

# CHAPTER 1

## Introduction to Financial Statements

### ANSWERS TO QUESTIONS

1. The three basic forms of business organizations are (1) sole proprietorship, (2) partnership, and (3) corporation.
2. Advantages of a corporation are limited liability (stockholders not being personally liable for corporate debts), easy transferability of ownership, and ease of raising funds. Disadvantages of a corporation are increased taxation and government regulations.
3. Proprietorships and partnerships receive favorable tax treatment compared to corporations and are easier to form than corporations. They are also owner controlled. Disadvantages of proprietorships and partnerships are unlimited liability (proprietors/partners are personally liable for all debts) and difficulty in obtaining financing compared to corporations.
4. Yes. A person cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or dispensing financial information. Accounting provides financial information to interested users through the preparation and distribution of financial statements.
5. Internal users are managers who plan, organize, and run a business. To assist management, accounting provides timely internal reports. Examples include financial comparisons of operating alternatives, projections of income from new sales campaigns, forecasts of cash needs for the next year, and financial statements.
6. External users are those outside the business who have either a present or potential direct financial interest (investors and creditors) or an indirect financial interest (taxing authorities, regulatory agencies, labor unions, customers, and economic planners).
7. The three types of business activities are financing activities, investing activities, and operating activities. Financing activities include borrowing money and selling shares of stock. Investing activities include the purchase and sale of property, plant, and equipment. Operating activities include selling goods, performing services, and purchasing inventory.
8. (a) Income statement. (d) Balance sheet.  
(b) Balance sheet. (e) Balance sheet.  
(c) Income statement. (f) Balance sheet.
9. When a company pays dividends, it reduces the amount of assets available to pay creditors. Therefore, banks and other creditors monitor dividend payments to ensure they do not put a company's ability to make debt payments at risk.
10. Yes. Net income does appear on the income statement—it is the result of subtracting expenses from revenues. In addition, net income appears in the retained earnings statement—it is shown as an addition to the beginning-of-period retained earnings. Indirectly, the net income of a company is also included in the balance sheet. It is included in the retained earnings account which appears in the stockholders' equity section of the balance sheet.

11. The primary purpose of the statement of cash flows is to provide financial information about the cash receipts and cash payments of a business for a specific period of time.

## Questions Chapter 1 (Continued)

12. The three categories of the statement of cash flows are operating activities, investing activities, and financing activities. The categories were chosen because they represent the three principal types of business activities.
13. Retained earnings is the net income retained in a corporation. Retained earnings is increased by net income and is decreased by dividends and a net loss.
14. The basic accounting equation is  $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$ .
15. (a) Assets are resources owned by a business. Liabilities are amounts owed to creditors. Put more simply, liabilities are existing debts and obligations. Stockholders' equity is the ownership claim on net assets.
- (b) The items that affect stockholders' equity are common stock, retained earnings, dividends, revenues, and expenses.
16. The liabilities are (b) Accounts payable and (g) Salaries and wages payable.
17. (a) Net income from the income statement is reported as an increase to retained earnings on the retained earnings statement.
- (b) The ending amount on the retained earnings statement is reported as the retained earnings amount on the balance sheet.
- (c) The ending amount on the statement of cash flows is reported as the cash amount on the balance sheet.
18. The purpose of the management discussion and analysis section is to provide management's views on its ability to pay short-term obligations, its ability to fund operations and expansion, and its results of operations. The MD&A section is a required part of the annual report.
19. An unqualified opinion shows that, in the opinion of an independent auditor, the financial statements have been presented fairly, in conformity with generally accepted accounting principles. This gives investors more confidence that they can rely on the figures reported in the financial statements.
20. Information included in the notes to the financial statements clarifies information presented in the financial statements and includes descriptions of accounting policies, explanations of uncertainties and contingencies, and statistics and details too voluminous to be reported in the financial statements.
21. Using dollar amounts, Tootsie Roll's accounting equation is:

$$\begin{array}{r} \text{Assets} \\ \$857,856,000 \end{array} = \begin{array}{r} \text{Liabilities} \\ \$191,921,000^* \end{array} + \begin{array}{r} \text{Stockholders' Equity} \\ \$665,935,000 \end{array}$$

\*\$58,355,000 + \$133,566,000