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STUDENT WORKBOOK

FINANCIAL

TOOLS FOR BUSINESS DECISION MAKING

ACCOUNTING

Fourth Edition

STUDENT WORKBOOK

to accompany

FINANCIAL ACCOUNTING

Tools for Business Decision Making

4th Edition

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ISBN-13 978-0-471-75081-9

ISBN-10 0-471-75081-6

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

Printed and bound by Courier Kendallville, Inc.

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Specimen Financial Statements: The Coca-Cola Company

Specimen Financial Statements: PepsiCo, Inc.

CHAPTER 1

Introduction to Financial Statements

CHAPTER OVERVIEW

Chapter 1 introduces you to a variety of financial accounting topics. You will learn about the primary forms of business organization and the three principal types of business activity. You will also learn about users of accounting information and how that information is delivered. Finally, you will learn about the basic financial statements and their components as well as items that supplement the financial statements in an annual report.

REVIEW OF SPECIFIC STUDY OBJECTIVES

SO1. Describe the primary forms of business organization.

- ▲ A **sole proprietorship** is a business owned by one person. It is simple to set up, and the owner has control over the business. Because they are so simple to organize, there are many thousands of sole proprietorships operating in the business world.
- ▲ A **partnership** is a business owned by two or more persons associated as partners. It provides strength in numbers: each partner may bring economic resources or unique talents or skills to the combination.

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- ▲ A **corporation** is a separate legal entity owned by stockholders. Advantages include the fact that shares of stock are easy to sell and that the raising of funds is easy. While there are many more sole proprietorships and partnerships than there are corporations, corporations produce far more revenue.

SO2. Identify the users and uses of accounting.

- ▲ The **purpose of financial information** is to provide inputs for decision making. **Accounting is the information system that identifies, records, and communicates the economic events of an organization to interested users.**
- ▲ **Internal users** are people who work for the business, managers who plan, organize, and run a business. Accounting information helps to answer questions such as, "Does the business have enough resources to build a new manufacturing plant?" Internal reports help to provide the required information.
- ▲ **External users** work outside of the business and include investors who use accounting information for their stock decisions; creditors who evaluate the risk of lending to and the credit-worthiness of business borrowers; taxing authorities, which review compliance with tax laws; regulatory agencies, which review compliance with prescribed rules; customers; labor unions; and economic planners.
- ▲ It is **critical that users trust accounting reports and financial statements**. Concerned about the financial scandals and afraid that users would lose confidence in corporate accounting, United States regulators and lawmakers in 2002 passed the Sarbanes-Oxley Act. Among the provisions of the act are: top management must certify the accuracy of financial information; penalties for fraudulent financial activity are very severe; outside auditors must be more independent; and boards of directors have increased responsibility in their oversight roles.

SO3. Explain the three principal types of business activity.

- ▲ There are **three types of business activity** which the accounting information system tracks: financing, investing, and operating.
- ▲ **Financing activities** deal with the ways a business raises funds for operations. The **two primary sources of outside funds** are borrowing money and selling shares of stock.
- ▲ A business may **borrow money** by taking out a loan at a bank, issuing debt securities, or purchasing goods on credit. A **creditor** is a person or entity to which a business owes money, and a **liability** is a debt or other obligation that represents creditors' claims on the business. Examples of liabilities are notes payable, resulting from direct borrowing or purchasing on credit and bonds payable, sold to investors and usually due several years in the future. A creditor has a legal right to be paid at an agreed-upon time and must be paid before an owner (stockholder) is paid.

- ▲ A corporation may also **sell shares of stock** to investors. Common stock is the term which describes the total amount paid into the corporation by stockholders for the shares of stock purchased. A stockholder is an owner of the business and receives payments in the form of dividends. (Please note that there are companies which do not pay dividends to stockholders). As noted above, stockholder claims are secondary to creditor claims.
- ▲ **Investing activities** deal with what a corporation does with the financing it receives. Certainly a new business must purchase assets with which to operate. An **asset** is a resource owned by a business. Examples of assets are property, plant, and equipment, such as buildings and trucks. Cash is one of the most important assets owned by a company, and if it has excess cash, it might invest it in debt or equity securities. Such investments are another example of an investing activity.
- ▲ **Operating activities** are just that: operations of the business. Different businesses have different operations, of course. A paper company produces and sells paper while a dairy company produces and sells milk. When a company operates, it earns revenues. **Revenues** are the increase in assets arising from the sale of a product or service. While the purchase of a long-lived asset is an investing activity, operating activities give rise to assets with shorter lives, such as accounts receivable (a customer's promise to pay in the future) and inventory (goods available for future sale). When a company operates, it also incurs costs or expenses. **Expenses** are the cost of assets consumed or services used in the process of generating revenues. Examples of expenses are cost of goods sold, selling expenses, marketing expenses, administrative expenses, and interest expense. Liabilities may arise from these expenses. Examples are accounts payable, interest payable, wages payable, sales taxes payable, property taxes payable, and income taxes payable. If revenues exceed expenses (hopefully!), then a business earns net income. If expenses exceed revenues, then a business incurs a net loss.

