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CHAPTER 2 The Financial Statements

KEY POINTS

The following key points are emphasized in this chapter:

- **The three basic activities of a business and how they are reflected in the financial statements.**
- **The balance sheet, income statement, statement of shareholders' equity, and statement of cash flows and how these financial statements are used.**
- **Similarities and differences between non-U.S. and U.S. financial statement format and terminology.**

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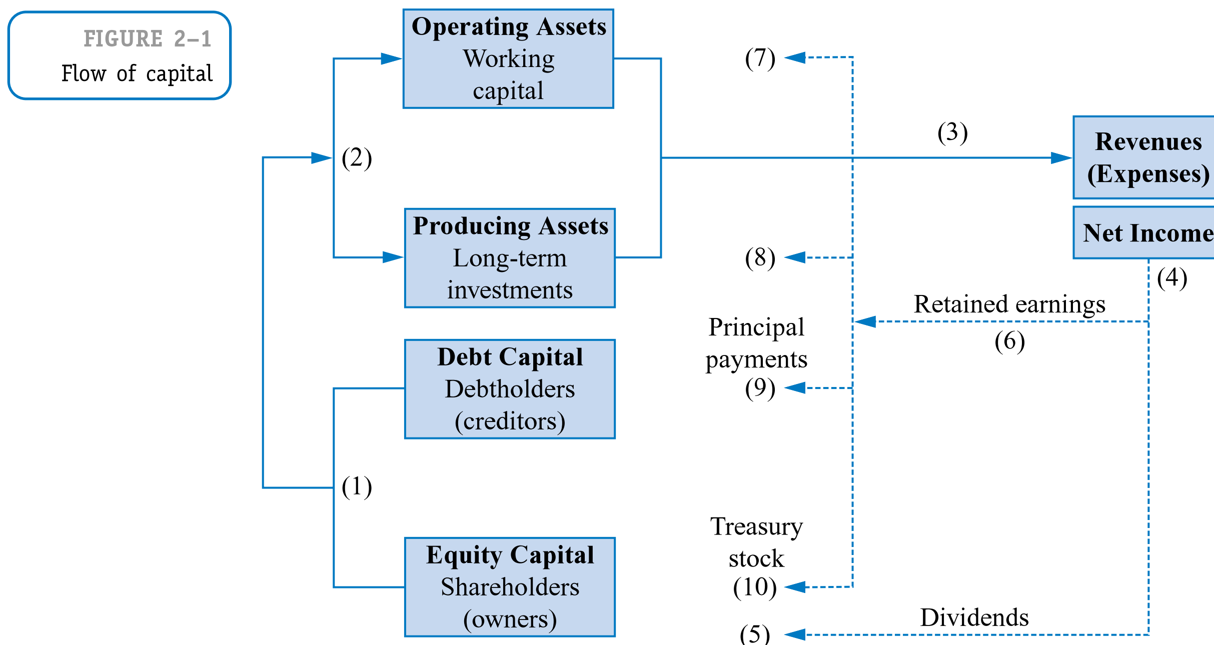
In 2008, Borders Group, Inc., one of the nation's largest book retailers, reported a loss from operations of $185 million, a significant change from a $20 million operating loss in the prior year. This deterioration occurred partly as a result of a decrease in revenue of $313 million. From early February 2008 to January 2009, Borders' liabilities decreased by nearly $500 million. Over the same period the company's cash position decreased by $5 million, even though the company used over $260 million in cash to repay debt and over $6 million to pay dividends to shareholders. These kinds of activities, so vital to Borders or any other company, are reflected in different ways on the financial statements—the balance sheet, income statement, statement of shareholders' equity, and statement of cash flows. In this chapter we discuss the financial statements in more detail.

As you read this chapter, consider the following questions. How do operating, investing, and financing decisions affect the dollar amounts reported on the financial statements? What information on the financial statements can be used to assess solvency and earning power? How might investors and creditors use the dollar values shown on the financial statements to control and monitor the business decisions of managers? Why and how do firm stock prices react to reported financial information? Is management able to influence the preparation of these statements so that solvency and earning power are depicted attractively? Such questions give economic meaning to financial statements and cannot be ignored by savvy managers and investors.

CAPITAL FLOWS AND OPERATING, INVESTING, AND FINANCIAL ACTIVITIES

Figure 2–1 illustrates the flow of capital through the firm, highlighting a number of concepts that we rely on heavily throughout the text. Management must (1) attract money, often called capital, from two sources: shareholders by selling the ownership (equity) of the firms and debtholders (creditors) through borrowings. Management

FIGURE 2–1
Flow of capital



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normally attracts this capital by presenting historical and prospective information to these potential investors, explaining how it expects to use the capital to create returns for the investors. Shareholders (equity investors) expect returns in the form of price appreciation of their investments and/or dividends. Debtholders (debt investors) expect returns in the form of interest.

Management invests the capital (2) in both producing assets (e.g., property, plant, equipment; other companies; intangible assets; ideas) and operating assets (e.g., inventory), often referred to as working capital. Producing assets typically provides benefits for the firm over many periods by supporting the operating activities, the management of the assets used in day-to-day operations. Managing the producing and operating assets generates revenues (e.g., sales of inventories or services), which are matched against the expenses incurred to generate them (e.g., wages and salaries), including interest on the outstanding debt (3). The difference between revenues and expenses (4) is called net income, profit, or earnings and represents a measure of the wealth created by management for the shareholders during a given time period. The shareholders, normally through the board of directors, decide whether to take the created wealth out of the firm in the form of dividends (5) or to reinvest it in the firm (6). The reinvestment is called retained earnings, a measure of resources management can use to (7) purchase working capital and (8) purchase assets, (9) pay off loans, and/or (10) buy back ownership interests (shares of stock) from the shareholders in the form of treasury stock.

This process highlights three fundamental activities involved in managing a business: (1) operating activities, (2) investing activities, and (3) financing activities. **Operating activities** involve managing the operating assets, which includes activities related to the production and sale of goods and services (e.g., sales, receivables, inventory, and payables management). **Investing activities** involve acquiring and disposing of producing assets, the assets used to produce and support the goods and services provided (e.g., buildings, equipment, know-how). **Financing activities** involve raising capital through equity or debt issuances and the related payments to capital providers such as debt payments, dividends, and share repurchases.

In its 2008 annual report, Zimmer Holdings, Inc., a well-known medical parts manufacturer, reported cash provided by operating activities of over $1 billion, cash used by investing activities of $924 million, and cash used for financing activities of $344 million. Describe some of the transactions that led to each of these three cash flow numbers.

The remainder of the chapter is devoted to describing and interpreting the financial statements. As you study them, keep in mind that they are designed to measure different aspects of businesses as depicted in Figure 2–1. The balance sheet includes assets (working capital and producing assets) and financing sources (equity, debt, and reinvestments from net earnings) as of a point in time. The income statement is a measure of operations, the activities involved in selling the goods and services. The statement of shareholders' equity keeps track of the investments made by the shareholders—either through equity investments or reinvested earnings—reduced by dividends paid to the shareholders. The statement of cash flows reports the cash inflows and outflows associated with the operating, investing, and financing activities of the business. Managers must understand the link between the financial statements and the company's financial condition and performance, as well as how their operating, investing, and financing decisions are reflected on the statements.

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THE CLASSIFIED BALANCE SHEET

We now turn to more in-depth discussions of the four financial statements. Figure 2–2 shows the balance sheet for Harbour Island Company as of December 31, 2011. It is entitled a **classified balance sheet** because the asset and liability accounts are grouped into classifications: current assets; long-term investments; property, plant, and equipment; intangible assets; current liabilities; and long-term liabilities.

A Photograph of Financial Condition

Think of the balance sheet as a photograph of the business at a specific point in time. The title includes a specific date (December 31, 2011). As of this date, the balance sheet measures the financial condition of Harbour Island Company. In fact, some companies refer to the balance sheet as the *statement of financial condition.* This "photograph" of financial condition shows that as of December 31, 2011, Harbour Island has $220 in cash, total assets of $18,615, contributed capital of $9,550, retained earnings of $1,385, and total liabilities plus shareholders' equity of $18,615.

The balance sheet lists Harbour Island's assets and their sources as of December 31, 2011. The company's total assets (valued at $18,615) came from three separate sources: (1) $7,680 (41 percent) came from various forms of borrowing (total liabilities) and must be repaid in the future; (2) $9,550 (51 percent) was received when the company sold (issued) stock to the shareholders (contributed capital); and (3) $1,385 (8 percent), the dollar amount in the retained earnings account, was generated through the company's operating activities and not returned to the shareholders in the form of dividends. The addition of (2) and (3) represents the entire investment made by the shareholders in the business, and on this investment they expect some form of return in the future.

Balance Sheet Classifications

Assets are divided into current assets ($1,415); long-term investments ($4,000); property, plant, and equipment ($11,500); and intangible assets ($1,700). These categories and the order of the accounts within them are listed in order of **liquidity.** The assets listed near the top of the balance sheet (e.g., current assets) are expected to be converted into cash within a shorter time period than those listed at or near the bottom. They are, therefore, considered to be more liquid. The assets in the current asset category are also listed in order of liquidity. Cash, the most liquid of all assets, is understandably listed at the top.

Explain why total assets on the balance sheet of McDonald's Corporation consists of over 70 percent property, plant, and equipment, while property, plant, and equipment comprises only about 20 percent of Google's total assets.

Liabilities are divided into current liabilities ($740) and long-term liabilities ($6,940). These two categories, and the accounts within them, are also listed in order of liquidity. Those near the top (e.g., current liabilities) are expected to require the payment of cash within a shorter time period than those at or near the bottom. Study these categories and the order of the accounts contained within them. This is the general format required under U.S. generally accepted accounting principles, and it is important that you be familiar with it.

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FIGURE 2–2
Classified balance sheet for Harbour Island Company

Harbour Island Company
Classified Balance Sheet
December 31, 2011

ASSETS			
Current assets:			
Cash		$ 220	
Short-term investments		150	
Accounts receivable	$ 350		
Less: Uncollectibles	5	345	
Inventory		600	
Prepaid expenses		100	
Total current assets			$ 1,415
Long-term investments:			
Long-term notes receivable		$1,000	
Land		500	
Securities		2,500	
Total long-term investments			4,000
Property, plant, and equipment:			
Property		$6,000	
Plant	$4,000		
Less: Accumulated depreciation	1,100	2,900	
Equipment	$3,500		
Less: Accumulated depreciation	900	2,600	
Total property, plant, & equip.			11,500
Intangible assets:			
Goodwill		$ 800	
Patent		200	
Trademark		700	
Total intangible assets			1,700
Total assets			$18,615
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities:			
Accounts payable		$ 250	
Wages payable		25	
Interest payable		155	
Short-term notes payable		75	
Current maturities of long-term debts		60	
Deferred revenues		75	
Other payables		100	
Total current liabilities			$ 740
Long-term liabilities:			
Long-term notes payable		$1,500	
Bonds payable		3,500	
Mortgage payable		1,940	
Total long-term liabilities			6,940
Shareholders' equity:			
Contributed capital		$9,550	
Earned capital (primarily retained earnings)		1,385	
Total shareholders' equity			10,935
Total liabilities and shareholders' equity			$18,615

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Many non-U.S. firms that publish IFRS-based balance sheets list their assets in the opposite order, starting with non-current assets, followed by current assets.

Assets

We now discuss the individual balance sheet accounts. This section reviews current assets; long-term investments; property, plant, and equipment; and intangible assets.

CURRENT ASSETS

Assets categorized as current are expected to be realized or, in most cases, converted into cash in the near future, usually within one year.[1] They are grouped into a separate category because they are considered to be highly liquid. The amount of highly liquid assets held by a company can be an indication of its ability to meet debt payments as they come due. Consequently, the current asset category is often reviewed by financial statement users who are interested in assessing a company's solvency position. **Current assets** include cash, short-term investments, accounts receivable, inventory, and prepaid expenses, and they often represent a significant portion of a company's total assets.

Explain why the current assets of Sears Holdings Corporation, a major retailer, typically comprise nearly 50 percent of total assets, while current assets for AT&T comprise only 8 percent of total assets.

CASH. Cash represents the currency a company has access to as of the balance sheet date. It may be in a bank savings account, a checking account, or perhaps on the company premises in the form of petty cash. Cash amounts that a company can use immediately should be separated on the balance sheet from cash that is restricted. As a condition of granting a loan, for example, banks often require that the borrowing company maintain a certain cash balance with the bank while the loan is outstanding. Cash amounts of this nature, called *compensating balances,* are normally described in the footnotes to the financial statements so that readers can draw a distinction between available cash and restricted cash. Such a distinction can be useful when assessing how much cash is available to meet an outstanding debt. For example, ARCO, a subsidiary of BP Amoco, notes in its financial reports that "the company maintains compensating balances for some of its various banking services and products."

