

Intermediate Accounting

CHAPTER ONE FINANCIAL STATEMENTS

Finance & Banking Department

2021-2022

CHAPTER ONE

FINANCIAL STATEMENTS

INCOME STATEMENT

The income statement is the report that measures the success of company operations for a given period of time. (It is also often called the statement of income or statement of earnings. The business and investment community uses the income statement to determine profitability, investment value, and creditworthiness. It provides investors and creditors with information that helps them predict the amounts, timing, and uncertainty of future cash flows.

Usefulness of the Income Statement

The income statement helps users of financial statements predict future cash flows in a number of ways. For example, investors and creditors use the income statement information to:

1. *Evaluate the past performance of the company*
2. *Provide a basis for predicting future performance.*
3. *Help assess the risk or uncertainty of achieving future cash flows*

Limitations of the Income Statement

4. *Companies omit items from the income statement that they cannot measure reliably.*
5. *Income numbers are affected by the accounting methods employed.*
6. *Income measurement involves judgment.*

Format of the income statement

Net income results from revenue, expense, gain, and loss transactions. The income statement summarizes these transactions. This method of income measurement, the [transaction approach](#), focuses on the income-related activities that have occurred during the period.⁴ The statement can further classify income by customer, product, line, or function, or by operating and nonoperating, continuing and discontinued, and regular and non-recurring categories.⁵ The following lists more formal definitions of income-related items, referred to as the major elements of the income statement.

ELEMENTS OF FINANCIAL STATEMENTS

REVENUES. Inflows or other enhancements of assets of an entity or settlements of its liabilities during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

EXPENSES. Outflows or other using-up of assets or incurrences of liabilities during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

GAINS. Increases in equity (net assets) from peripheral or incidental transactions of an entity except those that result from revenues or investments by owners.

LOSSES. Decreases in equity (net assets) from peripheral or incidental transactions of an entity except those that result from expenses or distributions to owners.⁶

Intermediate Components of the Income Statement

It is common for companies to present some or all of the following sections and totals within the income statement as shown in Illustration below ,This format is often referred to as the **multiple-step income statement**.

- 1. OPERATING SECTION.** A report of the revenues and expenses of the company's principal operations.
 - (a) **Sales or Revenue.** A subsection presenting sales, discounts, allowances, returns, and other related information. Its purpose is to arrive at the net amount of sales revenue.
 - (b) **Cost of Goods Sold.** A subsection that shows the cost of goods that were sold to produce the sales.
 - (c) **Selling Expenses.** A subsection that lists expenses resulting from the company's efforts to make sales.
 - (d) **Administrative or General Expenses.** A subsection reporting expenses of general administration.⁷
- 2. NONOPERATING SECTION.** A report of revenues and expenses resulting from secondary or auxiliary activities of the company. In addition, special gains and losses that are infrequent or unusual, or both, are normally reported in this section. Generally these items break down into two main subsections:
 - (a) **Other Revenues and Gains.** A list of the revenues recognized or gains incurred, generally net of related expenses, from nonoperating transactions.
 - (b) **Other Expenses and Losses.** A list of the expenses or losses incurred, generally net of any related incomes, from nonoperating transactions.
- 3. INCOME TAX.** A section reporting federal and state taxes levied on income from continuing operations.
- 4. DISCONTINUED OPERATIONS.** Material gains or losses resulting from the disposition of a component of the business.
- 5. NONCONTROLLING INTEREST.** Allocation of income to noncontrolling shareholders.
- 6. EARNINGS PER SHARE.** A measure of performance over the reporting period.

As indicated, companies report all revenues, gains, expenses, and losses on the income statement. This statement separates operating transactions from nonoperating transactions, and matches costs and expenses with related revenues. It highlights certain intermediate components of income that analysts use to compute ratios for assessing the performance of the company. Companies present nonoperating revenues, gains, expenses, and losses in a separate section, before income taxes and income from operations. Companies report discontinued operations as a separate element in the income statement. Segregating income with different

2021-2022

characteristics and providing intermediate income figures helps readers evaluate earnings information in assessing the amounts, timing, and uncertainty of future cash flows.

