**Chapter 1 - The Financial Statements**

**Directed Reading Worksheet Answer Key**

**Part I: Explain why accounting is the language of business (LO1)**

1. 2014: $8,004 million

2013: $6,636 million

Income Statement

1. Companies have financial statements in order to report the results of their activities to various groups of users, such as managers, investors, creditors, and regulatory agencies.
2. Bookkeeping
3. a. Individuals

b. Investors and creditors

c. Regulatory bodies

d. Nonprofit organizations

1. a. Financial accounting (external)

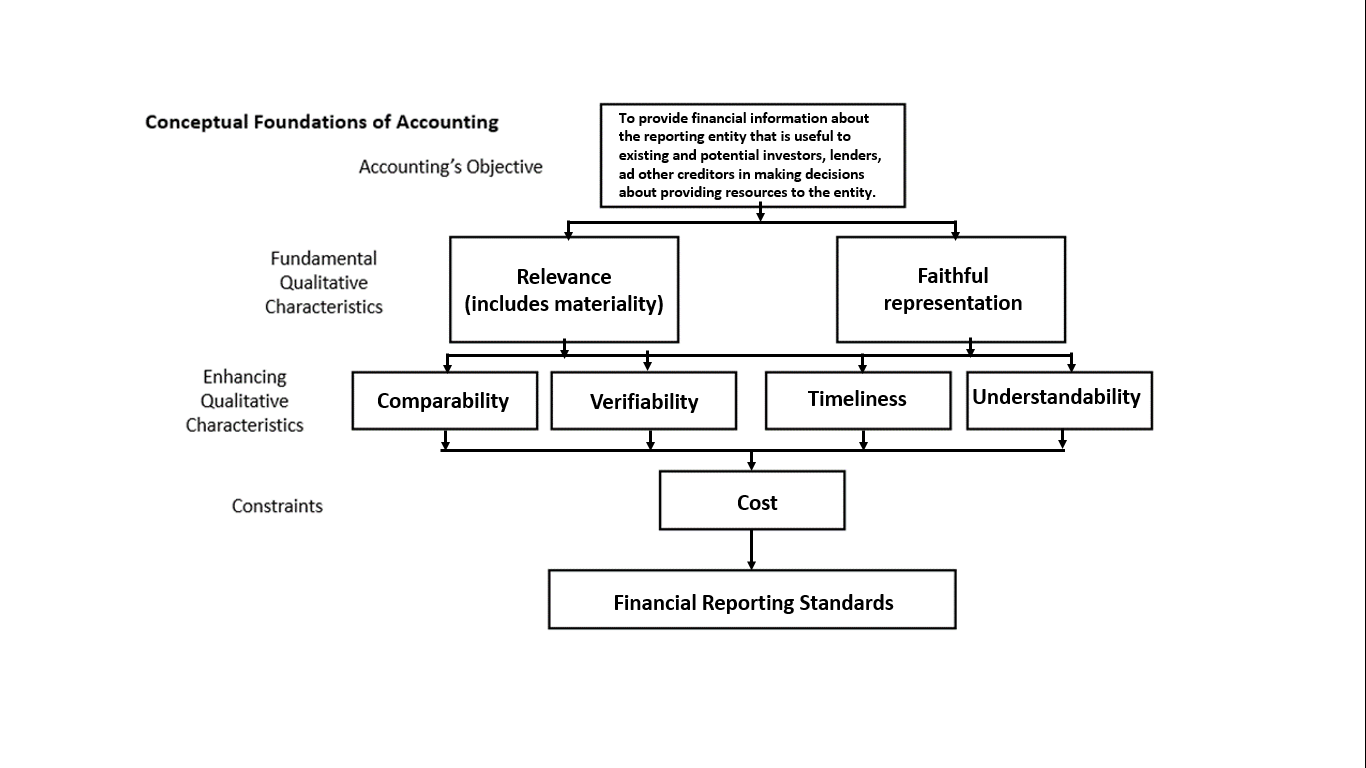
b. Management accounting (internal)

1. Proprietorship
2. Partnership
3. Limited-Liability Company
4. Corporation
5. Stockholders or shareholders who own stock in the corporation

**Part II: Explain and apply underlying accounting concepts, assumptions, and principles (LO2)**

1. a. Generally Accepted Accounting Principles (GAAP)

b. International Financial Reporting Standards (IFRS)

1. 
2. **Relevance** means that the information could change the outcome or make a decision maker chose a different path. If information would have no impact on the decision, then it is not relevant. If the information could change the decision makers mind, it is relevant.