SHORT-TERM INVESTMENTS. Short-term investments include stocks (equity investments in other companies), bonds (debt investments in the government or other companies), and similar investments. These securities are both *readily marketable* (i.e., able to be sold immediately) and intended by management to be sold within a short period of time, usually less than one year. A company often purchases these kinds of securities to earn income with cash that would otherwise be idle for a short time. The dollar value of this account is the total selling price (market value) of securities held by a company as of the balance sheet date. For purposes of solvency assessment, this dollar amount is normally viewed to be the same as available cash.

1. The actual definition of "current asset" is an asset expected to be converted into cash or used within one year or the operating cycle, whichever is longer. Operating cycles are discussed in Chapter 6.

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Why do you think that WellPoint, an insurance company with assets of over $48 billion, carries cash and short-term investments of over $4.8 billion?

ACCOUNTS RECEIVABLE. The **accounts receivable** account represents the amount of money a company expects to collect from its customers. Such receivables arise from sales of products or services for which customers have not yet paid. These sales are often referred to as *credit sales* or *sales on account.* The dollar amount appearing on the balance sheet for this account is computed by taking the total dollar amount of the receivables owed and subtracting an estimate for *uncollectibles,* those accounts not expected to be received. The uncollectibles estimate is highly subjective, and users must be careful not to conclude that all reported receivables will necessarily lead to cash receipts.

Briefly explain why the giant bank JPMorgan Chase carries receivables in excess of $720 billion, which is approximately 35 percent of the company's total assets, while an even larger company, Wal-Mart, carries receivables of only about $4 billion.

INVENTORY. Inventory represents items or products on hand that a company intends to sell to its customers. It is often called **merchandise inventory.** The dollar value in this account is very important because a company's success often depends on its ability to sell these items. Users are very interested in the sales value of a company's inventory, but unfortunately, the balance sheet value of inventory is the cost of acquiring (purchasing or producing) it or the cost of replacing it as of the balance sheet date, whichever is lower.

Why do companies like Home Depot and Goodyear Tire & Rubber Company carry inventories that comprise most of their current assets and a large portion of total assets, while companies like Yahoo! and Bank of America carry no inventories at all?

A second kind of inventory account is called *supplies inventory*. It represents items used to support a company's operations; office supplies and spare parts are two common examples. The dollar amount of this account on the balance sheet is usually the cost of acquiring the items. Major manufacturers often carry a substantial inventory of spare parts. Normally about 10 percent of The Boeing Company's total inventory is composed of spare parts.

PREPAID EXPENSES. Prepaid expenses are exactly what the name suggests: expenses that have been paid by a company before the corresponding service or right is actually used. Insurance premiums, for example, are normally paid prior to the period of coverage. Similarly, rent is usually paid before the rental period. A prepaid expense, therefore, is considered an asset because it represents a benefit to be enjoyed by the company in the future; it is not considered an expense, appearing on the income statement, until it is used. Prepaid expenses are originally recorded on the balance sheet at the cost of acquiring them. For most companies, prepaid expenses are a very small, often insignificant, part of total assets. Also, prepaid expenses do not create future cash inflows, a fact that users must recognize when assessing a company's solvency position.

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On its 2009 balance sheet, Walt Disney Company lists a current asset in the amount of $631 million called television costs. Explain what kind of prepaid expense this might be.

LONG-TERM INVESTMENTS

Long-term investments are acquired by companies to provide benefits for periods of time usually extending beyond one year. Examples include long-term notes receivable and investments in land and debt and equity securities.

The notes receivable account includes company receivables that are evidenced by promissory notes. *Promissory notes* are contracts (formal, legally enforceable documents) that state the face value of the receivable, the date when the face value is due, and the periodic interest payments to be made while the note is outstanding. The date when the receivable is due, called the *maturity date,* is often beyond one year, so this account is often listed in the long-term investment section of the balance sheet. However, if the maturity date of a note receivable is within one year, it should be disclosed as a current asset.

Notes receivable often arise because companies receive notes in exchange for the sale of expensive items. For example, The Boeing Company often receives notes in payment for sold aircraft and currently carries over $5.8 billion in long-term notes receivable. Alternatively, such notes can result from direct company loans to employees and others. It also happens that customers with large, overdue accounts are asked to sign promissory notes. Like accounts receivable, an estimate—often subjective—for uncollectibles must be provided for notes receivable.

The long-term investment section of the balance sheet can also include a number of other investments. Land, for example, may be purchased and held as a long-term investment. Investments in debt and equity securities that are not intended to be sold in the near future represent other common examples. Most major U.S. companies have made significant investments in the equity securities of other, usually smaller, companies, intending to exert long-term influence over their management. Owens Corning, for example, has major investments in the equity securities of over twenty different companies. Users should learn as much as possible about such investments, usually by reading the footnotes, because they signal areas where management has chosen to devote considerable attention.

PROPERTY, PLANT, AND EQUIPMENT

The property, plant, and equipment section of the balance sheet includes assets acquired for use in the day-to-day operations of the business. For many companies, especially manufacturers, this is the largest asset category on the balance sheet. For example, the property, plant, and equipment account for oil giant ConocoPhillips is valued at nearly $84 billion, which represents approximately 59 percent of its total assets. This account often contains the results of management's major investing activities, an important concern of financial statement users.

The **property** account represents the land on which the company conducts its operations. It is carried on the balance sheet at the original price for the land, which is not adjusted as the value of the property appreciates (i.e., increases). Be sure not to confuse this account with land in the long-term investment section. That land is held for investment purposes only and is not used in the operations of the business.

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Plant and equipment represent the physical structures that a company owns and uses in its operations. The plant account, for example, includes the value of factory and office buildings and warehouses, while the equipment account includes machinery, vehicles, furniture, and similar items. The dollar amount in these accounts on the balance sheet is the original cost at the time the assets were purchased, reduced by an amount that loosely approximates the asset's lost usefulness or deterioration over time. This amount is called *accumulated depreciation.* Subtracting accumulated depreciation from the acquisition cost results in the *net value* or **net book value** of the assets. The excerpt below, which illustrates the methods used to disclose property, plant, and equipment, was taken from the 2008 annual report of Johnson & Johnson (dollars in millions).

IN MILLIONS	2008	2007
Land, buildings, and equipment:		
Land and land improvements	$ 886	$ 756
Buildings and building equipment	7,720	7,913
Machinery and equipment	15,234	14,554
Construction in progress	3,552	3,243
Total land, buildings, and equipment	$27,392	$26,466
Less accumulated depreciation	13,027	12,281
Net land, buildings, and equipment	$14,365	$14,185

INTANGIBLE ASSETS

Intangible assets are so named because they have no physical substance. In most cases they represent legal rights to the use or sale of valuable names, items, processes, or information. Many companies, such as Coca-Cola, have patents on certain formulas that grant them the sole legal right to produce and sell certain products. When NBC paid over $1 billion to acquire exclusive rights to broadcast the Olympics, it recognized an intangible asset on its balance sheet. In a similar way, the cost a company incurs to create a trademark (e.g., the golden arches of McDonald's) or its name (e.g., Goodyear Tire & Rubber) can also be accounted for as an intangible asset. Perhaps the most common intangible asset, called *goodwill,* represents the cost of purchasing another company over and above the total market price of that company's individual assets and liabilities. The goodwill account is prominent on the balance sheets of many major U.S. companies because they often purchase other companies, called *subsidiaries.* For example, when Google purchased Double Click in 2008, it recognized approximately $2.3 billion in goodwill on the transaction. Similar to property, plant, and equipment, intangibles are of interest to users because they often represent the results of a company's major investing activities.

Internet phone provider Vonage Holdings Corporation fought legal battles with Verizon Communications in 2007 over Verizon's claim that Vonage infringed three patents held by Verizon. The legal troubles threatened Vonage's ability to transmit phone calls over the Internet and put the company's future in question. Discuss how patents are valued and how they are shown on the balance sheet.

Intangible assets are carried on the balance sheet at net book value, which is equal to the cost of acquiring an intangible asset, reduced by a dollar amount, called *accumulated amortization,* which loosely approximates the asset's reduction in usefulness over time.[2]

2. Certain intangible assets, including goodwill, are not subject to amortization.

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The following excerpt was taken from the 2008 annual report of Merck, a leading pharmaceutical (dollars in millions):

	2008	2007
Goodwill	**$1,438.7**	**1,454.8**
Intangible subject to amortization:		
Patents and product rights	**1,656.4**	**$1,656.3**
Other	**779.2**	**781.0**
Total acquired cost	**2,435.6**	**2,437.3**
Patents and product rights	**1,528.5**	**1,494.4**
Other	**1,528.5**	**1,494.4**
Total accumulated amortization	**381.7**	**274.7**
	$1,910.2	**$1,724.1**

Almost 20 percent of the total assets of Cisco Systems, a worldwide leader in networking for the Internet, is composed of goodwill. What does this fact tell you about the growth strategy used by the company?

Liabilities

This section covers current and long-term liabilities. The dollar amounts disclosed in these sections of the balance sheet are very important to users who are interested in the timing of a company's future cash obligations, which is important when assessing whether a company can meet its debts when they come due. Total liabilities, as a percentage of total assets, vary significantly across companies in different industries. For example, ConocoPhillips carries liabilities of about 61 percent of total assets, while the liabilities of Citigroup represent approximately 93 percent of total assets.

CURRENT LIABILITIES

Current liabilities are obligations expected to be paid (or services expected to be performed) with the use of assets listed in the current asset section of the balance sheet. Examples include *accounts payable, wages payable, interest payable, short-term notes payable, income taxes payable, current maturities on long-term debts,* and *deferred revenues.*

Accounts payable are usually obligations to a company's suppliers for merchandise purchases made on account. Wages payable are obligations to a company's employees for earned but unpaid wages as of the balance sheet date. Interest payable and short-term notes payable are dollar amounts owed to creditors, often banks and other financial institutions. Income taxes payable are amounts owed to the government for taxes assessed on a company's income. **Current maturities of long-term debts** are portions of long-term liabilities that are due in the current period. They often arise when the principal amounts of long-term liabilities are due in installments over time. Deferred revenues represent services yet to be performed by a company for which cash payments have already been collected.

Financial statement users often closely examine a company's current liabilities as they assess a company's solvency position because most current liabilities require cash payments in the short-term future. Retailers rely heavily on suppliers as a source of financing. For example, on the balance sheet of The Gap, Inc., one of the largest liabilities is accounts payable—$975 million and approximately 13 percent of total assets.

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Many non-U.S. firms that publish IFRS-based balance sheets list current liabilities directly below current assets, leading to the computation of net current assets (current assets − current liabilities). This format emphasizes the important relationship between current assets and current liabilities when assessing the firm's solvency position.

LONG-TERM LIABILITIES

Long-term liabilities are obligations expected to require payment over a period of time beyond the current year. These obligations are usually evidenced by formal contracts that state their principal amounts, the periodic interest payments, and maturity dates. The form of these debt contracts, however, can vary widely. Common examples include accounts like *long-term notes payable, bonds payable,* and *mortgage payables*.

Long-term **notes payable** refer to obligations on loans that are normally due more than one year beyond the balance sheet date. They usually involve either direct borrowings from financial institutions or arrangements to finance the purchase of assets. **Bonds payable** represent notes that have been issued for cash to a large number of debt investors (called *bondholders*). Issuing bonds is a common form of financing for many major U.S. companies, which often use the funds to expand operations. During 2006, Lowe's, a home improvement retailer, issued approximately $990 million in bonds. The proceeds were used to finance capital expenditures and reduce other debt. **Mortgage payables** are obligations that are secured by real estate and are usually owed to financial institutions. The contractual terms (e.g., interest notes and covenant restrictions) associated with long-term debts are particularly important to financial statement users because they identify short-term cash outflows and constraints that may inhibit management's future activities.

Provide a reasonable explanation for why the current liabilities of Bank of America are much larger than long-term liabilities and represent well over 50 percent of the total assets.

Shareholders' Equity

The **shareholders' equity** section of the balance sheet is basically divided into two parts: contributed capital and earned capital (primarily retained earnings). Note in Figure 2–2 that the total amount of shareholders' equity ($10,935) is equal to total assets ($18,615) less total liabilities ($7,680). This dollar amount is called the *net book value* of the company, and it also represents the total investment made by the shareholders in the company.

CONTRIBUTED CAPITAL

Contributed capital is a measure of the assets that have been contributed directly to a company by its owners.[3] Such contributions are made by purchasing the equity securities issued by the company, contributing cash or other noncash assets, or providing services.

3. Contributed capital is not used as a title of a balance sheet section. It encompasses a group of accounts that reflect owner contributions.

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Whatever the form, the investor's contribution is exchanged for ownership interests (e.g., shares of stock) in the company. Such interests usually carry with them the right to have a voice in the management of the company (e.g., vote for the board of directors) as well as the right to receive assets (e.g., dividends), if they are distributed. In many cases, these ownership interests can be purchased and sold freely (e.g., through public stock markets), but such transactions have no effects on the company's balance sheet.

