
UNIT 7: FINANCIAL STATEMENTS AND ADDITIONAL DISCLOSURE

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7.0 AIMS AND OBJECTIVES

The aims of this unit are to discuss the concepts and techniques that underline the preparation and analysis of the income statement, statement of retained earnings, balance sheet and statements of cash flows. Along with the mechanic of preparation the chapter examines and illustrates acceptable disclosure requirements.

After you have studied this unit, you will:

- know the basic purpose and elements of the income statement
- understand the purpose and composition of the retained earnings statements

- understand the uses and limitations of the balance sheet
- be familiar with the usefulness of the statement of cash flows.

7.1 INTRODUCTION

In the previous chapters we have stressed that the measurement of the resource and obligations of a business enterprise is fundamental to the accounting process. The ongoing recording of transactions and events and the preparation of end-of-period adjusting entries may be described as a process measuring assets and liabilities. The result of this process is summarized in general-purpose financial statements that provide decision makers with useful information.

To supplement the basic financial statements, additional disclosures may be included in notes to the financial statements and in other sections of the annual report to share holders.

7.2 INCOME STATEMENT

The income statement presents revenues, gains, expense and losses recognized by the firm for a specified period of time. The income statement is an important financial statement because it provides investors and creditors with information that helps them predict the amount, timing, and uncertainty of future cash flows. Through use of the income statement, investors and creditors are able to evaluate the past performance of an enterprise and determine the risk of achieving particular cash flows.

7.2.1 Alternative Forms of Income Statement

The manner in which accounting information is displayed in an income statement can influence the reader's interpretation of the information.

Except for three specific items (extra ordinary items, discontinued operations, and effects of changes in accounting principles), GAAP does not require a standard format for organizing and presenting the firms revenues, expenses, gains, and losses. These income statement elements are organized in one of two general ways: a single-step format and a multiple-step format.

Single-Step Format

The single-step format uses only two broad section classifications: (1) a revenue and gains section, and (2) an expenses and losses section. It is a single step statement because only one step is involved in computing and displaying operating income.

The single-step form of income statement is presented below:

NICE Corporation
Income Statement
For the Year ended Dec. 31, 1990.

Revenue:

Net sales -----	Br. 18,108
Investment income -----	420
Gain on disposal of equipment -----	<u>50</u>
Total revenue -----	18,578

Costs and Expenses:

Cost of goods sold -----	Br. 11,988
Selling Expenses -----	2640
General and administrative Expense -----	1620
Interest Expense -----	230
Income taxes expense -----	<u>1,043</u>
Total costs and expenses -----	<u>17,521</u>

Net income -----Br. 1,057

Multiple-Step Format

The multiple-step format provides for several classifications and intermediate subtotal measures of income. It typically distinguishes among various operations and activities that affect income. The multiple-step form is more likely to be found in more detailed income statements prepared for the use of management bankers and other creditors.

The multiple-step form of income statement is presented below:

NICE Corporation
Income Statement
For the year ended December 31, 1990
(In thousands of birrs)

Sales (net of discounts, returns, and allowances) -----Br. 18,108

Cost of goods sold:

Inventories Jan 1, 1990 -----Br. 1,000

Purchases (net of discounts, returns, and allowances) 10,302

Freight-in -----1,266 11,568

Cost of goods available for sale -----12,568

Less: Inventories Dec. 31, 1990 -----580

Cost of goods sold -----11,988

Gross profit on sales -----6,120

Operating expenses:

Selling expenses:

Sales salaries -----Br. 1260

Advertising and promotion -----880

Building occupancy (including depreciation
and property taxes on building) -----420

Other -----80 Br. 2,640

General and administrative expenses:

Salaries -----1,160

Property tax -----308

Depreciation on equipment -----80

Other -----72 1620

Total operating expenses -----Br. 4260

Income from operation -----Br. 1,860

Other revenue (Expenses):

Investment income-----	Br. 420	
Gain on disposal of equipment -----	50	
Interest expense -----	(230)	<u>240</u>
Income before income taxes -----	Br. 2,100	
Income taxes expense (including Br. 20 differed) -----		<u>1,043</u>
Net income -----	Br. <u>1057</u>	
Earning per share of common stock -----	Br. <u>1.25</u>	

7.2.2 Classification of Revenue

The major source of revenue for most business enterprises is the production and sale of goods and services. Examples of secondary sources are dividends, royalties, interest, rents, investment income from affiliated companies, and gains on the disposal of assets.

