

Introduction to Accounting: The Language of Business

Lesson 2: General Purpose Financial Statements

Supplemental Textbook



Financial statements of business organizations

Business entities may have many objectives and goals. For example, one of your objectives in owning a physical fitness center may be to improve *your* physical fitness. However, the two primary objectives of every business are profitability and solvency. **Profitability** is the ability to generate income. **Solvency** is the ability to pay debts as they become due. Unless a business can produce satisfactory income and pay its debts as they become due, the business cannot survive to realize its other objectives.

There are four basic financial statements. Together they present the profitability and strength of a company. The financial statement that reflects a company's profitability is the **income statement**. The **statement of retained earnings** shows the change in retained earnings between the beginning and end of a period (e.g. a month or a year). The **balance sheet** reflects a company's solvency and financial position. The **statement of cash flows** shows the cash inflows and outflows for a company over a period of time. The headings and elements of each statement are similar from company to company. You can see this similarity in the financial statements of actual companies in the appendix of this textbook.

The **income statement**, sometimes called an earnings statement, reports the profitability of a business organization for a *stated period of time*. In accounting, we measure profitability for a period, such as a month or year, by comparing the revenues earned with the expenses incurred to produce these revenues. **Revenues** are the inflows of assets (such as cash) resulting from the sale of products or the rendering of services to customers. We measure revenues by the prices agreed on in the exchanges in which a business delivers goods or renders services. **Expenses** are the costs incurred to produce revenues. Expenses are measured by the assets surrendered or consumed in serving customers. If the revenues of a period exceed the expenses of the same period, **net income** results. Thus,

$$\text{Net income} = \text{Revenues} - \text{Expenses}$$

Net income is often called the *earnings* of the company. When expenses exceed revenues, the business has a **net loss**, and it has operated unprofitably.

In Exhibit 1, Part A shows the income statement of Metro Courier, Inc., for July 2010. This corporation performs courier delivery services of documents and packages in San Diego in the state of California, USA.

Metro's income statement for the month ended 2010 July 31, shows that the revenues (or delivery fees) generated by serving customers for July totaled USD 5,700. Expenses for the month amounted to USD 3,600. As a result of these business activities, Metro's net income for July was USD 2,100. To determine its net income, the company subtracts its expenses of USD 3,600 from its revenues of USD 5,700. Even though corporations are taxable entities, we ignore corporate income taxes at this point.

One purpose of the *statement of retained earnings* is to connect the income statement and the balance sheet. The **statement of retained earnings** explains the changes in retained earnings between two balance sheet dates. These changes usually consist of the addition of net income (or deduction of net loss) and the deduction of dividends.

Dividends are the means by which a corporation rewards its stockholders (owners) for providing it with investment funds. A **dividend** is a payment (usually of cash) to the owners of the business; it is a distribution of

income to owners rather than an expense of doing business. Corporations are not required to pay dividends and, because dividends are not an expense, they do not appear on the income statement.

The effect of a dividend is to reduce cash and retained earnings by the amount paid out. Then, the company no longer retains a portion of the income earned but passes it on to the stockholders. Receiving dividends is, of course, one of the primary reasons people invest in corporations.

The statement of retained earnings for Metro Courier, Inc., for July 2010 is relatively simple (see Part B of Exhibit 1). Organized on June 1, Metro did not earn any revenues or incur any expenses during June. So Metro's beginning retained earnings balance on July 1 is zero. Metro then adds its USD 2,100 net income for July. Since Metro paid no dividends in July, the USD 2,100 would be the ending balance of retained earnings. See below.

