the beginning inventory amount. **Net purchases** represents all costs related to merchandise purchased during the period. To calculate net purchases, add the transportation charges for the period (**Transportation In**) to the **Purchases** balance and then subtract the balances of **Purchases Discounts** and **Purchases Returns and Allowances**.

$$\begin{array}{r} \text{Purchases} \\ + \text{Transportation In} \\ \hline \text{Cost of Delivered Merchandise} \\ - \text{Purchases Discounts} \\ - \text{Purchases Returns and Allowances} \\ \hline \text{Net Purchases} \end{array}$$

Calculating Cost of Merchandise Sold. To calculate the cost of merchandise sold, subtract the ending merchandise inventory amount from the cost of merchandise available for sale. Refer to **Figure 19–2** on page 560 as you learn how to complete the cost of merchandise sold section.

1. On the line below net sales, enter the words *Cost of Merchandise Sold*: at the left edge.
2. Next, enter *Merchandise Inventory, January 1, 20*— indented about half an inch. Enter the amount of the beginning inventory in the *third* amount column. (The beginning inventory is found on the work sheet, in the Trial Balance section, on the Merchandise Inventory line.)
3. Next, enter *Purchases*, indented about half an inch, and place the **Purchases** account balance in the *first* amount column.
4. On the next line, enter *Plus: Transportation In* indented about half an inch. Enter the balance of **Transportation In** in the *first* amount column, below the **Purchases** amount. Draw a line across the *first* amount column under the **Transportation In** amount.
5. On the next line, write *Cost of Delivered Merchandise* indented about half an inch. Add the balances of **Purchases** and **Transportation In**. Enter the result in the *second* amount column.
6. On the next line, write *Less: Purchases Discounts*, indented about half an inch, and place the **Purchases Discounts** account balance in the *first* amount column.
7. On the next line, write *Purchases Returns and Allowances* so that it lines up with **Purchases Discounts** in the line above and place the

On Your Mark Athletic Wear			
Income Statement			
For the Year Ended December 31, 20--			
<i>Revenue:</i>			
<i>Sales</i>			320 4 5 0 00
<i>Less: Sales Discounts</i>		7 3 0 00	
<i>Sales Returns and Allowances</i>	2 0 0 0 00	2 7 3 0 00	
<i>Net Sales</i>			317 7 2 0 00
<i>Cost of Merchandise Sold:</i>			
<i>Merchandise Inventory, January 1, 20--</i>			849 2 1 00
<i>Purchases</i>	206 7 0 0 00		
<i>Plus: Transportation In</i>	4 0 3 6 18		
<i>Cost of Delivered Merchandise</i>		210 7 3 6 18	
<i>Less: Purchases Discounts</i>	1 3 4 0 00		
<i>Purchases Returns and Allowances</i>	1 8 0 0 00	3 1 4 0 00	
<i>Net Purchases</i>			207 5 9 6 18
<i>Cost of Merchandise Available</i>			292 5 1 7 18
<i>Merchandise Inventory, December 31, 20--</i>			813 8 5 00
<i>Cost of Merchandise Sold</i>			211 1 3 2 18
<i>Gross Profit on Sales</i>			106 5 8 7 82

Figure 19–2 Income Statement Through Gross Profit on Sales

Purchases Returns and Allowances account balance in the *first* amount column.

8. To find the total deduction from **Purchases**, add the balances of the **Purchases Discounts** and **Purchases Returns and Allowances** accounts. Enter the total on the **Purchases Returns and Allowances** line, in the *second* amount column. Draw a line across the *first* and *second* amount columns under this total.
9. On the next line, write *Net Purchases* indented about half an inch. Subtract the total of the **Purchases Discounts** and **Purchases Returns and Allowances** accounts from the cost of delivered merchandise. The difference is the amount of net purchases for the period. Enter the amount in the *third* amount column. Draw a line across the *third* amount column under this amount.
10. On the next line, write *Cost of Merchandise Available* indented about half an inch. Add the net purchases amount to the beginning inventory amount. The total is the cost of merchandise available for sale. Enter the total in the *third* amount column.
11. On the next line, write *Merchandise Inventory, December 31, 20--* indented about half an inch. Enter the amount of the ending inventory in the *third* amount column. (The ending inventory is found on the work sheet, in the Balance Sheet section, on the Merchandise Inventory line.) Draw a line across the *third* amount column under this amount.
12. On the next line, write *Cost of Merchandise Sold* indented about one inch. Subtract the ending inventory amount from the cost of merchandise available for sale. The difference is the cost of merchandise sold during the period. Enter the amount in the *fourth* amount column. Draw a line across the *fourth* amount column under this amount.

The Gross Profit on Sales Section

After the cost of merchandise sold has been calculated, the gross profit on sales can be determined. The **gross profit on sales** during the period is the profit made before operating expenses are deducted. Gross profit on sales is found by subtracting the cost of merchandise sold from net sales. *Gross Profit on Sales* is entered at the left edge, and the amount is placed in the *fourth* amount column. In **Figure 19–2** you can see that On Your Mark's gross profit on sales is \$106,587.82.

As You READ

Instant Recall

Gross Recall that *gross* means the total amount before deductions or subtractions.

The Operating Expenses Section

The next section of the income statement shows the operating expenses for the period. **Operating expenses** are the costs of the goods and services used in the process of earning revenue for the business. Some businesses choose to further classify operating expenses into **selling expenses** (incurred to sell or market the merchandise sold) and **administrative expenses** (related to the management of the business). Look at **Figure 19–3** on page 562. *Operating Expenses* is entered at the left edge on the line following the gross profit on sales. On the following lines, the names and balances of all expense accounts except **Federal Corporate Income Tax Expense** are listed in the same order as on the work sheet. Federal corporate income tax is a normal expense for a corporation, but it is not considered to be an operating expense. Rather than a cost related to earning revenue, income tax represents a cost *resulting* from the revenue earned.

Notice that the balances of the expense accounts are entered in the *third* amount column. The balances are totaled. The total, \$63,918.10, is entered in the *fourth* amount column.

The Net Income Section

The final section of the income statement reports the net income (or net loss) for the period, both before and after federal corporate income taxes. It is customary to present the federal corporate income tax amount *separately* on the income statement. This is done so that the income statement shows the amount of operating income. **Operating income** is the excess of gross profit over operating expenses. It is the amount of income earned before deducting federal corporate income taxes.

As You READ

Compare and Contrast

Explain the difference between operating income and net income.