Revenue offsets should be distinguished from expenses; they are deducted from gross revenue in the income statement. Such items as sales discounts and sales returns and allowances are not expenses, but rather revenue that is never realized.

7.2.3 Classification of Costs and Expenses

Costs and expenses are classified in the income statement to help users understand the operating cost relationships of the business enterprise. Classifications may be according to the nature of expenses (natural classification), business functions, (functional classification), areas of responsibility, or any other useful basis.

In many income statements, costs and express are reported in single-step form, classified according to the nature of expenses i.e. in categories that reflect the kind of resources used during the accounting period. Examples are merchandise and supplies, salaries and fringe benefits, purchased services, depreciation etc.

Expenses may be classified on a functional basis as cost of goods sold, selling expenses, general and administrative expenses, income tax expense etc.

Check your progress – 1

- i. What is generally included in the heading of a financial statement?

_____.

- ii. Explain the difference between the single-step form and the multiple-step form of the income statement?

_____.

7.3 STATEMENT OF RETAINED EARNINGS

A statement of retained earnings often presented as a supplement to the financial statements. The purpose of statements of retained earnings is to reconcile the beginning and ending balances of retained earnings, showing all changes in retained earnings, during the accounting period, and to provide connecting ink between the income statement and the balance sheet.

The ending balance of retained earnings is reported on the balance sheet as one element of owners' equity. Major components of a statement of retained earnings are:

1. Prior period adjustments
2. Net income or loss for the period
3. Dividends – both stock dividends and cash dividends
4. On special accounting changes, retroactive effects of accounting principle change.

Disclosure of cash dividends per share also is made in the statement of retained earnings.

7.3.1 Prior Period Adjustments

Prior period adjustments are correction of errors in the financial statements from a prior period that affect retained earnings. Material errors in the financial statements might include arithmetical mistakes, the misuse or omissions of information, mistakes in the application of accounting principles and failure to interpret properly the accounting aspects of transactions.

In the financial statements for the current accounting period, a prior period adjustment is reported as a correction to the beginning balance of retained earnings.

The format of the statement of retained earning is presented below:

NICE Corporation
Statement of Retained Earnings
For the year ended December 31, 1990

Retained earnings, beginning of the year, as originally reported -----	Br. 2,800
Less: Prior period adjustment (correction of error), net of income tax effect of Br. 240 -----	<u>360</u>
Retained Earnings, beginning of year, as restated -----	Br. 2,440
Add: Net income -----	<u>1,057</u>
Subtotal -----	3, 497
Less: Cash dividends on preferred stock -----	Br. 57
Cash dividends on common stock -----	<u>400</u> <u>457</u>
Retained Earnings, end of year -----	<u>3,040</u>

Check your progress – 2

- i. Define prior period adjustments and indicate how these are reported in financial statements.

_____.

7.4 BALANCE SHEET

The balance sheet provides economic information about an entity's resources (assets), claims against those resources (liabilities) and the remaining claim accruing to the owners (owners' equity).

If a balance sheet is examined carefully, users can gain a considerable amount of information related to enterprise liquidity and financial flexibility. Balance sheet is

basically a historical statement, because it shows the cumulative effect of past transactions and events.

7.4.1 Uses and Limitations of the Balance Sheet

A balance sheet in comparative form provides valuable information to creditors, stockholders, management, prospective investor, and the public.

Individuals with the ability to interpret comparative balance sheets may learn much as to the short-run solvency of a business enterprise, favorable or unfavorable trends in liquidity, commitments that must be met in the future, and the relative positions of creditors and stockholders.

The major limitation of the traditional balance sheet lies in the inability of accountants to measure the “current fair value” of an enterprise’s net assets. The inability of accountants to foresee future economic events necessitates the preparation of balance sheets on a different basis. Further more, accountants are unable to identify and provide a valuation for many factors that have a material effect on the financial position of an enterprise. The quality, morale, and character of management and other personnel, the market position of an enterprise and the regulation of its products are subjective and intangible factors of great importance in the evaluation of the financial position of an enterprise. None of these factors is reported directly in the birr and cents framework of the accounting process that leads to a balance sheet.

