PART 1

1

1A. External Financial Reporting Decisions

Module

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MODULE 1

(Optional) Background: Accounting Cycle

Part 1
Unit 1

This section is designed to provide an overview of the accounting cycle and provide a refresher on fundamental concepts. Although specific questions related to the accounting cycle may not be seen on the exam, the concepts here are foundational to accounting and are assumed to be known and understood by exam candidates.

1 Accounting Cycle

The primary objective of the accounting cycle is to capture the economic activity of a business. The accounting cycle can be broken down into the following steps:

1. Journalize transactions.
2. Post transaction to the general ledger.
3. Prepare an unadjusted trial balance.
4. Record adjusting entries.
5. Prepare an adjusted trial balance.
6. Prepare the financial statements.
7. Prepare closing entries.
8. Prepare the post-closing trial balance.

Each economic transaction captured by the accounting system has an effect on the accounting equation. The accounting equation can be expressed as follows:

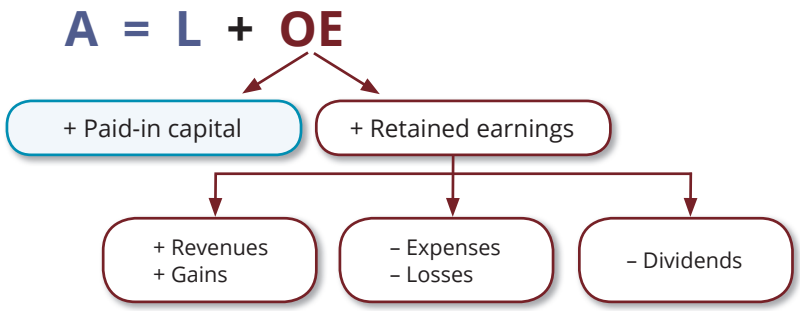
Assets = Liabilities + Owners' equity (or Stockholders' equity)

This equation and any transaction captured by the accounting system demonstrates the equality of total economic resources (assets) and the claims against those resources (liabilities and ownership).

Properly recorded journal entries maintain equilibrium in the accounting equation.

The equity portion of the accounting equation is further broken down to demonstrate the relationship of an owner's equity to the income statement. Contributed capital and retained earnings are the two primary categories of equity. Contributed capital represents investments made by owners to the business. Retained earnings represent the utilization of assets in the creation of wealth for owners and the ability to create returns/profits to owners. These retained earnings may be reinvested back into the company or made available to pay out to shareholders as a return through dividends.

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Every transaction of a business should be analyzed to determine the effect on the accounting equation. In any transaction, a minimum of two accounts will be affected. When analyzing the effects of each transaction, follow the steps indicated below:

1. Identify which accounts are involved in the transaction (remember there will be at least two).
2. Determine if the accounts are increasing or decreasing.
3. Ensure the accounting equation balances after the transaction is analyzed.

Illustration 1 Transaction Effects on Financial Statement Elements

For each of the following transactions, indicate the impact on the financial statements and ensure the accounting equation balances.

1. February 1: The corporation issued an additional 10,000 shares of capital stock to Harris Corp. in exchange for $15,000 cash.
2. February 1: Purchased a building from Sweeney Enterprise for $150,000. A cash payment of $25,000 was made at the time of the purchase, and a note payable was issued for the remaining balance.
3. February 1: Paid $7,800 for fire insurance on building for next 3 years.
4. February 9: Purchased additional supplies on account for $3,500.
5. February 11: Billed students $35,840 for tutoring services provided during the first half of February.
6. February 16: Paid $12,300 in salaries earned by employees during the first half of February.
7. February 18: Received $10,500 cash in advance from students for tutoring services to be provided in the future.
8. February 22: Collected cash from accounts receivable of $40,000.
9. February 25: Paid $3,330 for utilities during period.
10. February 25: Paid $6,250 cash on accounts payable.
11. February 28: Declared and paid a $2,000 dividend.

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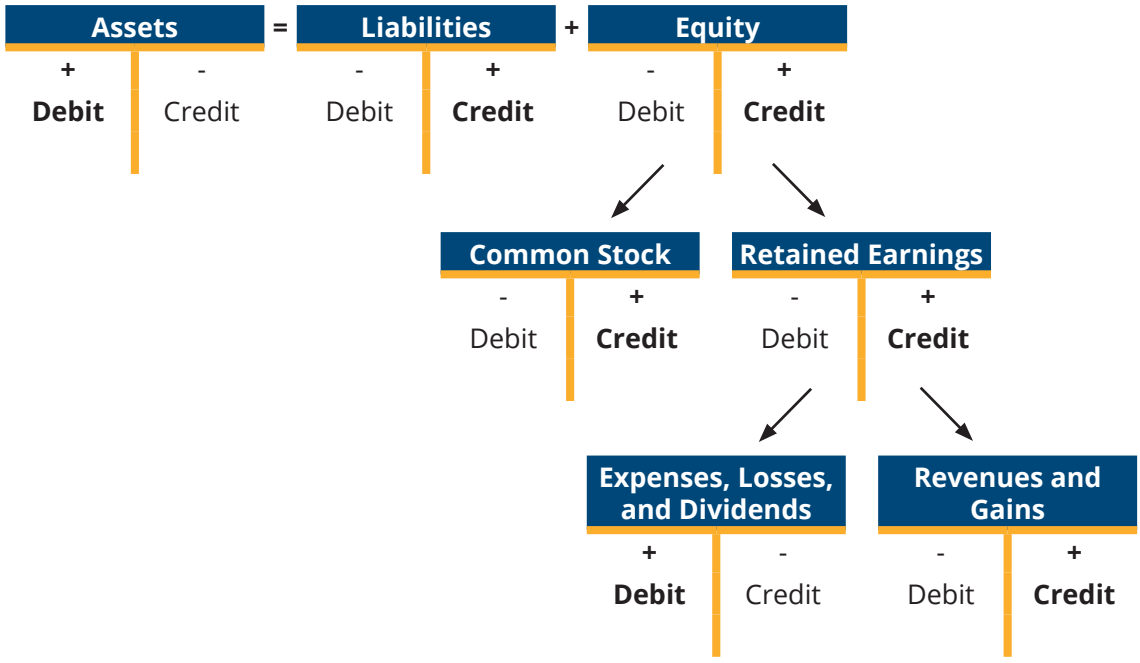
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	Balance Sheet			*Statement of Stockholders' Equity*	*Income Statement*		
	Assets =	**Liabilities +**	**Stockholders' Equity**	**Dividends**	**Revenues**	**– Expenses**	**= Net Income**
February 1	+15,000		+15,000				
February 1	+125,000	+125,000					
February 1	Net effect $0						
February 19	+3,500	+3,500					
February 11	+35,840		+35,840		+35,840		+35,840
February 16	(12,300)		(12,300)			+12,300	(12,300)
February 18	+10,500	+10,500					
February 22	Net effect $0						
February 25	(3,330)		(3,330)			+3,330	(3,330)
February 25	(6,250)	(6,250)					
February 28	(2,000)		(2,000)	+2,000			