During the late 1990s, as with many high-tech companies, issuing stock was the principal form of financing used by Amazon.com—with three major common stock issuances, raising over $1 billion.

EARNED CAPITAL

Earned capital is composed of two components: retained earnings and other accumulated comprehensive income.[4] **Retained earnings** is a measure of the assets that have been generated through a company's operating activities but not paid out to shareholders in the form of dividends. This account is particularly troublesome to accounting students who tend to visualize it as a tangible pool of cash. Nothing could be further from the truth. The $1,385 in Harbour Island's retained earnings account in Figure 2–2 is not in the form of cash in the company treasurer's office or in the bank. In fact, it is not associated with any specific asset or group of assets. It is simply a measure of the amount of the assets appearing on the balance sheet that have been provided by profitable operations. All we know from the balance sheet in Figure 2–2 is that $1,385 of the $18,615 total in the asset account has been provided by the company's profitable operations.

The relative size of retained earnings on the balance sheets of major U.S. companies varies significantly across industries. Bank of America, for example, normally reports retained earnings of only 4 percent of total assets, while Boeing is currently reporting retained earnings of about 42 percent of total assets. Users normally consider a large balance in retained earnings to be a positive sign because it indicates that the company has been profitable in the past and has chosen to reinvest those profits. However, young companies often report negative retained earnings because it takes several years to become profitable. Also, some very successful companies report relatively low levels of retained earnings because they pay large dividends.

After three years as a well-known, publicly traded company, Amazon.com reported a deficit in retained earnings of over $800 million. Explain how this could have occurred.

ORGANIZATIONAL FORM AND THE EQUITY SECTION

A business entity in the United States can be legally organized in either of two basic ways: as a corporation or as a partnership (called a *proprietorship* if there is only one owner).[5] A *corporation* is a legal entity that is separate and distinct from its owners. It can be taxed or sued, and the owners, called *shareholders* or *stockholders,* are legally liable only for the amount of their original contributions to the corporation. Shareholders acquire ownership interests by purchasing shares of stock in the corporation.

4. Other accumulated comprehensive income tends to be relatively small and is discussed later in the text.

5. Other business forms exist that have characteristics of both partnerships and corporations. Examples include subchapter S corporations and limited liability corporations.

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FIGURE 2–3
Owners' equity: corporation vs. partnership

Corporation		Partnership	
Shareholders' equity:		**Owners' equity:**	
Contributed capital	$20,000	Capital account, Ms. A	$12,000
Retained earnings	14,000	Capital account, Mr. B	15,000
Total shareholders' equity	$34,000	Total owners' equity	$27,000

Their interests give them the right to vote for its board of directors at annual shareholders' meetings as well as the right to receive dividends, which are distributed on a per-share basis, if declared by the board.

A *partnership,* or *proprietorship,* on the other hand, is not a legal entity. It can neither be taxed nor sued, and the legal liability of the owners, called *partners* or *proprietors,* is not limited to their original contributions. Asset distributions to partners are called *withdrawals*.

The differences between corporations and partnerships are reflected in differences in the equity sections of their balance sheets. The shareholders' equity section of a corporate balance sheet, as illustrated in Figure 2–2, draws a distinction between contributed capital, the measure of the assets directly contributed by the shareholders, and retained earnings, the assets generated through the company's operating activities and not returned to shareholders in the form of dividends.

On the other hand, the equity section on a partnership's balance sheet, called **owners' equity,** makes no distinction between contributed capital and retained earnings. Instead, it consists of separate accounts for each partner, which show the status of each partner's personal capital balance, reflecting all contributions and withdrawals. Figure 2–3 illustrates the differences between the shareholders' equity section of a corporation and the owners' equity section of a partnership with two partners. Throughout most of the text, the discussions and illustrations assume the corporate form of organization.

Many non-U.S. firms that publish IFRS-based balance sheets add shareholders' equity to non-current liabilities, referring to the total as **capital employed,** which represents the firm's debt and equity financing sources. Consequently, the balance sheet format looks like this:

Non-current assets + Current assets − Current liabilities = Non-current liabilities + Shareholders' equity

Explain how this format differs from the U.S. format.

THE INCOME STATEMENT

The income statement, sometimes called the statement of operations, measures operating performance over a particular period—the activities associated with the acquisition and sale of the company's inventories or services. An example, for the Harbour Island Company covering the year ended December 31, 2011, is illustrated in Figure 2–4. Note that it consists of three categories: operating revenues ($5,000), operating expenses ($3,895), and other revenues and expenses (−$20). The net amount of these three numbers yields a number called *net income* or *loss, net earnings,* or *profits* ($1,085). Net income is a very common and useful measure of operating performance.

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FIGURE 2-4
Income statement for Harbour Island Company

Harbour Island Company
Income Statement
for the Year Ended December 31, 2011

Operating revenues:		
Sales	$4,000	
Fees earned	1,000	
Total operating revenues		$5,000
Operating expenses:		
Cost of goods sold	$1,500	
Wage expense	1,000	
Rent expense	295	
Selling expense	300	
Depreciation expense	500	
Amortization expense	300	
Total operating expenses		3,895
Operating income		$1,105
Other revenues and expenses:		
Other revenues	$ 880	
Other expenses	900	
Net other revenues and expenses		(20)
Net income		$1,085

Most analysts, investors, creditors, and managers agree that net income is the most important number disclosed on the financial statements.

Operating Revenues

Operating revenues represent the inflow of assets (or decrease in liabilities) due to a company's operating activities over a period of time. Examples include sales and fees earned. The ability to generate operating revenues is often viewed as one of the important keys to success for a company.

Sales is perhaps the most common revenue account. It represents a measure of asset increases (usually in the form of cash or accounts receivable) due to selling a company's products or inventories. Operating revenues for Google increased by over 350 percent from 2006 to 2009.

If a company provides a service (e.g., a law firm or accounting firm) instead of selling a product, the revenue account reflecting such activity is called **fees earned** or **service revenue.** Walt Disney's income statement routinely includes both sales and service revenues. Sales are recognized when Disney products are sold, and service revenues come from its theme parks and films.

Many non-U.S. companies, especially in Europe, use the term "turnover" instead of revenue.

Operating Expenses

Operating expenses represent the periodic and usual outflow of assets (or creation of liabilities) required to generate operating revenues. Examples include cost of goods

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sold and expenses related to wages, rent, selling, depreciation, and amortization. As important as generating revenues, controlling expenses is also a barometer of a company's success. Many consider Dell Computer to be a leading computer-systems company because it does an excellent job of using the Internet to reduce operating costs.

The **cost of goods sold** account represents the original cost of the inventory items (purchase price or cost of manufacturing) that are sold to generate sales revenue. For retail and manufacturing companies, this *inventory expense* is normally separated from other operating expenses because it is comparatively large, and it is often compared to sales revenue to indicate the relationship between the selling price of the inventory and its cost. Users pay close attention to this percentage because it indicates by how much the sales price exceeds the cost of a good. Cost of goods sold as a percentage of sales for The Gap, a large retailer, exceeds 60 percent, while Monsanto, a large manufacturer, typically reports cost of goods sold in the 45 percent range.

Why do you think that H&R Block, a firm that offers tax services, reports no cost of goods sold?

The remaining operating expenses differ based on the nature of a company's operations. For retailing companies, which simply purchase finished goods and then sell them (e.g., Wal-Mart), this expense category contains accounts reflecting the decrease in assets (or creation of liabilities) due to such items as commissions to salespersons, salaries, wages, insurance, advertising, rentals, utilities, property taxes, equipment maintenance, depreciation of plant and equipment, and amortization of intangible assets. Manufacturing companies, on the other hand (e.g., General Motors), typically include only selling and administrative expenses in this category. Note from the expenses listed on the income statement in Figure 2–4 that Harbour Island is a retailer.

As investors cheered company profit reports in spring and summer of 2009, the stock market rallied. With the chill of fall and winter, however, came skepticism about the sustainability of future earnings. Many analysts feared that corporate expenses had been cut as low as possible by reducing workforces, and revenue growth would be difficult to achieve due to the continuing economic recession. Explain why analysts were skeptical about future profits.

Other Revenues and Expenses

The category *Other revenues and expenses* (sometimes called Other gains and losses) can include a number of items. It usually contains revenues and expenses from activities not central to a company's operations; therefore, the dollar amount of this category is also usually small. Other revenues include interest on bank accounts, rent collected on the rental of excess warehouse space, and book gains recognized when assets are sold for amounts that exceed those costs. Other expenses include interest on outstanding loans and book losses recognized when assets other than inventory are sold for amounts that are less than their original costs. It is very important that users appreciate the difference between revenues and expenses generated by core business activities and those generated by "one-shot" transactions. Presumably, core activities can be expected to recur, whereas "one-shot" transactions cannot.

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The large electric utility TXU Corporation reported a quarterly loss of $497 million. However, TXU reported that its operating income for the quarter was $444 million. At the time of the announcement, TXU was in the process of being purchased by a private equity investment group for $32 billion; the stock market reacted to the loss by pushing up TXU shares by 46 cents to $66.62 per share. Discuss how net income from operating activities can be positive, while net income is negative. Also discuss the stock market's reaction to the company's news.

THE STATEMENT OF SHAREHOLDERS' EQUITY

The statement of shareholders' equity, which is illustrated for Harbour Island in Figure 2–5, explains the changes in the shareholders' equity accounts (contributed capital and retained earnings) over a period. It represents a summary of the activity in the accounts that keep track of the shareholders' investment in the company. The shareholders' investment increases when capital is collected from the sale (issuance) of equity securities (contributed capital) and when profits, which belong to the shareholders, are reinvested in the business (earned capital). Dividends paid to the shareholders reduce their investment in the company. Note that the beginning dollar balances, which come from the December 31, 2010 balance sheet, are adjusted for the activity during 2011 leading to the ending dollar balances, which appear on the December 31, 2011 balance sheet. During 2011 Harbour Island collected $3,100 from common stock issuances, recorded net income of $1,085, and paid dividends of $200.

FIGURE 2–5 Statement of shareholders' equity for Harbour Island Company

	Contributed capital	Retained earnings	Total
December 31, 2010	$6,450	$ 500	$ 6,950
Net income		1,085	1,085
Less: dividends		(200)	(200)
Common stock issuance	3,100		3,100
December 31, 2011	$9,550	$1,385	$10,935

Retained earnings represents past profits that have not been returned to the shareholders in the form of dividends. By comparing dividends to profits across time, a user can ascertain a company's dividend policy.

Johnson & Johnson consistently pays significant dividends to its shareholders—normally on the order of 30 to 40 percent of net income. How would this be reported on the financial statements, and what portion of earnings is normally reinvested in the business?

It is important to realize that retained earnings is nothing in and of itself, but rather a measure of something else. It is not cash, nor is it an asset that can be touched or used. Instead, it is similar to an inch, a gallon, or a pound, all of which are measures of something tangible. An inch reflects a length of rope, the width of a table, or the height of a person, while retained earnings represents a measure of the assets, all of which are

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listed on the asset side of the balance sheet, that have been generated through profitable operations and retained in the business. Recall that assets can come from three sources: borrowings, contributions from owners, and profitable operations. Retained earnings is a measure of the third source.

Under IFRS, the requirements for a complete set of financial statements (balance sheet, income statement, statement of shareholders' equity, and statement of cash flows) are very similar to those under U.S. GAAP.

THE STATEMENT OF CASH FLOWS

The statement of cash flows is a summary of the activity in a company's cash account over a period of time. Understanding the statement of cash flows is simply a matter of recognizing that certain transactions entered into by a company during a given period increase the cash account, while others decrease it. The statement summarizes these transactions and, in the process, explains how the cash balance at the beginning of the period came to be the cash balance at the end of the period. The statement of cash flows for Harbour Island Company for the year ended December 31, 2011, appears in Figure 2–6.[6]

The statement of cash flows is divided into three basic categories: (1) operating activities, (2) investing activities, and (3) financing activities. The transactions summarized within each of these three categories either increased or decreased cash during the period, and the net result of the three totals explains the change in a company's overall cash balance. For example, on Harbour Island's cash flow statement, operating activities increased cash by $1,470, investment activities decreased cash by $4,100, and financing activities increased cash by $2,750. The net result is $120 ($1,470 − $4,100 + $2,750), the increase in the cash balance during 2011.

The statement of cash flows provides important information to investors and creditors, especially those who are interested in assessing a company's solvency position. In a recent survey of over 60,000 companies that failed, over 60 percent blamed their failure on factors linked to cash flows.

A recent report from the Georgia Institute of Technology indicates that companies are inconsistent in how they define operating, investing, and financing activities when they prepare the statement of cash flows. Several years ago, for example, Avis Budget Group announced that it was reclassifying a $45 million cash outflow from its Operating section to its Investing section for the quarter. The "Net Increase in Cash" reported on the statement did not change, but the categorizations were altered. Why would investors care if cash flow was considered Investing instead of Operating? Why do you think the company made the change and publicized it in a press release?