7.4.2 Balance Sheet Classifications

The classifications, group headings, and number of items on a balance sheet vary considerably depending on the size of the enterprise, the nature of its operations, and whether the financial statements are intended for wide distribution or for the use of a few owners and creditors.

As a generalization subject to many exceptions, the following classification of balance sheet items is suggested as representative:

Assets

- Current assets

- Investment (held for control or not readily marketable)

- Plant assets

- Intangible assets

- Other non current assets (including deferred charges)

Liabilities

- Current liabilities

- Long-term debt (including deferred income tax credits & deferred revenue)

Stockholders' equity

- Capital stock (preferred and common stock)

- Additional paid-in capital

- Retained earnings

Working Capital

The working capital of a business enterprise is the excess of current assets over current liabilities. This amount always has been considerable interest to creditors as a measure of short-run solvency. The ability to finance current operations and to pay obligations as they mature.

Current assets include cash and other assets that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business or within one year from the balance sheet date.

The normal operating cycle of a business is the average length of time from the expenditure of cash to inventory, to sale, to accounts receivable, and finally back to cash. Most companies use one year as the time period for classifying items as current or long-term because either the operating cycle is less than one year or the operating cycle may be difficult to measure reliably.

Five general types of assets generally are included in the current assets classification:

1. Cash – Money in any form-cash and checks a waiting deposit, balances in checking accounts, and expendable cash funds.

2. Secondary cash resources – Various short-term investments that are readily marketable. Any such resources whose availability for current use is restricted by contract are excluded
3. Short-term receivables – Trade accounts receivable (including installment receivables collected during the enterprises operating cycle) and notes receivable with short-term maturities.
4. Inventories – Material, supplies, goods in process, finished goods. This category includes items held for sale in the ordinary course of operation, items in process of production of goods or services. Goods held on consignment from others are not included because title is not held to such goods.
5. Short-term prepayments – The cost of various services, such as insurance, taxes, and rent, which have been paid for in advance of use. Short-term prepayments sometimes are referred to as prepaid expenses.

Current liabilities: are obligations whose liquidation is expected to require the use of current assets or the creation of other current liabilities. Three main classes of current liabilities fall within this definition.

1. Obligations for the acquisition of goods and services that have entered the operating cycle.

This includes trade payables (including notes and accounts payable to suppliers) and accrued liabilities such as wages, commissions, income taxes, property taxes etc.

2. Other debts that may be expected to required payment within the operating cycle or one year.

This includes short-term notes payable to banks and the currently maturing portions of long-term debt.

3. Collections received in advance of the delivery of goods or the performance of services.

These advances often are described as “deferred revenue” but it is the obligation to furnish the goods or services or to refund the payment that requires them to be classified in the current liabilities section of the balance sheet.

Some liabilities that will be paid shortly after the balance sheet date are excluded from current liabilities, because of the requirements that a current liability must involve the use of current assets or the issuance of new short-term debt for its extinction.

Examples are (1) obligations due at an early date that will be retired by the issuance of new-long-term debts, for example, bonds that will be refunded or a loan secured by the cash surrender value of life insurance policies (the amount of cash that would be received if the policies were canceled) that will be renewed, and (2) obligations that will be paid from a fund included among non current assets, for example, a life insurance policy loan that will be liquidated by offset against the cash surrender value of the policy, or by deduction from the proceeds of the life insurance policy at maturity.

7.2.2 Non current Resources and Obligations

The definition of Noncurrent assets determines by exclusion those assets that are reported as non-current. There are four categories of non current assets:

1. Long-term funds, investments, and receivables:

Many long-term commitments of funds do not qualify as secondary cash resources. Investments in the common stock of investees made for the purpose of influence or control are included in this category. Also included are non-current receivable (such as long-term advances to affiliated companies), the cash surrender value of life insurance policies, and funds established for such purposes as the payment of pensions, retirement of preferred stock, or repayment of long-term debt. Assets, such as land held for speculative purposes and future plant sites also are included in this category.

2. Long-term tangible resources used in operations

These are tangible (have physical substance) and are held for productive use in business operations. Land, natural resources subject to depletion, buildings, equipment, machines, tools, leased assets under capital leases, leasehold improvements, and plant assets under construction are included. Long-term prepayments for the use of physical assets, such as

leaseholds, easements, or rights of way, also may be included in this category, though some accountants group these in the next category.