1.1 Journal Entries

Accountants record transactions using the double-entry accounting system using debits (on the left) and credits (on the right). A T-account is used to graphically represent each account used in the general ledger. The side an account increases on (shown in bold, below) is considered the normal balance.



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Illustration 2 Journal Entries

Required: For each of the following transactions, record the journal entry.

1. February 1: The corporation issued an additional 10,000 shares of capital stock to Harris Corp. in exchange for $15,000 cash.
2. February 1: Purchased a building from Sweeney Enterprise for $150,000. A cash payment of $25,000 was made at the time of the purchase, and a note payable was issued for the remaining balance.
3. February 1: Paid $7,800 for fire insurance on building for next 3 years.
4. February 9: Purchased additional supplies on account for $3,500.
5. February 11: Billed students $35,840 for tutoring services provided during the first half of February.
6. February 16: Paid $12,300 in salaries earned by employees during the first half of February.
7. February 18: Received $10,500 cash in advance from students for tutoring services to be provided in the future.
8. February 22: Collected cash from accounts receivable of $40,000.
9. February 25: Paid $3,330 for utilities during period.
10. February 25: Paid $6,250 cash on accounts payable.
11. February 28: Declared and paid a $2,000 dividend.

February 1 journal entry: Assets (cash) and equity (common stock) increased by $15,000.

DR	Cash	$15,000	
CR	Common stock		$15,000

February 1 journal entry: Assets (building and cash) and liabilities (note payable) increased by $125,000.

DR	Building	$150,000	
CR	Cash		$25,000
CR	Note payable		125,000

February 1 journal entry: Assets increased (prepaid insurance) and decreased (cash) by $7,800.

DR	Prepaid insurance	$7,800	
CR	Cash		$7,800

February 9 journal entry: Assets increased (supplies) and liabilities decreased (accounts payable) by $3,500.

DR	Supplies	$3,500	
CR	Accounts payable		$3,500

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February 11 journal entry: Assets (accounts receivable) and revenues (sales revenue) increased as a result of the credit sale. The increase in revenue increases net income and eventually increases retained earnings.

DR	Accounts receivable	$35,840	
CR	Sales revenue		$35,840

February 16 journal entry: Assets (cash) decreased and expenses (wage expense) increased as a result of wages paid to employees. The increase in expenses decreases net income and eventually decreases retained earnings.

DR	Wage expense	$12,300	
CR	Cash		$12,300

February 18 journal entry: Assets (cash) and liabilities (unearned revenue) increased as a result of the advanced cash payment for tutoring services to be provided in the future by the company.

DR	Cash	$10,500	
CR	Unearned revenue		$10,500

February 22 journal entry: Assets (cash) increased and decreased (accounts receivable) by $40,000.

DR	Cash	$40,000	
CR	Accounts receivable		$40,000

February 25 journal entry: Assets (cash) decreased and expenses (utilities) increased as a result of the utilities payment. The increase in expenses decreases net income and eventually decreases retained earnings.

DR	Utilities expense	$3,330	
CR	Cash		$3,330

February 25 journal entry: Assets (cash) decreased and liabilities (accounts payable) decreased by $6,250.

DR	Accounts payable	$6,250	
CR	Cash		$6,250

February 28 journal entry: Assets (cash) decreased and dividends increased as a result of the dividend payment. The increase in dividends decreases retained earnings at the end of the period.

DR	Dividends	$2,000	
CR	Cash		$2,000

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1.2 General Ledger

Each transaction journalized requires an update to the general ledger. The general ledger shows the debits and credits recorded for each account and shows the account balance at any point in time.

Illustration 3 Posting to the General Ledger

For each of the following transactions, post the activity recorded in the journal (in the previous illustration) into the ledger.

1. February 1: The corporation issued an additional 10,000 shares of capital stock to Harris Corp. in exchange for $15,000 cash.
2. February 1: Purchased a building from Sweeney Enterprise for $150,000. A cash payment of $25,000 was made at the time of the purchase, and a note payable was issued for the remaining balance.
3. February 1: Paid $7,800 for fire insurance on building for next 3 years.
4. February 9: Purchased additional supplies on account for $3,500.
5. February 11: Billed students $35,840 for tutoring services provided during the first half of February.
6. February 16: Paid $12,300 in salaries earned by employees during the first half of February.
7. February 18: Received $10,500 cash in advance from students for tutoring services to be provided in the future.
8. February 22: Collected cash from accounts receivable of $40,000.
9. February 25: Paid $3,330 for utilities during period.
10. February 25: Paid $6,250 cash on accounts payable.
11. February 28: Declared and paid a $2,000 dividend.