A. Income Statement		
METRO COURIER INC		
Income Statement For the Month Ended		
2010 July 31		
Revenues:		
Service revenue		\$ 5,700
Expenses:		
Salaries expense	\$ 2,600	
Rent expense	400	
Gas and oil expense	600	
Total expenses		3,600
Net income		\$ 2,100 (A)

B. Statement of Retained Earnings	
METRO COURIER , INC.	
Statement of Retained Earnings	
For the Month Ended 2010 July 31	
Retained earnings, July 1	-0-
Add: Net income for July	(A)2,100
Retained earnings, July 31	\$ 2,100 (B)

C. Balance Sheet			
METRO COURIER, INC.			
Balance Sheet			
2010 July 31			
Assets		Liabilities and Stockholder's Equity	
Cash	\$ 15,500	Liabilities:	
Account receivables	700	Accounts payable	\$ 600
Trucks	20,000	Notes payable	6,000
Office equipment	2,500	Total liabilities	\$ 6,600
		Stockholders equity:	

		Capital stock	\$ 30,000
		Retained earnings	(B)2,100
		Total stockholders' equity	\$ 32,100
Total assets	\$ 38,700	Total liabilities and stockholders' equity	\$ 38,700

Exhibit 1:

Next, Metro carries this USD 2,100 ending balance in retained earnings to the balance sheet (Part C). If there had been a net loss, it would have deducted the loss from the beginning balance on the statement of retained earnings. For instance, if during the next month (August) there is a net loss of USD 500, the loss would be deducted from the beginning balance in retained earnings of USD 2,100. The retained earnings balance at the end of August would be USD 1,600.

Dividends could also have affected the Retained Earnings balance. To give a more realistic illustration, assume that (1) Metro Courier, Inc.'s net income for August was actually USD 1,500 (revenues of USD 5,600 less expenses of USD 4,100) and (2) the company declared and paid dividends of USD 1,000. Then, Metro's statement of retained earnings for August would be:

METRO COURIER, INC. Statement of Retained Earnings For the Month Ended 2010 August 31	
Retained earnings, August 1.....	\$2,100
Add: Net income for August.....	1,500
Total.....	\$3,600
Less: Dividends.....	1,000
Retained earnings, August 31.....	\$2,600

The **balance sheet**, sometimes called the *statement of financial position*, lists the company's assets, liabilities, and stockholders' equity (including dollar amounts) as of a specific moment in time. That specific moment is the close of business on the date of the balance sheet. Notice how the heading of the balance sheet differs from the headings on the income statement and statement of retained earnings. A balance sheet is like a photograph; it captures the financial position of a company at a particular *point* in time. The other two statements are for a *period* of time. As you study about the assets, liabilities, and stockholders' equity contained in a balance sheet, you will understand why this financial statement provides information about the solvency of the business.

Assets are things of value owned by the business. They are also called the *resources* of the business. Examples include cash, machines, and buildings. Assets have value because a business can use or exchange them to produce the services or products of the business. In Part C of Exhibit 1 the assets of Metro Courier, Inc., amount to USD 38,700. Metro's assets consist of cash, **accounts receivable** (amounts due from customers for services previously rendered), trucks, and office equipment.

Liabilities are the debts owed by a business. Typically, a business must pay its debts by certain dates. A business incurs many of its liabilities by purchasing items on credit. Metro's liabilities consist of **accounts payable** (amounts owed to suppliers for previous purchases) and **notes payable** (written promises to pay a specific sum of money) totaling USD 6,600.¹

Metro Courier, Inc., is a corporation. The owners' interest in a corporation is referred to as **stockholders' equity**. Metro's stockholders' equity consists of (1) USD 30,000 paid for shares of capital stock and (2) retained

1 Most notes bear interest, but in this chapter we assume that all notes bear no interest. Interest is an amount paid by the borrower to the lender (in addition to the amount of the loan) for use of the money over time.

earnings of USD 2,100. **Capital stock** shows the amount of the owners' investment in the corporation. **Retained earnings** generally consists of the accumulated net income of the corporation minus dividends distributed to stockholders. We discuss these items later in the text. At this point, simply note that the balance sheet heading includes the name of the organization and the title and date of the statement. Notice also that the dollar amount of the total assets is equal to the claims on (or interest in) those assets. The balance sheet shows these claims under the heading "Liabilities and Stockholders' Equity".