6. The operating section of this statement of cash flows can be presented under either the direct or indirect method. The statement in Figure 2–6 uses the direct form of presentation. Most major U.S. companies use the indirect form of presentation, which we cover later and throughout the text.

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FIGURE 2–6
Statement of cash flows for Harbour Island Company

Harbour Island Company
Statement of Cash Flows
for the Year Ended December 31, 2011

Operating activities:			
Cash collections from sales	$ 4,800		
Cash collections from rent	800		
Cash collections from interest	10		
Cash provided by operating activities		$ 5,610	
Cash paid to suppliers	$(1,800)		
Cash paid to employees	(1,050)		
Cash paid for rent	(290)		
Cash paid for selling activities	(300)		
Cash paid for interest and taxes	(700)		
Cash disbursed for operating activities		(4,140)	
Net cash increase (decrease) from operating activities			$ 1,470
Investing activities:			
Purchase of investment securities		$ (100)	
Purchase of property		(4,500)	
Proceeds from sale of investment securities		500	
Net cash increase (decrease) from investing activities			(4,100)
Financing activities:			
Proceeds from issuing equity		$ 3,100	
Principal payments on short-term notes		(100)	
Principal payments on long-term debt		(50)	
Cash dividends to shareholders		(200)	
Net cash increase (decrease) from financing activities			2,750
Increase (decrease) in cash balance			$ 120
Beginning cash balance (December 31, 2010)			100
Ending cash balance (December 31, 2011)			$ 220

Cash Flows from Operating Activities

Cash flows from operating activities include those cash inflows and outflows associated with the acquisition and sale of a company's products and services. The items found in this section are closely related to those found on the income statement because both measure operating inflows and outflows. However, the dollar amounts of these items on the statement of cash flows do not necessarily agree with the dollar amounts appearing for these items on the income statement. The statement of cash flows records only cash inflows and outflows; the income statement consists of revenues and expenses, which reflect more general asset and liability inflows and outflows. Cash is just one of a company's many assets.

Consider, for example, the sale of a service in exchange for a receivable. This transaction produces no cash; therefore, it has no effect on the statement of cash flows. It does, however, appear as a revenue on the income statement because an asset in the form of a receivable has been created. Consequently, net cash flow from operating activities on the statement of cash flows is rarely equal to net income on the income statement. In the case

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of Harbour Island, for example, net cash flow from operating activities in Figure 2–6 is equal to $1,470, while net income for the same period (see Figures 2–4 and 2–5) is equal to $1,085.

Two well-known companies that emerged in the 1990s are Yahoo! and Amazon.com. Yahoo! showed negative cash flows from operations in its first few years but began showing positive numbers in 1998. Amazon reported negative cash flows from operations until 2002. Where would these numbers be reported, and how might an analyst react to them?

Cash Flows from Investing Activities

Cash flows from investing activities include the cash inflows and outflows associated with the purchase and sale of a company's investments. Cash effects from the purchase or sale of a company's marketable securities or property, plant, and equipment are common examples. Note in Figure 2–6 that Harbour Island used $100 and $4,500 to purchase long-term investment securities and property, respectively. It also generated $500 in cash by selling long-term investments. These transactions in total reduced Harbour Island's cash balance by $4,100.

In the same year that Yahoo! reported net cash used by investing activities of $346 million, Amazon reported cash inflows from investing activities of $813 million. What kinds of transactions might have led to these two amounts?

Cash Flows from Financing Activities

Cash flows from financing activities include the cash inflows and outflows associated with a company's two sources of outside capital: liabilities and contributed capital. Cash proceeds from and cash principal payments on short- and long-term liabilities are reflected in this section of the statement of cash flows. As indicated in Figure 2–6, while Harbour Island borrowed no additional funds during 2011, it made cash principal payments on both short-term notes ($100) and long-term debt ($50). Cash proceeds from shareholder contributions, or equity issuances, and cash dividends to shareholders are also included in this section. Note that Harbour Island collected $3,100 in cash from issuing equity and paid cash dividends of $200.

In their early years, Yahoo! and Amazon both experienced fast growth and relied heavily on common stock issuances to raise capital. Do you expect that they showed positive or negative net cash flows from financing activities during this time period? Explain.

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RELATIONSHIPS AMONG THE FINANCIAL STATEMENTS

Figure 2–7 presents a general overview of the four basic financial accounting statements for Harbour Island Company and shows how they relate to one another. Take some time to study it.

Note the four statements indicated by the numbers: (1) balance sheet, (2) income statement, (3) statement of shareholders' equity, and (4) statement of cash flows. Note also that an additional balance sheet, prepared at the end of the period, is included on the right side of the figure. The account balances on this balance sheet are different from those on the balance sheet on the left. To explain how the balance sheet accounts changed during the year, examine the other three financial statements: the statement of cash flows, the statement of shareholders' equity, and the income statement.

The statement of cash flows explains the activity during the year in the company's cash account. At the beginning of 2011 the balance in the cash account was $100. During the year, operating, investing, and financing transactions affected the cash balance, and the end result was $220. The statement of cash flows ties into the cash accounts listed on the balance sheet at the beginning and end of 2011.

The statement of shareholders' equity, like the statement of cash flows, also explains the activity in balance sheet accounts during 2011—contributed capital and retained earnings, which appear in the shareholders' equity section of each balance sheet. The beginning and ending balances tie directly to the balance sheets for the beginning and end of 2011.

The income statement contains revenues and expenses, which are reflected in the statement of shareholders' equity through the net income number. The income statement connects directly to the retained earnings account, which in turn connects directly to the two balance sheets.

As a result of these interrelationships, every transaction affecting the income statement affects the balance sheet in at least two places. Revenues and expenses are components of retained earnings and increase or decrease the retained earnings balance accordingly. In addition, each account on the income statement has a related account in either the asset or liability section of the balance sheet. Recognizing a sale, for example, can affect *cash and accounts receivable*. Recognizing an expense, such as wage expense, can affect *cash and wages payable*. Thus, the balance sheet and the income statement are closely related. As you work through this text, it is important that you clearly understand these relationships.

INTERNATIONAL PERSPECTIVE: AN EXAMPLE OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

International Financial Reporting Standards (IFRS) are becoming increasingly important and, as we discussed in Chapter 1, are already accepted by the SEC. The consolidated balance sheet, income statement, and cash flow statement of Unilever, one of the world's leading suppliers of consumer brands (e.g., Knorr, Lipton, Dove, Hellman's), are provided below. These statements have been prepared according to IFRS, and the Unilever Group is registered in the Netherlands. Its shares are listed on the London and New York stock exchanges.

Note first that the financial statements cover up to December 31, 2008, and are expressed in euros, not U.S. dollars. While not a requirement under IFRS, Unilever's balance sheet, like many non-U.S. companies, is organized by listing non-current assets first, followed by current assets, current liabilities, non-current liabilities and, finally, shareholders' equity.

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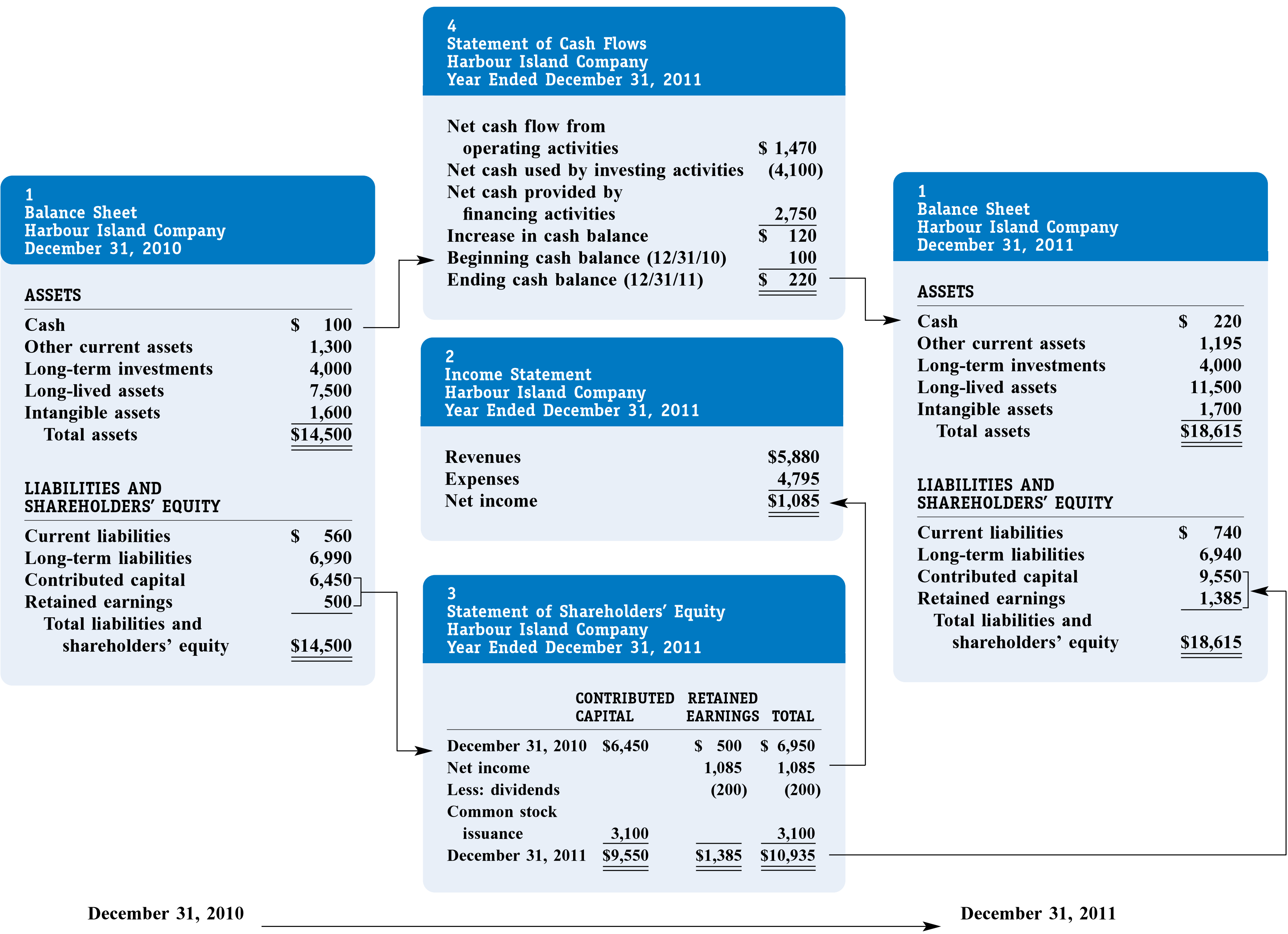
FIGURE 2–7 Relationships among the financial statements



1 Balance Sheet — Harbour Island Company — December 31, 2010

ASSETS	
Cash	$ 100
Other current assets	1,300
Long-term investments	4,000
Long-lived assets	7,500
Intangible assets	1,600
Total assets	$14,500

LIABILITIES AND SHAREHOLDERS' EQUITY	
Current liabilities	$ 560
Long-term liabilities	6,990
Contributed capital	6,450
Retained earnings	500
Total liabilities and shareholders' equity	$14,500

4 Statement of Cash Flows — Harbour Island Company — Year Ended December 31, 2011

Net cash flow from operating activities	$ 1,470
Net cash used by investing activities	(4,100)
Net cash provided by financing activities	2,750
Increase in cash balance	$ 120
Beginning cash balance (12/31/10)	100
Ending cash balance (12/31/11)	$ 220

2 Income Statement — Harbour Island Company — Year Ended December 31, 2011

Revenues	$5,880
Expenses	4,795
Net income	$1,085

3 Statement of Shareholders' Equity — Harbour Island Company — Year Ended December 31, 2011

	CONTRIBUTED CAPITAL	RETAINED EARNINGS	TOTAL
December 31, 2010	$6,450	$ 500	$ 6,950
Net income		1,085	1,085
Less: dividends		(200)	(200)
Common stock issuance	3,100		3,100
December 31, 2011	$9,550	$1,385	$10,935

1 Balance Sheet — Harbour Island Company — December 31, 2011

ASSETS	
Cash	$ 220
Other current assets	1,195
Long-term investments	4,000
Long-lived assets	11,500
Intangible assets	1,700
Total assets	$18,615

LIABILITIES AND SHAREHOLDERS' EQUITY	
Current liabilities	$ 740
Long-term liabilities	6,940
Contributed capital	9,550
Retained earnings	1,385
Total liabilities and shareholders' equity	$18,615

December 31, 2010 → December 31, 2011

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Non-current assets + Current assets − Current liabilities = Non-current liabilities + Shareholders' equity

This format illustrates that non-current borrowings and investments by shareholders (via contributed and earned capital) provide the financing for the company's non-current assets and working capital, a relationship depicted in Figure 2-1. For the most part, the account names appearing on Unilever's balance sheet are similar to those used by U.S. companies. We will discuss some of these differences as we move through the text.