Assets

Cash

Date	Debit	Credit
Beg. Bal.	$32,000	
Feb. 1	15,000	
Feb. 1		$25,000
Feb. 1		7,800
Feb. 16		12,300
Feb. 18	10,500	
Feb. 22	40,000	
Feb. 25		3,330
Feb. 28		6,250
Feb. 28		2,000
End. Bal.	**$40,820**	

Liabilities

Accounts Payable

Date	Debit	Credit
Beg. Bal.		$4,200
Feb. 9		3,500
Feb. 25	$6,250	
End. Bal.		**$1,450**

Unearned Revenue

Date	Debit	Credit
Beg. Bal.		$ 0
Feb. 18		10,500
End. Bal.		**$10,500**

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Assets

Accounts Receivable

Date	Debit	Credit
Beg. Bal.	$11,000	
Feb. 11	35,840	
Feb. 22		$40,000
End. Bal.	**$ 6,840**	

Supplies

Date	Debit	Credit
Beg. Bal.	$5,600	
Feb. 9	3,500	
End. Bal.	**$9,100**	

Prepaid Insurance

Date	Debit	Credit
Beg. Bal.	$ 0	
Feb. 1	7,800	
End. Bal.	**$7,800**	

Land

Date	Debit	Credit
Beg. Bal.	$68,000	
End. Bal.	**$68,000**	

Building

Date	Debit	Credit
Beg. Bal.	$ 0	
Feb. 1	150,000	
End. Bal.	**$150,000**	

Liabilities

Notes Payable

Date	Debit	Credit
Beg. Bal.		$ 0
Feb. 1		125,000
End. Bal.		**$125,000**

Equity

Common Stock

Date	Debit	Credit
Beg. Bal.		$ 85,000
Feb. 1		15,000
End. Bal.		**$100,000**

Retained Earnings

Date	Debit	Credit
Beg. Bal.		$27,400
End. Bal.		**$27,400**

Dividends

Date	Debit	Credit
Feb. 28	$2,000	
End. Bal.	**$2,000**	

Expenses

Wage Expense

Date	Debit	Credit
Feb. 16	$12,300	
End. Bal.	**$12,300**	

Utility Expense

Date	Debit	Credit
Feb. 25	$3,330	
End. Bal.	**$3,330**	

Revenue

Revenue

Date	Debit	Credit
Feb. 11		$35,840
End. Bal.		**$35,840**

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1.3 Unadjusted Trial Balance

The unadjusted trial balance reflects the balances in each financial statement account at a point in time. This trial balance is prepared at the end of the period, prior to any adjusting entries necessary to ensure total debits posted equal total credits posted and serve as a basis for determining any adjusting entries needed.

Illustration 4 Unadjusted Trial Balance

The unadjusted trial balance below reflects activity journalized and posted during the month of February.

Harris Enterprise
Unadjusted Trial Balance
At February 28, Year 2

Account	Debit	Credit
Cash	$ 40,820	
Accts. receivable	6,840	
Supplies	9,100	
Prepaid insurance	7,800	
Land	68,000	
Building	150,000	
Accounts payable		$ 1,450
Unearned revenue		10,500
Notes payable		125,000
Common stock		100,000
Retained earnings		27,400
Dividends	2,000	
Tutoring service revenue		35,840
Wage expense	12,300	
Utility expense	3,330	
Total	**$300,190**	**$300,190**

Note that total debits equal total credits.

1.4 Adjusting Entries

Adjusting journal entries are necessary under accrual accounting to ensure all revenues earned during the period and expenses incurred are captured so that the correct balances are reflected on the balance sheet and income statement. Accrual-based accounting does not delay the recognition of revenues and expenses until cash is collected or cash is paid. The matching principle requires companies to record expenses when incurred to match them properly against the associated revenues. Because accrual accounting is based on the timing of revenue and expense recognition and not when cash is received or paid, adjusting entries are necessary at the end of each accounting period in order to ensure all revenues earned and expenses incurred are captured in the accounting system.

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There are three broad categories of adjusting journal entries: prepayments/deferrals, accruals, and estimates.

1.4.1 Prepayments/Deferrals

Prepayments, also referred to as deferrals, are transactions in which cash flows precede the revenue or expense recognition. Examples of prepayments/deferrals include:

- **Prepaid/Deferred Expense:** Represents assets associated with a cash distribution resulting in benefits to be received or to be used beyond the current reporting period. Common examples would include prepaid rent, prepaid insurance, and office supplies. As prepaid expenses (which are classified as assets) are used, an expense is recognized and the asset is reduced.
- **Unearned Revenue:** Represents the receipt of cash prior to the providing of a good or service to a customer. Advance collections of cash from customers result in liabilities on the part of the company because there is a required future action or event that must take place before the business earns the revenue.

Illustration 5 Initial Entries With Year-end Adjusting Entries: Rent

Assume that on November 1, Year 1, Swift Corp. prepaid four months of rent by paying $8,000.

November 1 initial journal entry:

DR	Prepaid rent	$8,000	
CR	Cash		$8,000

December 31 adjusting journal entry:

DR	Rent expense	$4,000	
CR	Prepaid rent		$4,000

November and December rent expense of $2,000 per month must be recognized and the prepaid rent account needs to reflect only two months of prepaid rent remaining.

Prepaid Rent

			Balance	
Date	**Debit**	**Credit**	**Debit**	**Credit**
Nov. 1	$8,000		$8,000	
Dec. 31		$4,000	**$4,000**	

Rent Expense

			Balance	
Date	**Debit**	**Credit**	**Debit**	**Credit**
Dec. 31	$4,000		**$4,000**	

Assume that on January 1, Year 1, Swift purchases $1,000 of supplies. A physical count of office supplies available at the end of the month showed that only $200 in supplies remain.

