prior to cash collection. In this case, Krispy Kreme will increase Accounts Receivable and increase Sales Revenue. When the cash is subsequently received from Safeway, Krispy Kreme will increase Cash and reduce Accounts Receivable.

Transaction: *Revenue recorded for sales on account.*

Balance Sheet							Income Statement				
Assets	=	Liabilities	+	Stockholders' Equity: Contrib. Capital	+	Retained Earnings	Revenues	−	Expenses	=	Net Income
+100 Accounts Receivable	=					+100	+100 Sales	−		=	+100

Transaction: *Recognize cash received for sales on account.*

Balance Sheet							Income Statement				
Assets	=	Liabilities	+	Stockholders' Equity: Contrib. Capital	+	Retained Earnings	Revenues	−	Expenses	=	Net Income
+100 Cash	=							−		=	
−100 Accounts Receivable	=							−		=	

Cash Received *Before* Revenue Is Earned

Assume that **Albertsons** prepays for its donut purchases by giving Krispy Kreme a cash payment prior to receiving any donuts. Even though Krispy Kreme has received cash, it has not yet earned the revenue, and thus, will defer the recognition of sales revenue until it is earned, which is at the time of delivery. Upon receipt of the cash, Krispy Kreme will record an increase in Cash and an increase in a liability account, Advances from Customers. When the donuts are delivered, Krispy Kreme will record a reduction in Advances from Customers and an increase in Sales Revenue. As these examples demonstrate, it is the earning of sales revenue that determines when revenue is recognized by a company under the accrual basis of accounting, and not the timing of the cash collection.

Transaction: *Recognize the receipt of cash prior to revenue being earned.*

Balance Sheet							Income Statement				
Assets	=	Liabilities	+	Stockholders' Equity: Contrib. Capital	+	Retained Earnings	Revenues	−	Expenses	=	Net Income
+100 Cash	=	+100 Advances from customers						−		=	

Transaction: *Recognize earned revenue when the goods are delivered.*

Balance Sheet							Income Statement				
Assets	=	Liabilities	+	Stockholders' Equity: Contrib. Capital	+	Retained Earnings	Revenues	−	Expenses	=	Net Income
	=	−100 Advances from customers				+100	+100 Sales revenue	−		=	+100

TAKEAWAY 3.1	Concept	Method	Assessment
	When should sales revenue be recognized?	Record revenue when it is earned. Revenue is earned when the company performs its contractual obligation to the customer.	Early recognition of revenue overstates current period revenue; recognizing revenue too late understates current period revenue.

Expense Recognition (Matching) Principle

Under accrual basis accounting, expenses are recognized during the same period as the revenues they generate. In other words, the expenses are "matched" with the revenues that they produce. Like the recognition of revenue, expenses may be recognized prior to, at the same time, or subsequent to the payment of cash. It is the recognition of revenue, and not the payment of cash, that determines when expenses are recognized under the accrual basis of accounting.

Referring again to Krispy Kreme, assume the company pays $50 cash to acquire baking materials for its donuts. This purchase is not recognized as an expense until Krispy Kreme sells the donuts it produces. The cash purchase of the materials prior to the sale is accounted for as a decrease in Cash and an increase in Supplies, both assets.

Transaction: *Paid cash for supplies.*

Assets	=	Liabilities	+	Contrib. Capital	+	Retained Earnings	Revenues	-	Expenses	=	Net Income
−50 Cash	=							-		=	
+50 Supplies	=							-		=	

The cash payment precedes the revenue recognition and the matching of the expense. But what happens if the materials are purchased on account? In this case, Krispy Kreme will record an increase in Baking Supplies and an increase in a liability, Accounts Payable. When the $50 is subsequently paid, it will decrease Cash and Accounts Payable.

