Chapter 2
Corporate Financial Statements

CONCEPT QUESTIONS

1. The three main forms of businesses are 1) sole proprietorships, where there is one owner, 2) partnerships, where ownership is spread over two or more people, and 3) corporations, where a separate legal entity is established in a state and ownership is spread over investors.

2. The advantages of a sole proprietorship are the owner maintains complete control of the business and reaps all of the profits. A disadvantage is that the owner bears all the risks of failure.

The advantages of a partnership are expanded expertise through pooled skills, additional capital for the business, and spreading of the financial risk among several people. Disadvantages include shared ownership and decision-making and personal liability for the debts of the business.

The advantages of a corporation include the ability to raise capital through the sale of ownership interests and limited liability of the owners for the corporation’s debts. The disadvantages are ownership is spread among owners, the business is subject to government regulations, and profits are taxable to the corporation and to the owners if distributed as dividends.

3. GAAP refers to Generally Accepted Accounting Principles, which are those accounting standards, terms, methods, principles, etc. that have been accepted and used over time by the accounting profession.

4. GAAP are determined by a number of institutions such as the Securities and Exchange Commission, the Financial Accounting Standards Board, and the American Institute of Certified Public Accountants.

5. The main classifications on a classified Balance Sheet are as follows:

Assets: current assets, long-term investments, fixed assets, intangible assets, and other assets.

Liabilities: current liabilities and long-term liabilities.

Equity: capital stock and retained earnings

6. Fixed assets are tangible resources that are used in a company's operations for more than one year and are not intended for resale. Examples include land, buildings, equipment, furniture, fixtures, etc. Intangible assets are also used for more than one year and are not intended for resale, but they have no physical substance. They give the business certain rights or privileges. Examples include trademarks, patents, franchise rights, copyrights, and goodwill.

7. Current liabilities and long-term liabilities both represent obligations of the business. Current liabilities are reasonably expected to be satisfied within the normal operating cycle of a business or within one year. Long-term liabilities are not expected to be satisfied within the next year.

8. Equity is classified as capital stock or retained earnings. Capital stock is the portion of equity contributed by stockholders through the purchase of common or preferred stock. Retained earnings are the profits that a company earns over time and retains in the business.

9. The Income Statement is divided into multiple steps in order to provide information on the profitability of various aspects of the company's operations.

10. The subtotals of income on a multiple-step income statement include gross margin, operating profit, income before taxes, and net income. Gross margin is calculated by subtracting cost of sales from sales revenue. Operating profit represents the difference between gross margin and operating expenses. Income before taxes is calculated by adding other revenues and subtracting other expenses, such as interest income or interest expense, to or from operating profit. Net income results from subtracting income taxes from the income before taxes.

11. Horizontal analysis is used to calculate the change in an account balance from one period to the next and expresses that change in both absolute and percentage terms.

12. Vertical analysis is used to show how various balances relate to a larger base account by stating each account balance as a percentage of the base account.

13. Horizontal analysis shows the growth or decline in each account, but it does not explain the reason for the change. Vertical analysis shows how various balances relate to a larger base amount.

14. The Statement of Stockholders' Equity shows the changes in all equity accounts, including Retained Earnings and Contributed Capital, over a period of time.

15. Retained earnings is calculated by adding net income (or subtracting a net loss) to the previous period's ending retained earnings and subtracting dividends paid. Retained earnings is one element of stockholder's equity along with contributed capital.

16. In addition to providing the financial statements in an Annual Report, companies also disclose Notes to the Financial Statements, the Auditor's Report, and Management's Discussion and Analysis. Notes to the Financial Statements include disclosure of accounting methods used to prepare financial statements, additional detail and explanation of financial statement account balances, and additional information such as contingencies and future commitments. The Auditor's Report, which is prepared by an independent Certified Public Accountant, states an opinion as to the fairness of the financial statements in representing the company's financial condition, results of operations, and cash flows in conformity with generally accepted accounting principles (GAAP). Management's Discussion and Analysis discusses and analyzes the company's financial activities.

MULTIPLE CHOICE

1. B
2. C
3. D
4. C
5. A
6. C
7. D
8. B ($24,000 - $10,000)
9. A ($24,000 - $10,000 - $8,500 – 1,500)
10. D
11. C
12. C
13. B
14. C (($120,000 - $100,000) ÷ $100,000 = 20%)
15. A ($15,000 ÷ $85,000 = 17.6%)
16. D ($12,000 ÷ $90,000 = 13%)
17. B ((115,000 - 123,000) ÷ 123,000 = (6.5%))
18. D
19. D
20. B

BRIEF EXERCISES

1. 1. A form of business in which multiple entities join together. **Partnership**

2. Information following the financial statements that provides additional information and disclosures. **Notes to the financial statements**
3. A form of business that is established by filing proper forms in a state. **Corporation**
4. A report that attests to the fair presentation of a company's financial statements. **Auditor's report**
5. The most common form of business. **Sole proprietorship**
6. Analysis of a company's financial activities that focuses on results of operations, ability to pay debts, and expansion plans. **Management's discussion and analysis**

Teaching Tip: One of the first decisions that any new business faces is the form that it will take. In addition to financial statements, the notes to the financial statements, the auditor's report, and management's discussion and analysis provide information that is useful to creditors and investors.

2. 1. The accounting rules followed by U.S. corporations. **GAAP**
2. The governmental entity whose mission is to protect investors. **SEC**
3. The accounting organization that contributes rules for more technical issues. **AICPA**
4. The major accounting rule-making body in the United States. **FASB**
5. The international accounting rule-making body. **IASB**

Teaching Tip: The accounting standards, rules, principles, and procedures (GAAP) that compose authoritative practice for financial accounting have been developed over time by the FASB, AICPA, SEC, and IASB. This question provides an excellent opportunity to emphasize the role of each of these regulatory bodies.

Helpful Hint for Students: Several regulatory bodies play an important role in the development of accounting standards, principles, and procedures.

3. **Supplies** is an *asset* that is classified as a *current asset*
Retained earnings is an *equity* account that is classified as *retained earnings* **Prepaid insurance** is an *asset* that is classified as a *current asset*
Interest payable is a *liability* that is classified as a *current liability*
Equipment is an *asset* that is classified as a *fixed asset*
Salaries payable is a *liability* that is classified as a *current liability*

4. Current assets:

Cash	$ 7,330
Short-term investments	800
Accounts receivable	1,200
Inventory	3,150
Prepaid insurance	2,800
Total current assets	$ 15,280

5. Gross profit = Sales – Cost of sales = $15,000 – $11,500 = $3,500

6. Operating profit = Gross profit – Operating expenses

= $7,750,000 – $1,500,000 – $2,100,000 = $4,150,000

Net income = Operating profit – Income Tax Expense
= $4,150,000 – $2,000,000 = $2,150,000

7.