The income statement uses the term "**turnover**" instead of revenue, which is common for many European companies, and, as with the U.S. format, makes a distinction between operating and non-operating revenue (turnover) and expenses. Note, for example, that operating profit is followed by a number of non-operating increases (income) and decreases (costs), including "finance costs," which is called interest expense in the U.S. The numbers listed behind many of the account names refer to footnotes, where greater detail is provided.

The cash flow statement, as in the U.S., is divided into three sections: net cash flow from operating activities, net cash flow from (used in) investing activities, and net cash flow from (used in) financing activities. The statement indicates that the detail explaining the operating cash amount is contained in footnote 28 (not provided in this text), and for the most part the account items listed in the investing and financing sections are similar to those listed in U.S.-based statements of cash flow.

A brief analysis of these statements indicates that Unilever was profitable across the three-year period, although there was virtually no growth in either revenues or profits. Non-current assets plus working capital dipped from 2007 to 2008, and the company relied more heavily on non-current liabilities as a source of financing. Over the three-year period Unilever did generate about 12 billion euros of cash through its operations, which was used primarily to pay dividends, buy back Unilever shares, and invest in property, plant, and equipment.

Unilever
Consolidated Balance Sheet
as at 31 December

	€ million 2008	€ million 2007
Goodwill[9]	11,665	12,244
Intangible assets[9]	4,426	4,511
Property, plant, and equipment[10]	5,957	6,284
Pension asset for funded schemes in surplus[20]	425	2,008
Deferred tax assets[12]	1,068	1,003
Other non-current assets[11]	1,426	1,324
Total non-current assets	24,967	27,374
Inventories[13]	3,889	3,894
Trade and other current receivables[14]	3,823	4,194
Current tax assets	234	367
Cash and cash equivalents[15]	2,561	1,098
Other financial assets[15]	632	216
Non-current assets held for sale[27]	36	159
Total current assets	11,175	9,928

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	€ million 2008	€ million 2007
Financial liabilities[16]	(4,842)	(4,166)
Trade payables and other current liabilities[18]	(7,824)	(8,017)
Current tax liabilities	(377)	(395)
Provisions[19]	(757)	(968)
Liabilities associated with non-current assets held for sale[27]	—	(13)
Total current liabilities	(13,800)	(13,559)
Net current assets/(liabilities)	(2,625)	(3,631)
Total assets less current liabilities	22,342	23,743
Financial liabilities due after one year[16]	6,363	5,483
Non-current tax liabilities	189	233
Pensions and post-retirement healthcare liabilities:		
Funded schemes in deficit[20]	1,820	827
Unfunded schemes[20]	1,987	2,270
Provisions[19]	646	694
Deferred tax liabilities[12]	790	1,213
Other non-current liabilities	175	204
Total non-current liabilities	11,970	10,924
Share capital[21]	484	484
Share premium[21]	121	153
Other reserves[21]	(6,469)	(3,412)
Retained profit[21]	15,812	15,162
Shareholders's equity	9,948	12,387
Minority interests[21]	424	432
Total equity	10,372	12,819
Total capital employed	22,342	23,743

Unilever
Consolidated Balance Sheet
for the Year Ended 31 December

	€ million 2008	€ million 2007	€ million 2006
Continuing operations			
Turnover[2]	40,523	40,187	39,642
Operating profit[2]	7,167	5,245	5,408
After (charging)/crediting:			
Restructuring[3]	(868)	(875)	(704)
Business disposals, impairments and other[3]	2,137	306	196
Gain on US healthcare and UK pensions[3]	—	—	266
Net finance costs[5]	(257)	(252)	(721)
Finance income	106	147	128
Finance costs	(506)	(550)	(590)
Preference shares provision	—	(7)	(300)
Pensions and similar obligations	143	158	41

(*Continued*)

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Unilever
Consolidated Balance Sheet
for the Year Ended 31 December (Continued)

	€ million 2008	€ million 2007	€ million 2006
Share of net profit/(loss) of joint ventures[11]	125	102	78
Share of net profit/(loss) of associates[11]	6	50	36
Other income from non-current investments[11]	88	39	30
Profit before taxation	7,129	5,184	4,831
Taxation[6]	(1,844)	(1,128)	(1,146)
Net profit from continuing operations	5,285	4,056	3,685
Profit for the year from discontinued operations[27]	—	80	1,330
Net profit	5,285	4,136	5,015
Cash flow from operating activities[28]	5,326	5,188	5,574
Income tax paid	(1,455)	(1,312)	(1,063)
Net cash flow from operating activities	3,871	3,876	4,511
Interest received	105	146	125
Purchase of intangible assets	(147)	(136)	(113)
Purchase of property, plant and equipment	(1,142)	(1,046)	(1,013)
Disposal of property, plant, and equipment	190	163	192
Sales and leaseback transactions resulting in operating leases	—	36	—
Acquisition of group companies, joint ventures and associates	(211)	(214)	(96)
Disposal of group companies, joint ventures and associates	2,476	164	1,873
Acquisition of other non-current investments	(126)	(50)	(90)
Disposal of other non-current investments	47	33	61
Dividends from joint ventures, associates and other non-current investments	132	188	120
(Purchase)/sale of financial assets	91	93	96
Net cash flow from/(used in) investing activities	1,415	(623)	1,155
Dividends paid on ordinary share capital	(2,086)	(2,182)	(2,602)
Interest and preference dividends paid	(487)	(552)	(605)
Additional financial liabilities	4,544	4,283	2,154
Repayment of financial liabilities	(3,427)	(2,896)	(5,364)
Sale and leaseback transactions resulting in finance leases	(1)	25	2
Capital element of finance lease rental payments	(66)	(74)	(73)
Share buy-back programme	(1,503)	(1,500)	—
Other movements on treasury stock	103	442	98
Other financing activities	(207)	(555)	(182)
Net cash flow from/(used in) financing activities	(3,130)	(3,009)	(6,572)
Net increase/(decrease) in cash and cash equivalents	2,156	244	(906)
Cash and cash equivalents at the beginning of the year	901	710	1,265
Effect of foreign exchange rate changes	(697)	(53)	351
Cash and cash equivalents at the end of the year[15]	2,360	901	710

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REVIEW PROBLEM

The following information was taken from the 2008 annual report of Bed Bath & Beyond. All dollar values are in thousands.

Net sales for Bed Bath & Beyond increased 2.3 percent from fiscal 2007 to fiscal 2008, and 6.5 percent from 2006 to 2007. Gross profit (net sales less cost of sales) decreased over the three years, dropping from 43 percent (2006) to 40 percent (2008). Operating profit saw a similar decline, as selling, general and administrative expenses ate up a large share of sales. Analysts would view these earning power trends negatively, and might be concerned about sales growth and increased expense control in the future.

The balance sheet shows growth in total assets, with the largest change coming from short-term liquid assets. Inventories as a percentage of total assets are down, suggesting that even though profits are down, inventories are not building up. Current liabilities decreased, while current assets increased, implying greater solvency. The company has no interest-bearing debt, and retained earnings has increased.

The statement of cash flows shows that the company, even in a recession, has the ability to generate cash from its operating activities, which is being used to purchase investments, acquire long-term assets (capital expenditures), and repurchase outstanding shares of its own stock. Both the statement of cash flow and the statement of shareholders' equity show that in each of the three years (2006, 2007, and 2008) the company paid no dividends, and both issued and bought back its own stock.

In summary, from 2007 to 2009, Bed Bath & Beyond's earning power experienced some challenges from a recessionary environment, which affected all retailers. Sales growth was down from previous years, while profits were hurt by expense growth. Cash flow remained strong, and although the company paid no dividends, cash was distributed to shareholders through stock buybacks. Bed Bath & Beyond's solvency position remained excellent with increased liquid assets, very little debt, and the ability to generate cash from operations. Further, the company continued to invest in its future through capital expenditures.

Bed Bath & Beyond Inc. and Subsidiaries
Consolidated Statements of Earnings

	FISCAL YEAR ENDED		
(In thousands, except per share data)	February 28, 2009	March 1, 2008	March 3, 2007
Net sales	$7,208,340	$7,048,942	$6,617,429
Cost of sales	4,335,104	4,123,711	3,782,027
Gross profit	2,873,236	2,925,231	2,835,402
Selling, general and administrative expenses	2,199,340	2,087,209	1,946,001
Operating profit	673,896	838,022	889,401
Interest income	9,412	27,210	43,478
Earnings before provision for income taxes	683,308	865,232	932,879
Provision for income taxes	258,185	302,424	338,635
Net earnings	$ 425,123	$ 562,808	$ 594,244
Net earnings per share—Basic	$ 1.66	$ 2.13	$ 2.12
Net earnings per share—Diluted	$ 1.64	$ 2.10	$ 2.09
Weighted average shares outstanding—Basic	256,410	264,824	280,199
Weighted average shares outstanding—Diluted	258,619	268,409	284,956

See accompanying Notes to Consolidated Financial Statements.

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Bed Bath & Beyond Inc. and Subsidiaries
Consolidated Balance Sheets

(In thousands, except per share data)	February 28, 2009	March 1, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 668,209	$ 224,084
Short term investment securities	2,000	—
Merchandise inventories	1,642,339	1,616,981
Other current assets	250,251	238,646
Total current assets	2,562,799	2,079,711
Long term investment securities	221,134	326,004
Property and equipment, net	1,148,435	1,121,906
Other assets	336,475	316,472
Total assets	$ 4,268,843	$ 3,844,093
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 514,734	$ 570,605
Accrued expenses and other current liabilities	247,508	258,989
Merchandise credit and gift card liabilities	165,621	171,252
Current income taxes payable	25,105	13,266
Total current liabilities	952,968	1,014,112
Deferred rent and other liabilities	227,209	192,778
Income taxes payable	88,212	75,375
Total liabilities	1,268,389	1,282,265
Commitments and contingencies		
Shareholders' equity:		
Preferred stock—$0.01 par value; authorized—1,000 shares; no shares issued or outstanding	—	—
Common stock—$0.01 par value; authorized—900,000 shares; issued 314,678 and 312,229 shares, respectively; outstanding 259,701 and 258,920 shares, respectively	3,147	3,122
Additional paid-in capital	878,568	813,568
Retained earnings	4,154,921	3,729,766
Treasury stock, at cost	(2,031,642)	(1,983,590)
Accumulated other comprehensive loss	(4,540)	(1,038)
Total shareholders' equity	3,000,454	2,561,828
Total liabilities and shareholders' equity	$ 4,268,843	$ 3,844,093

See accompanying Notes to Consolidated Financial Statements.

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Bed Bath & Beyond Inc. and Subsidiaries
Consolidated Statements of Cash Flows

	FISCAL YEAR ENDED		
(In thousands)	February 28, 2009	March 1, 2008	March 3, 2007
Cash Flows from Operating Activities:			
Net earnings	$ 425,123	$ 562,808	$ 594,244
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation	175,601	157,770	132,955
Amortization of bond premium	—	1,538	3,532
Stock-based compensation	43,708	43,755	52,596
Tax benefit from stock-based compensation	(1,183)	2,719	6,691
Deferred income taxes	(22,325)	2,315	(87,225)
Other	476	—	—
(Increase) decrease in assets, net of effect of acquisition:			
Merchandise inventories	(25,358)	(96,673)	(204,080)
Trading investment securities	(17)	(3,020)	(2,958)
Other current assets	(3,065)	(16,217)	(38,241)
Other assets	(954)	529	(695)
(Decrease) increase in liabilities, net of effect of acquisition:			
Accounts payable	(40,863)	(31,764)	75,883
Accrued expenses and other current liabilities	(13,301)	15,774	9,784
Merchandise credit and gift card liabilities	(5,631)	24,430	30,223
Income taxes payable	24,676	(74,530)	21,575
Deferred rent and other liabilities	27,083	25,102	19,348
Net cash provided by operating activities	583,970	614,536	613,632
Cash Flows from Investing Activities:			
Purchase of held-to-maturity investment securities	—	—	(124,125)
Redemption of held-to-maturity investment securities	—	494,526	309,818
Purchase of available-for-sale investment securities	—	(1,495,155)	(1,443,115)
Redemption of available-for-sale investment securities	107,550	1,546,430	1,177,250
Capital expenditures	(215,859)	(358,210)	(317,501)
Investment in unconsolidated joint venture, including fees	(4,786)	—	—
Payment for acquisition, net of cash acquired	—	(85,893)	—
Net cash (used in) provided by investing activities	(113,095)	101,698	(397,673)
Cash Flows from Financing Activities:			
Proceeds from exercise to stock options	17,650	22,672	43,393
Excess tax benefit from stock-based compensation	3,652	5,990	14,001
Repurchase of common stock, including fees	(48,052)	(734,193)	(301,002)
Payment of deferred purchase price for acquisition	—	—	(6,667)
Net cash used in financing activities	(26,750)	(705,531)	(250,275)
Net increase (decrease) in cash and cash equivalents	444,125	10,703	(34,316)
Cash and cash equivalents:			
Beginning of period	224,084	213,381	247,697
End of period	$ 668,209	$ 224,084	$ 213,381

See accompanying Notes to Consolidated Financial Statements.