Look at **Figure 19–3** again. To calculate operating income, subtract the total operating expenses from the gross profit on sales. On Your Mark's operating income for the period is \$42,669.72.

To calculate net income, follow these steps.

1. Enter *Less: Federal Corporate Income Tax Expense* on the next line, indented about half an inch.
2. Enter the amount of income taxes, \$9,995, in the *fourth* amount column. Federal corporate income taxes appear in the Income Statement section of the work sheet. Draw a line across the *fourth* column under this amount.
3. Enter *Net Income* (or *Net Loss*) on the next line at the left edge.
4. Subtract the amount of federal corporate income taxes from the operating income. The result is net income or net loss.

On Your Mark Athletic Wear			
Income Statement			
For the Year Ended December 31, 20--			
<i>Revenue:</i>			
Sales		320	450 00
Less: Sales Discounts		730 00	
Sales Returns and Allowances		200 00	2730 00
Net Sales			317720 00
<i>Cost of Merchandise Sold:</i>			
Merchandise Inventory, January 1, 20--			84921 00
Purchases	206	700 00	
Plus: Transportation In	4036	18	
Cost of Delivered Merchandise		210	736 18
Less: Purchases Discounts	1340	00	
Purchases Returns and Allowances	1800	00	3140 00
Net Purchases			207596 18
Cost of Merchandise Available			292517 18
Merchandise Inventory, December 31, 20--			81385 00
Cost of Merchandise Sold			211132 18
<i>Gross Profit on Sales</i>			106587 82
<i>Operating Expenses:</i>			
Advertising Expense		2450	00
Bank Card Fees Expense		4199	27
Insurance Expense		125	00
Maintenance Expense		3519	25
Miscellaneous Expense		348	28
Payroll Tax Expense		3826	83
Rent Expense		14000	00
Salaries Expense		29374	60
Supplies Expense		3710	00
Utilities Expense		2364	87
Total Operating Expenses			63918 10
<i>Operating Income</i>			42669 72
Less: Federal Corporate Income Tax Expense			9995 00
<i>Net Income</i>			32674 72

Figure 19–3 On Your Mark's Completed Income Statement

- Enter the difference, \$32,674.72, in the *fourth* amount column. Net income on the income statement must agree with the net income shown on the work sheet. If it does, draw a double rule under the amount to show that the income statement is proved and complete. If it does not, check the addition and subtraction on the income statement. Also check that all the accounts and balances in the Income Statement section of the work sheet appear correctly on the income statement.

Analyzing Amounts on the Income Statement

Why Do People Look at Percentages?

Managers use financial analysis to evaluate the company's financial performance. The information reported on the income statement and other

As You READ**Key Point****Vertical Analysis**

Vertical analysis expresses financial statement items as percentages of a base amount.

financial statements is expressed in dollars. Dollar amounts are useful, but the analysis can be expanded and made more meaningful by expressing the dollar amounts as percentages. These percentages more clearly indicate the relationships among the items on the financial statements. They also enable financial statement users to compare the relationships within an accounting period and changes in these relationships between accounting periods.

One type of analysis is called **vertical analysis**. With vertical analysis, each dollar amount reported on a financial statement is also reported as a percentage of another amount, called a base amount, appearing on that same statement. For example, on the income statement, each amount is reported as a percentage of net sales. Current-period percentages can be compared with percentages from past periods or with percentages from other companies within the same industry.

Figure 19–4 shows a comparative income statement. As you can see, the net sales amount for each year is assigned a percentage of 100. Every other amount on the income statement is stated as a percentage of the net sales amount. Notice that net income was 14.68 percent of net sales in the previous year and only 10.28 percent of net sales for the current year. Managers would want to find the cause to *interpret* (explain) the decrease. Analysis like this helps managers make informed decisions about future operations.

On Your Mark Athletic Wear**Comparative Income Statement**

For the Current and Previous Years Ended December 31

	Current Year		Previous Year	
	Dollars	Percent	Dollars	Percent
Revenue:				
Sales	\$ 320,450.00	100.86 %	\$ 296,350.00	100.79 %
Less: Sales Discounts	730.00	0.23	625.00	0.21
Sales Ret. and Allow.	2,000.00	0.63	1,700.00	0.58
Net Sales	\$ 317,720.00	100.00 %	\$ 294,025.00	100.00 %
Cost of Merchandise Sold:				
Merch. Inventory, Jan. 1	\$ 84,921.00	26.73 %	\$ 82,100.00	27.92 %
Net Purchases	207,596.18	65.34	186,836.56	63.54
Merch. Available for Sale	292,517.18	92.07 %	268,936.56	91.47 %
Merch. Inventory, Dec. 31	81,385.00	25.62	84,921.00	28.88
Cost of Merchandise Sold	\$ 211,132.18	66.45 %	\$ 184,015.56	62.59 %
Gross Profit on Sales	\$ 106,587.82	33.55 %	\$ 110,009.44	37.41 %
Operating Expenses:				
Advertising Expense	\$ 2,450.00	0.77 %	\$ 1,779.00	0.61 %
Bankcard Fees Expense	4,199.27	1.32	3,569.37	1.21
Insurance Expense	125.00	0.04	0.00	0.00
Maintenance Expense	3,519.25	1.11	3,308.10	1.13
Miscellaneous Expense	348.28	0.11	742.00	0.25
Payroll Tax Expense	3,826.83	1.20	3,444.15	1.17
Rent Expense	14,000.00	4.41	13,200.00	4.49
Salaries Expense	29,374.60	9.25	26,437.14	8.99
Supplies Expense	3,710.00	1.17	2,968.00	1.01
Utilities Expense	2,364.87	0.74	2,305.75	0.78
Total Operating Expenses	\$ 63,918.10	20.12 %	\$ 57,753.51	19.64 %
Operating Income	\$ 42,669.72	13.43 %	\$ 52,255.93	17.77 %
Fed. Corp. Inc. Tax Exp.	9,995.00	3.15	9,085.00	3.09
Net Income	\$ 32,674.72	10.28 %	\$ 43,170.93	14.68 %

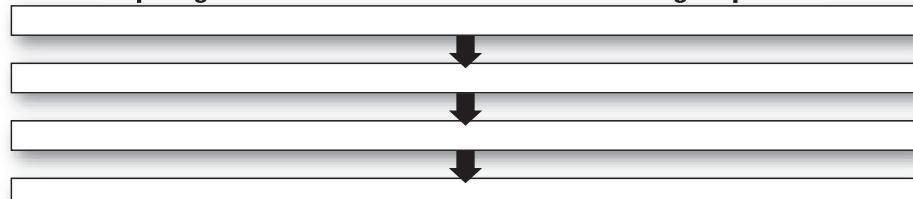
Figure 19–4 Comparative Income Statement Showing Vertical Analysis

As You READ**In Your Own Experience**

Name a corporation whose profits or losses have been reported in a newspaper, on TV or radio, or on the Internet. Why was this information important enough to be reported in the mass media?