Horizontal Analysis:

Dollar change =	$66,540 – $63,180 =	$3,360 increase
Percentage change =	$3,360/$63,180 =	5.3% increase

Vertical Analysis:	**Current year**	**Prior Year**
Inventory/Total assets	$66,540/$270,450 = 24.6%	$63,180/$240,680 = 26.3%

8.

Horizontal Analysis:

Dollar change =	$1,787 – $1,252 =	$535 increase
Percentage change =	$535/$1,252 =	42.7% increase

Vertical Analysis:	**Current year**	**Prior Year**
Gross profit/Net sales	$1,787/$4,605 = 38.8%	$1,252/$3,758 = 33.3%

The company was more profitable in the current year. Both horizontal and vertical analyses prove this. Horizontal analysis shows that gross profit increased 42.7% in the current year. Vertical analysis shows that gross profit as a percentage of net sales grew from 33.3% in the prior year to 38.8% in the current year.

9. Either (a) or (c) could explain the 22.8% increase in sales revenue from 2009 to 2010.

a. A sales promotion was highly successful. **Yes—would mean more customers buying more products.**
b. A manufacturing plant was offline for much of the year due to maintenance. **No—this would explain a decrease in sales.**
c. The company opened several new stores. **Yes—would likely generate new sales from new customers.**
d. The company lost market share to a new competitor. **No—this would explain a decrease in sales.**
e. The company issued $1.5 million of stock during the year. **No—this explains a source of cash, not revenue.**

Teaching Tip: Horizontal analysis is a method of analyzing a company's account balances over time and is very useful in identifying trends in a company.

Helpful Hint for Students: Consider what activities would cause sales to increase for a company. Effective advertising and sales promotions? Opening of additional stores? Did the company's market share increase?

10.

Statement of Stockholders' Equity
Year End

	Common Stock	APIC	Retained Earnings	Treasury Stock	Total
Balance at year-end	20,600	100,000	75,129	(22,000)	173,729

Note: Retained Earnings = Retained Earnings + Net Income – Dividends
= $62,496 + $22,133 – $9,500 = $75,129

EXERCISES

11. Mortgage payable – Long-term liability
Short-term investments – Current asset
Cash – Current asset
Prepaid rent – Current asset Patents
– Intangible asset Common stock –
Contributed capital Accounts
payable – Current liability Buildings
– Fixed asset
Notes payable – Current liability

Teaching Tip: A classified balance sheet groups together accounts of similar nature and reports them in a few major classifications that help when reviewing and analyzing a company. Assets are generally grouped into five main categories on a classified balance sheet: current assets, long-term investments, fixed assets, intangible assets, and other assets. Liabilities are generally grouped as current liabilities and long-term liabilities. Stockholders' equity is classified as contributed capital and retained earnings.

Helpful Hint for Students: The five classifications of assets can be remembered as follows: **C**olorful **L**eaves **F**all **I**n **O**ctober. (**C**urrent, **l**ong-term investments, **f**ixed, **i**ntangible, and **o**ther)

12. Additional paid-in capital – Contributed capital
Land – Fixed asset
Treasury stock – Contributed capital Income
taxes payable – Current liability Long-term
investments – Long-term investments Accounts
receivable – Current asset
Bonds payable – Long-term liability
Copyrights – Intangible asset
Dividends payable – Current liability
Notes payable – Long-term liability

13.

1. f	6. a
2. b	7. c
3. e	8. i
4. g	9. d
5. h	

14.

Sally's Fish and Chips:

Other assets = $13,500	Total assets minus current assets, long-term investments, fixed assets, and intangible assets
Total liabilities = $60,500	Current liabilities plus long-term liabilities
Retained earnings = $104,500	Total liabilities and stockholders' equity minus total liabilities and capital stock

Brina's Bar and Grill:

Long-term investments = $32,500	Total assets minus current assets, fixed assets, intangible assets, and other assets
Long-term liabilities = $68,000	Total liabilities minus current liabilities
Capital stock = $45,750	Total liabilities and stockholders' equity minus total liabilities and retained earnings
Total liabilities and stockholders' equity = $225,750	Same as total assets

Ely's Tanning Salon:

Total assets = $236,000	Current assets plus long-term investments plus fixed assets plus intangible assets plus other assets
Current liabilities = $3,500	Total liabilities minus long-term liabilities
Retained earnings = $99,500	Total liabilities and stockholders' equity minus total liabilities and capital stock
Total liabilities and stockholders' equity = $236,000	Same as total assets

Teaching Tip: This is a good opportunity to reinforce the accounting equation introduced in Chapter 1. The new classifications do not change the premise of the accounting equation.

Helpful Hint for Students: By using your knowledge of the accounting equation and the relationship among the balance sheet accounts, you can make this a simple math problem.

15.

Auburn Bowling Lanes
Balance Sheet
December 31

ASSETS		
Current assets:		
Cash	$20,840	
Accounts receivable	14,520	
Prepaid insurance	4,680	
Total current assets		$ 40,040
Fixed assets:		
Building, net	$60,200	
Equipment, net	63,680	
Land	61,200	
Total fixed assets		185,080
Total assets		$225,120
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$12,480	
Interest payable	3,600	
Mortgage payable—due next year	13,600	
Total current liabilities		$ 29,680
Mortgage payable		89,440
Total liabilities		$119,120
Stockholders' equity:		
Common stock	$66,000	
Retained earnings	40,000	
Total stockholders' equity		106,000
Total liabilities and stockholders' equity		$225,120

Teaching Tip: A classified balance sheet groups together accounts of similar nature and reports them in a few major classifications that help when reviewing and analyzing a company. Assets are generally grouped into five main categories on a classified balance sheet: current assets, long-term investments, fixed assets, intangible assets, and other assets. Liabilities are generally grouped as current liabilities and long-term liabilities. Stockholders' equity is classified as contributed capital and retained earnings.

Helpful Hint for Students: Even though a classified balance sheet groups together accounts of similar nature and reports them in a few major classifications, the accounting equation still prevails. Therefore, Assets = Liabilities + Stockholders' equity.

16.