CABRERA COMPANY			
INCOME STATEMENT			
FOR THE YEAR ENDED DECEMBER 31, 2017			
Sales			
Sales revenue			\$3,053,081
Less: Sales discounts	\$ 24,241		
Sales returns and allowances	56,427		<u>80,668</u>
Net sales			2,972,413
Cost of goods sold			<u>1,982,541</u>
Gross profit			989,872
Operating expenses			
Selling expenses			
Sales salaries and commissions	\$202,644		
Sales office salaries	59,200		
Travel and entertainment	48,940		
Advertising expense	38,315		
Delivery expense	41,209		
Shipping supplies and expense	24,712		
Postage and stationery	16,788		
Telephone and Internet expense	12,215		
Depreciation of sales equipment	9,005	453,028	
Administrative expenses			
Officers' salaries	186,000		
Office salaries	61,200		
Legal and professional services	23,721		
Utilities expense	23,275		
Insurance expense	17,029		
Depreciation of building	18,059		
Depreciation of office equipment	16,000		
Stationery, supplies, and postage	2,875		
Miscellaneous office expenses	2,612	350,771	<u>803,799</u>
Income from operations			186,073
Other revenues and gains			
Dividend revenue		98,500	
Rent revenue		72,910	<u>171,410</u>
			357,483
Other expenses and losses			
Interest on bonds and notes			<u>126,060</u>
Income before income tax			231,423
Income tax			<u>66,934</u>
Net income for the year			<u>\$ 164,489</u>
Earnings per common share			<u>\$1.74</u>

And the following are the format which is used for preparation of Income Statement:

Company Name
Income Statement
For the year ended Dec 31, 20XX

Description		Sub Amount	Sub Total	Grand Total
Net Revenue				
	Sales Revenue		x x x	
-	Sales Returns		(x x)	
-	Sales Allowance		<u>(x x)</u>	
Net Revenue				x x x x
Cost of goods sold				
	Beginning Inventory		x x x	
+	Net Purchase			
	Total Purchases	x x		
	Purchase Expense	x x		
-	Purchase Allowance & return	(x x)		
-	Purchase Discount	<u>(x x)</u>		
Net Purchase			<u>x x x</u>	
Available goods for sale			x x x	
-	Ending Inventory		<u>(x x)</u>	
Cost of goods sold				<u>x x x x</u>
Gross profit				x x x x
-	Operating Expenses			
	Selling & Marketing Expenses		x x x	
	Administrative Expenses		<u>x x x</u>	
Total of Operating Expense				<u>(x x x x)</u>
Operating Income				x x x x
+ -	Other Revenue & Expense			<u>x x x x</u>
+ -	Other Losses & Gains			<u>(x x x x)</u>
Income Before Tax				x x x x
-	Income Tax			<u>(x x)</u>
Net Income				<u>x x x x</u>

There are two formats of Income statement are:

1- Condensed Income Statements

In some cases, an income statement cannot possibly present all the desired expense detail. To solve this problem, a company includes only the totals of components in the statement of income. It then also prepares supplementary schedules to support the totals. This format may thus reduce the income statement itself to a few lines on a single sheet. For this reason, readers who wish to study all the reported data on operations must give their attention to the supporting schedules.

For example, consider the income statement shown in below Illustration for Boc Hong Company. This statement is a condensed version of the more detailed income statement presented in the Illustration. It is more representative of the type found in practice. The next illustration shows an example of a supporting schedule, cross-referenced as Note D and detailing the selling expenses.