Transaction: *Purchase of supplies on account.*

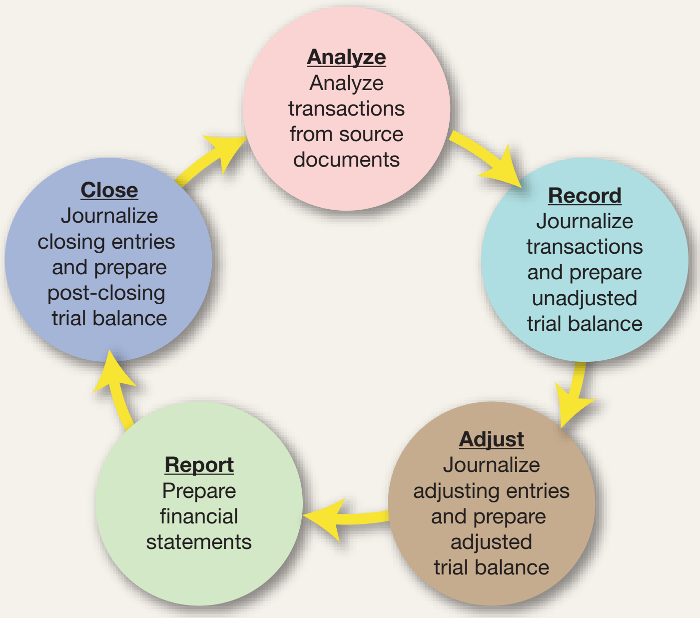
Assets	=	Liabilities	+	Contrib. Capital	+	Retained Earnings	Revenues	-	Expenses	=	Net Income
+50 Supplies	=	+50 Accounts payable						-		=	

Transaction: *Recognize the* payment of cash to the vendor.

Assets	=	Liabilities	+	Contrib. Capital	+	Retained Earnings	Revenues	-	Expenses	=	Net Income
−50 Cash	=	−50 Accounts payable						-		=	

In each of the above cases the expense is recognized when the donuts are sold, which is when the revenues related to the sale are recognized. At that point, Cost of Goods Sold increases and Baking Supplies decreases.

EXHIBIT 3-4 **The Accounting Cycle: A Summary**



REVIEW 3.3

Balke Laboratory began operations on July 1, 2017, and provides diagnostic services for physicians and medical clinics. The company's fiscal year ends on June 30, and the accounts are adjusted annually on this date. Balke's unadjusted balance sheet as of June 30, 2019, is as follows:

BALKE LABORATORY
Unadjusted Balance Sheet
June 30, 2019

	~~Debit~~	~~Credit~~
Assets		
Cash	$ 1,000	
Accounts receivable	9,200	
Prepaid insurance	6,000	
Supplies	31,300	
Laboratory equipment	270,000	
Accumulated depreciation	(30,000)	
Total assets		$287,500
Liabilities and stockholders' equity		
Accounts payable	3,100	
Diagnostic fees received in advance	4,000	
Total liabilities		7,100
Common stock	90,000	
Retained earnings (beginning of year)	50,000	
Diagnostic fees revenue	220,400	
Wage expense	(58,000)	
Rent expense	(22,000)	
Total stockholders' equity		280,400
Total liabilities and stockholders' equity		$287,500

continued

IDENTIFYING A WIN-WIN COMPANY

After a visit to one of **Apple**'s many retail stores, you will likely find it hard to believe that the company ever faced financial difficulties. The company has a cult-like following for its products but things have not always been so good for the company. In fact, Apple suffered crippling financial losses and record low stock prices in the mid-1990s. Steve Jobs was instrumental in leading Apple back to profitability through creative technological innovations.

Being a profitable company has allowed Apple to benefit from what some refer to as a virtuous cycle in which the company is able to both do good financially and do good socially. Apple believes that a win-win situation can be obtained through its commitment to social responsibility.

But what if we decide to consider investing in a company like Apple? How should we go about determining whether Apple is a good investment? We first want to do some research to determine if the company is profitable and financially sound.

Road Map

LO	Learning Objective	Page	eLecture	Guided Example	Assignments
LO1	**Describe the qualities that make financial reporting useful.**	130	E4-1		
LO2	**Explain where you can find accounting information.**	132	E4-2		
LO3	**Describe a classified balance sheet.**	132	E4-3	4.1, 4.4	SE1, E1A, E4A, E1B, E4B, P1A, P2A, P4A, P1B, P2B, P4B
LO4	**Describe a classified (single-step and multi-step) income statement.**	137	E4-4	4.2, 4.4	SE8, E2A, E6A, E2B, E6B, P3A, P6A, P10A, P3B, P6B, P10B
LO5	**Discuss the use of a balance sheet and ratios to assess liquidity and solvency.**	140	E4-5	4.3	SE3, SE4, SE6, E3A, E5A, E3B, E5B, P5A, P8A, P9A, P5B, P8B, P9B
LO6	**Discuss the use of the income statement and ratios to assess profitability.**	142	E4-6	4.3	SE2, SE7, E3A, E5A, E8A, E3B, E5B, E8B, P5A, P6A, P8A, P9A, P5B, P6B, P8B, P9B
LO7	**Explain the components of the statement of stockholders' equity.**	143	E4-7		E7A, E9A, E7B, E9B, P7A, P7B
LO8	**Explain the purpose of the statement of cash flows.**	144	E4-8	4.4	SE5, E10A, E10B, P4A, P4B