Management is interested in the cash inflows to the company and the cash outflows from the company because these determine the company's cash it has available to pay its bills when due. The **statement of cash flows** shows the cash inflows and cash outflows from operating, investing, and financing activities. *Operating activities* generally include the cash effects of transactions and other events that enter into the determination of net income. *Investing activities* generally include business transactions involving the acquisition or disposal of long-term assets such as land, buildings, and equipment. **Financing activities** generally include the cash effects of transactions and other events involving creditors and owners (stockholders).

The income statement, the statement of retained earnings, the balance sheet, and the statement of cash flows of Metro Courier, Inc., show the results of management's past decisions. They are the end products of the accounting process, which we explain in the next section. These financial statements give a picture of the solvency and profitability of the company. The accounting process details how this picture was made. Management and other interested parties use these statements to make future decisions. Management is the first to know the financial results; then, it publishes the financial statements to inform other users. The most recent financial statements for most companies can be found on their websites under "Investor Relations" or some similar heading.

The financial accounting process

In this section, we explain the accounting equation—the framework for the entire accounting process. Then, we show you how to recognize a business transaction and describe underlying assumptions that accountants use to record business transactions. Next you learn how to analyze and record business transactions.

In the balance sheet presented in Exhibit 1 (Part C), the total assets of Metro Courier, Inc., were equal to its total liabilities and stockholders' equity. This equality shows that the assets of a business are equal to its equities; that is,

$$\text{Assets} = \text{Equities}$$

Assets were defined earlier as the things of value owned by the business, or the economic resources of the business. **Equities** are all claims to, or interests in, assets. For example, assume that you purchased a new company automobile for USD 15,000 by investing USD 10,000 in your own corporation and borrowing USD 5,000 in the name of the corporation from a bank. Your equity in the automobile is USD 10,000, and the bank's equity is USD 5,000. You can further describe the USD 5,000 as a liability because you owe the bank USD 5,000. If you are a corporation, you can describe your USD 10,000 equity as stockholders' equity or interest in the asset. Since the owners in a corporation are stockholders, the basic **accounting equation** becomes:

$$\text{Assets (A)} = \text{Liabilities (L)} + \text{Stockholders' equity (SE)}$$

From Metro's balance sheet in Exhibit 1 (Part C), we can enter in the amount of its assets, liabilities, and stockholders' equity:

$$A = L + SE$$

$$\text{USD } 38,700 = \text{USD } 6,600 + \text{USD } 32,100$$

Remember that someone must provide assets or resources—either a creditor or a stockholder. Therefore, this equation must always be in balance.

You can also look at the right side of this equation in another manner. The liabilities and stockholders' equity show the sources of an existing group of assets. Thus, liabilities are not only claims against assets but also sources of assets.

Together, creditors and owners provide all the assets in a corporation. The higher the proportion of assets provided by owners, the more solvent the company. However, companies can sometimes improve their profitability by borrowing from creditors and using the funds effectively. As a business engages in economic activity, the dollar amounts and composition of its assets, liabilities, and stockholders' equity change. *However, the equality of the basic accounting equation always holds.*

A classified balance sheet

The balance sheets we presented so far have been unclassified balance sheets. **Unclassified balance sheet** has three major categories: assets, liabilities, and stockholders' equity. A **classified balance sheet** contains the same three major categories and subdivides them to provide useful information for interpretation and analysis by users of financial statements.

Exhibit 2, shows a slightly revised classified balance sheet for The Home Depot, Inc., and subsidiaries.² Note that The Home Depot classified balance sheet is in a vertical format (assets appearing above liabilities and stockholders' equity) rather than the horizontal format (assets on the left and liabilities and stockholders' equity on the right). The two formats are equally acceptable.

The Home Depot classified balance sheet subdivides two of its three major categories. The Home Depot subdivides its assets into current assets, property and equipment, long-term investments, long-term notes receivable, intangible assets (cost in excess of the fair value of net assets acquired), and other assets. The company subdivides its liabilities into current liabilities and long-term liabilities (including deferred income taxes). A later chapter describes minority interest. Stockholders' equity is the same in a classified balance sheet as in an unclassified balance sheet. Later chapters describe further subdivisions of the stockholders' equity section.