SO4. Describe the content and purpose of each of the financial statements.

SO5. Explain the meaning of assets, liabilities, and stockholders' equity, and state the basic accounting equation.

- ▲ Various users desire information to help them make decisions, and this financial **information is provided in the form of financial statements**, which form the backbone of financial accounting. There are four financial statements: the income statement, the statement of retained earnings, the balance sheet, and the statement of cash flows.
- ▲ The **income statement** reports the success or failure of the company's operations during the period. Only **revenues and expenses** appear on the income statement, along with their difference, either net income (revenues exceed expenses) or net loss (expenses exceed revenues). Beginning students often want to put the account "Cash" on the income statement, but this is incorrect because cash is an asset (a resource owned by a business). So remember: only revenues and expenses appear on the income statement.

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▲ The **statement of retained earnings** shows the amounts and causes of changes in the retained earnings balance during the period. To beginning retained earnings is added net income (or, if there is a net loss, that amount is deducted), and then dividends are deducted. (Remember that a business will have either net income or a net loss; it can't have both at the same time.) Users of financial statements can find out about management's dividend policy by analyzing this statement. To summarize, the Retained Earnings account is the total of all the net income that the company has earned, all the net losses it has incurred, and all the dividends it has declared. The statement of retained earnings documents this activity.

▲ The **balance sheet** reports assets and claims to those assets at a specific point in time. There are **two types of claims**: claims of creditors (liabilities) and claims of owners (stockholders' equity). The balance sheet is an expanded expression of the **basic accounting equation** which is:

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

Please note that this is a mathematical equation and must be in balance at all times. It can be used to answer questions such as: if assets total \$100 and liabilities total \$20, then what is the total of stockholders' equity? (Answer: \$80 because \$20 plus something must equal \$100, and the something must be \$80.)

Stockholders' equity consists of **two parts**: common stock and retained earnings.

▲ The **statement of cash flows** provides financial information about the cash receipts and cash payments of a business for a specific period of time. Here a user will find information about the financing, investing, and operating activities of the business.

▲ Note the **interrelationships between statements**:

1. Net income or net loss from the income statement appears on the statement of retained earnings.
2. The ending balance of retained earnings is the same number reported on the balance sheet for retained earnings.
3. The ending balance of cash must be the same both on the balance sheet and on the statement of cash flows.

▲ Companies usually present **comparative statements**, which are statements reporting information for more than one period.

▲ Please be aware of the following when you **prepare financial statements**:

1. All statements **must have a heading**. The company name appears on the first line, the name of the document appears on the second line, and the date appears on the third line. With respect to **dates**, the **balance sheet date** is for one point in time (June 30, 2007, or December 31, 2007), while the **date on the income statement, the statement of retained earnings, and the statement of cash flows** is for a period of time ("For the month ended June 30, 2007" or "For the year ended December 31, 2007").

2. The number at the top of a column should have a dollar sign: this indicates that it is the first number in that column. The final number on a statement, such as Net Income or Total Assets, should have a dollar sign and be double-underlined. This indicates that it is the "answer." If there is a negative number, such as Net Loss, then it should be presented in parentheses or brackets. These are part of a type of shorthand used by preparers of statements and understood by users of statements.

SO6. Describe the components that supplement the financial statements in an annual report.

- ▲ Companies provide their shareholders with an **annual report**, which includes the financial statements, a management discussion and analysis section, notes to the financial statements, and an independent auditor's report.
- ▲ The **management discussion and analysis (MD&A) section** covers three financial aspects of a company: its ability to pay near-term obligations, its ability to fund operations and expansion, and its results of operations.
- ▲ The **notes to the financial statements** provide additional details about the items presented in the main body of the statements. Examples of notes are one explaining which methods a company uses for its inventory and one explaining the progress of a lawsuit against the company.
- ▲ The **independent auditor's report** is prepared by an auditor, a professional who conducts an independent examination of a company's accounting data. Please note that only a certified public accountant (CPA) may conduct an audit. The **most desirable opinion** is the unqualified opinion which states that the financial statements are in accordance with generally accepted accounting principles.