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January 1 initial entry:

DR	Office supplies	$1,000	
CR	Cash		$1,000

January 31 adjusting entry:

DR	Supply expense	$800	
CR	Office supplies		$800

The supplies that have been used during the period no longer have a benefit to the company (they are no longer an asset), therefore, an entry is necessary to record the expense associated with the use of the supplies and to adjust the office supplies account to reflect supplies still on hand at the end of the period.

Office Supplies

			Balance	
Date	**Debit**	**Credit**	**Debit**	**Credit**
Jan. 1	$1,000		$1,000	
Dec. 31		$800	**$ 200**	

Supply Expense

			Balance	
Date	**Debit**	**Credit**	**Debit**	**Credit**
Dec. 31	$800		**$800**	

When advance collections of cash create a liability (unearned revenue) on the part of a company, adjusting entries are necessary as services are earned.

Assume on May 1, Year 1, Swift receives $600 in prepayments from customers for three events that Swift will host for $200 per event. By the end of May, Swift has hosted two of the three events. Prepare both the initial and adjusting entries necessary.

May 1 initial journal entry:

DR	Cash	$600	
CR	Unearned revenue		$600

May 31 adjusting journal entry:

DR	Unearned revenue	$400	
CR	Service revenue		$400

Swift has earned the revenue by hosting two events and at May 31, Swift is only responsible for hosting one remaining event. Two of the three events hosted results in revenue of $400 earned; the $200 remaining balance in the liability account, unearned revenue, reflects the one remaining event.

Unearned Revenue

			Balance	
Date	**Debit**	**Credit**	**Debit**	**Credit**
May 1		$600		$600
Dec. 31	$400			**$200**

Service Expense

			Balance	
Date	**Debit**	**Credit**	**Debit**	**Credit**
Dec. 31		$400	–	

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1.4.2 Accruals

Accruals involve transactions where the cash outflow or inflow takes place in the period following the adjusting entry. The adjusting entry for accruals happens first followed by the cash inflow in future periods.

Common examples of accruals include accruals for liabilities as well as for receivables at the end of a period.

- Accrued liabilities represent liabilities recorded when an expense has been incurred, but no cash has been paid yet. Common examples of accrued liabilities would include wages payable and interest payable. For example, when employees perform work associated with wages, at the end of the accounting period, the company must accrue earned wages for unpaid work. A corresponding liability is recognized at the time of the accrual. The liability is reversed when payments occur in the following period.
- Accrued receivables involve situations when revenue has been earned and is eligible for recognition, but cash has not yet been received. For example, when investments in debt made by a company result in the periodic receipt of interest payments, any interest earned at the end of the period is accrued and a receivable representing the right to receive the interest is reflected on the balance sheet.

Illustration 6 Initial Entries With Year-end Adjusting Entries: Interest

Assume Harris Investments has earned $1,500 in interest on investments in Dawson Enterprises at December 31, Year 1. The interest payment will not be made until January 1, Year 2.

December 31 adjusting journal entry:

DR	Interest receivable	$1,500	
CR	Interest revenue		$1,500

January 1 subsequent journal entry:

DR	Cash	$1,500	
CR	Interest receivable		$1,500

The interest revenue is recognized in the period earned, regardless of the collection of cash. With revenue/receivable accruals, the adjusting entry precedes the collection of cash.

Interest Receivable

			Balance	
Date	Debit	Credit	Debit	Credit
Dec. 31	$1,500		**$1,500**	
Jan. 1		$1,500	—	

Interest Revenue

			Balance	
Date	Debit	Credit	Debit	Credit
Dec. 31		$1,500		**$1,500**

Assume employees earn wages of $35,000 per week based on a five-day work week. December 31 is a Tuesday, and payday is Friday.

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December 31 adjusting entry:

DR	Wage expense	$14,000	
CR	Wage payable		$14,000

January 3 subsequent entry:

DR	Wage expense	$21,000	
DR	Wage payable	14,000	
CR	Cash		$35,000

The wage expense incurred in December should be recognized in December regardless of cash payment in January. $35,000 / 5 days = $7,000 per day × 2 days = 14,000 expense associated with December. With expense/liability accruals, the adjusting entry precedes the payment of cash.

Wages Payable

			Balance	
Date	**Debit**	**Credit**	**Debit**	**Credit**
Dec. 31		$14,000		**$14,000**

Wage Expense

			Balance	
Date	**Debit**	**Credit**	**Debit**	**Credit**
Dec. 31	$14,000		**$14,000**	

1.4.3 Estimates

Many adjusting entries involve either prepayments or accruals; however, estimates made in the accounting process also result in adjusting entries. A common example of this is depreciation. When long-term assets are acquired, an allocation of the cost of the asset over period of benefit is used to match depreciation expense against revenues earned during the period.

Many estimates go into the calculation of the allocation process. For example, the purchase of equipment at a cost of $10,000 on January 1, with an expected useful life of four years and no salvage value would be depreciated on a straight-line basis $2,500 per year for four years ($10,000 / 4 years = $2,500 per year). Depreciation is not an attempt to reflect market value of an asset, but merely to allocate cost over the period of expected benefit, matching the expense of the asset to the revenues generated during its use.

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Illustration 7 Initial Entries With Year-end Adjusting Entries: Depreciation

Assume Jones Co. purchased a $50,000 building with a 25-year life on January 1, Year 1.

January 1 initial entry:

DR	Building	$50,000	
CR	Cash/note payable		$50,000

December 31 adjusting entry:

DR	Depreciation expense	$2,000	
CR	Accumulated depreciation—building		$2,000

The year-end adjusting entries would include $2,000 in depreciation expense for one year of benefit received out of the estimated 25-year life.