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Bed Bath & Beyond Inc. and Subsidiaries
Consolidated Statements of Shareholders' Equity

(In thousands)	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	TREASURY STOCK		ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)	TOTAL
	SHARES	AMOUNT			SHARES	AMOUNT		
Balance at February 25, 2006	306,156	$3,062	$575,559	$2,632,224	(25,166)	$ (948,395)	$ —	$2,262,450
Net earnings								594,244
Shares sold under employee stock option plans, including tax benefit	2,603	26	61,628					61,654
Issuance of restricted shares, net	991	10	(10)					—
Stock-based compensation expense, net			61,744					61,744
Repurchase of common stock, including fees					(7,5100)	(301,002)		(301,002)
Adoption of SAB 108			38,288	(72,612)				(34,324)
Adoption of SFAS No. 158							4,385	4,385
Balance at March 3, 2007	309,750	3,098	737,209	3,153,856	(32,676)	(1,249,397)	4,385	2,649,151
Adoption of FIN 48				13,102				13,102
Comprehensive Income (Loss):								
Net earnings				562,808				562,808
Temporary Impairment of auction rate securities, net of taxes							(4,516)	(4,516)
Pension adjustment, net of taxes							(736)	(736)
Currency translation adjustment							(171)	(171)
Comprehensive Income								557,385
Shares sold under employee stock option plans, including tax benefit	1,463	14	31,367					31,381
Issuance of restricted shares, net	1,016	10	(10)					—
Stock-based compensation expense, net			45,002					45,002
Repurchase of common stock, including fees					(20,633)	(734,193)		(734,193)
Balance at March 1, 2008	312,229	3,122	813,568	3,729,766	(53,309)	(1,983,590)	(1,038)	2,561,828
Comprehensive Income (Loss):								
Net earnings				425,123				425,123
Change in temporary impairment of auction rate securities, net of taxes							(615)	(615)

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Unrealized loss included in net earnings, net of taxes							3,528	3,528
Pension adjustment, net of taxes							(4,593)	(4,593)
Currency translation adjustment							(1,822)	(1,822)
Comprehensive Income								421,621
Shares sold under employee stock option plans, including tax benefit	1,218	12	19,910					19,922
Issuance of restricted shares, net	1,224	13	(13)					—
Stock-based compensation expense, net			44,906					44,906
Director fees paid in stock	7		197					197
Repurchase of common stock, including fees					(1,668)	(48,052)		(48,502)
SFAS No. 158 change in measurement date effect				32				32
Balance at February 28, 2009	314,678	$3,147	$878,568	$4,154,921	(54,977)	$(2,031,642)	$(4,540)	$3,000,454

See accompanying Notes to Consolidated Financial Statements.

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SUMMARY OF KEY POINTS

The three basic activities of a business and how they are reflected in the financial statements.

Businesses must first attract capital and then invest it in productive assets that can be used to produce saleable goods and/or services. The three basic activities involved in conducting a business are (1) financing activities, (2) investing activities, and (3) operating activities. Financing activities involve the collection of capital through equity or debt issuances and any associated payments, such as dividends and debt payments. Investing activities involve the acquisition and sale of producing assets, the assets used to produce and support the goods and services provided. Operating activities involve the sale of the goods and services. Operating activities produce additional capital that can be reinvested in the producing assets, used to service debt payments, and distributed to the owners in the form of dividends.

The balance sheet lists assets (goods and producing assets) and financing sources (equity, debt, and reinvestments from net earnings) at a particular point in time. The income statement is a measure of operations, the activities (revenues and expenses) involved in selling the goods and services. The statement of shareholders' equity measures changes in contributed capital and the extent to which the business reinvests its net earnings and pays dividends. The statement of cash flows contains the cash inflows and outflows associated with the operating, investing, and financing activities of the business.

The balance sheet, income statement, statement of shareholders' equity, and statement of cash flows and how these financial statements are used.

The asset accounts reported on the balance sheet are listed in order of liquidity and are divided into four categories: (1) current assets, which include cash, short-term investments, accounts receivable, inventory, and prepaid expenses; (2) long-term investments, which include long-term notes receivable, land, securities, the cash value of life insurance, and special investment funds; (3) property, plant, and equipment; and (4) intangible assets, which include patents, trademarks, and other intangibles, such as goodwill.

Liabilities are divided into two categories: (1) current liabilities, which primarily include short-term payables; and (2) long-term liabilities, which include items such as long-term notes, bonds, and mortgages payable. The shareholders' equity section for a corporation contains contributed capital and retained earnings; the owners' equity section for a partnership contains an account for each partner that records the cumulative balance of the partner's contributions less withdrawals.

The income statement consists of two basic categories: revenues and expenses. Revenues, which represent asset inflows (or liability decreases) associated with operating transactions during a given period, include sales, fees earned, service revenues, and other revenues (e.g., interest, book gains). Expenses, which represent the asset outflows (or liability increases) required to generate the revenues, include cost of goods sold, operating expenses (e.g., wages, rent), and other expenses (e.g., interest, book losses). Revenues less expenses equal net income.

The statement of shareholders' equity consists of the changes in two basic accounts: (1) contributed capital (e.g., the funds collected from shareholders through stock issuances) and (2) earned capital, primarily retained earnings, which represents past reinvested (not paid to the shareholders in the form of dividends) profits. The statement of cash flows contains three categories: (1) cash flows from operating activities; (2) cash flows from investing activities; and (3) cash flows from financing activities.

This information enables external users to assess the earning power and solvency position of the company. Assets generate cash through their use and sale, and liabilities represent cash requirements. The income statement indicates how profitable the company's operations have been, and the statement of cash flows shows how the company's cash is managed. The statement of shareholders' equity provides information about the investment in the company made by the shareholders.

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Similarities and differences between non-U.S. financial statement format and terminology

The financial statement format used by non-U.S. companies is very similar to that of the U.S. for the income statement, statement of cash flows, and statement of shareholders' equity. For the balance sheet, many non-U.S. companies begin with non-current assets, add current assets, and then subtract current liabilities. This computation reflects the resources (non-current assets and working capital) management has at its disposal to generate revenues and profits. The balance sheet then lists non-current liabilities and then shareholders' equity, which represents the financing source of those resources, and is often referred to as "capital employed." Other terminology differences exist, and we noted, for example, that "turnover" is often used to describe revenue, and "financing cost" is used to describe interest expense. Additional terminology differences will be discussed in the text as they arise.

KEY TERMS

Note: Definitions for these terms are provided in the glossary at the end of the text.

Accounts payable (p. 42)
Accounts receivable (p. 39)
Bonds payable (p. 43)
Capital employed (p. 45)
Classified balance sheet (p. 36)
Contributed capital (p. 43)
Cost of goods sold (p. 47)
Current assets (p. 38)
Current liabilities (p. 42)
Current maturities of long-term debts (p. 42)
Earned capital (p. 44)
Fees earned (p. 46)
Financing activities (p. 35)
Financing cost (p. 63)
Intangible assets (p. 41)
Investing activities (p. 35)
Liquidity (p. 36)
Long-term investments (p. 40)
Merchandise inventory (p. 39)
Mortgage payables (p. 43)
Net book value (p. 41)
Notes payable (p. 43)
Operating activities (p. 35)
Owners' equity (p. 45)
Plant and equipment (p. 41)
Prepaid expenses (p. 39)
Property (p. 40)
Retained earnings (p. 44)
Sales (p. 46)
Service revenue (p. 46)
Shareholders' equity (p. 43)
Short-term investments (p. 38)
Turnover (p. 54)

ETHICS in the Real World

For years German and Swiss accounting rules allowed management to "manage" earnings through discretionary adjustments. For the most part, the adjustments "smooth out" earnings variability across time, and many were used to German and Swiss managers argued that such adjustments were in the best interest of the firm, its shareholders, and the overall economy. Many of these companies have since adopted International Financial Reporting Standards (IFRS), which makes it more difficult to "manage" earnings. Many believe that these reporting standards encourage more transparency between corporate management and the investing community. Nonetheless, some Swiss companies were not quick to adopt IFRS, arguing that the standards imposed significant additional costs and simply made it more difficult for management to run their companies.

ETHICAL ISSUE Discuss the ethical issues facing a Swiss manager who is hesitant to adopt IFRS.

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INTERNET RESEARCH EXERCISE

Review the discussion about Borders in the introduction to this chapter and provide a brief description and discussion of Borders' recent financial performance and core business. Begin your search at www.borders.com.

BRIEF EXERCISES

REAL DATA
BE2–1
Dividends as a percentage of net income

Revenues and expenses for PepsiCo during 2008 were $43.3 billion and $38.2 billion, respectively. The December 31, 2007 and 2008 balances in retained earnings were $28.2 billion and $30.6 billion, respectively. Compute dividends paid by PepsiCo during 2008. What percentage of net income did PepsiCo pay out in dividends during 2008?

REAL DATA
BE2–2
Financing assets

A summary of a recent balance sheet for Boeing Co. is as follows (dollars in billions):

Assets		Liabilities and Shareholders' Equity	
Current assets	$27	Current liabilities	$32
Property, plant, and equipment	8	Long-term debt	18
Other assets	24	Shareholders' equity	9
Total	$59	Total	$59

What amount and what percentage of Boeing's assets were financed by (1) current liabilities, (2) long-term debt, and (3) shareholders' equity?

REAL DATA
BE2–3
Assessing solvency

In BE2–2, Boeing's current assets consisted primarily of cash and short-term investments of $9.3 billion, accounts receivable of $5.7 billion, inventory of $9.6 billion, and miscellaneous current assets of $2.4 billion. Does the company appear solvent? Why or why not? Can Boeing pay off its current liabilities with liquid assets? Would it be more or less solvent if the dollar amounts in accounts receivable and inventory were reversed?

REAL DATA
BE2–4
The statement of cash flows across time

Excerpts from the annual report of AT&T, Inc., are as follows.

Statement of Cash Flows (Dollars in Millions)

	2008	2007	2006
Net cash from operating activities	$?	$34,242	$15,688
Net cash from investing activities	(29,143)	(18,616)	(8,366)
Net cash from financing activities	(4,691)	?	(6,128)
Net change in cash	?	(448)	?
Cash balance at beginning of year	1,970	?	?
Cash balance at end of year	1,792	?	2,418

Compute the missing values and briefly discuss AT&T's sources and uses of cash during the three-year period.

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REAL DATA

BE2–5

Balance sheet format differences

A recent balance sheet of Royal Dutch Shell, a huge oil and gas company that prepares financial statements using IFRS, reported the following dollar amounts (in millions).

Non-current assets	$154,073
Current assets	115,397
Current liabilities	94,384
Non-current liabilities	49,118
Equity	125,968

First, format these balance sheet sections in a manner that is used by many non-U.S. companies (see the Unilever analysis in this chapter), and then format the sections in the manner most common in the U.S. Comment on the differences, and how they highlight different concepts.

EXERCISES

E2–1

Identifying financing, investing, and operating transactions

Listed below are eight transactions. In each case, identify whether the transaction is an example of financing, investing, or operating activities and which of the financial statements it would affect.

1. Common stock is issued for $500,000 in cash.
2. Twenty units of inventory are sold for $50 each.
3. Employee wages are paid.
4. A new warehouse facility is purchased.
5. Principal payments on outstanding debt are paid.
6. Dividends are paid to the shareholders.
7. A 4-year-old vehicle, used as a delivery truck, is sold for $9,000, its book value.
8. A utility bill for March is paid in April.

E2–2

Identifying financing, investing, and operating transactions

Listed below are eight transactions. In each case, identify whether the transaction is an example of financing, investing, or operating activities and which of the financial statements it would affect.

1. Company borrows $50,000 in cash, signing a 10-year note payable.
2. Twenty units of inventory are purchased from suppliers on account for $12,000.
3. The utility bill is paid at the end of the month, $5,200.
4. Services are performed, and customers are billed for $13,000.
5. Five parcels of real estate are purchased for a total of $55,000 in cash.
6. A long-term investment in an equity security is sold for $4,500 cash.
7. Principal payments are made on outstanding debts.
8. Cash is received from customers for services completed in a previous period.

E2–3

Balance sheet or income statement account?

Listed below are accounts that may appear on either the balance sheet or the income statement.

a. Equipment
b. Fees Earned
c. Retained Earnings
d. Wage Expense
e. Patent
f. Cost of Goods Sold
g. Common Stock
h. Dividend Payable
i. Accumulated Depreciation
j. Prepaid Expense
k. Gain on Sale of Short-Term Investments
l. Rent Revenue
m. Supplies Inventory
n. Accounts Receivable
o. Land
p. Insurance Expense
q. Interest Payable
r. Deferred Revenue

For each account, indicate whether a company would ordinarily disclose the account on the balance sheet or the income statement.