Reinforce the Main Idea

Use a diagram like this one to describe the steps for preparing an income statement for a merchandising corporation.

Preparing an Income Statement for a Merchandising Corporation**Do the Math**

Look at the comparative income statement provided here and answer the following questions using the vertical analysis of this financial statement.

1. What is the trend in sales?
2. How is that trend affecting the net income?
3. What expenses have decreased in the past year (as a percent of sales)?
4. Are there any significant changes in inventory?
5. What is the largest expense?
6. Would you invest your money in this business? Why or why not?

Comparative Income Statement			
For the Current and Previous Years Ended December 31			
	Current Year	Previous Year	
	Dollars	Percent	Dollars
Revenue:			
Sales	\$ 1,500,000	100.13 %	\$ 850,000
Less: Sales Ret. and Allow.	2,000	0.13	2,200
Net Sales	<u>\$ 1,498,000</u>	<u>100.00 %</u>	<u>\$ 847,800</u>
Cost of Merchandise Sold:			
Merch. Inventory, Jan. 1	\$ 250,000	16.69 %	\$ 100,000
Net Purchases	<u>800,000</u>	<u>53.40</u>	<u>650,000</u>
Merch. Available for Sale	<u>\$ 1,050,000</u>	<u>70.09 %</u>	<u>\$ 750,000</u>
Merch. Inventory, Dec. 31	60,000	4.01	250,000
Cost of Merchandise Sold	<u>\$ 990,000</u>	<u>66.09 %</u>	<u>\$ 500,000</u>
Gross Profit on Sales	<u>\$ 508,000</u>	<u>33.91 %</u>	<u>\$ 347,800</u>
Operating Expenses:			
Advertising Expense	\$ 50,000	3.34 %	\$ 25,000
Bankcard Fees Expense	10,000	0.67	8,000
Insurance Expense	5,300	0.35	5,300
Maintenance Expense	9,000	0.60	7,500
Payroll Tax Expense	6,200	0.41	3,200
Rent Expense	20,000	1.34	20,000
Salaries Expense	58,000	3.87	48,000
Supplies Expense	3,000	0.20	2,200
Utilities Expense	2,400	0.16	1,850
Total Operating Expenses	<u>\$ 163,900</u>	<u>10.94 %</u>	<u>\$ 121,050</u>
Operating Income	<u>\$ 344,100</u>	<u>22.97 %</u>	<u>\$ 226,750</u>
Fed. Corp. Inc. Tax Exp.	44,940	3.00	25,434
Net Income	<u>\$ 299,160</u>	<u>19.97 %</u>	<u>\$ 201,316</u>

**Problem 19–3 Calculating Amounts on the Income Statement****Instructions**

For each group of figures that follows, determine the missing amount.

1. Beginning merchandise inventory \$81,367
Net purchases 15,139
Cost of merchandise available for sale ?
2. Net sales \$52,935
Cost of merchandise sold 36,232
Gross profit on sales ?
3. Purchases \$26,472
Transportation in 1,311
Cost of delivered merchandise ?
4. Cost of merchandise available for sale \$49,769
Ending merchandise inventory 32,621
Cost of merchandise sold ?



SECTION 3

The Statement of Retained Earnings, Balance Sheet, and Statement of Cash Flows

In the previous section, you learned how to prepare and analyze the income statement, which reports the net income or loss for the period. In this section you will learn about a corporation's statement of retained earnings, balance sheet, and statement of cash flows.

The Statement of Retained Earnings

What Does This Statement Report?

A corporation has two stockholders' equity accounts, **Capital Stock** and **Retained Earnings**. The **Capital Stock** account represents the stockholders' investment in the corporation. Its balance changes only when the corporation issues additional shares of stock. The **Retained Earnings** account summarizes the accumulated profits of a corporation minus any amounts paid to stockholders as returns on their investments.

In Chapter 9 you learned about the statement of changes in owner's equity for a sole proprietorship. It shows the changes in the owner's capital account during the period. A corporation prepares a similar statement, the **statement of retained earnings**, that reports the changes in the **Retained Earnings** account during the period. These changes result from business operations and *dividends*, which are the distributions of earnings to stockholders.

The changes to **Retained Earnings** are summarized as follows:

Retained Earnings	
Debit	Credit
–	+
Decreased by net loss dividends	Increased by net income

The statement of retained earnings is prepared from information found on the work sheet. The statement of retained earnings is a supporting document for the balance sheet. The final balance of the **Retained Earnings** account, as calculated on the statement of retained earnings, is used when preparing the balance sheet.

Figure 19–5 shows the statement of retained earnings for On Your Mark. The first line shows the balance of the **Retained Earnings** account at the beginning of the period. This balance comes from the Balance

BEFORE
You READ

Main Idea

In addition to the income statement, a corporation prepares the statement of retained earnings, the balance sheet, and the statement of cash flows.

Read to Learn...

- how and why a statement of retained earnings is prepared. (p. 565)
- how to prepare a balance sheet for a merchandising business organized as a corporation. (p. 566)
- how to apply horizontal analysis to a financial statement. (p. 568)
- about the statement of cash flows. (p. 569)

Key Terms

statement of retained earnings
horizontal analysis
base period
cash inflows
cash outflows
operating activities
investing activities
financing activities

Sheet section of the work sheet. The second line is the net income for the period. This is from the Income Statement columns of the work sheet. Add net income to the beginning balance of the **Retained Earnings** account. Since On Your Mark did not distribute any of its net income to stockholders during the period, there are no deductions from **Retained Earnings**. The new balance of the **Retained Earnings** account is \$52,445.91.

On Your Mark Athletic Wear				
Statement of Retained Earnings				
For the Year Ended December 31, 20--				
<i>Retained Earnings, January 1, 20--</i>				19 7 7 1 19
<i>Net Income</i>				32 6 7 4 72
<i>Retained Earnings, December 31, 20--</i>				52 4 4 5 91

Figure 19–5 Statement of Retained Earnings



The Balance Sheet

How Is the Balance Sheet for a Corporation Different from the Balance Sheet for a Sole Proprietorship?