² Founded in 1978, The Home Depot is America's largest home improvement retailer and ranks among the nation's 30 largest retailers. The company has more than 1,000 full-service warehouse stores. Their primary customers are do-it-yourselfers.

We discuss the individual items in the classified balance sheet later in the text. Our only purpose here is to briefly describe the items that can be listed under each category. Some of these items are not in The Home Depot's balance sheet.

THE HOME DEPOT, INC. AND SUBSIDIARIES
Consolidated Balance Sheet
2001 January 28
(amounts in millions, except share data)

	January 28, 2001	
Assets		
Current Assets:		
Cash and Cash Equivalents	\$ 167	
Short-Term Investments, including current maturities of long-term investments	10	
Receivables, net	835	
Merchandise Inventories	6,556	
Other Current Assets	209	
Total Current Assets		\$ 7,777
Property and Equipment, at cost:		
Land	\$ 4,230	
Buildings	6,167	
Furniture, Fixtures and Equipment	2,877	
Leasehold Improvements	665	
Construction in Progress	1,032	
Capital Leases	261	
	\$ 15,232	
Less: Accumulated Depreciation and Amortization	2,164	
Net Property and Equipment	\$ 13,068	
Long-Term Investments	15	
Notes Receivable	77	
Cost in Excess of Fair Value of Net Assets Acquired, net of accumulated amortization of \$41 at January 25, 2001 and \$33 at January 30, 2000	314	
Other	134	13,608
Total assets		\$ 21,385
Liabilities and Stockholders' Equity		
Current Liabilities:		
Accounts Payable	\$ 1,976	
Accrued Salaries and Related Expenses	627	
Sales Taxes Payable	298	
Other Accrued Expenses	1,402	
Income Taxes Payable	78	
Current Installments of Long-Term Debt	4	
Total Current Liabilities		\$4,385
Long-Term Debt, excluding current installments	\$ 1,545	
Other Long-Term Liabilities	245	
Deferred Income Taxes	195	1,985
Minority Interest		11
Stockholders' equity:		
Common Stock, par value \$0.05. Authorized: 10,000,000,000 shares; issued and outstanding- 2,323,747,000 shares at 2001 January 28 and 2,304,317,000 shares at 2000 January 30	116	
Paid-In Capital	4,810	
Retained Earnings	10,151	

Accumulated Other Comprehensive Income	(67)	
	15,010	
Less: Shares Purchased for Compensation Plans	6	
Total Stockholders' Equity		15,004
Total Liabilities and Stockholders' Equity		\$ 21,385

Exhibit 2: A classified balance sheet

Current assets are cash and other assets that a business can convert to cash or uses up in a relatively short period—one year or one operating cycle, whichever is longer. An **operating cycle** is the time it takes to start with cash, buy necessary items to produce revenues (such as materials, supplies, labor, and/or finished goods), sell services or goods, and receive cash by collecting the resulting receivables. Companies in service industries and merchandising industries generally have operating cycles shorter than one year. Companies in some manufacturing industries, such as distilling and lumber, have operating cycles longer than one year. However, since most operating cycles are shorter than one year, the one-year period is usually used in identifying current assets and current liabilities. Common current assets in a service business include cash, marketable securities, accounts receivable, notes receivable, interest receivable, and prepaid expenses. Note that on a balance sheet, current assets are in order of how easily they are convertible to cash, from most liquid to least liquid.

Cash includes deposits in banks available for current operations at the balance sheet date plus cash on hand consisting of currency, undeposited checks, drafts, and money orders. Cash is the first current asset to appear on a balance sheet. The term cash normally includes cash equivalents.

Cash equivalents are highly liquid, short-term investments acquired with temporarily idle cash and easily convertible into a known cash amount. Examples are Treasury bills, short-term notes maturing within 90 days, certificates of deposit, and money market funds.