Best Buy Inc.
Balance Sheet
February 26, 2011

ASSETS		
Current assets:		
Cash	$ 1,103	
Short-term investments	22	
Accounts receivable	2,348	
Inventory	5,897	
Other current assets	1,103	
Total current assets		10,473
Fixed assets		3,823
Intangible assets		2,587
Other assets		966
Total assets		$17,849
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 4,894	
Other current liabilities	3,769	
Total current liabilities		8,663
Long-term liabilities		1,894
Total liabilities		10,557
Stockholders' equity:		
Common stock	39	
Additional paid-in capital	18	
Retained earnings	6,372	
Other equity	863	
Total stockholders' equity		7,292
Total liabilities and stockholders' equity		$17,849

17.

Account	**Reported on:**	
Sales	Income statement	Affects all subtotals of income
Accounts receivable	Balance sheet	Classified as a current asset
Interest payable	Balance sheet	Classified as a current liability
Interest expense	Income statement	Affects Income before taxes and Net income
Supplies Expense	Income statement	Affects all subtotals except gross profit
Supplies	Balance sheet	Classified as a current asset
Inventory	Balance sheet	Classified as a current asset
Cost of sales	Income statement	Affects all subtotals of income

Salaries payable	Balance sheet	Classified as a current liability
Salaries expense	Income statement	Affects all subtotals except gross profit
Income tax expense	Income statement	Affects net income
Income tax payable	Balance sheet	Classified as a current liability

18. The Bike Shop:

Sales = $63,000	Cost of sales plus gross profit
Selling expenses = $6,000	Total operating expenses minus administrative expenses
Income tax expense = $1,500	Operating profit minus net income

The Rental Center:

Net income = $14,400	Operating profit minus income tax expense
Administrative expenses = $4,600	Total operating expenses minus selling expenditures
Gross profit = $39,000	Operating profit plus total operating expenses
Cost of sales = $39,000	Sales minus gross profit

The Uniform Center:

Cost of sales = $28,000	Sales minus gross profit
Operating profit = $2,500	Net income plus income tax expense
Total operating expenses = $4,500	Gross profit minus operating profit
Administrative expenses = $1,500	Total operating expenses minus selling expenditures

Teaching Tip: Companies generally use one of two forms for their income statements—a single-step statement or a multi-step statement. A multi-step income statement calculates income by grouping certain revenues and expenses together and calculating several subtotals of income. These subtotals provide information on the profitability of various aspects of the company's operations.

Helpful Hint for Students: In a multi-step statement, multiple steps are required to calculate net income (or loss). As a result, the income statement has several subtotals: gross profit, operating profit, income before taxes, and finally, net income (or loss).

19.

Brown's Used Cars
Income Statement
For the Year Ending December 31

Net sales		$154,900
Cost of sales		75,620
Gross profit		$ 79,280
Operating expenses:		
Administrative expense	$15,230	
Selling expense	14,600	
Utilities expense	17,650	
Total operating expenses		47,480
Operating profit		$ 31,800
Other revenue and expenses:		
Interest revenue	$ 500	
Interest expense	(50)	450
Income before income taxes		$ 32,250
Income tax expense ($32,250 × 30%)		9,675
Net income		$ 22,575

Teaching Tip: A multi-step income statement calculates income by grouping certain revenues and expenses together and calculating several subtotals of income. Sales revenue is listed first. Listed next is cost of sales. Subtracting cost of sales from net sales then yields the first subtotal of income, gross profit. After gross profit is reported, operating expenses are listed, and then other revenues and expenses. Finally, net income (or loss) is determined.

Helpful Hint for Students: In addition to cost of sales and operating expenses, companies sometimes generate revenues and expenses that are outside of their normal operations. These are listed separately as "Other revenues and expenses" and are netted against operating profit to yield the third subtotal of income, "Income before taxes." Usually, the amount of tax in a given period is listed separately on a multi-step statement as provision for income taxes. It this exercise, use 30% × Income before taxes.

20.

Matthews Music Group
Income Statement
For the Year Ending December 31

Sales		$153,010
Cost of Sales		83,910
Gross profit		$ 69,100
Operating expenses:		
Advertising	$ 6,210	
Insurance	3,960	
Rent	11,410	
Salaries	28,525	
Supplies	5,600	
Total operating expenses		55,705
Operating income		$ 13,395
Other revenues (expenses):		
Interest revenue		6,055
Interest expense		(4,115)
Income before income tax		$ 15,335
Income tax expense		2,250
Net income		$ 13,085

21.

a. $188,000 ($96,000 + $92,000)
b. Cost of sales or Cost of goods sold
c. Gross profit
d. $28,000 ($92,000 − $11,500 − $52,500)
e. Operating profit
f. $18,400 ($52,500 − $9,200 − $43,300)
g. Income before income taxes
h. $43,300 ($28,310 + $14,990)
i. Income tax expense

22.

Treasury stock:	**Balance sheet and statement of stockholders' equity**
Interest revenue:	**Income statement**
Buildings:	**Balance sheet**
Dividends:	**Statement of stockholders' equity**
Accounts payable:	**Balance sheet**
Retained earnings:	**Balance sheet and statement of stockholders' equity**
Interest payable:	**Balance sheet**
Common stock:	**Balance sheet and statement of stockholders' equity**
Cost of sales:	**Income statement**
Administrative expense:	**Income statement**
Additional paid-in capital:	**Balance sheet and statement of stockholders' equity**
Cash:	**Balance sheet**

Teaching Tip: Treasury stock is common stock that the company has purchased back from stockholders. Since the purchase of treasury stock is effectively a return of capital to owners, the balance in treasury stock is subtracted from stockholders' equity.

Helpful Hint for Students: A statement of stockholders' equity is a financial statement that shows how and why each equity account in the company's balance sheet changed from one year to the next. It therefore focuses not only on retained earnings, but other equity accounts relating to a company's contributed capital, including capital stock, dividends, and treasury stock.