3. Long-term intangible resources

Long-term property rights of an intangible nature may be of greater importance to a business enterprise than its tangible assets. Examples of such asserts are patents, goodwill, trademarks, copyrights, organization costs, and franchise.

4. Other non-current assets /Deferred charges/

Included in this category are items such as plant assets no longer used in operations and held for disposal costs incurred in the issuance of long-term debts, deferred start-up and moving costs, and any other non current assets that is not included in one of the first three categories.

Contingent assets: Assets, as well as liabilities, may be contingent. A contingent asset is a property right whose existence is conditional on the happening of some future event (gain contingency). Generally, it is not appropriate to include contingent assets in the accounting records, because to do so would violate the principle of revenue realization and reliability.

Non-current liabilities

A non-current liability is an obligation that will not require the use of current assets or the issuance of short-term debt within the next year or operating cycle, whichever is longer. They may be classified into the following

1. Long-term debt based on security issues or related contractual arrangements

Included in this category are notes and bonds, reported net of unamortized discount and including any unamortized premium. The distinguishing characteristic is that there is a borrowing transaction supported by a contractual obligation to pay principal and interest.

2. Other non-current liabilities

This includes all long-term liabilities that do not belong in the first category. An amount received in advance on a long-term commitment to furnish goods or services deferred revenue, differed income tax credits, liabilities under capital leases and non current amount payable under pension plans are examples.

Contingent liabilities

Liabilities that may or may not come into existence as a result of transactions or events that have not yet been finalized usually are not reported in birr amount in the balance sheet. Some examples, of contingent liabilities are possible additional income tax assessments and pending lawsuits that may result in the payment of damages.

Check your progress – 3

- i. How is the definition of a current liability related to the definition of current assets?

- ii. Indicate circumstances under which liabilities payable within a few months after the balance sheet date might be excluded from current liabilities.

7.2.3 Owner's Equity

The owners' equity in a business enterprise is the residual interest in assets, after liabilities have been deducted. The amount of owners' equity thus is directly dependent on the values assigned to assets and liabilities.

Owners' equity for a corporation is called stockholders' equity, that for a partnership, partners' equity, and that for a sole proprietorship, proprietors' equity. Owners' equity includes contributed (or paid-in) capital and retained earnings.

Because of legal requirements, owners' equity is sub classified to reflect detailed sources. For corporations, the most commonly reported sources are:

▮ Capital Stock

It is the firm's stated or legal capital. It is the par value of the issued or outstanding preferred and common stock of the corporation and represents the amount that is not available for dividend declarations. Legal capital is specified by state law and the articles of incorporation (the charter) of the corporation.

▢ **Contributed capital in excess of par (or stated value)**

If reports the value of assets received by the corporation above the par (or stated value) of the capital stock given in exchange. These amounts usually arise when the corporation sells its stock above par (or the stated amount per share) or issues stock dividends. Sometimes called additional paid-in capital or premium on stock, it is considered legal capital in most instances.

▢ **Other contributed capital**

It arises from such transactions as the sale of treasury stock above its acquisition cost and capital arising from recapitalizations. For balance sheet presentation, there is generally only one additional contributed capital account, which includes contributed capital in excess of par. The specific underlying sub accounts are maintained in a subsidiary ledger.

▢ **Retained Earnings**

It is essentially a corporation's accumulated net earnings, less dividends paid out, since the company's inception. In many corporations, retained earnings are the largest amount in the owners' equity section. A negative balance in retained earnings is called a deficit and usually arises when a company experiences operating losses.

▢ **Treasury Stock**

Shares that have been issued and then repurchased by the company, but not retired, are called treasury stock. Treasury stock is not an asset of the issuing firm. Companies repurchase their own stock for several reasons:

1. To meet employee stock purchase or option plan needs
2. To increase reported earnings per share
3. To stabilize the stock's price
4. To reduce the outstanding shares, perhaps to discourage a hostile takeover attempt
5. To contract the firm's operations
6. To indicate that management believes the stock is under valued

Check your progress – 4

- i. Discuss how treasury stock is reported in the balance sheet

7.5 STATEMENT OF STOCKHOLDERS' EQUITY

A financial statement that lists the beginning and ending balances of each equity account and describes all the changes that occurred during the year.