Accumulated Depreciation—Building

			Balance	
Date	**Debit**	**Credit**	**Debit**	**Credit**
Dec. 31		$2,000		**$2,000**

Depreciation Expense

			Balance	
Date	**Debit**	**Credit**	**Debit**	**Credit**
Dec. 31	$2,000		**$2,000**	

1.5 Adjusted Trial Balance

After adjusting entries are made, the general ledger is updated to reflect the adjusted balances and an adjusted trial balance is prepared. The adjusted trial balance is the starting point for the preparation of the company's financial statements, because all transactions and financial changes for the period reported have been captured by the accounting system. The format of an adjusted trial balance is identical to the initial trial balance, but the title is updated to indicate "adjusted" because new revenue and expense items may exist as well as increases/decreases to related assets and liabilities after the adjustments are made.

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Illustration 8 Adjusted Trial Balance

Based on adjusting entries, the adjusted trial balance for Harris Enterprises is shown below.

Harris Enterprises
Adjusted Trial Balance
February 28, Year 2

Account	Debit	Credit
Cash	$ 40,820	
Accts. receivable	6,840	
Supplies	1,500	
Prepaid insurance	7,583	
Land	68,000	
Building	150,000	
Accumulated depreciation		$ 625
Accounts payable		1,450
Unearned revenue		5,750
Wage payable		11,600
Interest payable		1,250
Note payable		125,000
Common stock		100,000
Retained earnings		27,400
Dividends	2,000	
Tutoring service revenue		40,590
Wage expense	23,900	
Utility expense	3,330	
Insurance expense	217	
Supply expense	7,600	
Depreciation expense	625	
Interest expense	1,250	
Total	**$313,665**	**$313,665**

Note that total debits equal total credits.

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1.6 Closing Entries and the Post-Closing Trial Balance

Once the adjusted trial balance is prepared, the financial statements can be prepared. At the end of a reporting period, all temporary accounts must be closed. Temporary accounts include all revenues, expenses, and dividends during the period. Revenues less expenses (net income) and dividends paid to shareholders during the period are then closed into the retained earnings account.

Only permanent accounts (assets, liabilities, and equity) remain after closing. Once all closing journal entries have been made, a post-closing trial balance is prepared to reflect assets, liabilities, and equity. The only permanent account that will have a change from the adjusted to post-closing trial balance is the retained earnings account.

Illustration 9 Preparing Closing Entries

Use the information from Harris Enterprises Income Statement to prepare the closing entries.

February 28 close revenue accounts to retained earnings:

DR	Tutoring service revenue	$40,590	
CR	Retained earnings		$40,590

February 28 close expense accounts to retained earnings:

DR	Retained earnings	$36,922	
CR	Wage expense		$23,900
CR	Utility expense		3,330
CR	Insurance expense		217
CR	Supply expense		7,600
CR	Depreciation expense		625
CR	Interest expense		1,250

February 28 close dividends to retained earnings:

DR	Retained earnings	$2,000	
CR	Dividends		$2,000

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(continued)

Once the closing entries are prepared, the post-closing trial balance is checked to ensure only balance sheet accounts remain:

Harris Enterprises
Post-Closing Trial Balance
February 28, Year 2

Account	Debit	Credit
Cash	$ 40,820	
Accts. receivable	6,840	
Supplies	1,500	
Prepaid insurance	7,583	
Land	68,000	
Building	150,000	
Accumulated depreciation		$ 625
Accounts payable		1,450
Unearned revenue		5,750
Wage payable		11,600
Interest payable		1,250
Note payable		125,000
Common stock		100,000
Retained earnings		29,068
Total	**$274,743**	**$274,743**

Note that total debits equal total credits.

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MODULE

2 A.1. Financial Statements: Part 1

Part 1
Unit 1

This module covers the following content from the IMA *Learning Outcome Statements*.

CMA LOS Reference: Part 1—Section A.1. Financial Statements: Part 1

The candidate should be able to:

a. identify the users of these financial statements and their needs

b. demonstrate an understanding of the purposes and uses of each statement

c. identify the major components and classifications of each statement

d. identify the limitations of each financial statement

e. identify how various financial transactions affect the elements of each of the financial statements and determine the proper classification of the transaction

f. demonstrate an understanding of the relationship among the financial statements

g. demonstrate an understanding of how a balance sheet, an income statement, a statement of changes in equity, and a statement of cash flows (indirect method) are prepared

1 Income Statement

LOS 1A1a

The purpose of the income statement is to provide information about the revenues, expenses, gains, and losses associated with the operations of the company during a specified period of time.

1.1 Uses of the Income Statement

LOS 1A1b

The income statement is useful in determining profitability and value for investment purposes, as well as creditworthiness for prospective lenders. Evaluating profitability provides insight into the utilization of company assets in the creation of wealth for shareholders. The evaluation of the income statement allows users to determine/estimate the value of the company as well as make decisions regarding the long-term solvency. The multistep income statement categorizes and lists the components of net income in order for users to determine profit (loss) from operations and from ancillary activities.

1.2 Components of the Income Statement

LOS 1A1c

LOS 1A1e

The multistep income statement consists of two categories: operating items and nonoperating items. Operating revenues and expenses are directly related to the primary revenue generating activities of the company. Nonoperating revenues, expenses, gains, and losses (interest expense, interest revenue, etc.) are associated with the company's peripheral or incidental activities and included in income from continuing operations.

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Classifying items as either operating or nonoperating allows users to differentiate between recurring earnings and nonrecurring earnings. Recurring items are likely to occur on a regular basis and have a more consistent effect on earnings. Nonrecurring items are not likely to recur and can have an irregular effect on earnings.

Income tax expense is reported separately on an income statement as a major subtotal.

Example 1 Cost Classification

Facts: Dawson Corp.'s adjusted trial balances consist of the following income statement items:

	Debit	Credit
Service revenue		$5,000,000
Interest income		150,000
Gain on the sale of investments		25,000
Cost of sales	$2,700,000	
Selling expenses	340,000	
General and administrative expenses	660,000	
Interest expense	15,000	
Research and development expense	78,000	

Required: Classify costs as operating and nonoperating. Calculate the company's operating income for the year.