REVIEW 10.2

Match the description in the right column with the appropriate term in the left column:

1. Authorized	*a.* The right to receive dividends omitted in prior years.
2. Outstanding	*b.* The most basic class of stock ownership.
3. Common stock	*c.* Stock with one or more preferences over common stock.
4. Preemptive right	*d.* The maximum number of shares of each class of stock that may be issued.
5. Preferred stock	*e.* Shares actually held by stockholders.
6. Cumulative	*f.* The right to maintain a proportionate ownership interest in a corporation.

The solution is on page 415.

STOCK ISSUANCES FOR CASH

LO4 Describe the accounting for issuances of capital stock.

When issuing capital stock to investors, a corporation may use the services of an investment bank, a specialist in marketing securities to the capital market. The investment bank may *underwrite* a stock issue by agreeing to sell the shares on a firm commitment basis— that is, buying the shares from the corporation and then reselling them to investors. Under a firm commitment agreement, a corporation does not risk being unable to sell its stock. The underwriter bears this risk in return for the fees and profits generated by selling the shares to investors at a price higher than it paid to the corporation. An investment bank that is unwilling to underwrite a stock issue may handle the issuance of the shares on a *best efforts* basis. In this case, the investment bank agrees to sell as many shares as possible at a set price, but the corporation bears the risk of any unsold shares.

When capital stock is issued to investors, the appropriate capital stock account is increased for the par value of the stock issued, or if the stock is no-par value stock, with its stated value, if any. The asset received in exchange for the stock (usually cash) is also increased, and any difference is reflected as an increase to the Paid-in Capital in Excess of Par Value account.

To illustrate how various stock issuances in exchange for cash affect the financial statements, assume that Los Altos, Inc. issued two different types of capital stock during its first year of operations:

Issuing Stock at a Premium

1. Issued 1,000 shares of $100 par value, 9% preferred stock at $107 cash per share:

Transaction: *Issue 1,000 shares of $100 par value, 9% preferred stock at $107 cash per share.*

Balance Sheet							*Income Statement*				
Assets	=	Liabilities	+	Stockholders' Equity							
				Contrib. Capital	+	Retained Earnings	*Revenues*	-	*Expenses*	=	*Net Income*
+107,000 Cash	=			+ 100,000 Preferred stock + 7,000 Paid-in capital in excess of par value---Preferred stock				-		=	

In this transaction, the preferred stock is issued at a price greater than its par value—that is, the shares were sold at a premium. The par value of the preferred stock issued is recorded as an increase to the Preferred Stock account and the $7,000 premium to the Paid-in Capital in Excess of Par Value account. If there is more than one class of par value stock, the account title may indicate the class of stock to which the premium relates, in this case Paid-in Capital in Excess of Par Value—Preferred Stock.

Issuing No-Par Stock

2. Issued 30,000 shares of no-par value common stock, stated value $5, at $8 cash per share:

Transaction: *Issued 30,000 shares of no-par value common stock, stated value $5, at $8 cash per share.*

Balance Sheet							Income Statement				
Assets	=	Liabilities	+	Stockholders' Equity							
				Contrib. Capital	+	Retained Earnings	*Revenues*	-	*Expenses*	=	*Net Income*
+240,000 Cash	=			+ 150,000 Common stock + 90,000 Paid-in capital in excess of stated value---Common stock				-		=	

When no-par value stock has a stated value, as in Entry 2, the stated value of the total shares issued is recorded in the proper capital stock account, and any additional amount received is an increase to the account Paid-in Capital in Excess of Stated Value. If there is no stated value for the no-par value stock, the entire proceeds are recorded in the appropriate capital stock account. For example, in the second transaction, if the common stock had no stated value, the entire $240,000 amount would have been an increase to the Common Stock account.