The balance sheet reports the balances of all asset, liability, and stockholders' equity accounts for a specific date. The balance sheet is prepared from the information in the Balance Sheet section of the work sheet and from the statement of retained earnings.

Figure 19–6 shows On Your Mark's balance sheet. This balance sheet is prepared in report form. In the report form, classifications (assets, liabilities, and stockholders' equity) are shown one under the other.

The assets are listed first. The classification *Assets* is centered on the first line. The account names are listed at the left edge in the same order as they appear on the work sheet. The individual balances are entered in the first amount column. *Total Assets* is entered on the line below the last account name, indented about half an inch. The total assets amount is entered in the second amount column. The double rule, however, is not drawn until the Liabilities and Stockholders' Equity sections are complete, and the total of these two sections equals the total of the Assets section.

The Liabilities section begins with *Liabilities* centered on the second line below total assets. As in the Assets section, the account names are listed at the left edge in the same order as they appear on the work sheet. The individual balances are entered in the first amount column. *Total Liabilities* follows on the line below the last account name, indented about half an inch. The total liabilities amount is then entered in the second amount column.

Next, the Stockholders' Equity section begins on the second line below total liabilities. *Stockholders' Equity*, which is centered on this line, consists of two accounts, **Capital Stock** and **Retained Earnings**. The **Capital Stock** account balance is from the work sheet's Balance Sheet section. The **Retained Earnings** account balance is from the statement of retained earnings. Again,

the account names are listed at the left edge, and their individual balances are listed in the first amount column. *Total Stockholders' Equity* follows on the line below the last account name, indented about half an inch. The stockholders' equity total is entered in the second amount column.

On the line following total stockholders' equity, *Total Liabilities and Stockholders' Equity* is entered at the left edge. The total of the Liabilities section and the total of the Stockholders' Equity section are added. The total is entered in the second amount column. This total must agree with the total assets amount. If it does, double rule the balance sheet. If it does not, check the addition on the balance sheet. Also check that the accounts and amounts have been transferred from the work sheet accurately.

On Your Mark Athletic Wear	
Balance Sheet	
December 31, 20--	
Assets	
<i>Cash in Bank</i>	15 179 00
<i>Accounts Receivable</i>	10 404 00
<i>Merchandise Inventory</i>	81 385 00
<i>Supplies</i>	1 839 00
<i>Prepaid Insurance</i>	1 375 00
<i>Delivery Equipment</i>	19 831 00
<i>Office Equipment</i>	9 825 00
<i>Store Equipment</i>	5 200 00
<i>Total Assets</i>	<u>145 038 00</u>
Liabilities	
<i>Accounts Payable</i>	13 850 00
<i>Federal Corporate Income Tax Payable</i>	1 55 00
<i>Employees' Federal Income Tax Payable</i>	6 40 00
<i>Employees' State Income Tax Payable</i>	80 00
<i>Social Security Tax Payable</i>	2 48 00
<i>Medicare Tax Payable</i>	58 00
<i>Federal Unemployment Tax Payable</i>	18 36
<i>State Unemployment Tax Payable</i>	1 14 73
<i>Sales Tax Payable</i>	2 428 00
<i>Total Liabilities</i>	17 592 09
Stockholders' Equity	
<i>Capital Stock</i>	75 000 00
<i>Retained Earnings</i>	52 445 91
<i>Total Stockholders' Equity</i>	127 445 91
<i>Total Liabilities and Stockholders' Equity</i>	<u>145 038 00</u>

Figure 19–6 On Your Mark's Balance Sheet

Analyzing Amounts on the Balance Sheet

How Can You Detect Trends?

When analyzing financial statements, you learned that while the dollar amounts provided on the statements are useful, the analysis can be expanded and made more meaningful by expressing the dollar amounts as percentages. Percentage amounts are used in vertical analysis and also in horizontal analysis. **Horizontal analysis** is the comparison of the same items on financial statements for two or more accounting periods or dates, and the determination of changes from one period or date to the next. In horizontal analysis, each amount on the current statement is compared with its corresponding amount on the previous statement. A **base period** is a period, usually a year, that is used for comparison.

Look at the example of a comparative balance sheet in Figure 19–7. By comparing the amounts for the two years, you can see that **Cash in Bank** increased by 49.76 percent and **Accounts Payable** decreased by 50.73 percent. The accountant might use this information to assess why cash has

+/- MATH HINTS

Percentage Change

To find the percent of increase, subtract the base year amount from the current year amount, and then divide by the base year amount.

For example:

- if assets in the base year are \$240,000 and \$280,000 this year,
- the increase is \$40,000.
- The percentage change is 17 percent ($\$40,000 \div \$240,000$).

On Your Mark Athletic Wear Comparative Balance Sheet December 31, Current Year and Previous Year				
	Current Year	Previous Year	Increase (Decrease) Current over Previous	
			Dollars	Percent
Assets				
Cash in Bank	\$ 15,179.00	\$ 10,135.28	\$ 5,043.72	49.76 %
Accounts Receivable	10,404.00	8,220.00	2,184.00	26.57
Merchandise Inventory	81,385.00	84,921.00	(3,536.00)	(4.16)
Supplies	1,839.00	1,587.00	252.00	15.88
Prepaid Insurance	1,375.00	0.00	1,375.00	—
Delivery Equipment	19,831.00	12,462.00	7,369.00	59.13
Office Equipment	9,825.00	5,854.00	3,971.00	67.83
Store Equipment	5,200.00	3,500.00	1,700.00	48.57
Total Assets	<u>\$ 145,038.00</u>	<u>\$ 126,679.28</u>	<u>\$ 18,358.72</u>	14.49 %
Liabilities				
Accounts Payable	\$ 13,850.00	\$ 28,113.14	\$ (14,263.14)	(50.73)%
Fed. Corp. Inc. Tax Payable	155.00	140.00	15.00	10.71
Employees' Fed. Inc. Tax Pay.	640.00	685.00	(45.00)	6.57
Employees' State Inc. Tax Pay.	80.00	72.00	8.00	11.11
Social Security Tax Payable	248.00	241.00	7.00	2.90
Medicare Tax Payable	58.00	56.35	1.65	2.93
Federal Unemployment Tax Pay.	18.36	16.50	1.86	11.27
State Unemployment Tax Pay.	114.73	103.10	11.63	11.14
Sales Tax Payable	2,428.00	2,481.00	(53.00)	2.14
Total Liabilities	<u>\$ 17,592.09</u>	<u>\$ 31,908.09</u>	<u>\$ (14,316.00)</u>	(44.87)%
Stockholders' Equity				
Capital Stock	\$ 75,000.00	\$ 75,000.00	\$ 0.00	0.00 %
Retained Earnings	<u>52,445.91</u>	<u>19,771.19</u>	<u>32,674.72</u>	165.26
Total Stockholders' Equity	<u>\$ 127,445.91</u>	<u>\$ 94,771.19</u>	<u>\$ 32,674.72</u>	34.48 %
Total Liab. and Stockholders' Equity	<u>\$ 145,038.00</u>	<u>\$ 126,679.28</u>	<u>\$ 18,358.72</u>	14.49 %