CABRERA COMPANY		
INCOME STATEMENT		
FOR THE YEAR ENDED DECEMBER 31, 2017		
Net sales		\$2,972,413
Cost of goods sold		<u>1,982,541</u>
Gross profit		989,872
Selling expenses (see Note D)	\$453,028	
Administrative expenses	<u>350,771</u>	<u>803,799</u>
Income from operations		186,073
Other revenues and gains		<u>171,410</u>
		357,483
Other expenses and losses		<u>126,060</u>
Income before income tax		231,423
Income tax		<u>66,934</u>
Net income for the year		<u>\$ 164,489</u>
Earnings per common share		<u><u>\$1.74</u></u>

2021-2022

Note D: Selling expenses

Sales salaries and commissions	\$202,644
Sales office salaries	59,200
Travel and entertainment	48,940
Advertising expense	38,315
Delivery expense	41,209
Shipping supplies and expense	24,712
Postage and stationery	16,788
Telephone and Internet expense	12,215
Depreciation of sales equipment	9,005
Total selling expenses	\$453,028

2- Single-Step Income Statements

In reporting revenues, gains, expenses, and losses, some companies often use a format known as the **single-step income statement** instead of a multiple-step income statement. The single-step statement consists of just two groupings: revenues and expenses. Expenses are deducted from revenues to arrive at net income or loss, hence the expression “single-step.” Frequently, companies report income tax separately as the last item before net income to indicate its relationship to income before income tax. Illustration below shows the single-step income statement of Cabrera Company.

CABRERA COMPANY
INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2017

Revenues	
Net sales	\$2,972,413
Dividend revenue	98,500
Rent revenue	72,910
Total revenues	3,143,823
Expenses	
Cost of goods sold	1,982,541
Selling expenses	453,028
Administrative expenses	350,771
Interest expense	126,060
Income tax expense	66,934
Total expenses	2,979,334
Net income	\$ 164,489
Earnings per common share	\$1.74

Companies that use the single-step income statement in financial reporting typically do so because of its simplicity. That is, **the primary advantage of the single-step format lies in its simple presentation and the absence of any implication that one**

2021-2022

type of revenue or expense item has priority over another. This format thus eliminates potential classification problems

POQUITO INDUSTRIES INC.		
INCOME STATEMENT		
FOR THE YEAR ENDED DECEMBER 31, 2017		
Sales revenue		\$1,420,000
Cost of goods sold		600,000
Gross profit		<u>820,000</u>
Selling and administrative expenses		320,000
Income from operations		<u>500,000</u>
Other revenues and gains		
Interest revenue		10,000
Other expenses and losses		
Loss on disposal of part of Textile Division	\$ 5,000	
Loss on sale of investments	30,000	
Interest expense	15,000	50,000
Income before income tax		<u>460,000</u>
Income tax		184,000
Income from continuing operations		<u>276,000</u>
Discontinued operations		
Income from operations of Pizza Division, less applicable income tax of \$24,800	54,000	
Loss on disposal of Pizza Division, less applicable income tax of \$41,000	90,000	36,000
Net income		<u><u>\$ 240,000</u></u>
Per share		
Income from continuing operations		\$2.76
Income from operations of discontinued division, net of tax		0.54
Loss on disposal of discontinued operation, net of tax		<u>0.90</u>
Net income		<u><u>\$2.40</u></u>

Example: (1)

The following are balances extracted from the Ledger of (Husain store) at the year ended at 31, Dec, 2008. (All values are in \$).

Net sales 30000 – Dividend revenue 9800 – Rental revenue 7500 – Cost of goods sold 20000 – Selling expenses 4500 – Administrative expenses 3500 – Interest expenses 1250 – Income tax expenses 6000.

Required:

Prepare income statement (Using Single – Step format)

Example: (2)

Starr Co. had sales revenue of \$540,000 in 2020. Other items recorded during the year were:

Cost of goods sold	\$330,000
Salaries and wages expense	120,000
Income tax expense	25,000
Other operating expenses	10,000

Instructions

Prepare a single-step income statement for Starr for 2020. Starr has 100,000 shares of stock outstanding

Example: (3)

Brisky Corporation had net sales of \$2,400,000 and interest revenue of \$31,000 during 2020. Expenses for 2020 were cost of goods sold \$1,450,000, administrative expenses \$212,000, selling expenses \$280,000, and interest expense \$45,000. Brisky's tax rate is 30%.