23. Round all percentages to one decimal place.

<u>Horizontal Analysis</u>:

	Increase/Decrease	**Computation**
Sales:	$50,000 Increase	($850,000 – $800,000)
	6.3% Increase	[($850,000 – $800,000)/$800,000]
Cost of sales:	$50,000 Increase	($325,000 – $275,000)
	18.2% Increase	[($325,000 – $275,000)/$275,000]
Gross profit:	$0 Increase/decrease	($525,000 – $525,000)
	0% Increase/decrease	[($525,000 – $525,000)/$525,000]
Operating expenses:	$55,000 Increase	($175,000 – $120,000)
	45.8% Increase	[($175,000 – $120,000)/$120,000]
Operating profit:	$55,000 Decrease	($350,000 – $405,000)
	13.6% Decrease	[($350,000 – $405,000)/$405,000]
Income tax expense:	$16,500 Decrease	($105,000 – $121,500)

	Increase/Decrease	Computation
	13.6 % Decrease	[($105,000 – $121,500)/$121,500]
Net income:	$38,500 Decrease	($245,000 – $283,500)
	13.6 % Decrease	[($245,000 – $283,500)/$283,500]

Vertical Analysis:	2012
Cost of sales/sales	$325,000/$850,000 = 38.2%
Gross profit/sales	$525,000/$850,000 = 61.8%
Operating expenses/sales	$175,000/$850,000 = 20.6%
Operating profit/sales	$350,000/$850,000 = 41.2%
Income tax expense/sales	$105,000/$850,000 = 12.4%
Net income/sales	$245,000/$850,000 = 28.8%

	2011
Gross profit/sales	$525,000/$800,000 = 65.6%
Operating expenses/sales	$120,000/$800,000 = 15.0%
Operating profit/sales	$405,000/$800,000 = 50.6%
Income tax expense/sales	$121,500/$800,000 = 15.2%
Net income/sales	$283,500/$800,000 = 35.4%

Teaching Tip: Since financial statements communicate economic information about a company to interested parties, certain comparisons can provide a more thorough understanding of a company's financial activities. Horizontal analysis is a method of analyzing a company's account balances over time and is very useful in identifying trends in a company. Vertical analysis is a method of comparing a company's account balances *within* one year.

Helpful Hint for Students: Horizontal analysis is calculated as follows. First, the dollar change in an account is determined. This is defined as the current year balance less the prior year balance. The dollar change is then divided by the prior year balance to yield a percentage change. Vertical analysis is calculated by dividing each account balance by a base account, yielding a percentage. The base account is total assets for balance sheet accounts and net sales or revenues for income statement accounts.

24. Round all percentages to one decimal place.

Horizontal Analysis	**Dollar change**	**Percentage change**
Cash	\$142 – \$160 = (\$18)	(\$18) / \$160 = (11.3%)
Accounts receivable	\$35 – \$30 = \$5	\$5 / \$30 = 16.7%
Inventory	\$428 – \$382 = \$46	\$46 / \$382 = 12.0%
Current assets	\$605 – \$572 = \$33	\$33 / \$572 = 5.8%
Equipment, net	\$880 – \$790 = \$90	\$90 / \$790 = 11.4%
Total assets	\$1,485 – \$1,362 = \$123	\$123 / \$1,362 = 9.0%
Accounts payable	\$201 – \$220 = (\$19)	(\$19) / \$220 = (8.6%)
Salaries payable	\$169 – \$162 = \$7	\$7 / \$162 = 4.3%
Current liabilities	\$370 – \$382 = (\$12)	(\$12) / \$382 = (3.1%)
Bonds payable	\$350 – \$300 = \$50	\$50 / \$300 = 16.7%
Total liabilities	\$720 – \$682 = \$38	\$38 / \$682 = 5.6%
Retained Earnings	\$382 – \$300 = \$82	\$82 / \$300 = 27.3%
Common Stock	\$383 – \$380 = \$3	\$3 / \$380 = 0.8%
Total equity	\$765 – \$680 = \$85	\$85 / \$680 = 12.5%
Total liabilities and equity	\$1,485 – \$1,362 = \$123	\$123 / \$1,362 = 9.0%

Vertical Analysis	**2012**	**2011**
Cash	\$142 / \$1,485 = 9.7%	\$160 / \$1,362 = 11.7%
Accounts receivable	\$35 / \$1,485 = 2.4%	\$30 / \$1,362 = 2.2%
Inventory	\$428 / \$1,485 = 28.8%	\$382 / \$1,362 = 28.0%
Current assets	\$605 / \$1,485 = 40.7%	\$572 / \$1,362 = 42.0%
Equipment, net	\$880 / \$1,485 = 59.3%	\$790 / \$1,362 = 58.0%
Total assets	\$1,485 / \$1,485 = 100.0%	\$1,362 / \$1,362 = 100.0%
Accounts payable	\$201 / \$1,485 = 13.5%	\$220 / \$1,362 = 16.2%
Salaries payable	\$169 / \$1,485 = 11.4%	\$162 / \$1,362 = 11.9%
Current liabilities	\$370 / \$1,485 = 24.9%	\$382 / \$1,362 = 28.0%
Bonds payable	\$350 / \$1,485 = 23.6%	\$300 / \$1,362 = 22.0%
Total liabilities	\$720 / \$1,485 = 48.5%	\$682 / \$1,362 = 50.1%
Retained Earnings	\$382 / \$1,485 = 25.7%	\$300 / \$1,362 = 22.0%
Common Stock	\$383 / \$1,485 = 25.8%	\$380 / \$1,362 = 27.9%
Total equity	\$765 / \$1,485 = 51.5%	\$680 / \$1,362 = 49.9%
Total liabilities and equity	\$1,485 / \$1,485 = 100.0%	\$1,362 / \$1,362 = 100.0%

25. Round all percentages to one decimal place.

Horizontal Analysis:

	Increase/Decrease	**Computation**
Total Assets:	$150,000 Increase	($850,000 – $700,000)
	21.4% Increase	[($850,000 – $700,000)/$700,000]
Total Liabilities:	$40,000 Decrease	($240,000 – $280,000)
	14.3% Decrease	[($240,000 – $280,000)/$280,000]
Total Equity:	$190,000 Increase	($610,000 – $420,000)
	45.2% Increase	[($610,000 – $420,000)/$420,000]

Vertical Analysis:	**2012**
Total Liabilities/Total Assets	$240,000/$850,000 = 28.2%
Total Equity/Total Assets	$610,000/$850,000 = 71.8%
	2011
Total Liabilities/Total Assets	$280,000/$700,000 = 40%
Total Equity/Total Assets	$420,000/$700,000 = 60%

Ellis is less risky in 2012 because it generates more assets through equity. Total liabilities as a percentage of total assets decrease from 40% in 2011 to 28.2% in 2012. Total equity increases from 60% in 2011 to 71.8% in 2012, meaning that more assets came from equity, which is less risky.

Teaching Tip: Since financial statements communicate economic information about a company to interested parties, certain comparisons can provide a more thorough understanding of a company's financial activities. Horizontal analysis is a method of analyzing a company's account balances over time and is very useful in identifying trends in a company. Vertical analysis is a method of comparing a company's account balances *within* one year. An examination of the balance sheet shows overall growth. Total assets increased and total liabilities decreased, which indicates that the company's asset growth was not generated by borrowing from creditors.