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E2–4

Financial statement and the lending decision

Assume a banker is interested in finding answers to the following questions about a company applying for a loan. In each case, indicate which of the four financial statements the banker should examine first to answer the question. If appropriate, also indicate which other financial statement(s) would provide further support for the answer.

1. What percent of earnings was retained in the business during each of the last three years?
2. What percent of sales revenue is spent on employee compensation?
3. How has the mix of assets and liabilities, both short-term and long, changed over the last two years?
4. How much cash has the company spent on new long-term assets?
5. What sources of capital does the company use to finance its operations?
6. Is the company growing?
7. How much above the cost of its products does the company charge its customers?
8. How quickly does the company pay its debts?

REAL DATA

E2–5

Relationships between retained earnings and revenues and expenses across time

Duke Energy Corporation is one of America's leading diversified energy companies. At the end of 2008 the company had a balance in its retained earnings account of $1.6 billion. Compute the missing amounts in the following table, and comment on the company's performance. Specifically, analyze the company's sales growth, profits, profits as a percentage of sales, and dividends declared as a percentage of net income (dollar amounts in billions).

	2008	2007	2006
Beginning retained earnings	**$?**	**$ 5.7**	**$ 5.3**
Revenues for the period	**13.2**	**12.7**	**10.6**
Expenses for the period	**11.8**	**?**	**8.7**
Dividends declared	**1.2**	**5.8**	**?**

E2–6

Relationships between retained earnings and revenues and expenses across time

At the end of 2009 a fast-growing advertising agency had a negative balance of $596 million in its retained earnings account. Compute the missing amounts in the following table, and comment on the company's performance. Specifically, analyze the company's sales growth, profits, profits as a percentage of sales, and dividends declared as a percentage of net income (dollars in millions).

	2009	2008	2007
Beginning retained earnings	**$ (758)**	**$ (523)**	**$ (499)**
Revenues for the period	**?**	**1,522**	**1,383**
Expenses for the period	**1,550**	**1,608**	**?**
Dividends declared	**5**	**?**	**0**

REAL DATA

E2–7

Using working capital to assess solvency

La-Z-Boy Incorporated included the following information in its 2009 annual report (dollars in millions).

	2009	2008
Cash	**$ 17**	**$ 14**
Accounts receivable	**148**	**200**
Inventory	**140**	**178**
Other current assets	**43**	**35**
Total current assets	**$348**	**$427**
Current liabilities	**126**	**164**
Current assets minus current liabilities	**$222**	**$263**

Define solvency and discuss how this information might be useful in assessing the company's solvency position. What drawbacks are associated with using this information in such a way?

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REAL DATA

E2–8

The effects of different forms of financing on financial statement numbers and debt covenants

Suppose that La-Z-Boy in E2–7 signed a debt covenant specifying that current assets must exceed current liabilities by $200 million. Assume further that in early January 2010, the company planned to purchase a $200-million piece of machinery and had two possible methods of paying for it: (1) short-term note payable or (2) long-term note payable. Compute the effect of each alternative on the difference between current assets and current liabilities, and discuss which method seems to be the most feasible.

REAL DATA

E2–9

The statement of cash flows across time

The information below was taken from the 2009 annual report of Cisco Systems, a worldwide leader in networking for the Internet. As of the end of 2009, Cisco had a cash balance of $5.7 billion. Compute the missing amounts in the following table. Describe and evaluate the company's cash management activities in each of the three years (dollars in millions).

	2009	2008	2007
Beginning cash balance	$5,191	$?	$ 3,297
Net cash flow from operating activities	9,897	?	10,104
Net cash flow from investing activities	(9,959)	(4,193)	?
Net cash flow from financing activities	?	(6,433)	(1,331)
Ending cash balance	$5,718	$?	$ 3,728

REAL DATA

E2–10

The statement of cash flows across time

Southwest Airlines is a major airline. The following information was taken from its 2008 annual report. As of the end of 2008, Southwest had a cash balance of $1.4 billion. Compute the missing amounts in the following table. Describe and evaluate the company's cash management activities in each of the three years (dollars in millions).

	2008	2007	2006
Beginning cash balance	$?	$1,390	$?
Net cash flow from operating activities	(1,521)	2,845	1,406
Net cash flow from investing activities	?	(1,529)	(1,495)
Net cash flow from financing activities	1,654	?	(801)
Ending cash balance	$1,368	$2,213	$?

E2–11

Preparing a statement of cash flows

From the following transactions, prepare a statement of cash flows for Lana and Sons in the proper form. The company began the year with a cash balance of $13,000. Describe and evaluate the company's cash management activities during the year.

1. The shareholders contributed $7,000 in cash.
2. Performed services for $5,000, receiving $4,000 in cash and a $1,000 receivable.
3. Incurred expenses of $4,000; paid $3,000 in cash and $1,000 is still payable.
4. Purchased machinery for $10,000; paid $3,000 in cash and signed a long-term note payable for the remainder.
5. Paid the shareholders a $1,500 dividend.

E2–12

Preparing a statement of cash flows

From the following transactions, prepare a statement of cash flows for Emory Inc. in the proper form. The company began the year with a cash balance of $25,000. Describe and evaluate the company's cash management activities during the year.

1. Borrowed $30,000 from a bank, signing a long-term note.
2. Performed services for $45,000, receiving $40,000 in cash and a $5,000 receivable.
3. Incurred expenses of $34,000; paid $23,000 in cash and $11,000 is still payable.
4. Purchased equipment for $28,000; paid $23,000 in cash and signed a long-term note payable for the remainder.
5. Paid the shareholders a dividend in an amount that ensured an ending cash balance of $25,000.

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E2-13
Preparing financial statements from simple transactions

George began a business, and after collecting $6,000 from an equity investor and borrowing $5,000 from a bank, he purchased a piece of land for $8,000. During the year, he leased the land to Sheila and received $3,000 in cash. He paid $2,500 cash for expenses during the year and paid an $800 dividend to the equity investor.

Prepare an income statement, a statement of shareholders' equity, a balance sheet, and statement of cash flows for the period. What did George do that may have concerned the bank? Explain.

E2-14
Preparing financial statements from simple transactions

Mary began a business, and after collecting $30,000 from an equity investor and borrowing $15,000 from a bank, she purchased a piece of land for $40,000. During the year, she leased the land to Karl and received $12,000 in cash, paying $14,000 cash for expenses. She paid a $1,000 dividend to the equity investor at year-end.

Prepare an income statement, a statement of shareholders' equity, a balance sheet, and a statement of cash flows for the period. Evaluate Mary's decision to pay the $1,000 dividend.

PROBLEMS

P2-1
Classifying balance sheet accounts

Presented below are the main section headings of the balance sheet:

a. Current assets
b. Long-term investments
c. Property, plant, and equipment
d. Intangible assets
e. Current liabilities
f. Long-term liabilities
g. Contributed capital
h. Retained earnings

REQUIRED:
Classify the following accounts under the appropriate headings, and prepare a balance sheet in proper form without account balances.

1. Dividends payable
2. Payments received in advance
3. Allowance for uncollectible accounts
4. Inventories
5. Capital stock
6. Accumulated depreciation—building
7. Bonds payable
8. Machinery and equipment
9. Accounts receivable
10. Short-term investments
11. Buildings
12. Patents
13. Property
14. Investment fund for plant expansion
15. Wages payable
16. Cash
17. Accumulated depreciation—equipment
18. Prepaid rent
19. Trademarks
20. Land held for investment
21. Current portion due of long-term debt
22. Accounts payable
23. Short-term notes payable

P2-2
Classifying income statement accounts

The main section headings of the income statement are:

a. Sales
b. Fees earned
c. Other revenues
d. Cost of goods sold
e. Operating expenses
f. Other expenses

REQUIRED:
Classify the following descriptions under the appropriate headings and prepare an income statement in proper form without account balances.

1. Office salary expense
2. Sales of services provided
3. Insurance expense
4. Sales of inventories
5. Salespeople commission expense
6. Depreciation expense
7. Office supplies expense
8. Loss on sale of equipment
9. Income from interest on savings account
10. Income from dividends on investments

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11. Advertising expense
12. Loss on sale of building
13. Interest expense on outstanding loans
14. Cost of sold inventories
15. Gain on sale of short-term investments

P2–3

Financial statement interrelationships

Review Figure 2–7, and complete the blanks below to show the relationships among the four financial statements for Nimmo Brothers Corporation:

Balance Sheet (12/31/2010)		Statement of Cash Flows (year ending 12/31/2011)		Balance Sheet (12/31/2011)	
Cash	$ 420	Cash—Operating	$ 275	Cash	$?
Other current assets	1,300	Cash—Investing	(200)	Other current assets	1,550
Long-term assets	1,400	Cash—Financing	330	Long-term assets	1,600
Total assets	$3,120	Δ in cash	?	Total assets	?
		Cash—12/31/10	?		
		Cash—12/31/11	?		
Current liabilities	$ 620	**Income Statement (year ending 12/31/2011)**		Current liabilities	$ 995
Long-term liabilities	1,000	Revenue	$4,200	Long-term liabilities	1,200
Contributed capital	1,000	Expenses	4,050	Contributed capital	1,200
Retained earnings	500	Net income	?	Retained earnings	?
Total	$3,120			Total	?

Statement of Shareholders' Equity (year ending 12/31/2011)

	Contributed Capital	Retained Earnings
12/31/10	$1,000	$500
Net income		?
Dividends		(70)
Stock issuance	200	?
12/31/11	?	?

P2–4

Preparing a balance sheet in proper form and comparing U.S. and non-U.S. practices

The following information is available relating to the activities of Johnson Co. as of December 31, 2011.

- Cash balance on 12/31/11 is $8,000.
- Short-term investments have a fair market value of $40,000 on 12/31/11.
- Accounts receivable balance of $125,000 on 12/31/11 includes $2,400 that is not likely to be collected.
- Inventory costing $165,000 has a replacement cost (market value) of $161,000 on 12/31/11.
- Buildings having a fair market value of $68,500 were purchased for $35,000 and have accumulated depreciation of $8,000.
- Accounts payable at year-end total $110,000.
- Taxes payable at year-end total $29,400.
- Balance in the long-term notes payable account at the end of the period is $79,100.
- Fair market value of the Johnson Co. stock is $10 per share on 12/31/11. When originally issued, 12,500 shares were sold for $8 per share.
- The total amount of net income earned by Johnson Co. since its inception several years ago is $65,000. Over that same period, Johnson Co. has paid $24,900 in dividends.

REQUIRED:

Prepare a balance sheet as of 12/31/11 in proper form for Johnson Co. Would you invest in this company? Why or why not? Reformat the balance using the balance sheet format used by Unilever, illustrated on pp. 54. Does this format highlight anything differently?

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P2–5

Balance sheet and income statement relationships across five years

Compute the missing values for the following chart and analyze the financial performance and position of this company. The first year of operations is 2005.

	2011	2010	2009	2008
Assets:				
Cash	$500	$200	$ 300	$ 300
Accounts receivable	700	?	300	200
Inventory	400	400	?	500
Land	400	400	200	100
Property, plant, and equipment (net)	800	700	600	700
Liabilities and shareholders' equity:				
Accounts payable	?	500	300	200
Bonds payable	700	800	600	500
Contributed capital	600	600	400	?
Retained earnings	600	300	800	400
Sales	?	700	1,100	1,000
Expenses	(600)	?	?	(400)
Net income	?	(100)	400	?
Dividends	200	?	?	?

REAL DATA

P2–6

Using financial statements to assess solvency and earning power

Excerpts from the financial statements for Kroger, a major supermarket retailer, are as follows (dollars in millions).

	2009	2008
Cash	$ 263	$ 242
Accounts receivable	944	786
Inventory	4,859	4,849
Property, plant, and equipment	13,161	12,498
Other assets	3,984	3,918
Accounts payable	3,822	3,867
Other short-term debts	3,807	4,816
Long-term debt	10,406	8,696
Shareholders' equity	5,176	4,914
Sales	76,000	70,235
Expenses	74,751	69,054

REQUIRED:

Organize these numbers into income statement and balance sheets, and comment on Kroger's solvency and earning power positions.

P2–7

Balance sheet value and the fair market value of the assets

Because of consistent losses in the past several years, Eat and Run, a fast-food franchise, is in danger of bankruptcy. Its most current balance sheet follows.

Assets		Liabilities and Shareholders' Equity	
Cash	$ 25,000	Accounts payable	$ 42,000
Short-term investments	15,000	Wages payable	20,000
Accounts receivable	35,000	Other short-term payables	34,000
Inventory	42,000	Long-term notes	75,000
Prepaid insurance	10,000	Mortgage payable	25,000
Property, plant, and equipment	82,000	Contributed capital	50,000
Other assets	50,000	Retained earnings	13,000
Total assets	$259,000	Total liabilities and shareholders' equity	$259,000

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Additional information:

- The fair market value of the marketable securities is $19,000.
- The sale of the accounts receivable to a local bank would produce about $25,000 cash.
- A portion of the inventory originally costing $21,000 is now obsolete and can be sold for $3,000 scrap value. The remaining inventory is worth approximately $30,000.
- Prepaid insurance is nonrefundable.
- In the event of bankruptcy, the property, plant, and equipment owned by Eat and Run would be divided up and sold separately. It has been estimated that these sales would bring approximately $100,000 cash.
- Other assets (primarily organizational costs) cannot be recovered.