Figure 19–7 Comparative Balance Sheet Showing Horizontal Analysis

increased or why accounts payable have decreased. Perhaps the business is receiving more sales in cash instead of on account. The business may also be purchasing less inventory on account. These are trends that would be of interest to management.

The Statement of Cash Flows

What Does the Statement of Cash Flows Report?

As you learned in Chapter 9, the *statement of cash flows* reports how the activities of a business caused the cash balance to change during the accounting period. This information is vital for sound decision making. See **Figure 19–8** on page 570 for On Your Mark's statement of cash flows.

Most businesses consider cash to be a major asset, and they need a sufficient amount to operate efficiently. Maintaining a positive cash flow is a primary goal of financial management. An adequate amount of available cash allows a business to pay its debts in a timely manner, take advantage of discounts, purchase equipment, and fund expansion. Creditors and investors use the statement of cash flows to evaluate a company's ability to pay its debts and pay dividends.

Cash inflows (receipts of cash) come into and **cash outflows** (payments of cash) go out of a business from different activities. The statement of cash flows classifies these activities as *operating, investing, or financing*.

Cash Flows from Operating Activities

Operating activities include all transactions that occurred during the accounting period as part of normal business operations. The information needed to complete this section is taken from On Your Mark's income statement (**Figure 19–3**) and comparative balance sheet (**Figure 19–7**).

Recall that revenue is recorded when it is earned and expenses are recorded when they are incurred, regardless of when items are actually paid. This is called the *accrual basis of accounting*.

To determine operating cash inflows and outflows for the accounting period, the accountant must convert income statement and balance sheet amounts to the *cash basis of accounting*, which records revenues *only when cash is received* and expenses *only when cash is paid out*. This is the reason that On Your Mark's net sales reported on the income statement is \$317,720.00, but sales to customers reported on the statement of cash flows is \$315,536.00.



Cash Flows from Investing Activities

Investing activities include loans the business makes, payments received for those loans, purchase and sale of plant assets, and investments. *Plant assets* are property that will be used in the business for more than one year.

During the current accounting period, On Your Mark purchased delivery equipment, office equipment, and store equipment for cash. When a plant asset is purchased for cash, the appropriate general ledger asset account is

On Your Mark Athletic Wear Statement of Cash Flows For the Year Ended December 31, 20--		
Cash Flows from Operating Activities		
Cash Receipts from:		
Sales to Customers	\$ 315,536.00	
Total Cash Receipts from Operating Activities		\$ 315,536.00
Cash Payments for:		
Purchases	(221,859.32)	
Accrued Payables	(67.86)	
Operating Expenses	(65,545.10)	
Federal Corporate Income Tax Expense	(9,980.00)	
Total Cash Payments from Operating Activities		(297,452.28)
Net Cash Flows from Operating Activities		\$ 18,083.72
Cash Flows from Investing Activities		
Purchase of Plant Assets	(13,040.00)	
Net Cash Flows from Investing Activities		(13,040.00)
Cash Flows from Financing Activities		
		-0-
Net Increase in Cash		\$ 5,043.72

Figure 19–8 Statement of Cash Flows

debited and **Cash in Bank** is credited. Since the purchase of plant assets is a cash outflow, the \$13,040.00 is placed in parentheses on the statement of cash flows.

Cash Flows from Financing Activities

Financing activities are the borrowing activities needed to finance the company operations and the repayment of these debts. On Your Mark had no financing activities during this accounting period.

The statement of cash flows indicates that cash increased by \$5,043.72 during the period. This amount agrees with the increase in cash shown on the comparative balance sheet.

Typical cash inflows and outflows for the three activities of a business are shown here.

Activity	Cash Inflows (receipts)	Cash Outflows (payments)
Operating Activities	<ul style="list-style-type: none"> • Sales • Interest Income 	<ul style="list-style-type: none"> • Merchandise Purchases • Operating Expenses • Interest Expense • Fed. Corp. Income Tax
Investing Activities	<ul style="list-style-type: none"> • Selling plant assets • Selling investments 	<ul style="list-style-type: none"> • Purchasing plant assets • Purchasing investments
Financing Activities	<ul style="list-style-type: none"> • Long-term borrowing • Issuing stock 	<ul style="list-style-type: none"> • Repaying loans (principal, not interest) • Paying dividends on stock

Reinforce the Main Idea

Use a chart like this one to describe how stockholders and creditors use each of the listed financial statements.

	Stockholders	Creditors
Statement of Retained Earnings		
Balance Sheet		
Statement of Cash Flows		

**Do the Math**

Larry Campbell is the owner of Craftsman Furniture, a successful family-owned furniture store. As the accountant for Craftsman Furniture, it is your responsibility to run a vertical analysis on the income statement. Mr. Campbell asks you to prepare an Executive Summary of a three-year vertical analysis. Using the information provided, calculate the percentages for each year in your working papers and complete the columns of the draft report. Mr. Campbell will review the draft with you so he clearly understands the trends in sales for Craftsman Furniture.

	Year 1	Year 2	Year 3
Net Sales	\$ 1,000,000	\$ 1,500,000	\$ 1,600,000
Gross Profit on Sales	600,000	750,000	780,000
Total Operating Expenses	25,000	21,000	23,000
Net Income	\$ 575,000	\$ 729,000	\$ 757,000

**Problem 19-4 Analyzing a Balance Sheet**

Use the comparative balance sheet for On Your Mark in Figure 19-7 to answer the following questions.

1. Which asset account has the larger percentage of increase in the two years? Larger decrease?
2. Which liability account has the larger percentage increase in the two years?
3. Did the overall value (total assets) of the corporation increase or decrease in the two years? What is the dollar amount? What is the percentage?
4. What is the percentage increase in retained earnings in the two years?
5. What conclusions might you draw based on the change in Accounts Receivable? Accounts Payable?
6. Can you provide a possible explanation for the difference in the balance of the Prepaid Insurance account?