These two stock issuances are reflected in **Exhibit 10-2**, which presents the stockholders' equity section from Los Altos, Inc.'s year-end balance sheet. (It is assumed that the company is authorized to issue 1,000 shares of preferred stock and 40,000 shares of common stock, and that retained earnings are $25,000.) The stockholders' equity section is divided into two major categories: ❶ Contributed Capital and ❷ Retained Earnings. **Contributed capital** is the amount of capital contributed to the corporation from various capital stock transactions such as the issuance of preferred stock and common stock. The capital contributed by stockholders through the issuance of stock is divided between the legal capital (the par value or stated value of the stock) and the amounts received in excess of the legal capital. Later in this chapter we discuss treasury stock transactions that may affect a corporation's contributed capital. **Retained earnings** represent the cumulative net income and losses of the company that have not been distributed to stockholders as a dividend.

A.K.A. *Contributed Capital* is also referred to as Paid-in Capital.

EXHIBIT 10-2 **Stockholders' Equity Section of the Balance Sheet**

❶	Contributed Capital		
	9% Preferred stock, $100 par value, 1,000 shares authorized, issued, and outstanding	$100,000	
	No-par common stock, $5 stated value, 40,000 shares authorized; 30,000 shares issued and outstanding.	150,000	$250,000
	Additional paid-in capital		
	In excess of par value—Preferred stock	7,000	
	In excess of stated value—Common stock	90,000	97,000
	Total Contributed Capital		347,000
❷	Retained earnings		25,000
	Total Shareholders' Equity		$372,000

Noncash Stock Issuances

Sometimes a corporation will exchange its common stock for services, operating assets, or for its own convertible debt. For example, some start-up companies lacking cash will exchange their common stock for professional services provided by attorneys and accountants. When this occurs, the exchange is recorded as an increase to the Professional Services Expense account and an increase to Common Stock—Par Value and to the Paid-in Capital in Excess of Par Value—Common Stock account for the fair value of the services received.

eLectures MBC

LO6 **Explain** the accounting for treasury stock.

6

TREASURY STOCK

When a corporation acquires its own outstanding shares for a purpose other than retiring (cancelling) them, the acquired shares are called **treasury stock**. Treasury stock may be purchased for a variety of reasons, to include reissuing them to officers and employees in profit sharing programs or employee stock option plans. Whatever the purpose, treasury stock purchases reduce a company's stockholders' equity. The repurchased shares do not carry voting privileges or preemptive rights, are not paid dividends, and do not receive assets in the event of a corporation's liquidation.

ACCOUNTING IN PRACTICE

Greenmail Corporations usually purchase their own shares by buying them through a brokerage firm on the open market or by making a tender offer to stockholders. Under a tender offer, the company offers to buy back its shares of stock at a specified price per share. Another way to acquire treasury stock is to negotiate a purchase of shares from a single large stockholder. In some cases, this latter technique may involve greenmail. *Greenmail* is a ploy in which an investor purchases a large number of a company's shares, threatens to take control of the company, and then sells the shares back to the company at a premium. Management pays the premium to entice the investor to "be quiet and go away." Although it is not illegal, payment of an unjustified greenmail premium is likely to upset other stockholders and may lead to legal action against a company.

Accounting for Treasury Stock

Accountants commonly record treasury stock at its acquisition cost, increasing the Treasury Stock account and decreasing the Cash account. The Treasury Stock account is a contra-stockholders' equity account, and its balance is deducted when deriving total stockholders' equity on the balance sheet. To illustrate the affect on the financial statements of purchasing treasury stock, assume that Los Altos, Inc. had 20,000 shares of $10 par value common stock outstanding and then purchased 1,000 shares at its market price of $12 per share. The purchase is recorded as follows: (While Treasury Stock is a contra-stockholders' equity account, for ease of presentation, we include it under Contributed Capital in the template.)