Helpful Hint for Students: Horizontal analysis is calculated as follows. First, the dollar change in an account is determined. This is defined as the current year balance less the prior year balance. The dollar change is then divided by the prior year balance to yield a percentage change. Vertical analysis is calculated by dividing each account balance by a base account, yielding a percentage. The base account is total assets for balance sheet accounts, and net sales or revenues for income statement accounts.

26.

<u>Horizontal Analysis</u>:

	Increase/Decrease	**Computation**
Net sales:	$1,473 Increase	($121,345 – $119,872)
	1.2% Increase	$1,473/$119,872
Accounts receivable:		
	$17,516 Increase	($30,192 – $12,676)
	138.2% Increase	$17,516)/$12,676
Total assets:	$3,428 Decrease	($246,933 – $250,361)
	1.4% Decrease	$(3,428)/$250,361

<u>Vertical Analysis</u>:	**Current year**
Accounts receivable/Total assets	$30,192/$246,933 = 12.2%
	Prior year
Accounts receivable/Total assets	$12,676/$250,361 = 5.1%

Yes – the company should be concerned. Although horizontal analysis of net sales shows some growth in sales of 1.2%, overall total assets shrank by 1.4% during the year. Most concerning is that accounts receivable increased 138.2% (which is more than doubling). Moreover, accounts receivable as a percentage of assets rose from 5.1% in the prior year to 12.2% in the current year. These analyses suggest that the increase to receivables is not because sales or assets increased but because the company is having difficulty collecting its sales.

27.

a. 3
b. 2
c. 4
d. 5
e. 1
f. 6

PROBLEMS

28.

Bay Company
Balance Sheet
December 31

ASSETS		
Current assets:		
Cash	$ 8,000	
Accounts receivable	12,000	
Other current assets	4,000	
Total current assets		$ 24,000
Fixed assets:		
Land	$20,000	
Buildings	70,000	
Equipment	41,000	
Total fixed assets		131,000
Total assets		$155,000
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$16,000	
Interest payable	14,000	
Total current liabilities		$30,000
Bonds payable		40,000
Total liabilities		$ 70,000
Stockholders' equity:		
Common stock	$35,000	
Retained earnings	50,000	
Total stockholders' equity		85,000
Total liabilities and stockholders' equity		$155,000

Teaching Tip: A classified balance sheet groups together accounts of similar nature and reports them in a few major classifications that help when reviewing and analyzing a company. Assets are generally grouped into five main categories on a classified balance sheet: current assets, long-term investments, fixed assets, intangible assets, and other assets. Liabilities are generally grouped as current liabilities and long-term liabilities. Stockholders' equity is classified as contributed capital and retained earnings.

Helpful Hint for Students: The five classifications of assets can be remembered as follows: **C**olorful **L**eaves **F**all **I**n **O**ctober. (**C**urrent, **l**ong-term investments, **f**ixed, **i**ntangible, and **o**ther). Current assets are listed in order of liquidity.

29.

Foshee Corporation
Income Statement
For the Year Ending December 31

Sales	$ 130,000	
Cost of sales	80,000	
Gross profit		$ 50,000
Selling expense	$ 13,000	
Total operating expenses		(13,000)
Operating profit		$ 37,000
Other revenue and expenses		
Interest revenue	$ 16,500	
Interest expense	(15,000)	1,500
Income before taxes		$ 38,500
Income tax expense		12,850
Net income		$ 25,650

Teaching Tip: A multi-step income statement calculates income by grouping certain revenues and expenses together and calculating several subtotals of income. Sales revenue is listed first. Listed next is cost of sales. Subtracting cost of sales from net sales then yields the first subtotal of income, gross profit. After gross profit is reported, operating expenses are listed and then other revenues and expenses. Finally, net income (or loss) is determined.

Helpful Hint for Students: In addition to cost of sales and operating expenses, companies sometimes generate revenues and expenses that are outside of their normal operations. These are listed separately as "Other revenues and expenses" and are netted against operating profit to yield the third subtotal of income, "Income before taxes." Usually, the amount of tax in a given period is listed separately on a multi-step statement as provision for income taxes.

30.

Wilson Inc.
Income Statement
For the Year Ending December 31, 2012

Sales		$78,480
Cost of sales		41,250
Gross profit		$37,230
Operating expenses:		
Utilities	$ 4,180	
Advertising	4,200	
Insurance	4,680	
Salaries	17,420	
Total operating expenses		30,480
Operating profit		$ 6,750
Income tax expense		3,260
Net income		$ 3,490

Wilson Inc.
Balance Sheet
December 31, 2012

ASSETS		
Current assets:		
Cash		$16,080
Accounts receivable		8,470
Prepaid insurance		5,970
Total current assets		30,520
Equipment, net		45,420
Total assets		$75,940
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable		$15,780
Salaries payable		5,210
Total current liabilities		$20,990
Long-term liabilities		9,920
Total liabilities		$30,910
Stockholders' equity:		
Common stock	$ 15,400	
Retained earnings	29,630	
Total stockholders' equity		45,030
Total liabilities and stockholders' equity		$75,940

Note: Retained earnings for the balance sheet is calculated as follows:

Retained Earnings, Jan 1 + Net Income – Dividends

= $28,450 + $3,490 – $2,310 = $29,630

31.

a.

Carnell Inc.
Comparative Balance Sheets
December 31

ASSETS	**2012**	**2011**
Current assets:		
Cash	$ 15,000	$ 25,635
Accounts receivable	50,000	85,065
Inventory	25,650	27,270
Supplies	12,500	13,500
Prepaid rent	10,150	12,275
Total current assets	$113,300	$163,745
Long-term investments	$125,000	$100,000
Fixed assets:		
Buildings, net	$240,000	$300,000
Equipment, net	24,000	24,000
Land	300,000	200,000
Total fixed assets	$564,000	$524,000
Patents	$ 6,000	$ 6,000
Total assets	$808,300	$793,745
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 75,500	$ 35,035
Interest payable	13,755	7,550
Income taxes payable	12,250	16,465
Notes payable	100,000	–
Salaries payable	35,500	33,560
Total current liabilities	$237,005	$ 92,610
Long-term liabilities		
Notes payable, due 6/30/13	–	$100,000
Bonds payable, due 12/31/16	125,000	25,000
Total long-term liabilities	$125,000	$125,000
Total liabilities	$362,005	$217,610
Stockholders' equity		
Capital stock, $5 par	$100,000	$ 80,000
Additional paid-in capital	200,000	190,000
Retained earnings	146,295	306,135
Total stockholders' equity	$446,295	$576,135
Total liabilities and stockholders' equity	$808,300	$793,745

b. Round all percentages to one decimal place.