Marketable securities are temporary investments such as short-term ownership of stocks and bonds of other companies. Such investments do not qualify as cash equivalents. These investments earn additional money on cash that the business does not need at present but will probably need within one year.

Accounts receivable (also called trade accounts receivable) are amounts owed to a business by customers. An account receivable arises when a company performs a service or sells merchandise on credit. Customers normally provide no written evidence of indebtedness on sales invoices or delivery tickets except their signatures. Notice the term net in the balance sheet of The Home Depot (Exhibit 2). This term indicates the possibility that the company may not collect some of its accounts receivable. In the balance sheet, the accounts receivable amount is the sum of the individual accounts receivable from customers shown in a subsidiary ledger or file.

Merchandise inventories are goods held for sale.

A **note** is an unconditional written promise to pay another party the amount owed either when demanded or at a certain specified date, usually with interest (a charge made for use of the money) at a specified rate. A note receivable appears on the balance sheet of the company to which the note is given. A note receivable arises (1) when a company makes a sale and receives a note from the customer, (2) when a customer gives a note for an amount due on an account receivable, or (3) when a company loans money and receives a note in return.

Other current assets might include interest receivable and prepaid expenses. **Interest receivable** arises when a company has earned but not collected interest by the balance sheet date. Usually, the amount is not due until later. **Prepaid expenses** include rent, insurance, and supplies that have been paid for but all the benefits have not yet been realized (or consumed) from these expenses. If prepaid expenses had not been paid for in advance, they would require the future disbursement of cash. Furthermore, prepaid expenses are considered assets because they have service potential.

Long-term assets are assets that a business has on hand or uses for a relatively long time. Examples include property, plant, and equipment; long-term investments; and intangible assets.

Property, plant, and equipment are assets with useful lives of more than one year; a company acquires them for use in the business rather than for resale. (These assets are called property and equipment in The Home Depot's balance sheet.) The terms plant assets or fixed assets are also used for property, plant, and equipment. To agree with the order in the heading, balance sheets generally list property first, plant next, and equipment last. These items are fixed assets because the company uses them for long-term purposes. We describe several types of property, plant, and equipment next.

Land is ground the company uses for business operations; this includes ground on which the company locates its business buildings and that is used for outside storage space or parking. Land owned for investment is not a plant asset because it is a long-term investment.

Buildings are structures the company uses to carry on its business. Again, the buildings that a company owns as investments are not plant assets.

Office furniture includes file cabinets, desks, chairs, and shelves.

Office equipment includes computers, copiers, FAX machines, and phone answering machines.

Leasehold improvements are any physical alterations made by the lessee to the leased property when these benefits are expected to last beyond the current accounting period. An example is when the lessee builds room partitions in a leased building. (The lessee is the one obtaining the rights to possess and use the property.)

Construction in progress represents the partially completed stores or other buildings that a company such as The Home Depot plans to occupy when completed.

Accumulated depreciation is a contra asset account to depreciable assets such as buildings, machinery, and equipment. This account shows the total depreciation taken for the depreciable assets. On the balance sheet, companies deduct the accumulated depreciation (as a contra asset) from its related asset.

Long-term investments A **long-term investment** usually consists of securities of another company held with the intention of (1) obtaining control of another company, (2) securing a permanent source of income for the investor, or (3) establishing friendly business relations. The long-term investment classification in the balance sheet does not include those securities purchased for short-term purposes. For most businesses, long-term investments may be stocks or bonds of other corporations. Occasionally, long-term investments include funds accumulated for specific purposes, rental properties, and plant sites for future use.

Intangible assets **Intangible assets** consist of the noncurrent, nonmonetary, nonphysical assets of a business. Companies must charge the costs of intangible assets to expense over the period benefited. Among the intangible assets are rights granted by governmental bodies, such as patents and copyrights. Other intangible assets include leaseholds and goodwill.