Key Concepts

- Individuals become owners of a corporation by buying shares of stock. This ownership is known as *stockholders' equity*.

Here is the entry to record ownership of a corporation:

GENERAL JOURNAL							PAGE <u>1</u>	
	DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT			
1	20--							1
2	Date	1 Cash in Bank		xx	xxx	xx		2
3		Capital Stock				xx	xxx	xx
4								4

- The work sheet is a tool that organizes all the accounting information needed to prepare the financial statements. Corporations prepare the income statement, the statement of retained earnings, the balance sheet, and the statement of cash flows.
 - Most of the information needed to complete the *income statement* comes from the work sheet's Income Statement section.
 - The *statement of retained earnings* reports the changes in the **Retained Earnings** account.
 - The corporate *balance sheet* information comes from the work sheet's Balance Sheet section.
 - Information for the *statement of cash flows* comes from the income statement and the comparative balance sheet.
- The primary difference between financial statements for a sole proprietorship and a corporation involves how ownership is presented on the balance sheet.

	Sole Proprietor	Corporation
Balance Sheet Section	Owner's Equity	Stockholders' Equity
Account(s)	Owner's Capital—the owner's investment of cash and assets in the business	<ul style="list-style-type: none"> Capital Stock—the investments by stockholders (owners) Retained Earnings—earnings the corporation generated in past periods and retained instead of distributing to stockholders as dividends

- For a merchandising business, the *income statement* contains the following elements:
 - Net sales* (total sales minus deductions for sales discounts, returns, and allowances).
 - Net purchases* (total cost of merchandise bought plus transportation charges minus deductions for purchases discounts, returns, and allowances).

- *Cost of merchandise sold* calculated as follows:

$$\begin{array}{r} \text{Beginning Merchandise Inventory} \\ + \text{Net Purchases During the Period} \\ \hline \text{Cost of Merchandise Available for Sale} \\ - \text{Ending Merchandise Inventory} \\ \hline \text{Cost of Merchandise Sold} \end{array}$$

- *Gross profit on sales* (net sales minus cost of merchandise sold)
- Operating expenses
- Operating income
- *Federal income tax* paid by a corporation (listed separately)
- *Net income or net loss*

The *statement of retained earnings* reports the changes in the corporate **Retained Earnings** account that occurred during the period as a result of business operations and the distribution of earnings to stockholders through dividends.

The *balance sheet* reports asset, liability, and stockholders' equity accounts for a specific date and comes from the work sheet's Balance Sheet section.

The *statement of cash flows* reports how the activities of a business caused the cash balance to increase or decrease during the accounting period.

5. Vertical analysis helps the accountant determine the relationships among items on a financial statement and the changes in these relationships from one period to another.

Horizontal analysis compares amounts for the same item on a financial statement for two or more accounting periods.

Key Terms

administrative expenses	(p. 561)	net purchases	(p. 559)
base period	(p. 568)	net sales	(p. 558)
Capital Stock	(p. 552)	operating activities	(p. 569)
cash inflows	(p. 569)	operating expenses	(p. 561)
cash outflows	(p. 569)	operating income	(p. 561)
comparability	(p. 554)	relevance	(p. 555)
financing activities	(p. 570)	reliability	(p. 555)
full disclosure	(p. 555)	retained earnings	(p. 554)
gross profit on sales	(p. 561)	selling expenses	(p. 561)
horizontal analysis	(p. 568)	statement of retained earnings	(p. 565)
investing activities	(p. 569)	stockholders' equity	(p. 552)
materiality	(p. 555)	vertical analysis	(p. 563)

AFTER
YOU

READ

Check Your Understanding

1. **Ownership of a Corporation**
 - a. How are stockholders' equity and owner's equity similar?
 - b. What is retained earnings?
2. **Work Sheet and Financial Statements**
 - a. What four financial statements are prepared by a corporation?
 - b. How is the work sheet used to prepare financial statements?
3. **Financial Statement Differences**
 - a. How does an income statement for a merchandising business differ from that for a service business?
 - b. How does the stockholders' equity section of a balance sheet differ from the owner's equity section?
4. **Merchandising Corporation Financial Statements**
 - a. What type of expense appears on the income statement of a corporation but not on those of a sole proprietorship or partnership?
 - b. What is the difference between the cost of merchandise available for sale and the cost of merchandise sold?
5. **Financial Statement Analysis**
 - a. Why would you analyze financial statement information using horizontal analysis?
 - b. How is vertical analysis helpful?

Apply Key Terms

Your company, The Bookworm, was purchased several months ago by an international bookstore chain—The Best Seller. Your new boss, Gabriella Sitta, asks you to create the end-of-year financial statements. Gabriella is not native to the United States and does not understand all the English-language business terms. On a separate sheet of paper, write each term's definition and its relationship to the preparation of financial statements.

administrative expenses
base period
Capital Stock
cash inflows
cash outflows
comparability
financing activities
full disclosure

gross profit on sales
horizontal analysis
investing activities
materiality
net purchases
net sales
operating activities
operating expenses
operating income

relevance
reliability
retained earnings
selling expenses
statement of
retained earnings
stockholders' equity
vertical analysis



Preparing Financial Statements

Making the Transition from a Manual to a Computerized System

Task	Manual Methods	Computerized Methods
Preparing financial statements	<ul style="list-style-type: none">After all business transactions have been journalized and posted, prepare the trial balance.Calculate, journalize, and post the adjusting entries.Prepare the income statement, statement of retained earnings, and balance sheet.	<ul style="list-style-type: none">After all business transactions have been journalized and posted, print a working trial balance.Journalize the adjusting entries.Print the income statement, statement of retained earnings, and balance sheet.



Peachtree® Q & A

Peachtree Question	Answer
How do I print the Income Statement, Statement of Retained Earnings, and Balance Sheet?	<ol style="list-style-type: none">From the <i>Reports</i> menu, select Financial Statements.Select Income Statement, Retained Earnings Statement, or Balance Sheet from the Preview list.Click the Screen icon to display the Options window.Select a time frame for the information to be included in the report. Current period is the default.Review the statement on the screen.Click Print.



QuickBooks Q & A

QuickBooks Question	Answer
How do I print the Profit & Loss report and Balance Sheet?	<ol style="list-style-type: none">From the <i>Reports</i> menu, select Company & Financial.Select Profit & Loss Standard or Balance Sheet Standard.Enter the correct dates for the statement.Review the statement on the screen.Click Print.