CHAPTER SELF-TEST

As you work the exercises and problems, remember to use the **Decision Toolkit** discussed and used in the text:

1. Decision Checkpoints: at this point you ask a question.
2. Info Needed for Decision: you make a choice regarding the information needed to answer the question.
3. Tool to Use for Decision: at this point you review just what the information chosen in step 2 does for the decision-making process.
4. How to Evaluate Results: you perform evaluation of information for answering the question.

Note: The notation (SO1) means that the question was drawn from study objective number one.

Completion

Please write in the word or words that will complete the sentence.

1. (SO1) A _____ is a separate legal entity owned by stockholders.
2. (SO1) A business owned by two or more associated persons is a _____.
3. (SO2) A manager who plans, organizes, and runs a business is an example of an _____ user.
4. (SO2) A customer is an example of an _____ user.
5. (SO3) An example of a(n) _____ activity is a corporation's sale of stock to investors.
6. (SO4) The purpose of the _____ is to report the success or failure of the company's operations during the period.
7. (SO4) The _____ statement includes an addition of net income and a deduction of dividends.
8. (SO5) Claims of creditors on the assets of the business are called _____; claims of owners are called _____.
9. (SO5) If liabilities total \$6,000 and stockholders' equity totals \$10,000, then assets must total _____.
10. (SO6) Only a certified public accountant (CPA) may perform an _____ of a company's financial statements.

Multiple Choice

Please circle the correct answer.

1. (SO1) Which of the following statements is correct?
 - a. A sole proprietor has no personal liability for debts of his business.
 - b. There are far more corporations than there are sole proprietorships and partnerships.
 - c. Revenue produced by corporations is much greater than that produced by proprietorships and partnerships.
 - d. It is very difficult for a corporation to raise capital.
2. (SO2) Which of the following is an example of an external user of accounting information?
 - a. Marketing manager of the business
 - b. President of the labor union
 - c. Officer of the corporation
 - d. Production supervisor of the business
3. (SO3) Which of the following is an investing activity?
 - a. Borrowing money from a bank
 - b. Earning revenue from the sale of products
 - c. Incurring salaries expense
 - d. The purchase of a delivery truck
4. (SO3) A business's earning of revenues is considered to be a(n):
 - a. operating activity.
 - b. investing activity.
 - c. financing activity.
 - d. balance sheet activity.
5. (SO3) Borrowing money from a bank is considered to be a(n):
 - a. operating activity.
 - b. investing activity.
 - c. financing activity.
 - d. balance sheet activity.
6. (SO4) Which of the following accounts will be found on an income statement?
 - a. Revenues, expenses, and dividends
 - b. Revenues and expenses
 - c. Revenues, expenses, and cash
 - d. Expenses, dividends, and cash
7. (SO4) Which of the following accounts will be found on a balance sheet?
 - a. Accounts payable, cash, inventory
 - b. Cash, sales revenue, accounts receivable
 - c. Cost of goods sold, notes payable, common stock
 - d. Cash, wages payable, advertising expense

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8. (SO4) If revenues are \$20,000 and expenses are \$5,000, then the business:
 - a. incurred a net loss of \$25,000.
 - b. earned net income of \$20,000.
 - c. earned net income of \$15,000.
 - d. incurred a net loss of \$15,000.
9. (SO4) If revenues are \$18,000 and expenses are \$22,000, then the business:
 - a. incurred a net loss of \$4,000.
 - b. incurred a net loss of \$40,000.
 - c. earned net income of \$4,000.
 - d. earned net income of \$18,000.
10. (SO4) If beginning retained earnings is \$10,000, net loss is \$3,000, and dividends are \$1,000, then the ending retained earnings shown on the statement of retained earnings is:
 - a. \$14,000.
 - b. \$12,000.
 - c. \$ 8,000.
 - d. \$ 6,000.
11. (SO4) If beginning retained earnings is \$15,000, net income is \$6,000, and ending retained earnings is \$20,000, how much did the company distribute in dividends?
 - a. \$6,000
 - b. \$5,000
 - c. \$4,000
 - d. \$1,000
12. (SO5) Which of the following is an appropriate date for a balance sheet?
 - a. December 31, 2005
 - b. For the month ending December 31, 2005
 - c. For the quarter ending December 31, 2005
 - d. For the year ending December 31, 2005
13. (SO5) Which of the following is the correct expression of the basic accounting equation?
 - a. $\text{Liabilities} = \text{Assets} + \text{Stockholders' Equity}$
 - b. $\text{Stockholders' Equity} = \text{Assets} + \text{Liabilities}$
 - c. $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$
 - d. $\text{Assets} = \text{Liabilities} - \text{Stockholders' Equity}$
14. (SO5) Which of the following is another correct expression of the basic accounting equation?
 - a. $\text{Assets} - \text{Liabilities} = \text{Stockholders' Equity}$
 - b. $\text{Assets} + \text{Liabilities} = \text{Stockholders' Equity}$
 - c. $\text{Assets} = \text{Liabilities} - \text{Stockholders' Equity}$
 - d. $\text{Liabilities} = \text{Assets} + \text{Stockholders' Equity}$