A **patent** is a right granted by the federal government; it gives the owner of an invention the authority to manufacture a product or to use a process for a specified time.

A **copyright** granted by the federal government gives the owner the exclusive privilege of publishing written material for a specified time.

Leaseholds are rights to use rented properties, usually for several years.

Goodwill is an intangible value attached to a business, evidenced by the ability to earn larger net income per dollar of investment than that earned by competitors in the same industry. The ability to produce superior profits is a valuable resource of a business. Normally, companies record goodwill only at the time of purchase and then only at the price paid for it. The Home Depot has labeled its goodwill "cost in excess of the fair value of net assets acquired".

Accumulated amortization is a contra asset account to intangible assets. This account shows the total amortization taken on the intangible assets.

Current liabilities are debts due within one year or one operating cycle, whichever is longer. The payment of current liabilities normally requires the use of current assets. Balance sheets list current liabilities in the order they must be paid; the sooner a liability must be paid, the earlier it is listed. Examples of current liabilities follow.

Accounts payable are amounts owed to suppliers for goods or services purchased on credit. Accounts payable are generally due in 30 or 60 days and do not bear interest. In the balance sheet, the accounts payable amount is the sum of the individual accounts payable to suppliers shown in a subsidiary ledger or file.

Notes payable are unconditional written promises by the company to pay a specific sum of money at a certain future date. The notes may arise from borrowing money from a bank, from the purchase of assets, or from the giving of a note in settlement of an account payable. Generally, only notes payable due in one year or less are included as current liabilities.

Salaries payable are amounts owed to employees for services rendered. The company has not paid these salaries by the balance sheet date because they are not due until later.

Sales taxes payable are the taxes a company has collected from customers but not yet remitted to the taxing authority, usually the state.

Other accrued expenses might include taxes withheld from employees, income taxes payable, and interest payable. **Taxes withheld from employees** include federal income taxes, state income taxes, and social security taxes withheld from employees' paychecks. The company plans to pay these amounts to the proper governmental agencies within a short period. **Income taxes payable** are the taxes paid to the state and federal governments by a corporation on its income. **Interest payable** is interest that the company has accumulated on notes or bonds but has not paid by the balance sheet date because it is not due until later.

Dividends payable, or amounts the company has declared payable to stockholders, represent a distribution of income. Since the corporation has not paid these declared dividends by the balance sheet date, they are a liability.

Unearned revenues (revenues received in advance) result when a company receives payment for goods or services before earning the revenue, such as payments for subscriptions to a magazine. These unearned revenues represent a liability to perform the agreed services or other contractual requirements or to return the assets received.

Companies report any current installment on long-term debt due within one year under current liabilities. The remaining portion continues to be reported as a long-term liability.

Long-term liabilities are debts such as a mortgage payable and bonds payable that are not due for more than one year. Companies should show maturity dates in the balance sheet for all long-term liabilities. Normally, the liabilities with the earliest due dates are listed first.

Notes payable with maturity dates at least one year beyond the balance sheet date are long-term liabilities.

Bonds payable are long-term liabilities and are evidenced by formal printed certificates sometimes secured by liens (claims) on property, such as mortgages. Maturity dates should appear on the balance sheet for all major long-term liabilities.

The deferred income taxes on The Home Depot's balance sheet result from a difference between income tax expense in the accounting records and the income tax payable on the company's tax return.

Stockholders' equity shows the owners' interest in the business. This interest is equal to the amount contributed plus the income left in the business.

The items under stockholders' equity in The Home Depot's balance sheet are paid-in capital (including common stock) and retained earnings. **Paid-in capital** shows the capital paid into the company as the owners' investment. **Retained earnings** shows the cumulative income of the company less the amounts distributed to the owners in the form of dividends. Cumulative translation adjustments result from translating foreign currencies into US dollars (a topic discussed in advanced accounting courses).

The next section shows how two categories on the classified balance sheet relate to each other. Together they help reveal a company's short-term debt-paying ability.