For detailed instructions, see your Glencoe Accounting Chapter Study Guides and Working Papers.

Complete problems using:

Manual Glencoe
Working Papers OR Peachtree Complete
Accounting Software OR QuickBooks
Templates OR Spreadsheet
Templates**SPREADSHEET
SMART GUIDE****Step-by-Step Instructions:
Problem 19–5**

1. Select the spreadsheet template for Problem 19–5.
2. Enter your name and the date in the spaces provided on the template.
3. Complete the spreadsheet using the instructions in your working papers.
4. Print the spreadsheet and proof your work.
5. Complete the Analyze activity.
6. Save your work and exit the spreadsheet program.

Peachtree®**SMART GUIDE****Step-by-Step Instructions:
Problem 19–6**

1. Select the problem set for Sunset Surfwear (Prob. 19–6).
2. Rename the company and set the system date.
3. Print a Statement of Retained Earnings and a Balance Sheet.
4. Complete the Analyze activity.
5. End the session.

QuickBooks**PROBLEM GUIDE****Step-by-Step Instructions:
Problem 19–6**

1. Restore the Problem 19–6. QBB file.
2. Print a Balance Sheet.
3. Complete the Analyze activity.
4. Back up your work.

**Problem 19–5 Preparing an
Income Statement**

The work sheet for Sunset Surfwear for the year ended December 31 is shown in your working papers.

Instructions Prepare an income statement for Sunset Surfwear in your working papers. Refer to Figure 19–3 for guidance in setting up the income statement.

Analyze

Identify which general ledger account, Purchases Discounts or Purchases Returns & Allowances, had a higher amount this period.

**Problem 19–6 Preparing a Statement
of Retained Earnings
and a Balance Sheet**

Instructions Use the work sheet and the income statement from Problem 19–5 to prepare a statement of retained earnings and a balance sheet for Sunset Surfwear. Use the accounting stationery provided in your working papers.

Analyze

Calculate the ending balance of Retained Earnings assuming Sunset Surfwear had a net loss of \$6,492 instead of a net income for the period.

Problem 19–7 Preparing Financial Statements

Instructions The partially completed work sheet for Shutterbug Cameras is included in your working papers.

1. Complete the work sheet.
2. Prepare an income statement.
3. Prepare a statement of retained earnings.
4. Prepare a balance sheet.

Analyze

Identify the biggest asset account, the biggest liability account, and the highest expense account shown on the financial statements.

Problem 19-8 Completing a Work Sheet and Financial Statements

The trial balance for Cycle Tech Bicycles, prepared on a ten-column work sheet, is included in your working papers.

Instructions

1. Complete the work sheet for the year ended December 31. Use the following information to make the adjustments.

Ending merchandise inventory	\$25,191
Ending supplies inventory	1,221
Expired insurance	825
Total federal corporate income taxes for the year	3,472

2. Prepare an income statement.
3. Prepare a statement of retained earnings.
4. Prepare a balance sheet.

Cycle Tech Bicycles		
Work Sheet		
For the Year Ended December 31, 20-		
ACCT. NO.	ACCOUNT NAME	TRIAL BALANCE
		DEBIT CREDIT
1 101	Cash in Bank	21 931 00
2 115	Accounts Receivable	1 782 00
3 125	Merchandise Inventory	24 028 00
4 130	Supplies	4 159 00
5 135	Prepaid Insurance	1 800 000
6 140	Store Equipment	24 895 00
7 145	Office Equipment	16 113 00
8 201	Accounts Payable	11 224 00
9 210	Fed. Corp. Income Tax Payable	
10 211	Emply's Fed. Inc. Tax Payable	5 220 00
11 212	Emply's State Inc. Tax Payable	14 400
12 213	Social Security Tax Payable	4 130 00
13 214	Medicare Tax Payable	1 344 00
14 215	Sales Tax Payable	1 915 00
15 216	Fed. Unemployment Tax Payable	540 00
16 217	State Unemployment Tax Payable	271 00
17 301	Capital Stock	40 000 000
18 305	Retained Earnings	11 091 00
19 310	Income Summary	
20 401	Sales	127 151 00
21 405	Sales Discounts	2 460 00
22 410	Sales Returns and Allowances	1 328 00
23 501	Purchases	66 107 00
24 505	Transportation In	983 00
25 510	Purchases Discounts	822 00
26 515	Purchases Ret. and Allowances	376 00
27 601	Advertising Expense	2 380 00
28 605	Bankcard Fees Expense	18 100
29 625	Fed. Corp. Income Tax Expense	3 340 00
30 630	Insurance Expense	
31 645	Maintenance Expense	1 950 00
32 650	Miscellaneous Expense	1 831 00
33 655	Payroll Tax Expense	834 00
34 657	Rent Expense	10 800 00
35 660	Salaries Expense	4 734 00
36 665	Supplies Expense	
37 675	Utilities Expense	4 695 00
38		
39		194 117 00
40	Net Income	194 117 00
41		
42		

Analyze

Predict whether net income would be higher or lower if the ending value of Merchandise Inventory was actually \$28,000.

Peachtree®

SMART GUIDE

Step-by-Step Instructions: Problem 19-7

1. Select the problem set for Shutterbug Cameras (Prob. 19-7).
2. Rename the company and set the system date.
3. Print the following reports: Adjusted Trial Balance, Balance Sheet, Income Statement, and Statement of Retained Earnings.
4. Complete the Analyze activity.
5. End the session.

Peachtree®

SMART GUIDE

Step-by-Step Instructions: Problem 19-8

1. Select the problem set for Cycle Tech Bicycles (Prob. 19-8).
2. Rename the company and set the system date.
3. Print a Working Trial Balance to help you prepare the adjustments.
4. Record the adjustments using the **General Journal Entry** option.
5. Print a General Journal report and proof your work.
6. Print the following reports: Adjusted Trial Balance, Income Statement, Statement of Retained Earnings, and Balance Sheet.
7. Complete the Analyze activity.
8. End the session.

QuickBooks

PROBLEM GUIDE

Step-by-Step Instructions:
Problem 19-8

1. Restore the Problem 19-8.QBB file.
2. Print a Trial Balance to help you prepare the adjustments.
3. Record the adjustments using the **Make General Journal Entries** option.
4. Print a Journal report and proof your work.
5. Print the following reports: Trial Balance, Profit & Loss, and Balance Sheet.
6. Complete the Analyze activity.
7. Back up your work.