**Faithful representation** means that the information is accurate. Faithful representation makes the information reliable for decision makers to use it.

1. a. **Comparability:** capable of being compared with information from other companies in the same period

b. **Verifiability:** capable of being checked for accuracy, completeness, and reliability

c. **Timeliness:** made available to users early enough to help them make decisions

d. **Understandability:** would make sense to the reasonably informed user of information

1. Fair value
2. This assumption ignores inflation. It assumes that the dollar today is worth the same as a dollar tomorrow. In other words, the purchasing power of the dollar remains steady over time. Accountants use this assumption so they do not have to adjust prior amounts to current year dollars.

**Part III: Apply the accounting equation to business organizations (LO3)**

1. Benefit; Outsiders/Creditors; Insider
2. Assets = Liabilities + Owners’ (Stockholders’) Equity
3. Paid-in capital: the amount the stockholders have invested in the corporation

Retained earnings: the amount earned by income-producing activities and kept for use in the business

The main difference is that paid-in capital comes from the stockholders while retained earnings is from the operations of the business.

1. Revenues, expenses, and dividends

Decrease

1. ARE NOT; NEVER
2. Retained earnings = Revenues – Expenses – Dividends

Or

Retained earnings = Net income (net loss) – Dividends

**Part IV: Evaluate business operations through the financial statements (LO4)**

1. Income statement; Balance sheet
2. Operating, Investing, and Financing
3. Net income
4. True
5. The statement of retained earnings shows the portion of net income that a company has retained over the years. If the company has been profitable, it will have a positive balance in retained earnings. If it has had losses, then its retained earnings will be in a deficit. The statement of retained earnings also shows if the company has distributed dividends.
6. **a.** Assets: Assets are economic resources that are expected to provide a future benefit. They are divided into current and long-term assets.

**b.** Liabilities: Liabilities are debts that the company owes. They are also divided into current and long-term depending on when they become due.

**c.** Stockholders’ Equity: The claim of the owners or stockholders’ to the assets of the business.

1. Cash, Short-term investments, Inventory, Equipment
2. Accumulated depreciation
3. Treasury
4. Goods; services; long-term assets; issuing stock, paying dividends, borrowing, and repayments of borrowed funds.

**Part V: Construct financial statements and analyze the relationships among them (LO5)**

1. Revenues and expenses
2. Net loss
3. A statement of retained earnings starts with the beginning retained earnings balance. Then, net income is added or net loss is subtracted. Next, dividends are subtracted. The final line is then calculated, to give us ending retained earnings.
4. Students’ answers will vary. Some examples include, Cash, Accounts Receivable, Inventory, Prepaid Expenses, Equipment, Machinery, Land, Accounts Payable, Notes Payable, Unearned Service Revenue, Common Stock, Additional Paid-In Capital, Retained Earnings
5. Total assets to total liabilities
6. Students’ answers will vary. Possibilities include:

* Can the company sell its services and products? 🡪 Look at revenue on the income statement
* What are the main income measures and trends? 🡪 Calculate and analyze gross profit, operating income, and net income
* What percentage of revenue ends up as profit? 🡪 Divide net income by sales revenue
* Can the company pay its current and long-term liabilities? 🡪 Compare assets to liabilities on the balance sheet (both current and long-term)
* Where is the company’s cash coming from and how is it being used? 🡪 Examine the statement of cash flows

**Part VI: Evaluating business decisions ethically (LO6)**

1. Answers will vary. Ethics are shaped by our own background and experiences. They are similar to our morals. What is legal may not always be the most ethical thing to do.
2. **a.** Economic factor: the decision should be made in order to maximize economic benefits to the decision maker

**b.** Legal factor: based on the proposition that free societies are governed by laws

**c.** Ethical factor: recognizes that while certain actions might be both economically profitable and legal, they still may not be right

1. Legal compliance, transparency, conflict identification, and accountability
2. A good decision framework for making ethical judgements would be the following:

* Ask yourself, what is the issue?
* Identify who the stakeholders are and what the consequence of the decision would be to each of them.
* Weight the alternatives.
* Make the decision and prepare yourself to deal with the consequences.

This can be simplified into three questions. (1) Is the action legal? (2) Who will be affected and how? (3) How will this decision make me feel after? How would it make me feel if my family reads about it in the newspaper?