Horizontal Analysis:

Cash	41.5% decrease	[($15,000 – 25,635)/$25,635]
Accounts receivable	41.2% decrease	[($50,000 – 85,065)/$85,065]
Inventory	5.9% decrease	[($25,650 – 27,270)/$27,270]
Supplies	7.4% decrease	[($12,500 – 13,500)/$13,500]
Prepaid rent	17.3% decrease	[($10,150 – 12,275)/$12,275]
Total current assets	30.8% decrease	[($113,300 – 163,745)/$163,745]
Long-term investments	25% increase	[($125,000 – 100,000)/$100,000]
Buildings, net	20% decrease	[($240,000 – 300,000)/$300,000]
Equipment , net	No change	
Land	50% increase	[($300,000 – 200,000)/$200,000]
Total fixed assets	7.6% increase	[($564,000 – 524,000)/$524,000]
Patents	No change	
Total assets	1.8% increase	[($808,300 – 793,745)/$793,745]
Accounts payable	115.5% increase	[($75,500 – 35,035)/$35,035]
Interest payable	82.2% increase	[($13,755 – 7,550)/$7,550]
Income taxes payable	25.6% decrease	[($12,250 – 16,465)/$16,465]
Notes payable	No change	
Salaries payable	5.8% increase	[($35,500 – 33,560)/$33,560]
Total current liabilities	155.9% increase	[($237,005 – 92,610)/$92,610]
Bonds payable	400% increase	[($125,000 – 25,000)/$25,000]
Total liabilities	66.4% increase	[($362,005 – 217,610)/$217,610]
Capital stock	25% increase	[($100,000 – 80,000)/$80,000]
Additional paid-in capital	5.3% increase	[($200,000 – 190,000)/$190,000]
Retained earnings	52.2% decrease	[($146,295 – 306,135)/$306,135]
Total stockholders' equity	22.5% decrease	[($446,295 – 576,135)/$576,135]
Total liabilities and equity	1.8% increase	[($808,300 – 793,745)/$793,745]

Vertical Analysis:

Cash/Total assets	$15,000/$808,300 = 1.9%
Accounts receivable/Total assets	$50,000/$808,300 = 6.2%
Inventory/Total assets	$25,650/$808,300 = 3.2%
Supplies/Total assets	$12,500/$808,300 = 1.5%
Prepaid rent/Total assets	$10,150/$808,300 = 1.3%
Total current assets/Total assets	$113,300/$808,300 = 14%
Long-term investments/Total assets	$125,000/$808,300 = 15.5%
Buildings/Total assets	$240,000/$808,300 = 29.7%
Equipment/Total assets	$24,000/$808,300 = 3.0%
Land/Total assets	$300,000/$808,300 = 37.1%
Total fixed assets/Total assets	$564,000/$808,300 = 69.8%
Patents/Total assets	$6,000/$808,300 = 0.7%

Accounts payable/Total assets	$75,500/$808,300 = 9.3%
Notes payable/Total assets	$100,000/$808,300 = 12.4%
Salaries payable/Total assets	$35,500/$808,300 = 4.4%
Interest payable/Total assets	$13,755/$808,300 = 1.7%
Income tax payable/Total assets	$12,250/$808,300 = 1.5%
Total current liabilities/Total assets	$237,005/$808,300 = 29.3%
Bonds payable/Total assets	$125,000/$808,300 = 15.5%
Total liabilities/Total assets	$362,005/$808,300 = 44.8%
Capital stock/Total assets	$100,000/$808,300 = 12.4%
Additional paid-in-capital/Total assets	$200,000/$808,300 = 24.7%
Retained earnings/Total assets	$146,295/$808,300 = 18.1%
Total Stockholders' equity/Total assets	$446,295/$808,300 = 55.2%

Horizontal analysis shows that total assets were stable with only a 1.8% increase from 2011 to 2012. However, there were some significant changes within assets—current assets decreased 30.8%; long-term investments increased 25%; and land increased 50%. It appears that the company used its cash and collected receivables to purchase additional investments and land. Total liabilities increased over 66%, with most of that coming from an increase in bonds (400%) and a more than doubling of accounts payable. Equity was significantly lower due to a significant drop in retained earnings. Overall, horizontal analysis shows a shift to more long-term assets and a shift from equity to liabilities. Thus, investors and creditors may be concerned with the company's ability to pay its obligations in the future, especially in the short term. Vertical analysis confirms this potential concern, as it shows a much higher percentage of liabilities to assets and a much lower percentage of equity to assets in 2012 than 2011.

c. Yes, it does. If bonds payable is $0 and retained earnings is $271,295, then the company has not shifted as much to liabilities from equity. With the new numbers, liabilities would only have grown by 8.9% [($237,005 – 217,610)/$217,610], while retained earnings would have decreased by only 11.4% [($271,295 – 306,135)/$306,135]. Thus the change in the way in which the company finances its assets is not as drastically different across the years. As a result, investors and creditors would not be as concerned about the company's ability to satisfy its obligations.

Teaching Tip: Since financial statements communicate economic information about a company to interested parties, certain comparisons can provide a more thorough understanding of a company's financial activities. Horizontal analysis is a method of analyzing a company's account balances over time and is very useful in identifying trends in a company. Vertical analysis is a method of comparing a company's account balances *within* one year.

Helpful Hint for Students: Horizontal analysis is calculated as follows. First, the dollar change in an account is determined. This is defined as the current year balance less the prior year balance. The dollar change is then divided by the prior year balance to yield a percentage change. Vertical analysis is calculated by dividing each account balance by a base account, yielding a percentage. The base account is total assets for balance sheet accounts and net sales or revenues for income statement accounts.

32.

a.

Dansby Inc.
Comparative Income Statements
For The Years Ending December 31

	2012	**2011**
Sales	$95,950	$106,569
Cost of sales	48,596	58,896
Gross profit	$47,354	$ 47,673
Operating expenses		
Advertising	$ 7,765	$ 9,789
Commissions	4,879	6,010
Insurance	4,897	5,236
Rent	7,634	7,856
Salaries	19,320	21,012
Supplies	1,654	2,106
Total operating expenses	$46,149	$ 52,009
Operating profit	1,205	(4,336)
Other revenue (expenses)		
Interest revenue	$ 4,287	$ 4,189
Interest expense	(2,584)	(2,695)
Income before income tax	$ 2,908	$ (2,842)
Income tax expense	2,217	2,684
Net income (loss)	$ 691	$ (5,526)

b. Round all percentages to one decimal place.