Instructions

prepare a condensed multiple-step income statement for Brisky Corporation

Example: (4)

(Multiple-Step and Single-Step Statements) Two accountants for the firm of Elwes and Wright are arguing about the merits of presenting an income statement in a multiple-step versus a single-step format. The discussion involves the following 2020 information related to P. Bride Company (\$000 omitted).

Administrative expense	
Officers' salaries	\$ 4,900
Depreciation of office furniture and equipment	3,960
Cost of goods sold	60,570
Rent revenue	17,230
Selling expense	
Delivery expense	2,690
Sales commissions	7,980
Depreciation of sales equipment	6,480
Sales revenue	96,500
Income tax	9,070
Interest expense	1,860

Instructions

- Prepare an income statement for the year 2020 using the multiple-step form.**
- Prepare an income statement for the year 2020 using the single-step form.**
-

Example: (5)

The accountant of Latifa Shoe Co. has piled the following information from the company's records as a basis for an income statement for the year ended December 31, 2020.

Rent revenue	\$ 29,000
Interest expense	18,000
Market appreciation on land above cost	31,000
Salaries and wages expense (selling)	114,800
Supplies (selling)	17,600
Income tax	23,100
Salaries and wages expense (administrative)	135,900
Other administrative expenses	51,700
Cost of goods sold	496,000
Net sales	980,000
Depreciation on plant assets (70% selling, 30% administrative)	65,000
Cash dividends declared	16,000

There were 20,000 shares of common stock outstanding during the year.

Instructions

- Prepare a multiple-step income statement.**
- Prepare a single-step income statement.**

Example: (6)

The following balances are extracted from the ledger of (Aram Co.) at 31 / 12 / 2009:

Cash sales 60000 \$ - Sales on account 40000 \$ - Sales returned and allowances 1000 \$ - Beginning inventory 6500 \$ - Cash purchases 50 % from cash sales – Purchases on account 40 % from sales on account – Purchases returned and allowances 500 \$ - Purchases expenses 400 \$ - commission on purchases 10 % from total purchases – Advertising expenses 400 \$ - Sales expenses 500 \$ - Rent expenses 2400 \$ - Depreciation expenses 800 \$ - Ending inventory 2500 \$.

Required:

Prepare income statement (Using multiple – steps format).

Balance Sheet

The **balance sheet**, sometimes referred to as the **statement of financial position**, reports the assets, liabilities, and stockholders' equity of a business enterprise at a specific date. This financial statement provides information about the nature and amounts of investments in enterprise resources, obligations to creditors, and the owners' equity in net resources. It therefore helps in predicting the amounts, timing, and uncertainty of future cash flows.

Usefulness of the Balance Sheet

By reporting information on assets, liabilities, and stockholders' equity, the balance sheet provides a basis for computing rates of return and evaluating the capital structure of the enterprise. Analysts also use information in the balance sheet to assess a company's risk¹ and future cash flows. In this regard, analysts use the balance sheet to assess a company's liquidity, solvency, and financial flexibility.

- 1- **Liquidity** describes "the amount of time that is expected to elapse until an asset is realized or otherwise converted into cash or until a liability has to be paid."
- 2- **Solvency** refers to the ability of a company to pay its debts as they mature
- 3- **Liquidity and solvency** affect a company's **financial flexibility**, which measures the "Ability of an enterprise to take effective actions to alter the amounts and timing of cash flows"

Limitations of the Balance Sheet

1. Most assets and liabilities are reported at **historical cost**. As a result, the information provided in the balance sheet is often criticized for not reporting a more relevant fair value.
2. Companies use **judgments and estimates** to determine many of the items reported in the balance sheet.
3. The balance sheet necessarily **omits many items that are of financial value** but that a company cannot record objectively.