MODEL CORPORATION

Statement of Stockholders' Equity

For the year ended Dec. 31, 1990 and 1991

	<u>Common stock at Br. 10 par</u>		<u>Additional</u>	<u>Retained</u>	<u>Total</u>
	<u>No. of shares</u>	<u>Amount</u>	<u>Paid-in capital</u>	<u>Earnings</u>	<u>_____</u>
Balances, Jan. 1, 1990 -----	1,250	Br. 12,500	Br. 137,858	Br. 306,535	Br. 456,893
Net income in 1990				68,066	68,066
Cash dividend (Br. 11 a share) _____				(13,750)	(13,750)
Balance, Dec. 31, 1990 -----	1250	Br. 12,500	Br. 137,858	Br. 360,851	Br. 511,209
Net income, 1991				79,685	79,685
Cash dividends (Br. 16 a share)				(31,200)	(31,200)
Issuance of common stock -----	283	2,830	24,332		27,162
Conversion of Bonds					
Payable to common stock -----	417	4,170	30,315		34,485
50% stock dividend distributed --	975	9,750		(9,750)	
Balances, Dec. 31, 1991	<u>2925</u>	Br. <u>29,250</u>	Br. <u>192,505</u>	Br. <u>399,586</u>	Br. <u>621,341</u>

Check your progress – 5

- i. What is the function of a statement of stockholders' equity?

7.6 STATEMENT OF CASH FLOWS

Along with an income statements and balance sheet, a statement of cash flows is included in an annual reports to stockholders of publicity owned companies and is covered by the auditors' opinion. The objective of this statement are:

1. To summarize the financing, operating, and investing activities of a business enterprise during an accounting period, including the amount of cash equivalent obtained from operations, and
2. To complete the disclosure for changes in financial position during an accounting period that are not readily apparent in comparative balance sheets.

The statement of cash flows discloses transactions that affect cash directly, as well as significant investing and financing transactions that do not affect cash.

The statement of cash flows is prepared in three sections.

1. **Operating cash flows:** includes cash transaction that enter into the determination of net income. Reported under this classification are both the cash inflows and the cash outflows that are related to net income. The usual cash flows identified are:

Inflows – cash received from	Outflows-cash paid for
- Customers	– Purchase of goods for sale
- Interest on receivables	– interest on liabilities
- Dividends from investment	– income taxes, duties, & fines
- Refunds from suppliers	– salaries and wages

2. Investing cash flows:

This classification includes cash inflows and cash outflows related to the disposing of or acquiring operating facilities (plant, property, equipment), the sale or purchase of investments, and other non-operating (investment) assets. Outflows are investments of cash by the entity to acquire non-cash assets. Inflows under this classification occur only when cash is received from the sale or disposal of prior investments.

The following are typical cash flows under investing activities:

Inflows – cash received from

- Disposal / sale of property
- Disposal / sale of investment securities
- Collection of a loan (excluding interest which is an operating activity)

Outflows – cash paid for

- Acquisition / purchase of property
- Long-term investment in debt and equity securities.
- Loans to other parties
- Acquisition of intangible assets

3. Financing cash flows

This classification includes both cash inflows and outflows related to the financing activities (borrowing or issuing stock) used to obtain cash for the business. Outflows occur when principle amounts are returned to the owners and creditors for their earlier investments. The usual cash flows under these classifications are:

Inflows – cash received from

- Owners from issuing equity securities
- Creditors from issuing debt securities

Outflows – cash paid to

- Owners for dividends & other cash distributions
- Owners for retiring stock or treasury stock purchased
- Creditors for repayment of amounts borrowed (excluding interest, which is included in operating activities).

A complete discussion of the statement of cash flows is found in other accounting books. In this chapter we illustrate the statement without further explanation.

The statement of cash flows for NICE Corporation is presented below:

NICE CORPORATION

Statement of cash flows

For the year ended Dec 31, 1990.