REQUIRED:

a. The book value (balance sheet assets less liabilities) of Eat and Run is $63,000. Comment on why this balance sheet value may not be a good indication of the value of the company in the case of bankruptcy.

b. If Eat and Run goes bankrupt, what would you consider to be the value of the company?

c. When a company goes bankrupt, the creditors are usually paid off first with the existing assets, and then, if assets remain, the shareholders are paid. If Eat and Run goes bankrupt, would the shareholders receive anything? If so, how much?

P2-8

Analyzing financial statements

The chief executive officer of Romney Heights has included the following information from the financial statements in a loan application submitted to Acme Bank. The company intends to acquire additional equipment and wishes to finance the purchase with a long-term note.

	2011	2010
Balance Sheet		
Current assets	$ 14,000	$ 12,000
Long-term assets	50,000	43,000
Current liabilities	7,000	6,000
Long-term liabilities	26,000	21,000
Contributed capital	25,000	25,000
Retained earnings	6,000	3,000
Income Statement		
Revenues	$ 35,000	$ 32,000
Expenses	23,000	26,000
Statement of Cash Flows		
Net cash flow from operating activities	$ 15,000	$ 9,000
Net cash flow from investing activities	(14,000)	(12,000)
Net cash flow from financing activities	7,000	5,000
Change in cash balance	$ 8,000	$ 2,000
Beginning cash balance	3,000	1,000
Ending cash balance	$ 11,000	$ 3,000

REQUIRED:

Assume that you, a bank loan officer, review the financial statements and recommend whether Romney Heights should be considered for a loan. Support your recommendation with calculations.

P2-9

Analyzing financial statements

Ted Tooney has operated a small service company for several years. The following information is from the financial statements prepared by Ted's accountant.

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	2011	2010
Balance Sheet		
Current assets	$ 9,000	$ 8,000
Long-term assets	18,000	15,000
Current liabilities	7,000	4,000
Long-term liabilities	9,000	7,000
Contributed capital	9,000	9,000
Retained earnings	2,000	3,000
Income Statement		
Revenues	$92,000	$89,000
Expenses	78,000	72,000
Statement of Cash Flows		
Net cash flow from operating activities	$12,000	$15,000
Net cash flow from investing activities	(8,000)	(5,000)
Net cash flow from financing activities	(5,000)	(8,000)
Change in cash balance	$ (1,000)	$ 2,000
Beginning cash balance	5,000	3,000
Ending cash balance	$ 4,000	$ 5,000

REQUIRED:

Assume that you have some capital to invest and that Ted asked you to consider making an equity investment in his company. Review the financial statements and describe how you would respond to Ted's request. Support your recommendation with calculations.

P2–10

Debt covenants can limit investments and dividends

A summary of the December 31, 2011 balance sheet of Ellington Industries follows:

	2011
Assets	
Current assets	$12,000
Land investments	55,000
Total assets	$67,000
Liabilities and Shareholders' Equity	
Accounts payable	$ 9,000
Long-term liabilities	30,000
Shareholders' equity	28,000
Total liabilities and shareholders' equity	$67,000

On January 1, 2012, the company borrowed $40,000 (long-term debt) to purchase additional land. The debt covenant states that Ellington must maintain a current asset balance at least twice as large as its current liability balance over the period of the loan.

REQUIRED:

a. As of January 1, 2012, how much of the $40,000 can Ellington invest in land without violating the debt covenant?
b. Assume that Ellington invested the maximum allowable in land. Prepare Ellington's balance sheet as of January 1, 2012. Compute the following ratios: current assets/current liabilities and total liabilities/total assets.
c. Assume that Ellington invested the maximum allowable in land and that during 2012 it generated $150,000 in revenues (all cash), paid off the accounts payable outstanding as of December 31, 2011, and incurred $130,000 in expenses, of which $123,000 was paid

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in cash. The company neither purchased nor sold any of its long-term land investments, made no principal payments on the long-term debt, and issued no equity during 2012. Prepare a balance sheet as of the end of 2012, and compute how large a dividend the company can pay without violating the debt covenant. Compute total liabilities/total assets assuming that the company declares the maximum allowable dividend.

ISSUES FOR DISCUSSION

REAL DATA

ID2–1

Relationships among cash flows, income, and dividends

For over a year, Center Energy Corporation, a utility company in Ohio, had negative cash flow from operating activities, caused primarily by the escalating costs of one of its nuclear plants outside Cleveland. Yet the company reported positive earnings and paid a dividend to its shareholders of $2.56 per share.

REQUIRED:

a. Briefly explain how a company could have negative cash flow from operating activities, have a positive net income, and still pay dividends.
b. Could a company continue such a strategy over an extended period? Why or why not?

REAL DATA

ID2–2

Income statement classifications

In early May 2007, Walt Disney Company released its earnings for its fiscal second quarter. In the release, the company discussed its various operations, including

- Revenue from a surprising movie hit, *Wild Hogs*
- Upcoming revenue from two summer blockbuster movies, *Pirates of the Caribbean* and *Ratatouille*
- Sports programming costs at the television network ESPN
- A new licensing business model for ESPN mobile phone service
- Broadcasting revenue at its various television networks
- Merchandise sales related to its *Cars* movie release
- Softer theme park revenue

REQUIRED:

Discuss how the areas outlined above would be presented and classified on the income statement of Disney.

REAL DATA

ID2–3

Debt covenants

The following excerpt was taken from a financial report of Cummins Engine Company, a manufacturer of heavy-duty truck engines.

Loan agreements contain covenants that impose restrictions on the payment of dividends and distributions of stock, require maintenance of a 1.25:1 current ratio, and limit the amount of future borrowings. Under the most restrictive covenants, retained earnings of approximately $351 million were available for payment of dividends.

REQUIRED:

a. Briefly explain the meaning of this excerpt.
b. Why would a bank or other creditor impose such restrictions on a borrowing company?
c. Explain the role of financial accounting numbers in the restrictions described above.

REAL DATA

ID2–4

Statement of cash flow patterns across companies

The following information was taken from the 2008 annual reports—statements of cash flows—of Hewlett-Packard, Southwest Airlines, and The Boeing Co., Inc. (dollars in millions).

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Company	Cash from Operations	Cash from Investing	Cash from Financing
HP	$14,591	$(13,711)	$(2,020)
Southwest	(1.521)	(978)	1,654
Boeing	(401)	1,888	(5,202)

REQUIRED:
Each of these companies shows a different cash flow pattern. Explain what these patterns might indicate about each company.

REAL DATA
ID2-5
Statement of cash flow patterns across time

The following information was taken from the 2008 annual report—statements of cash flows—of Goodrich Corporation, a major company in the aerospace and defense industry (dollars in millions).

Year	Cash from Operations	Cash from Investing	Cash from Financing
2006	265.5	(250.6)	(90.4)
2007	593.7	(279.3)	(202.5)
2008	786.6	(410.0)	(414.4)

REQUIRED:
What does this pattern of cash flows indicate about Goodrich's business strategy, performance, and cash balances from 2006 to 2008?

REAL DATA
ID2-6
Balance sheet—non-U.S. format

The following balance sheet (prepared according to IFRS) was taken from the 2008 annual report of GlaxoSmithKline, a British pharmaceutical company (British pounds in millions).

GlaxoSmithKline
Consolidated Balance Sheet at 31st December 2008

	Notes	2008 £m	2007 £m
NON-CURRENT ASSETS			
Property, plant and equipment	17	9,678	7,821
Goodwill	18	2,101	1,370
Other intangible assets	19	5,869	4,456
Investments in associates and joint ventures	20	552	329
Other investments	21	478	517
Deferred tax assets	14	2,760	2,196
Derivative financial instruments	41	107	1
Other non-current assets	22	579	687
Total non-current assets		22,124	17,377

(*Continued*)

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GlaxoSmithKline
Consolidated Balance Sheet at 31st December 2008 (*Continued*)

	Notes	2008 £m	2007 £m
CURRENT ASSETS			
Inventories	23	4,056	3,062
Current tax recoverable	14	76	58
Trade and other receivables	24	6,265	5,495
Derivative financial instruments	41	856	475
Liquid investments	32	391	1,153
Cash and cash equivalents	25	5,623	3,379
Assets held for sale	26	2	4
Total current assets		17,269	13,626
Total assets		39,393	31,003
CURRENT LIABILITIES			
Short-term borrowings	32	(956)	(3,504)
Trade and other payables	27	(6,075)	(4,861)
Derivative financial instruments	41	(752)	(262)
Current tax payable	14	(780)	(826)
Short-term provisions	29	(1,454)	(892)
Total current liabilities		(10,017)	(10,345)
NON-CURRENT LIABILITIES			
Long-term borrowings	32	(15,231)	(7,067)
Deferred tax liabilities	14	(714)	(887)
Pensions and other post-employment benefits	28	(3,039)	(1,383)
Other provisions	29	(1,645)	(1,035)
Derivative financial instruments	41	(2)	(8)
Other non-current liabilities	30	(427)	(368)
Total non-current liabilities		(21,058)	(10,748)
Total liabilities		(31,075)	(21,093)
Net assets		8,318	9,910
EQUITY			
Share capital	33	1,415	1,503
Share premium account	33	1,326	1,266
Retained earnings	34	4,622	6,475
Other reserves	34	568	359
Shareholders' equity		7,931	9,603
Minority interests	34	387	307
Total equity		8,318	9,910

Approved by the Board on 3rd March 2009

Sir Christopher Gent
Chairman

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REQUIRED:
Identify where the format of this balance sheet differs from that required under U.S. GAAP, and prepare a balance sheet as close as possible in accordance with U.S. GAAP.

REAL DATA
ID2–7
Net income vs. cash flow from operations

The *Wall Street Journal* (April 16, 2004) reports, "For as long as companies have published cash-flow statements, investors have used them to gauge the credibility of earnings. The most closely watched portion of these reports is the part called cash flow from operating activities. If a company shows strong earnings but generates little cash flow from its core operations, it could be a warning sign that the earnings are illusory. Conversely, many investors take comfort in the quality of a company's earnings if they also see robust operating cash flow."

REQUIRED:
Comment on this quote.

REAL DATA
ID2–8
How transactions affect the balance sheet and statement of cash flows

In late 2009 General Electric, Vivendi SA, and the cable television company Comcast entered into a complicated transaction to change the ownership of the television and production company NBC Universal. Prior to the transaction, GE owned 80 percent of NBC, and Vivendi owned a minority share of 20 percent. GE bought the 20 percent of NBC owned by Vivendi (giving GE the entire company), and then sold 51 percent of NBC to Comcast. Both purchases were paid for with cash.

REQUIRED:
Explain why GE and Comcast would enter into such a transaction, and describe how these exchanges would affect the balance sheet and statement of cash flows of GE.

REAL DATA
ID2–9
Should the SEC have dropped the requirement to reconcile IFRS with U.S. GAAP?

Up until 2007 non-U.S. firms that published IFRS-based financial statements and wished to raise capital on the U.S. stock markets (e.g., New York Stock Exchange) were required to file with the SEC a Form 20-F that included reconciliations of both net income and shareholder's equity as measured under U.S. GAAP and IFRS. The reconciliations provided detailed explanation of the different ways in which net income and shareholders' equity were measured under the two systems.

REQUIRED:
Assume that you are an analyst attempting to compare the financial condition and performance of NIKE, which publishes U.S. GAAP–based financial statements, and adidas, which publishes IFRS-based financial statements. Would you be pleased with the SEC's decision to drop the reconciliation requirement? Explain.

REAL DATA
ID2–10
The SEC Form 10-K of NIKE

Excerpts taken from the SEC Form 10-K of NIKE are reproduced in Appendix C.

REQUIRED:
Review the NIKE Form 10-K, and answer the following questions.

a. Compute cost of sales, selling, general & administrative expenses, interest costs, and taxes as a percent of revenues for 2009, 2008, and 2007, and explain how NIKE's net income has changed over the three-year period.
b. Compute current and noncurrent assets as a percent of total assets, and explain how NIKE's asset structure changed from 2008 to 2009.
c. Compute current and long-term liabilities as a percent of total assets, and explain how NIKE's reliance on liabilities as a source of financing changed from 2008 to 2009.
d. Review the statement of cash flows, and comment on whether NIKE is growing and which financing sources have financed this growth.
e. Approximately what portion of NIKE's net income is paid to the shareholders in the form of dividends each year? Are there other methods that NIKE uses to return cash to shareholders?