Solution:

	Classification
Service revenue	Operating
Interest income	Nonoperating
Gain on the sale of investments	Nonoperating
Cost of sales	Operating
Selling expenses	Operating
General and administrative expenses	Operating
Interest expense	Nonoperating
Research and development expense	Operating

Operating Income:

Service revenue	**$5,000,000**
Cost of sales	**(2,700,000)**
Selling expenses	**(340,000)**
General and administrative expenses	**(660,000)**
Research and development expense	**(78,000)**
Operating income	**$1,222,000**

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1.3 Income Statement Presentation

LOS 1A1g

The income statement reports operating revenues and expenses separately from nonoperating revenues and expenses and other gains and losses. The multiple-step income statement presents major subtotals such as gross profit, operating income, and income before taxes. The benefit of the multiple-step income statement is enhanced user information; line items presented often provide the user with readily available data with which to calculate analytical ratios.

Maxwell Gear Corp.
Income Statement
For the Year Ended December 31, 2021

Sales revenue		$573,522
Cost of goods sold		(302,371)
Gross profit		$271,151
Operating expenses:		
Selling expense	$(47,341)	
General and administrative expense	(24,888)	
Research and development expense	(16,300)	
Total operating expenses		(88,529)
Operating income		$182,622
Other income (expense):		
Interest revenue	$ 5,500	
Gain on sale of investments	26,400	
Interest expense	(14,522)	
Total other income, net		17,378
Income before income taxes		$200,000
Income tax expense		(50,000)
Net income		$150,000

1.4 Single-Step Income Statement

In the single-step income statement, presentation of income from continuing operations and total expenses (including income tax expense) are subtracted from total revenues in a single step. The benefits of a single-step income statement are its simple design, and the various types of revenues or expenses do not appear to be more important than any other type.

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Maxwell Gear Corp.
Income Statement
For the Year Ended December 31, 2021

Revenue and gains:		
Sales revenue	$ 573,522	
Interest revenue	5,500	
Gain on sale of investments	26,400	
Total revenues and gains		$605,422
Expenses and losses:		
Cost of goods sold	$(302,371)	
Selling expense	(47,341)	
General and administrative expense	(24,888)	
Research and development expense	(16,300)	
Interest expense	(14,522)	
Total expenses and losses		(405,422)
Income before income taxes		$200,000
Income tax expense		(50,000)
Net income		$150,000

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1.5 Limitations of the Income Statement

Management has the ability to change reported income through the use of assumptions and estimates. Assumptions and estimates are utilized to account for items such as depreciation, warranty costs, and allowances for bad debts. For example, depreciation involves the allocation of cost over a period of benefit. The appropriate useful life, salvage value, and method of deprecation are determined by management based on estimates regarding the use of the asset. Estimates must be made and accounted for at the point of sale for future warranty costs associated with inventory sold. Credit sales may result in bad debts if customers do not ultimately pay. Allowances must be made by management based on an evaluation of receivables for this risk. Each of the items indicated creates uncertainties and therefore requires management to calculate an estimate. The subjective nature of items evaluated results in increased risks of manipulation of the assumptions and estimates used.

Manipulation of assumptions and estimates is sometimes referred to as income smoothing. Opposing views of the utilization of these techniques exist. Some argue that investors and creditors are better able to analyze reported income and make predictions of future performance when volatility of earnings is managed. However, many believe income smoothing leads to income manipulation, resulting in altering the financing performance and causing investors and creditors not to fully comprehend the risk of operations.

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Another limitation to the income statement is management's ability to undertake classification shifting. Classification shifting involves misclassifying operating expenses as nonoperating expenses, which results in higher reported operating income. Operating income is used by investors and creditors to evaluate the company's performance and to make predictions of future performance. Net income is not altered, but the evaluation of profits based on core operations (the quality of earnings) appears stronger than it should because of the misclassification of expenses. As such, classification shifting leads to distorted views of the profitability of the business.

Example 2 Multiple-Step Income Statement

Facts: The following adjusted trial balance contains a list of income statement accounts for the year ended December 31, Year 1.

Adjusted Trial Balance: Income Statement Accounts *Only*
For the Year Ended December 31, Year 1 *(in thousands)*

4000	Sales revenue		$380
4050	Sales returns	$ 25	
4060	Sales discounts	5	
4100	Service revenue		200
4200	Rental revenue		100
5000	Cost of goods sold	200	
5100	Cost of services sold	150	
5200	Cost of rental income	60	
5250	Salaries expense*	70	
5300	Freight out	25	
5400	Commissions	40	
5500	Advertising	15	
5600	Insurance expense	20	
5800	Depreciation expense	80	
5900	Income tax expense	100	
6000	Interest revenue		170
6200	Other revenue		130
6500	Gain on sale		50
7000	Interest expense	50	
7500	Loss on sale of assets	40	
7550	Loss on sale of investments	100	

*Salaries expense: $20 relates to salaries for sales representatives and $50 relates to salaries for officers of the company.

Note: This adjusted trial balance does not balance because the balance sheet accounts are excluded from this example.

(continued)

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(continued)

Required: Prepare a multiple-step income statement based upon the adjusted trial balance information above.

Solution:

Radon Industries Inc.
Income Statement
For the Year Ended December 31, Year 1
(in thousands)

Net sales (including goods, services, and rentals), less discounts and returns		$650
Cost of sales (including goods, services, and rentals):		(410)
Gross margin		$240
Selling expenses	$(100)	
General and administrative expenses	(70)	
Depreciation expense	(80)	(250)
Income (loss) from operations		$ (10)
Other revenues and gains:		
Interest revenue	$ 170	
Gain on sale of fixed assets	50	
Other revenue	130	350
Other expenses and losses:		
Interest expense	(50)	
Loss on sale of fixed assets	(40)	(90)
Income before income tax		$250
Loss on sale of available-for-sale securities		(100)
Income before income tax		$150
Income tax expense		(100)
Net income (or "income from continuing operations")*		$ 50

*"Income from continuing operations" would be used if the income statement includes "discontinued operations."