Transaction: *Purchase 1,000 shares of treasury stock at $12 per share.*

Balance Sheet							*Income Statement*			
Assets	=	Liabilities	+	Stockholders' Equity						
				Contrib. Capital	+	Retained Earnings	*Revenues*	-	*Expenses*	= *Net Income*
−12,000 Cash	=			- 12,000 Treasury stock				-		=

Following this transaction, the stockholders' equity section of Los Altos, Inc. balance sheet would appear as follows (the values for Paid-in Capital in Excess of Par Value and Retained Earnings are assumed):

LOS ALTOS, INC.
Stockholders' Equity

Contributed Capital	
Common stock, $10 par value, authorized and issued 20,000 shares;	
1,000 shares in treasury, 19,000 shares outstanding	$200,000
Paid-in capital in excess of par value	20,000
Total Contributed Capital	220,000
Retained earnings	40,000
	260,000
Less: Treasury stock (1,000 shares) at cost	**12,000**
Total Stockholders' Equity	$248,000

Note that the $200,000 par value of all *issued* stock is disclosed, although the 1,000 treasury shares are no longer outstanding. The total cost of the 1,000 shares, however, is later deducted as the last component in the presentation of total stockholders' equity.

If Los Altos, Inc. subsequently resells 500 shares of its treasury stock at $14 per share (the market value at the time of the reissuance), the Treasury stock account is reduced by the original cost of the treasury stock (500 × $12 per share = $6,000) and the excess [(500 × ($14 − $12) = $1,000] increases paid-in capital in excess of par value.

Transaction: *Sale of 500 shares of treasury stock for $14 per share. The original cost of the treasury shares was $12.*

Balance Sheet							*Income Statement*				
Assets	=	Liabilities	+	Stockholders' Equity							
				Contrib. Capital	+	Retained Earnings	*Revenues*	-	*Expenses*	=	*Net Income*
+7,000 Cash	=			+ 6,000 Treasury stock + 1,000 Additional paid-in capital ---Treasury stock				-		=	

Note that the additional $1,000 received on the resale of the treasury stock is accounted for as an increase in contributed capital and not as net income. This is because the treasury stock is reissued at its market price, and thus does not result in a gain for the existing shareholders.

IFRS ALERT!

Under IFRS and U.S. GAAP, treasury stock is reported on the balance sheet as a contra stockholders' equity account; that is, the repurchase cost of any treasury stock is subtracted from total stockholders' equity. In addition, both IFRS and U.S. GAAP preclude the recognition of any gain or loss by a company from stock transactions involving its own shares—that is, any "gain" or "loss" from trading in a company's own shares is recorded as part of Paid-in Capital in Excess of Par Value. By way of contrast, some countries permit treasury stock to be reported on the asset side of the balance sheet as an investment in marketable securities. Under IFRS and U.S. GAAP, treasury stock does not satisfy the definition of an asset, and therefore, cannot be reported on the balance sheet as marketable securities. It is also noteworthy that in some countries, treasury stock purchases are illegal because they are viewed as a form of stock price manipulation.

REVIEW 10.4

The Fullerton Corporation purchased 5,000 shares of its outstanding $2 par value common stock for $75,000 cash on November 1. Management anticipates holding the stock in the treasury until it resells the stock. How much would the Fullerton Corporation report as Treasury Stock for this purchase?

The solution is on page 415.

CASH DIVIDENDS AND STOCK DIVIDENDS

LO7 **Identify** and **distinguish** between cash dividends and stock dividends.

Dividends are a distribution of assets or shares of stock from a corporation to its stockholders. A corporation can distribute dividends to stockholders only after its board of directors has formally voted to declare a distribution. Dividends are usually paid in cash but may also be paid as property or additional shares of stock in the firm. Legally, declared dividends are an obligation of the firm, and an entry to record the dividend obligation is made on the *dividend declaration date*. Cash and property dividends payable are carried as liabilities, and stock dividends to be issued are shown in the stockholders' equity section of the balance sheet. At the date of declaration, a *record date* and *payment date* are also established. For example, assume that on April 25 (the declaration date), the

E11-5A. Operating Cash Flows (Direct Method) Calculate the cash flow in each of the following cases:

LO4 (Appendix 11A) Homework MBC

a. Cash paid for advertising:

Advertising expense	$62,000
Prepaid advertising, January 1	11,000
Prepaid advertising, December 31	15,000

b. Cash paid for income taxes:

Income tax expense	$29,000
Income tax payable, January 1	7,100
Income tax payable, December 31	4,900

c. Cash paid for merchandise purchased:

Cost of goods sold	$180,000
Inventory, January 1	30,000
Inventory, December 31	25,000
Accounts payable, January 1	10,000
Accounts payable, December 31	12,000