Cash flows from operating activities:

Net income -----Br. 1,057

Items reconciling net income to net cash flow from operation:

Depreciation Expense -----186

Amortization of goodwill, patents, and bond discount -----64

Retirement benefits payable in future years -----40

Increase in deferred taxes -----20

Equity in income of subsidiaries -----(110)

Increase in short-term investments -----(60)

Increase in notes and interest receivable -----(125)

Increase in trade accounts receivables -----(312)

Decrease in short-term prepayments -----(40)

Decrease in trade notes and payables -----(330)

Decrease in income taxes payable -----(150)

Decrease in advances from customers -----(88)

Decrease in accrued liabilities -----(50)

Increase in retirements benefits payable currently -----5

Net cash provided by operating activities -----Br. 527

Cash flow from investing activities:

Disposal of equipment -----Br. 100

Increase in cash surrender value of life insurance----- (10)

Acquisition of patents -----(120)

Net cash used by investing activities -----Br. (30)

Cash flow from financing activities:

Issuance of preferred stock -----Br. 250

Dividends paid on preferred & common stock -----(432)

Increase in fund for retirement of preferred stock -----	(30)
Net cash used by financing activities -----	Br. (212)
Net increase in cash and cash equivalents -----	Br. 285
Cash and cash equivalent at beginning of year -----	200
Cash and cash equivalent at end of year -----	485

7.7 ADDITIONAL DISCLOSURES

The disclosure principle requires that financial statements include all significant information needed by users of the statements. If the omission of certain information would cause the financial statements to be misleading, disclosure of such information is essential. The financial statements included in annual reports to shareholders are accompanied by detailed notes to the statements. However, disclosure is not to supplement the information in the body of the financial statements, not to correct or justify improper presentations in the statements.

Some examples of information disclosed in notes to the financial statements included in annual reports of publicly owned companies include the following:

1. A summary of significant accounting policies
2. Description of stock option, pension, and employee stock ownership plans
3. Litigation in which the company is a party, loss and gain contingencies, and unusual commitments.
4. Terms of proposed business combinations and a description of any unusual events or transactions, such as related party transactions.
5. The amounts of depreciation expense and research and development costs.
6. An analysis of the composition of income taxes expense, including a reconciliation of the company's effective income tax rate with the statutory federal income tax rate.
7. Detailed description or summary of receivables, inventories, investments, plant assets, intangible assets, borrowing arrangements, with banks, long-term debts, and stockholders equity.

This partial list of the type of information that may be disclosed in notes to the financial statements suggests that such notes may be both numerous and complex.

Disclosure in a note to the financial statements is appropriate when subsequent events provide evidence with respect to conditions that did not exist on the balance sheet date. For example, a material write-off of trade receivables as a result of a major catastrophe, such as an earthquake after the balance sheet date, is not indicative of a condition that existed on that date. Therefore, the financial statements would not be adjusted but the amount of write-off would be disclosed in a note to the statements.

Check your progress – 7

- i. Describe the type of disclosures that are made in a note to the financial statements entitled “Summary of significant Accounting policies.”

7.8 SUMMARY

Business enterprises report their financial progress and financial position using different types of financial statements. Income statement, Balance sheet, Retained Earnings and cash flow statements.

The income statement measures the success of business operations for a given period of time. This statement assists the business community in determining profitability, investment value, and credit worthiness of a particular business enterprise. The income statement may be presented in the single-step format or the multiple-step format.

The statement of retained earnings serves to reconcile the balance of the retained earnings account from the beginning to the end of the year. The importance information communicated by the statement of retained earnings includes:

- a) Prior period adjustments (income or loss related to the corrections of errors in the financial statements of a prior period), (b) the relationship of dividend distributions to net income for the period, and (c) any transfers to and from retained earnings.

For many years financial statement users generally considered the income statement to be superior to the balance sheet as a basis for judging the economic well-being of an enterprise. However, the balance sheet can be a very useful financial statement. If a balance sheet is examined carefully, users can gain a considerable amount of information related to enterprise liquidity and financial flexibility.

The primary purpose of the statement of cash flows is to provide relevant information about the cash receipts and cash payments of an enterprise during a period.

7.9 ANSWERS TO CHECK YOUR PROGRESS

1. i. The heading of a financial statement includes the name of the business enterprise, the title of the statement, and the date or dates of the statement, such as “For Three months ended March 31, 1996”).
ii. In a multiple-step form various intermediate amounts, such as gross profit on sales, income from operations, and income before income taxes, are presented as separate line items. The single-step form presents all revenue in one category, all costs and expenses in another and derives net income as the final amount.
2. Prior period adjustment is correction of a material error related to a prior period or periods.

In the financial statements for the current accounting period, a prior period adjustment is reported as a correction to the beginning balance or retained earnings. When a correction of an error is made as a prior period adjustments, the issuance of comparative financial statements requires the restatement of prior periods financial statements to reflect the correction.