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LOS 1A1b
LOS 1A1c

2 Statement of Changes in Equity

Stockholders' equity (also called shareholders' equity or owners' equity) is the owners' claim to the net assets (i.e., assets minus liabilities) of a corporation. Stockholders' equity is generally presented on the statement of financial position (balance sheet) as the last major section, following liabilities. The accounts that make up stockholders' equity are clearly classified according to source.

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The two primary sources of ownership interests are amounts invested by shareholders of the corporation (paid-in capital) and amounts earned by the corporation on behalf of the shareholders (retained earnings).

2.1 Equity Components and Classifications

Shareholders' equity consists of four main classifications: paid-in capital, retained earnings, accumulated other comprehensive income, and treasury stock.

The balance sheet reports the shareholders' equity account balances at a specific point in time. The purpose of the statement of shareholders' equity is to disclose the activity in the equity accounts from the beginning of an accounting period to the end of the account period.

The illustration below shows the shareholders' equity portion of the balance sheet.

BGSE Capital Corp.
Partial Balance Sheet—Shareholders' Equity
December 31, Year 5

Capital Stock	
Preferred stock, cumulative, $100 par value; 10,000 shares authorized, 2,000 shares issued and outstanding	$ 200,000
Common stock, $10 par value; 1,000,000 shares authorized, 100,000 shares issued, 97,000 outstanding	1,000,000
Total capital stock	1,200,000
Additional Paid-in Capital	
Paid-in capital in excess of par—preferred stock	30,000
Paid-in capital in excess of par—common stock	2,500,000
Total Paid-in Capital	$ 3,730,000
Retained earnings	16,500,000
Accumulated other comprehensive income	350,000
Treasury stock	(120,000)
Total Shareholders' Equity	$20,460,000

2.2 Capital Stock

Legal capital or capital stock is the amount of capital that must be retained by the corporation for the protection of creditors.

2.2.1 Common Stock

Common stock is the basic ownership interest in a corporation. Common shareholders bear the ultimate risk of loss and receive the ultimate benefits of success. Because common shareholders bear risk of loss, they are not guaranteed dividends or a share of assets upon dissolution of the company. Common shareholders generally control management through their right to vote. Common shareholders also have the right to share in earnings of the corporation and the right to share in assets upon liquidation after the claims of creditors and preferred shareholders are satisfied.

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2.2.2 Preferred Stock

Preferred stock is an equity security with preferences and features not associated with common stock. Preferred stock may include a preference relating to dividends, which may be cumulative or noncumulative, and participating or nonparticipating. Preferred stock may also include a preference relating to liquidation. Usually, preferred stock does not have voting rights.

2.2.3 Par Value

Generally, preferred stock is issued with a par value, but common stock may be issued with or without a par value. No-par common stock may be issued as either true no-par stock or as no-par stock with a stated value. Any excess of the actual amount received over the par or stated value of the stock is accounted for as additional paid-in capital.

2.2.4 Authorized, Issued, and Outstanding

A corporation's charter contains the amounts of each class of stock that it may legally issue, and this is called authorized capital stock. When part or all of the authorized capital stock is issued, it is called issued capital stock. Because a corporation may own issued capital stock in the form of treasury stock, the amount of issued capital stock in the hands of shareholders is called outstanding capital stock. In summary, capital stock may be:

1. authorized (in the corporate charter);
2. authorized and issued (previously issued to shareholders but no longer owned by a shareholder); or
3. authorized, issued, and outstanding (previously issued to shareholders and still outstanding in the market).

The number of shares of each class of stock and their status as authorized, issued, or outstanding must be disclosed in the financial statements and the accompanying notes to the financial statements.

2.3 Additional Paid-in Capital

Additional paid-in capital is generally contributed capital in excess of par or stated value. It can also arise from other types of transactions. Additional paid-in capital may be aggregated and shown as one amount on the balance sheet.

Example 3 Journal Entry: Stock Issuance for Cash

Facts: On January 1, Year 1, Harris Enterprises issued 1 million shares of its $10 par common stock for $25 per share.

Required: Prepare the journal entry for the issuance of shares.

Solution:

January 1 journal entry:

DR	Cash	$25,000,000	
CR	Common stock		$10,000,000
CR	Additional paid-in capital—common stock		15,000,000

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2.4 Retained Earnings

Retained earnings (or deficit) is accumulated earnings (or losses) during the life of the corporation that have not been paid out as dividends. The amount of accumulated retained earnings is reduced by distributions to stockholders and transfers to additional paid-in capital for stock dividends. Retained earnings do not include treasury stock or accumulated other comprehensive income. If the retained earnings account has a negative balance, it is called a deficit.

	Net income/loss
–	**Dividends (cash, property, and stock) declared**
±	**Prior period adjustments**
±	**Accounting changes reported retrospectively**
	Retained earnings

2.5 Accumulated Other Comprehensive Income

Components of accumulated other comprehensive income include pension adjustments, unrealized gains and losses on available-for-sale debt securities, foreign currency translation adjustments, any portion of a gain or loss that is the result of a change in credit risk of debt when the fair value option is elected, and deferred gains and losses on the effective portion of cash flow hedges.

These components of other comprehensive income are not included in determining net income and, therefore, are not included in retained earnings. Rather, these components are recognized in the period in which they occur and are combined with net income to determine comprehensive income. Total accumulated other comprehensive income must be shown in the shareholders' equity section separate from capital stock, additional paid-in capital, and retained earnings.

2.6 Treasury Stock

Treasury stock is a corporation's own stock that has been issued to shareholders and subsequently reacquired (but not retired) by the corporation. Because treasury shares are held (owned) by the issuing corporation, they are not entitled to any of the common shareholders' ownership rights, such as the right to vote or to receive dividends.