Horizontal Analysis:

Sales	10% decrease	[($95,950 – 106,569)/$106,569]
Cost of sales	17.5% decrease	[($48,569 – 58,896)/$58,896]
Gross profit	0.7 % decrease	[($47,354 – 47,673)/$47,673]
Advertising expense	20.7% decrease	[($7,765 – 9,789)/$9,789]
Commissions expense	18.8% decrease	[($4,879 – 6,010)/$6,010]
Insurance expense	6.5% decrease	[($4,897 – 5,236)/$5,236]
Rent expense	2.8% decrease	[($7,634 – 7,856)/$7,856]
Salaries expense	8.1% decrease	[($19,320 – 21,012)/$21,012]
Supplies expense	21.5% decrease	[($1,654 – 2,106)/$2,106]
Total operating expenses	11.3% decrease	[($46,149 – 52,009)/$52,009]
Operating profit	127.8% increase	[($1,205 – (–4,336))/$4,336]
Interest revenue	2.3% increase	[($4,287 – 4,189)/$4,189]
Interest expense	4.1% decrease	[($2,584 – 2,695)/$2,695]
Income before income tax	202.3% increase	[($2,908 – (–2,842))/$2,842]
Income tax expense	17.4% decrease	[($2,217 – 2,684)/$2,684]
Net income (loss)	112.5% increase	[($691 – (–5,526))/$5,526]

<u>Vertical Analysis</u>: 2012 listed first, 2011 listed second

Cost of sales/Sales	2012: $48,596/$95,950 = 50.6%
	2011: $58,896/$106,569 = 55.3%
Gross profit/Sales	2012: $47,354/$95,950 = 49.4%
	2011: $47,673/$106,569 = 44.7%
Advertising/Sales	2012: $7,765/$95,950 = 8.1%
	2011: $9,789/$106,569 = 9.2%
Commissions/Sales	2012: $4,879/$95,950 = 5.1%
	2011: $6,010/$106,569 = 5.6%
Insurance/Sales	2012: $4,897/$95,950 = 5.1%
	2011: $5,236/$106,569 = 4.9%
Rent/Sales	2012: $7,634/$95,950 = 8.0%
	2011: $7,856/$106,569 = 7.4%
	2011: $21,012/$106,569 = 19.7%
Supplies/Sales	2012: $1,654/$95,950 = 1.7%
	2011: $2,106/$106,569 = 2.0%
Total operating expenses/Sales	2012: $46,149/$95,950 = 48.1%
	2011: $52,009/$106,569 = 48.8%
Operating profit/Sales	2012: $1,205/$95,950 = 1.3%
	2011: ($4,336)/$106,569 = (4.1%)
Interest expenses/Sales	2012: $2,584/$95,950 = 2.7%
	2011: $2,695/$106,569 = 2.5%
Interest revenue/Sales	2012: $4,287/$95,950 = 4.5%
	2011: $4,189/$106,569 = 3.9%
Income before income tax/Sales	2012: $2,908/$95,950 = 3.0%
	2011: ($2,842)/$106,569 = (2.7%)
Income tax expense/Sales	2012: $2,217/$95,950 = 2.3%
	2011: $2,684/$106,569 = 2.5%
Net income (loss)/Sales	2012: $691/$95,950 = 0.7%
	2011: ($5,526)/$106,569 = (5.2%)

Both sales and cost of sales decreased in 2012, but cost of sales decreased at a greater rate, so gross profit was stable. A decrease in operating expenses helped the company increase operating profit by 128%. Some minor changes in other income and taxes resulted in a 113% increase in profit in 2012. So, although sales were down, decreases in cost of sales and operating expenses allowed the company to increase net income. The company was much more efficient. Vertical analysis confirms this conclusion. Cost of sales consumed only 50% of sales dollars in 2012, compared to 55% in 2011. Operating expenses also consumed a lower percentage of sales.

c. If cost of sales in 2011 was $45,670 and cost of sales in 2012 was $62,470, conclusions about the company would be much different. Instead of improving from a net loss to net income, the company would generate net income of $7,700 in 2011, only to see it fall to a

$13,138 net loss in 2012. This drop in income would be caused entirely by the combination of increasing in cost of sales and decreasing sales. Specifically, horizontal analysis would show a 45% decrease in gross profit [($33,480 – 60,899)/$60,899] from 2011 to 2012. This would be extremely concerning to managers, creditors, and investors.

Teaching Tip: Since financial statements communicate economic information about a company to interested parties, certain comparisons can provide a more thorough understanding of a company's financial activities. Horizontal analysis is a method of analyzing a company's account balances over time and is very useful in identifying trends in a company. Vertical analysis is a method of comparing a company's account balances *within* one year.

Helpful Hint for Students: Horizontal analysis is calculated as follows. First, the dollar change in an account is determined. This is defined as the current year balance less the prior year balance. The dollar change is then divided by the prior year balance to yield a percentage change. Vertical analysis is calculated by dividing each account balance by a base account, yielding a percentage. The base account is total assets for balance sheet accounts and net sales or revenues for income statement accounts.

33.

	Current Year	**Prior Year**	**$ Change**	**% Change**
Net sales	$43,251	$39,474	$3,777	9.6%
Cost of sales	20,351	18,038	2,313	12.8
Selling and administrative expenses	15,965	14,266	1,699	11.9
Operating income	6,935	7,170	(235)	(3.3)
Other income	86	461	(375)	(81.3)
Income before taxes	7,021	7,631	(610)	(8.0)
Provision for income taxes	1,879	1,973	(94)	(4.8)
Net income	5,142	5,658	(516)	(9.1)

Although PepsiCo's sales are increasing, net income has decreased from the prior year. This is explained by the almost 13% increase in cost of goods sold and 12% increase in selling and administrative expenses.

34.

	Current Year	Prior Year	Horizontal Analysis	Vertical Analysis Current Year	Vertical Analysis Prior Year
Sales	$800,000	$500,000	60.0%	100.0%	100.0%
Cost of sales	300,000	200,000	50.0	37.5	40.0
Gross profit	500,000	300,000	66.7	62.5	60.0
Operating expenses	167,000	130,000	28.5	20.9	26.0
Operating income	333,000	170,000	95.9	41.6	34.0
One-time gain	0	180,000	(100.0)	0	36.0
Net income	$333,000	$350,000	(4.9)	41.6	70.0

Through horizontal analysis, you see sales grew 60% from the prior year, while net income decreased by 4.9%. During the prior year the company experienced a one-time gain of $180,000. Vertical analysis of this gain yields 36.0%, indicating the gain was a significant part of the prior year's performance. As this gain did not occur again in the current year, net income decreased slightly. However, through horizontal analysis, we see ABC Inc. experienced a 66.7% increase in gross profit, and a 95.9% increase in operating income. Therefore, profits from continuing operations are growing.