Elements of the Balance Sheet

- | | |
|--|---|
| <p>1. Assets. Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.</p> <p>2. Liabilities. Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer</p> | <p>assets or provide services to other entities in the future as a result of past transactions or events.</p> <p>3. Equity. Residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.⁴</p> |
|--|---|

Stockholders' Equity Section

- Capital Stock.** The par or stated value of the shares issued.
- Additional Paid-in Capital.** The excess of amounts paid in over the par or stated value.
- Retained Earnings.** The corporation's undistributed earnings.
- Accumulated Other Comprehensive Income.** The aggregate amount of the other comprehensive income items.
- Treasury Stock.** Generally, the cost of shares repurchased.
- Noncontrolling Interest (Minority Interest).** A portion of the equity of subsidiaries not wholly owned by the reporting company.

Scientific Products, Inc. Balance Sheet December 31, 2020			
Assets			
Current assets			
Cash		\$ 42,485	
Investments (available-for-sale)		28,250	
Accounts receivable	\$165,824		
Less: Allowance for doubtful accounts	<u>1,850</u>	163,974	
Notes receivable		23,000	
Inventories—at average-cost		489,713	
Supplies on hand		9,780	
Prepaid expenses		<u>16,252</u>	
Total current assets			\$ 773,454
Long-term investments			
Equity investments			87,500
Property, plant, and equipment			
Land—at cost		125,000	
Buildings—at cost	975,800		
Less: Accumulated depreciation	<u>341,200</u>	<u>634,600</u>	
Total property, plant, and equipment			759,600
Intangible assets			
Goodwill			<u>100,000</u>
Total assets			<u>\$ 1,720,554</u>

(continued)

2021-2022

Liabilities and Stockholders' Equity			
Current liabilities			
Notes payable to banks		\$ 50,000	
Accounts payable		197,532	
Accrued interest on notes payable		500	
Income taxes payable		62,520	
Accrued salaries, wages, and other liabilities		9,500	
Deposits received from customers		420	
		<u> </u>	
Total current liabilities			\$ 320,472
Long-term debt			
Twenty-year 12% debentures, due January 1, 2028			<u>500,000</u>
Total liabilities			820,472
Stockholders' equity			
Paid in on capital stock			
Preferred, 7%, cumulative			
Authorized, issued, and outstanding,			
30,000 shares of \$10 par value	\$300,000		
Common—			
Authorized, 500,000 shares of			
\$1 par value; issued and outstanding,			
400,000 shares	400,000		
Additional paid-in capital	<u>37,500</u>	737,500	
Retained earnings		153,182	
Accumulated other comprehensive income		8,650	
Less: Treasury stock		<u>12,750</u>	
Equity attributable to Scientific Products, Inc.			886,582
Equity attributable to noncontrolling interest			<u>13,500</u>
Total stockholders' equity			900,082
Total liabilities and stockholders' equity			<u><u>\$1,720,554</u></u>

Example: (1)

Harding Corporation has the following accounts included in its December 31, 2020, trial balance: Accounts Receivable \$110,000, Inventory \$290,000, Allowance for Doubtful Accounts \$8,000, Patents \$72,000, Prepaid Insurance \$9,500, Accounts Payable \$77,000, and Cash \$30,000.

Instructions

Prepare the current assets section of the balance sheet, listing the accounts in proper sequence.

Example: (2)

Koch Corporation's adjusted trial balance contained the following asset accounts at December 31, 2020: Cash \$7,000, Land \$40,000, Patents \$12,500, Accounts Receivable \$90,000, Prepaid Insurance \$5,200, Inventory \$30,000, Allowance for Doubtful Accounts \$4,000, and Equity Investments (to be sold in the next quarter) \$11,000.

Instructions

Prepare the current assets section of the balance sheet, listing the accounts in proper sequence.