Problem 19-9 Evaluating the Effect of an Error on the Income Statement

The accounting clerk for River's Edge Canoe & Kayak prepared the income statement for the year ended December 31. The accounting supervisor at River's Edge noticed that the balance of the **Transportation In** account was erroneously omitted from this statement. **Transportation In** has a balance of \$562.

Instructions Use the income statement shown in your working papers to answer the following questions.

1. In which section of the income statement is the account **Transportation In** entered?
2. How is net purchases affected by this omission (understated or overstated)? By what amount?
3. How does the omission of the **Transportation In** balance affect gross profit on sales? By what amount?
4. What is the correct amount for the cost of merchandise sold for the period?
5. What is the correct amount for net income?

Analyze

Determine the effect that an overstatement of expenses would have on net income.

Practice your test-taking skills! The questions on this page are reprinted with permission from national organizations:

- Future Business Leaders of America
- Business Professionals of America

Use a separate sheet of paper to record your answers.



Future Business Leaders of America

MULTIPLE CHOICE

1. One way to increase gross profit on sales is to
 - increase sales revenue.
 - increase cost of merchandise sold.
 - decrease sales revenue.
 - decrease expenses.
2. The _____ account represents the increase in stockholders' equity from net income that is held by the corporation and not distributed to stockholders as a return on their investment.
 - operating income
 - retained earnings
 - working capital
 - net sales
3. When using _____, each dollar amount on a financial statement is also stated as a percentage of a base amount on the same statement.
 - horizontal analysis
 - vertical analysis
 - statement of retained earnings
 - comparability
4. You are given the following information: cost of merchandise sold, \$404,000; operating expenses, \$785,122; and net sales, \$557,225. What is the company's gross profit on sales?
 - \$381,122
 - \$227,897
 - \$267,135
 - \$153,225



Business Professionals of America

MULTIPLE CHOICE

5. Beginning merchandise inventory plus net purchases minus ending inventory equals
 - net income.
 - gross profit on sales.
 - total expenses.
 - cost of goods sold.

Need More Help?

Go to glencoeaccounting.glencoe.com and click on Student Center. Click on Winning Competitive Events and select Chapter 19.

- Practice Questions and Test-Taking Tips
- Concept Capsules and Terminology



Critical Thinking**CASE STUDY****matter of ETHICS****COMMUNICATING ACCOUNTING****Financial Statements for a Corporation**

1. Name the two parts of stockholders' equity.
2. Explain the difference between gross profit on sales and operating income.
3. Compare the statement of retained earnings and the statement of cash flows, and explain how they are similar.
4. Look at vertical and horizontal analysis of financial statements. Explain why the percentages on comparative income statements and balance sheets add vital information for analysis by owners and managers.
5. Write a statement to explain why financial statements are prepared in this order: income statement, statement of retained earnings, balance sheet, and statement of cash flows.
6. Support the statement that all four financial statements must be examined to obtain an accurate understanding of a corporation's financial condition.

Merchandising Business: Gourmet Food Gifts

Gourmet Express sells cookies, candies, food baskets, and other gourmet gift items in retail stores and catalogs. Prices increased recently for sugar and chocolate, causing net income to decrease. The manager, Tara, does not want to use lower-priced ingredients because they may lower the products' quality.

In preparation for the Valentine's Day rush, Tara has asked you to suggest some ideas for increasing net income.

INSTRUCTIONS

1. Identify the items that affect net income.
2. List some possible areas to cut costs.

Reporting a Mistake

You are an accounting clerk for a major league sports franchise. Your responsibilities do not include any end-of-period activities. You learn that a co-worker made a significant error on the work sheet. It will affect the financial statements. You wonder whether to report the error or assume that someone else will catch it.

ETHICAL DECISION MAKING

1. What are the ethical issues?
2. What are the alternatives?
3. Who are the affected parties?
4. How do the alternatives affect the parties?
5. What would you do?

Explaining Financial Statements

As the CEO of First Rate Products, you regularly present the financial results at stockholders' meetings. It is imperative that your recently hired accounting clerk, James Van, understands the importance of accurate financial statements. Write a clear, concise memo to him outlining each financial statement's purpose and its relationship to the company's overall performance.



Sociability

You work for Big League Sports—a professional-sports merchandising company. Your boss, Lily Chang, asks you to make a simple but colorful presentation about trends in professional sports at the annual stockholders' meeting and reception.

INSTRUCTIONS With several classmates, make an outline for the presentation. Decide on topics to cover and visuals to use. Practice presenting to one another. Brainstorm questions for the question-and-answer segment. Give feedback on each speaker's presentation—both verbal and nonverbal communication skills including eye contact, stance, gestures, facial expressions, and use of visual aids.



Financial Statement Formats

The format of financial statements can vary by country. An example is the balance sheet of the German car manufacturer, BMW. It presents noncurrent assets before current assets, and stockholders' equity before liabilities.

INSTRUCTIONS Illustrate how the BMW balance sheet differs from the balance sheet of most U.S. companies as taught in this book.



Your Nest Egg

Social Security provides the only retirement funds for many people. Some analysts believe that it is in trouble and could become insolvent. You need to become educated about retirement funding and begin to plan early for it.

PERSONAL FINANCE ACTIVITY Use library resources or the Internet to research and compare the advantages and disadvantages of two retirement saving options.

PERSONAL FINANCE ONLINE Log on to glencoeaccounting.glencoe.com and click on Student Center. Click on Making It Personal and select Chapter 19.



Statement of Cash Flows

Look at PETsMART's statement of cash flows in Appendix F. It shows cash flows from operating activities, investing activities, and financing activities. It also shows the net cash provided (or used) by each activity. A company's *sources* of cash can be revealing. For long term success, a company's cash inflows must be from operating activities. If its main source of cash was investing activities, it may have sold some of its plant assets. If its main source of cash was financing activities, it may have issued stock or borrowed money. A firm that must sell its assets or borrow money to stay in business cannot do so indefinitely. A company's *use* of cash can also be revealing. A large use of cash for investing activities may indicate company expansion. A large use of cash for financing activities may mean that the company paid off its loans.

INSTRUCTIONS Use PETsMART's statements of cash flows in Appendix F to answer these questions.

1. For each of the three years shown, which activity *provided* the largest source of cash: operating, investing, or financing?
2. For each of the three years shown, which activity *used* the most cash: operating, investing, or financing?