3. i. Current liabilities are obligations whose liquidation is expected to require the use of current assets.
ii. Some liabilities that will be paid shortly after the balance sheet date are excluded from current liabilities, because of the requirement that a current liability must involve the use of current assets or the issuance of new short-term debt for its extinction.

4. The balance of treasury stock is reported in the balance sheet as a deduction from the balance sheet of stockholders' equity.
5. The statement of stockholders' equity lists the beginning and ending balances of each equity account & describes all the changes during the year.
6. Net cash flows refers to the inflows of cash minus the outflows of cash
7. The types of disclosures by a business enterprise in a separate section entitled "summary of significant Accounting policies" includes:
 - A. Basis for preparation of consolidated financial statements (principles of consolidation)
 - B. Method or methods used to compute depreciation, depletion, and amortization
 - C. Inventory pricing
 - D. Method of revenue recognition
 - E. Any changes in accounting principles during the most recent accounting period

7.10 MODEL EXAMINATION QUESTIONS

I. True / False

- _____ 1. The multiple-step income statement recognized a separation of operating transactions from non-operating transactions and matches costs and expenses with related revenues.
- _____ 2. The statement of retained earnings shows the total change in stockholders' equity for a specified period.
- _____ 3. Proper presentation of inventories for a manufacturing concern includes disclosure of the basis of valuation, the methods of pricing, and the stages of production
- _____ 4. Determination of cash flows from operating activities requires predicting the amount of cash the entity will collect from customers who purchase the entity's product on account.
- _____ 5. When the balance sheet is prepared using the report form, a special section is included that presents a narrative explanation of the balance sheet classifications.

II. Multiple Choice

- _____ 1. Which of the following items should never be included in the current section of the balance sheet?
- A. Receivable from a customer outstanding for more than a year
 - B. Deferred income taxes resulting from inter period tax allocation
 - C. Three-year premium for fire insurance on plant and equipment
 - D. A pension fund
- _____ 2. Which of the following balance sheet classification would normally require the greatest amount of supplementary disclosure?
- A. Current assets
 - B. Current liabilities
 - C. Plant assets
 - D. Long-term liabilities
- _____ 3. The statement of cash flows provides answers to all of the following questions except,
- A. Where did the cash come from during the period?
 - B. What was the cash used for during the period?
 - C. What is the impact of inflation on the cash balance at the end of the year?
 - D. What was the change in the cash balance during the period?
- _____ 4. The preparation of notes to the financial statements complies with the:
- A. Business entity principle
 - B. Continuity principle
 - C. Matching principle
 - D. Disclosure principle
- _____ 5. The following expenses and loss were among those incurred by KK Company during 1990.
- | | |
|--|-------------|
| Accounting and legal fees ----- | Br. 160,000 |
| Interest ----- | 60,000 |
| Loss on disposal of office equipment ----- | 25,000 |

Rent for office space -----200,000

One-quarter of the rented premises is occupied by the sales department. How much of the items listed above is included in KK's general and administrative expenses for 1990

- A. Br. 310,000
- B. Br. 335,000
- C. Br. 360,000
- D. Br. 370,000
- E. Some other amount

III. Exercise

Selected information for Root Company for the year ended December 31, 1990 follows:

Total assets -----Br. 2,255,000

Total liabilities -----600,000

Preferred stock, \$ 10 par -----100,000

Common stock \$ 1, par -----300,000

Additional paid-in-capital -----600,000

Prior period adjustment – overstatement of
net income in 1989 as a result of an

accounting error, net of income tax of \$ 57,600 -----70,400

Net income -----75,000

Dividends declared on common stock (\$ 0.20 a share) -----60,000

Dividends declared on preferred stock (\$ 1.50 a share) -----15,000

Prepare Root company's statement of retained earnings for the years ended December 31, 1990

2. Edmund corporation had inventories at the beginning and of 1992 as follows:

	Jan 1	Dec 31
Raw material	Br. 22,000	Br. 30,000
Goods in process	40,000	48,000
Finished goods	<u>25,000</u>	<u>18,000</u>
Totals	Br. <u>87,000</u>	Br. <u>96,000</u>

During 1992 the following costs and expense were incurred by Edmund

Raw material purchased -----	Br. 300,000
Direct labor -----	120,000
Indirect labor -----	60,000
Property taxes and deprecation of factory building -----	20,000
Property taxes and deprecation of sales room and office -----	15,000
Sales salaries -----	40,000
Office salaries -----	24,000
Utilities (60% applicable to factory 20% to sales room, and 20% to office) -----	60,000

Compute Edmund Corporation's cost of good sold for the year ended December 31, 1992.