Example: (3)

Included in Outkast Company's December 31, 2020, trial balance are the following accounts: Prepaid Rent \$5,200, Debt Investments (to be held to maturity until 2023) \$56,000, Unearned Fees \$17,000, Land (held for investment) \$39,000, and Notes Receivable (long-term) \$42,000.

Instructions

Prepare the long-term investments section of the balance sheet.

Example: (4)

Lowell Company's December 31, 2020, trial balance includes the following accounts: Inventory \$120,000, Buildings \$207,000, Accumulated Depreciation—Equipment \$19,000, Equipment \$190,000, Land (held for investment) \$46,000, Accumulated Depreciation—Buildings \$45,000, Land \$71,000, and Timberland \$70,000.

Instructions

Prepare the property, plant, and equipment section of the balance sheet.

Example: (5)

Crane Corporation has the following accounts included in its December 31, 2020, trial balance: Equity Investments (to be sold in the next 6 months) \$21,000, Goodwill \$150,000, Prepaid Insurance \$12,000, Patents \$220,000, and Franchises \$130,000.

Instructions

Prepare the intangible assets section of the balance sheet.

Example: (6)

Patrick Corporation's adjusted trial balance contained the following asset accounts at December 31, 2020: Prepaid Rent \$12,000, Goodwill \$50,000, Franchise Fees Receivable \$2,000, Franchises \$47,000, Patents \$33,000, and Trademarks \$10,000.

Instructions

Prepare the intangible assets section of the balance sheet.

Example: (7)

Thomas Corporation's adjusted trial balance contained the following liability accounts at December 31, 2020: Bonds Payable (due in 3 years) \$100,000, Accounts Payable \$72,000, Notes Payable (due in 90 days) \$22,500, Salaries and Wages Payable \$4,000, and Income Taxes Payable \$7,000.

Instructions

Prepare the current liabilities section of the balance sheet.

Example: (8)

Presented below is the adjusted trial balance of Abbey Corporation at December 31, 2015.

	<u>Debit</u>	<u>Credit</u>
Cash \$?	
Supplies	1,200	
Prepaid Insurance	1,000	
Equipment	48,000	
Accumulated Depreciation—Equipment		9,000
Trademarks	950	
Accounts Payable		10,000
Salaries and Wages Payable		500
Unearned Service Revenue		2,000
Bonds Payable (due 2022)		9,000
Share Capital—Ordinary		10,000
Retained Earnings		20,000
Service Revenue		10,000
Salaries and Wages Expense	9,000	
Insurance Expense	1,400	
Rent Expense	1,200	
Interest Expense	<u>900</u>	
Total	\$?	\$?

Additional information:

1. Net loss for the year was \$2,500.
2. No dividends were declared during 2015.

Instructions: Prepare a classified statement of financial position (balance sheet) as of December 31, 2015.

Example: (9)

There are balances from the Ledger of one of the Companies: (The amounts in \$)
 Cash 2250 – Cash in bank 3750 – Machinery 5600 – N / R 1800 – N / P 3200 – Buildings &
 Lands 10500 – Furniture 850 – Cars 6400 – A / R 1650 – A / P 1100 – Loan 8000 – Drawing
 1600 – Capital (beginning) 20300 – Ending inventory 8850 – Net income 10650.

Required:

Prepare balance sheet statement.

Example: (10)

SMART TOUCH LEARNING Post-Closing Trial Balance May 31, 2013		
	Debit	Credit
Cash	\$ 4,800	
Accounts receivable	2,600	
Supplies	600	
Prepaid rent	2,000	
Furniture	18,000	
Building	48,000	
Accumulated depreciation—furniture		\$ 300
Accumulated depreciation—building		200
Accounts payable		18,200
Salary payable		900
Interest payable		100
Unearned service revenue		400
Notes payable		20,000
Bright, capital		35,900
Total	\$ 76,000	\$ 76,000

Required:

Prepare balance sheet statement.