Classified income statement

In preceding chapters, we illustrated the unclassified (or single-step) income statement. An **unclassified income statement** has only two categories—revenues and expenses. In contrast, a **classified income statement** divides both revenues and expenses into operating and nonoperating items. The statement also separates operating expenses into selling and administrative expenses. A classified income statement is also called a multiple-step income statement.

In Exhibit 8, we present a classified income statement for Hanlon Retail Food Store. This statement uses the previously presented data on sales (Exhibit 4) and cost of goods sold (Exhibit 7), together with additional assumed

data on operating expenses and other expenses and revenues. Note in Exhibit 8 that a classified income statement has the following four major sections:

- Operating revenues.
- Cost of goods sold.
- Operating expenses.
- Nonoperating revenues and expenses (other revenues and other expenses).

The classified income statement shows important relationships that help in analyzing how well the company is performing. For example, by deducting cost of goods sold from operating revenues, you can determine by what amount sales revenues exceed the cost of items being sold. If this margin, called gross margin, is lower than desired, a company may need to increase its selling prices and/or decrease its cost of goods sold. The classified income statement subdivides operating expenses into selling and administrative expenses. Thus, statement users can see how much expense is incurred in selling the product and how much in administering the business. Statement users can also make comparisons with other years' data for the same business and with other businesses. Nonoperating revenues and expenses appear at the bottom of the income statement because they are less significant in assessing the profitability of the business.

An accounting perspective:

Business insight

Management chooses whether to use a classified or unclassified income statement to present a company's financial data. This choice may be based either on how their competitors present their data or on the costs associated with assembling the data.

HANLON RETAIL FOOD STORE

Income Statement

For the Year Ended 2010 December 31

Operating revenues:			
Gross sales			\$282,000
Less: Sales discounts		\$ 5,000	
Sales return and allowances		15,000	20,000
Net sales			\$262,000
Cost of goods sold:			
Merchandise inventory, 2010 January 1			\$24,000
Purchases		\$167,000	
Less: Purchase discount	\$3,000		
Purchase returns and allowances	8,000	11,000	
Net purchases		\$156,000	
Add: Transportation-in		10,000	
Net cost of purchases			166,000
Cost of goods available for sale			\$190,000
Less: Merchandise inventory, 2010 December 31			31,000

Cost of goods sold		159,000	
Gross Margin		\$103,000	
Operating expenses:			
Selling expenses:			
Salaries and commissions expense	\$ 26,000		
Salespersons' travel expense	3,000		
Delivery expense	2,000		
Advertising expense	4,000		
Rent expense—store building	2,500		
Supplies expense	1,000		
Utilities expense	1,800		
Depreciation expense—store equipment	700		
Other selling expense	400	\$41,400	
Administrative expenses:			
Salaries expense, executive	\$29,000		
Rent expense—administrative building	1,600		
Insurance expense	1,500		
Supplies expense	800		
Depreciation expense—office equipment	1,100		
Other administrative expenses	300	34,300	
Total operating expenses		75,700	
Income from operations		\$ 27,300	
Nonoperating revenues and expenses:			
Nonoperating revenues:			
Interest revenue		1,400	
		\$ 28,700	
Nonoperating expenses:			
Interest expense		600	
Net income		\$ 28,100	

Exhibit 3: Classified income statement for a merchandising company

Next, we explain the major headings of the classified income statement in Exhibit 8. The terms in some of these headings are already familiar to you. Although future illustrations of classified income statements may vary somewhat in form, we retain the basic organization.