3. The stockholders' equity of valentine corporation on June 30,1991 was as follows:

Common stock, \$ 10par -----	200,000
Additional paid-in-capital -----	225,000
Retained earnings -----	<u>610,000</u>
Total stockholders' equity -----	Br. <u>1,035,000</u>

The transactions affecting stockholders' equity for the year ended June 30,1992 were:

- 1) An additional 7,500 shares of common stock were issued on May 1,1992 at Br. 30 a share.
- 2) Dividends declared June 2,1992, amounted to Br. 100,000
- 3) Net income amounted to Br. 195,000

Prepare a statement of stockholder's equity for valentine corporation for the year ended June 30,1992.

4. From the following list of ledger account balances for LIFE Company, compute (a) the amount of working capital and (b) the equity (book value) per share of common stock:

Investment in affiliated companies (at equity)-----	Br. 100,000
Cash surrender value of life insurance policies -----	10,000
Organization costs -----	5,000

Interest receivable -----
2,000

Reserve for loss contingencies (recorded by a debit to
retained earnings) -----
50,000

Retained earnings-un appropriated -----	170,000
Common stock, \$ 5par -----	400,000
Additional paid-in capital -----	200,000
Deferred income tax credits -----	40,000
Cost of (construction) contracts in progress (for customers) -----	150,000
Bond sinking fund -----	80,000
Liability under product warranty -----	6,000
Creditors accounts with debit balance -----	4,500
Plant assets (net) -----	426,500
Other current assets -----	198,000
Other current liabilities -----	108,000

5. A condensed income statement prepared by Leventhal corporation for the year ended March 31, year 2, follows:

LEVENTHAL CORPORATION

Income statement

For year Ended March 31, 1992

Sales (net) -----Br. 900,000

Costs and Expenses:

Cost of goods sold -----Br. 620,000

Deprecation -----28,000

Amortization of intangible asset -----7,000

Other operating expenses -----112,000

Income tax (including deferred

Income taxes of Br. 10,000) 45,000 812,000

Net income Br. 88,000

Earnings per share of common stock Br. 4,40

Additional information

- 1) Dividends of Br. 50,000 were declared can paid
- 2) Equipment of Br. 40,000 was acquired in exchange for common stock
- 3) Equipment was sold for Br. 14,500 its carrying amount
- 4) The common stock was split 2 for 1
- 5) Long-term investments were acquired for Br. 60,000 cash
- 6) Treasury stock (common) was acquired for Br. 8,500 cash
- 7) Cash received as proceeds from long-term borrowing was 100,000
- 8) The working capital at the beginning of the year was Br. 425,400; working capital at the end of the year was Br. 554,400. Cash at the beginning of the year was Br. 120,000. Cash at the end of the year was Br. 150,000

Instructions

Prepare a statement of cash flows for Leventhal Corporation for the year ended March 31, 1992

7.11 GLOSSARY

1. Cash flows: - the inflows and outflows of cash for a firm.
2. Cash flow from financing activities: - the section of the statement of cash flows in which is reported the transactions involving cash receipts form the issuance of equity and debt securities and cash payments for dividends, repurchase of equity securities, and redemption of debt securities.
3. Cash flows from investing activities: - the section of the statement of cash flows in which is reported the activities involving cash

receipts from the sale of investments, plant assets and other non-current assets; and cash payments for the acquisition of investments, plant assets, and other non current assets.

4. Cash flows from operating activities: - the section of the statement of cash flows in which is reported the cash transactions that entered into the determination of net income
5. Deferred charge: - long-term prepayments
6. Multiple-step income statement: - an income statement with numerous sections and subsections with several intermediate balances before net income.
7. Prior period adjustments: - correction of a material error related to a prior period or periods, excluded from the determination of net income
8. Single-step income statement: - an income statement with the total of all expenses deducted from the total of all revenues
9. Treasury stock: - a corporation's own outstanding stock that has been reacquired
10. Working capital: - current assets less current liabilities