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BGSE Capital Corp.
Statement of Shareholders' Equity
For the Year Ended December 31, Year 5

	Preferred Stock	Common Stock	Add'l Paid-in Capital: PS	Add'l Paid-in Capital: CS	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Stockholders' Equity
Balances, January 1, Year 5	$200,000	$ 990,000	$30,000	$2,475,000	$11,265,000	$362,000	$(120,000)	$15,202,000
Net income					6,185,000			6,185,000
Other comprehensive income						(12,000)		(12,000)
Cash dividends					(950,000)			(950,000)
Issuance of common stock		10,000		25,000				35,000
Balances, December 31, Year 5	$200,000	$1,000,000	$30,000	$2,500,000	$16,500,000	$350,000	$(120,000)	$20,460,000

LOS 1A1d

2.7 Limitations of the Statement of Changes in Equity

The statement of changes in equity is a straightforward concept. This statement represents the residual interest of assets minus creditors' claims to those assets. Differences within state laws affect the account of shareholders' equity transactions and can cause variations in the accounting and reporting of equity, making the statement of shareholders' equity difficult to compare between companies.

Despite the relatively simple calculation of equity, this section is frequently misunderstood due to terminology differences of reporting companies. For example, the term shareholders' equity, shareowners' equity, stockholders' investments, contributed capital, and other similar titles can be used to describe equity. Terminology surrounding stock varies from common stock to class A shares or stock, preferred stock, or preference shares. Retained earnings may be referred to as reinvested earnings or earned capital.

The statement often provides a three-year reconciliation of the changes in balances of stockholders' equity accounts. Users of the financial statements should read management's discussion and analysis along with the footnotes to the financial statements to help decipher the components of equity.

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3 Balance Sheet

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The balance sheet reports the company's financial position (assets, liabilities, and equity) at a specific point in time. The formal name for the balance sheet is the statement of financial position. The formula for the balance sheet is:

Assets = Liabilities + Shareholders' equity

3.1 Purposes and Uses of the Balance Sheet

LOS 1A1b

The balance sheet provides a list of assets and liabilities held by an entity, which are classified into meaningful categories, and owners' equity. Classification of items on the balance sheet allows users of the financial statements to determine not only the composition of assets and liabilities, but also to evaluate the liquidity and long-term solvency.

3.2 Components of the Balance Sheet

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LOS 1A1e

The three main components of the balance sheet are assets, liabilities, and owners' equity.

3.2.1 Assets

Assets represent probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. Generally, assets are what a company "owns." There are five categories of assets reported on the balance sheet: current assets; investments and other funds; property, plant, and equipment; intangible assets; and other assets.

- **Current Assets:** Cash and other assets expected to be converted to cash or consumed either within one year of the balance sheet date or within the company's operating cycle, whichever is longer. Current assets are listed in order of liquidity. Examples: cash and cash equivalents, short-term investments (management ability and intent to sell within a year), accounts receivable, inventories, and prepaid expenses (receive benefit within one year).
- **Investments and Funds:** Assets that are not used directly in operations. These are noncurrent because of management's intent to not convert the assets into cash within the next year or within the company's operating cycle, (whichever is longer). Examples: investments in equity and debt securities of other companies, land held for speculation, noncurrent receivables, certificates of deposit having a maturity date greater than one year from the date the certificate was issued, and cash set aside for special purposes.
- **Property, Plant, and Equipment:** Assets that are tangible, long-lived, and used in business operations. Reported at historical cost less accumulated depreciation to date (except land, which is not depreciated). Examples: land, land improvements, buildings, equipment, machinery, furniture, and natural resources.

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- **Intangible Assets:** Assets that have no physical substance, are long-lived, and used in the operations of the business. These assets typically represent exclusive rights that a company can use to generate future revenues. Reported at historical cost net of accumulated amortization (usually shown net). Examples: patents, copyrights, trademarks, trade names, and franchises.
- **Other Assets:** A catch-all category of noncurrent assets. This category is reserved for assets that will not fit into one of the first four categories discussed above. Examples: long-term prepayments (sometimes called deferred charges) and deferred income taxes.

Each company varies in terms of asset composition; therefore, the types of assets reported on each company's balance sheet may differ.

3.2.2 Liabilities

Liabilities represent probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. Liabilities represent what a company "owes." Liabilities are reported as either current or non-current obligations.

- **Current Liabilities:** Represent obligations that are expected to be satisfied with current assets or the creation of other current liabilities. Includes all liabilities that are expected to be satisfied within one year or within the company's operating cycle, whichever is longer (with some exceptions outside the scope of the CMA Exam). Examples: accounts payable, notes payable, unearned (or deferred) revenues, accrued liabilities, and current maturities of long-term debt.
- **Long-Term Liabilities:** Represent obligations that will not be satisfied within the next year or within the company's operating cycle, whichever is longer. Examples: long-term notes, bonds, lease obligations, and pension obligations.

LOS 1A1g

3.2.3 Equity (or Net Assets)

Equity represents the shareholders' residual claim in the entity's assets after deducting liabilities. That is, the difference between what the company "owns" and what the company "owes." Categories of equity include paid-in capital, retained earnings, accumulated other comprehensive income, and treasury stock. Equity is presented in order of preference upon liquidation.

Illustration 1 Example Balance Sheet Presentation

Below is the balance sheet for Emmons Corp. at December 31, Year 1.

Amounts reflected in the financial statements come from the adjusted trial balance. Note the order of the presentation of total assets is consistent with the categories discussed above. The balance sheet below does not contain an "other asset" category because it did not apply to Emmons Corp. It is important to note the balance sheet must balance: Accounting equation assets = Liabilities + Owners' equity must always be in equilibrium. If the balance sheet does not balance, something has been incorrectly recorded.

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