- **Operating revenues** are the revenues generated by the major activities of the business—usually the sale of products or services or both.
- **Cost of goods sold** is the major expense in merchandising companies. Note the cost of goods sold section of the classified income statement in Exhibit 8. This chapter has already discussed the items used in calculating cost of goods sold. Merchandisers usually highlight the amount by which sales revenues exceed the cost of goods sold in the top part of the income statement. The excess of net sales over cost of goods sold is the **gross margin** or **gross profit**. To express gross margin as a percentage rate, we divide gross margin by net sales. In Exhibit 8, the gross margin rate is approximately 39.3 per cent (USD 103,000/USD 262,000). The gross margin rate indicates that out of each sales dollar, approximately 39 cents is available to cover other expenses and produce income. Business owners watch the gross margin rate closely since a small percentage fluctuation can cause a large dollar change in net income. Also, a downward trend in the gross margin rate may indicate a

problem, such as theft of merchandise. For instance, one Southeastern sporting goods company, SportsTown, Inc., suffered significant gross margin deterioration from increased shoplifting and employee theft.

- **Operating expenses** for a merchandising company are those expenses, other than cost of goods sold, incurred in the normal business functions of a company. Usually, operating expenses are either selling expenses or administrative expenses. **Selling expenses** are expenses a company incurs in selling and marketing efforts. Examples include salaries and commissions of salespersons, expenses for salespersons' travel, delivery, advertising, rent (or depreciation, if owned) and utilities on a sales building, sales supplies used, and depreciation on delivery trucks used in sales. **Administrative expenses** are expenses a company incurs in the overall management of a business. Examples include administrative salaries, rent (or depreciation, if owned) and utilities on an administrative building, insurance expense, administrative supplies used, and depreciation on office equipment.

Certain operating expenses may be shared by the selling and administrative functions. For example, a company might incur rent, taxes, and insurance on a building for both sales and administrative purposes. Expenses covering both the selling and administrative functions must be analyzed and prorated between the two functions on the income statement. For instance, if USD 1,000 of depreciation expense relates 60 per cent to selling and 40 per cent to administrative based on the square footage or number of employees, the income statement would show USD 600 as a selling expense and USD 400 as an administrative expense.

- **Nonoperating revenues** (other revenues) and **nonoperating expenses** (other expenses) are revenues and expenses not related to the sale of products or services regularly offered for sale by a business. An example of a nonoperating revenue is interest that a business earns on notes receivable. An example of a nonoperating expense is interest incurred on money borrowed by the company.

To summarize the more important relationships in the income statement of a merchandising firm in equation form:

- **Net sales** = Gross sales - (Sales discounts + Sales returns and allowances).
- **Net purchases** = Purchases - (Purchase discounts + Purchase returns and allowances).
- **Net cost of purchases** = Net purchases + Transportation-in.
- **Cost of goods sold** = Beginning inventory + Net cost of purchases - Ending inventory.
- **Gross margin** = Net sales - Cost of goods sold.
- **Income from operations** = Gross margin - Operating (selling and administrative) expenses.
- **Net income** = Income from operations + Nonoperating revenues - Nonoperating expenses.

Each of these relationships is important because of the way it relates to an overall measure of business profitability. For example, a company may produce a high gross margin on sales. However, because of large sales commissions and delivery expenses, the owner may realize only a very small percentage of the gross margin as profit. The classifications in the income statement allow a user to focus on the whole picture as well as on how net income was derived (statement relationships).

**An ethical perspective:
World auto parts corporation**

John Bentley is the chief financial officer for World Auto Parts Corporation. The company buys approximately USD 500 million of auto parts each year from small suppliers all over the world and resells them to auto repair shops in the United States.

Most of the suppliers have cash discount terms of 2/10, n/30. John has instructed his personnel to pay invoices on the 30th day after the invoice date but to take the 2 per cent discount even though they are not entitled to do so. Whenever a supplier complains, John instructs his purchasing agent to find another supplier who will go along with this practice. When some of his own employees questioned the practice, John responded as follows:

This practice really does no harm. These small suppliers are much better off to go along and have our business than to not go along and lose it. For most of them, we are their largest customer. Besides, if they are willing to sell to others at a 2 per cent discount, why should they not be willing to sell to us at that same discount even though we pay a little later? The benefit to our company is very significant. Last year our profits were USD 100 million. A total of USD 10 million of the profits was attributable to this practice. Do you really want me to change this practice and give up USD 10 million of our profits?

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