CASES

35.

		Current Year	Prior Year
a.	Current assets	$13,479	$13,900
	Net property and equipment	25,060	25,550
	Total assets	40,125	40,877
	Current liabilities	10,122	10,363
	Total liabilities	21,236	21,484
	Total stockholders' equity	18,889	19,393

b.	Current assets	($13,479 – $13,900) ÷ $13,900 = (3.0%)
	Net property and equipment	($25,060 – $25,550) ÷ $25,550 = (1.9%)
	Total assets	($40,125 – $40,877) ÷ $40,877 = (1.8%)
	Current liabilities	($10,122 – $10,363) ÷ $10,363 = (2.3%)
	Total liabilities	($21,236 – $21,484) ÷ $21,484 = (1.2%)
	Total stockholders' equity	($18,889 – $19,393) ÷ $19,393 = (2.6%)

Conclusion: Every balance decreased in the current year. The company reduced its size in almost every area during the year.

	Current Year	Prior Year
c. Gross profit	$23,304	$22,412
Operating income	5,839	4,803
Earnings before income taxes	5,273	3,982
Net earnings	3,338	2,661

d.	Gross profit	($23,304 – $22,412) ÷ $22,412 = 4.0%
	Operating income	($5,839 – $4,803) ÷ $4,803 = 21.6%
	Earnings before income taxes	($5,273 – $3,982) ÷ $3,982 = 32.4%
	Net earnings	($3,338 – $2,661) ÷ $2,661 = 25.4%

Conclusion: Each subtotal of income increased in the current year. The company was more profitable in every measure in the current year.

36.

a. Current Installments of Long-Term Debt represents the portion of long-term debt that is coming due within one year of the balance sheet date. Therefore, the obligation is no longer "long-term" but is rather a short-term, or current, obligation. As a result, the obligation is reported as a current liability.

b. There are six different senior notes that the company has outstanding at the end of the current year. Note that seven are listed, but the first one has a zero balance in the current year. Each outstanding note differs on the interest rate (ranging from 3.95% to 5.875%) and the maturity date (ranging from March 1, 2011, to September 15, 2040).

c. The Deferred Revenue account captures 1) the sale of gift cards and 2) payments received prior to the completion of services.

37.

a. The line above net earnings is as follows: Earnings (Loss) from Discontinued Operations, Net of Tax. This would represent the income or loss that Home Depot generated from operations that the company has discontinued and will no longer pursue.

b. According to note 4, Home Depot sold HD Supply. Since the company sold the unit, the earnings and losses from HD Supply are classified as discontinued operations.

c. Yes. Income statements should be as informative as possible. One way to make them more informative is to separate a company's *continuing* operations from those that have been *discontinued*. Since Home Depot will no longer generate profits and/or losses from HD Supply, those profits and losses should be separately reported so that investors will be informed.

38.

Horizontal analysis:

Net sales	($1,980,195 − $1,828,523) ÷ $1,828,523 = 8.3%
Cost of sales	($876,201 − $834,188) ÷ $934,188 = 5.0%
Gross profit	($1,103,994 − $994,335) ÷ $994,335 = 11.0%

Vertical analysis:

	Current Year		Prior Year
Net sales	$1,980,195 ÷ $1,980,195 =	100.0%	$1,828,523 ÷ $1,828,523 = 100.0%
Cost of sales	$876,201 ÷ $1,980,195 =	44.2%	$834,188 ÷ $1,828,523 = 45.6%
Gross profit	$1,103,994 ÷ $1,980,195 =	55.8%	$994,335 ÷ $1,828,523 = 54.4%

Horizontal analysis shows that sales for the current year increased faster than the cost of sales (8.3% versus 5.0%). This yielded an 11.0 increase in gross profit. Therefore, horizontal analysis shows increased profitability. Vertical analysis indicates the same. In the current year, Ann Taylor generated 55.8% of gross profit for every dollar of sales. This is an increase over the 54.4% gross profit in the prior year. In effect, this means that Ann Taylor was able to earn about one and one-half cents more of gross profit from every dollar of sales. While a penny and a half might not sound like much, when you earn an extra penny or so per dollar on almost $2 billion in sales, those pennies add up fast.

39.

To: Current and Future Investment Club Members
From: Student
Subject: Explanation of the Income Statement

The income statement shows a company's revenues and expenses over a period of time. To provide as much information as possible, many companies prepare multi-step income statements. A multi-step income statement calculates and reports several subtotals of income.

The first subtotal is gross profit. Gross profit is the profit generated when considering only the sales price and the cost of the inventory sold. It is calculated as sales less cost of sales. Readers examine gross profit to evaluate a company's ability to profit from the markup on its products.

The second subtotal is operating profit. Operating profit measures a company's profitability when considering all expenses associated with operations. It is calculated by subtracting operating expenses such as advertising and salaries from gross profit. Readers examine operating profit to evaluate a company's ability to profit from its normal operations.

The third subtotal is income before taxes. This subtotal includes all revenues and expenses a company experiences except for income taxes. Readers examine income before taxes to assess profitability from all activities other than taxes.

The final subtotal of income is net income, which includes the effect of all revenues and expenses.

LOWE'S COMPARATIVE ANALYSIS FROM PREP CARDS

1. The full company name is *Lowe's Companies, Inc.* Inc. stands for incorporated. Thus, Lowe's is a corporation.

2. Yes. As the Independent Auditor's Report (titled "Report of Independent Registered Public Accounting Firm") states that the financial information is presented "in conformity with accounting principles generally accepted in the United States of America."

3. Lowe's uses a multi-step income statement. It shows several subtotals (in italics), including:

Net sales
– Cost of sales
Gross margin
Expenses:
Selling, general and
administrative Depreciation
Interest - net
Total expenses
Pretax earnings
Income tax provision
Net earnings

4. **<u>Horizontal Analysis: 2011</u>**

Inventory:
($8,321 – 8,249)/$8,249 = 0.87%
Cost of sales:
($31,663 – 30,757)/$30,757 = 2.95%

<u>Vertical Analysis: 2011</u>

Inventory:
$8,321/$33,699 = 24.69%
Cost of sales:
$31,663/$ 48,815 = 64.86%

The horizontal analyses indicate that both inventory and cost of sales increased during the year, thus showing general growth in the company. As expected, the vertical analyses indicate that inventory is a significant part of Lowe's business. Inventory makes up about one-fourth of Lowe's assets. Moreover, for every dollar of sales, Lowe's spends about 65 cents on the merchandise sold. This leaves only 35 cents to cover all other expense and generate a profit.