E11-6A. Statement of Cash Flows (Direct Method) Use the following information regarding the cash flows of Mason Corporation to prepare a statement of cash flows using the direct method:

LO4 (Appendix 11A) Homework MBC

Cash balance, December 31	$ 12,000
Cash paid to employees and suppliers	148,000
Cash received from sale of land	40,000
Cash paid to acquire treasury stock	10,000
Cash balance, January 1	16,000
Cash received as interest	6,000
Cash paid as income taxes	11,000
Cash paid to purchase equipment	89,000
Cash received from customers	194,000
Cash received from issuing bonds payable	30,000
Cash paid as dividends	16,000

E11-7A. Operating Cash Flows (Direct Method) Refer to the information in Exercise E11-4A. Calculate the cash flow from operating activities using the direct method. Show a related cash flow for each revenue and expense.

LO4 (Appendix 11A) Homework MBC

E11-8A. Investing and Financing Cash Flows During the year, Paxon Corporation's Long-Term Investments account (at cost) increased $15,000, the net result of purchasing stocks costing $80,000 and selling stocks costing $65,000 at a $6,000 loss. Also, the Bonds Payable account decreased by $40,000, the net result of issuing $100,000 of bonds at 103 and retiring bonds with a face value (and book value) of $140,000 at a $9,000 gain. What items and amounts will appear in the (a) cash flows from investing activities and the (b) cash flows from financing activities sections of Paxon's statement of cash flows?

LO2, 4 (Appendix 11A)

E11-9A. Cash Flow from Operating Activities (Indirect Method) The Arcadia Company owns no plant assets and had the following income statement for the year:

LO2 Homework MBC

Sales revenue		$950,000
Cost of goods sold	$670,000	
Wages expense	210,000	
Rent expense	42,000	
Utilities expense	15,000	937,000
Net income		$ 13,000

b. Received cash as refund from supplier
c. Borrowed cash from bank on six-month note payable
d. Exchanged, at a gain, stock held as an investment for a parcel of land
e. Invested cash in a money market fund (cash may be easily withdrawn from the fund)
f. Loaned cash to help finance the start of a new biotechnology firm

E11-3B. Cash Flow from Operating Activities (Indirect Method) The following information was obtained from Galena Company's comparative balance sheets:

LO2, 3
Homework MBC

	End of Year	Beginning of Year
Cash	$ 19,000	$ 9,000
Accounts receivable	44,000	35,000
Inventory	55,000	49,000
Prepaid rent	6,000	8,000
Long-term investments	21,000	34,000
Plant assets	150,000	106,000
Accumulated depreciation	(40,000)	(32,000)
Accounts payable	24,000	20,000
Income tax payable	4,000	6,000
Common stock	121,000	92,000
Retained earnings	106,000	91,000
Capital expenditures	44,000	

Assume that Galena Company's income statement showed depreciation expense of $8,000, a gain on sale of investments of $9,000, and a net income of $45,000. (a) Calculate the cash flow from operating activities using the indirect method and (b) compute Galena's operating-cash-flow-to-capital-expenditures ratio.

E11-4B. Cash Flow from Operating Activities (Indirect Method) Cairo Company had a $21,000 net loss from operations. Depreciation expense for the year was $8,600, and a dividend of $6,000 was declared and paid. The balances of the current asset and current liability accounts at the beginning and end of the year are as follows:

LO2
Homework MBC

	End	Beginning
Cash	$ 3,500	$ 7,000
Accounts receivable	16,000	25,000
Inventory	50,000	53,000
Prepaid expenses	6,000	9,000
Accounts payable	12,000	8,000
Accrued liabilities	5,000	7,600

Did Cairo Company's operating activities provide or use cash? Use the indirect method to determine your answer.

E11-5B. Operating Cash Flows (Direct Method) Calculate the cash flow in each of the following cases:

LO4
(Appendix 11A)
Homework MBC

a. Cash paid for rent:

Rent expense	$60,000
Prepaid rent, January 1	10,000
Prepaid rent, December 31	8,000

b. Cash received as interest:

Interest income	$16,000
Interest receivable, January 1	3,000
Interest receivable, December 31	3,700

c. Cash paid for merchandise purchased:

Cost of goods sold	$98,000
Inventory, January 1	19,000
Inventory, December 31	22,000
Accounts payable, January 1	11,000
Accounts payable, December 31	7,000