15. (SO5) Assets total \$14,000, stockholders' equity totals \$9,000, and revenues total \$6,000. What is the dollar amount of liabilities?
- a. \$23,000
 - b. \$17,000
 - c. \$11,000
 - d. \$ 5,000
16. (SO5) Expenses total \$6,000, assets total \$15,000, and liabilities total \$4,000. What is the dollar amount of stockholders' equity?
- a. \$19,000
 - b. \$11,000
 - c. \$ 9,000
 - d. \$ 5,000
17. (SO5) The statement which shows the operating, investing, and financing activities of a business is the:
- a. statement of retained earnings.
 - b. statement of cash flows.
 - c. income statement.
 - d. balance sheet.
18. (SO6) In which section of the annual report does management highlight favorable or unfavorable trends and identify significant events and uncertainties affecting its ability to pay near-term obligations, ability to fund operations and expansion, and results of operations?
- a. Financial statements
 - b. Management discussion and analysis
 - c. Notes to the financial statements
 - d. Auditor's report
19. (SO6) Which of the following provides additional details about the items presented in the main body of the financial statements?
- a. Management discussion and analysis
 - b. Auditor's report
 - c. Notes to the financial statements
 - d. None of the above is correct.
20. (SO6) Which of the following gives the results of the independent examination of the company's financial data?
- a. Financial statements
 - b. Management discussion and analysis
 - c. Notes to the financial statements
 - d. Auditor's report

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Problems

1. From the appropriate accounts given below, please prepare a balance sheet for Jerome Corporation on September 30, 2007 (SO5):

Accumulated Depreciation	\$ 3,000
Common Stock	17,000
Service Revenue	20,000
Note Payable	5,000
Salaries Expense	10,000
Accounts Receivable	7,000
Dividends	2,000
Unearned Revenue	3,000
Retained Earnings	24,000
Supplies	2,000
Insurance Expense	1,500
Prepaid Insurance	3,000
Utilities Expense	4,000
Office Equipment	17,000
Accounts Payable	1,000
Cash	24,000

Jerome Corporation
Balance Sheet
September 30, 2007

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2. Please refer to PepsiCo's annual report at the end of this workbook for information for answering the following questions. Don't forget to use the Decision Toolkit approach for help in the problem-solving.
 - a. What is the total dollar amount of the company's assets on December 25, 2004? What are the two biggest asset classes and their dollar amount on that same date? (SO5)
 - b. Which class of liabilities has the largest total dollar amount on December 25, 2004? (SO5)
 - c. Was the company profitable in 2004? What has been the trend in company income over the three years shown? (SO4)
 - d. What was the company's biggest expense in 2004? (SO4)
 - e. What was the company's income tax expense in 2004? (SO4)

SOLUTIONS TO SELF-TEST**Completion**

1. corporation
2. partnership
3. internal
4. external
5. financing
6. income statement
7. retained earnings
8. liabilities; stockholders' equity
9. \$16,000
10. audit

Multiple Choice

1. c Sole proprietors are liable for debts of their businesses, there are more proprietorships and partnerships than there are corporations, and corporations easily raise capital through selling of stock and bonds.
2. b The marketing manager, corporation officer, and production supervisor all work for the business and thus are internal users.
3. d Borrowing money is a financing activity, and earning revenue and incurring expense are operating activities.
4. a Investing activities deal with the purchase of assets, and financing activities deal with the borrowing of money and selling of stock.
5. c Operating activities deal with the operations of the business, while investing activities deal with what a company does with the financing it receives. "Balance sheet activity" is not one of the three types of business activities.
6. b Dividends appear on the retained earnings statement, and cash is an asset on the balance sheet.
7. a Sales revenue, cost of goods sold, and advertising expense are income statement items.
8. c $\$20,000 - \$5,000$
9. a $\$18,000 - \$22,000 = (\$4,000)$
10. d $\$10,000 - \$3,000 - \$1,000$
11. d Retained earnings and net income are added together to arrive at \$21,000. Since ending retained earnings is \$20,000, dividends must have been \$1,000 ($\$21,000 - \$20,000 = \$1,000$).