

# 8 Financial Statements for a Proprietorship

## AFTER STUDYING CHAPTER 8, YOU WILL BE ABLE TO:

1. Define an accounting term related to financial statements for a service business organized as a proprietorship.
2. Identify accounting concepts and practices related to preparation of financial statements for a service business organized as a proprietorship.
3. Prepare an income statement for a service business organized as a proprietorship and analyze an income statement using component percentages.
4. Prepare a balance sheet for a service business organized as a proprietorship.

### TERM PREVIEW

component percentages

## REPORTING FINANCIAL INFORMATION

The financial information needed by managers and owners to make good business decisions can be found in the general ledger accounts. However, the information in the general ledger is very detailed. Therefore, to make this general ledger information more usable, the information is summarized, organized, and reported to the owners and managers.

Also, *all* financial information *must* be reported if good business decisions are to be made. A financial statement with incomplete information is similar to a book with missing pages. The complete story is not told. If a business has both rent and utilities expenses but reports only the rent expense, managers will have incomplete information on which to base decisions. The accounting concept, *Adequate Disclosure*, is applied when financial statements contain all information necessary to understand a business's financial condition. (**CONCEPT: Adequate Disclosure**)

Encore Music prepares two financial statements: an income statement and a balance sheet. Encore Music always prepares financial statements at the end of each monthly fiscal period. (**CONCEPT: Accounting Period Cycle**)

# ACCOUNTING IN YOUR CAREER

## ENHANCING FINANCIAL REPORTING

Tanya Allen works for Marci Stettner, who owns and operates Marci's Delivery Service, a proprietorship. Tanya is the office manager and does most of the clerical work, accounting, and appointment scheduling for the business. At the end of each month, Tanya prepares an income statement and a balance sheet for the business. Marci reviews the statements briefly and then files them away for future reference. In actual practice, Marci rarely looks at the statements again. The company's fiscal year ends on December 31. On December 31, Tanya prepares an income statement for the entire fiscal year, but not one for the month of December.



Tanya has not received much training in the preparation of financial statements. Each month she spends a number of hours keying each statement from scratch and arranging the columns in an attractive layout. Sometimes the appearance of the statements is inconsistent from that of the previous month.

Recently Marci has realized that the business is in trouble. She has been finding it difficult to pay the company's bills and also withdraw sufficient cash for her personal living expenses. Because she doesn't truly understand the financial statements, she spends little time reviewing them.

The company rarely shows more than \$500.00 in cash on the balance sheet; total liabilities and owner's equity averages \$25,000.00, but the owner's equity is usually around \$5,000.00. The income statement rarely shows more than \$1,000.00 in net income each month.

### **Critical Thinking:**

1. What is your opinion of the financial condition of Marci's Delivery Service?
2. What recommendations would you make to Tanya Allen about her method of preparing the financial statements?

# 8-1 Preparing an Income Statement

## INCOME STATEMENT INFORMATION ON A WORK SHEET

|    | ACCOUNT TITLE         | INCOME STATEMENT |        | BALANCE SHEET |        |
|----|-----------------------|------------------|--------|---------------|--------|
|    |                       | DEBIT            | CREDIT | DEBIT         | CREDIT |
| 12 | Sales                 |                  | 441100 |               |        |
| 13 | Advertising Expense   | 27300            |        |               |        |
| 14 | Insurance Expense     | 10000            |        |               |        |
| 15 | Miscellaneous Expense | 1000             |        |               |        |
| 16 | Rent Expense          | 25000            |        |               |        |
| 17 | Supplies Expense      | 256400           |        |               |        |
| 18 | Utilities Expense     | 11500            |        |               |        |
| 19 |                       | 331200           | 441100 |               |        |
| 20 | Net Income            | 109900           |        |               |        |
| 21 |                       | 441100           | 441100 |               |        |
| 22 |                       |                  |        |               |        |

An income statement reports financial information over a *specific period of time*, indicating the financial *progress* of a business in earning a net income or a net loss.

Revenue is the earnings of a business from business activities. Expenses are the amounts a business pays to operate the business and earn the revenue. The revenue earned and the expenses incurred to earn that revenue are reported in the same fiscal period. (*CONCEPT: Matching Expenses with Revenue*)

Information needed to prepare financial statements could be obtained from the general

ledger accounts. However, a work sheet is prepared to assist in planning the financial statements.

Information needed to prepare Encore Music's income statement is obtained from two places on the work sheet. Account titles are obtained from the work sheet's Account Title column. Account balances are obtained from the work sheet's Income Statement columns.

The income statement for a service business has four sections: (1) heading, (2) revenue, (3) expenses, and (4) net income or net loss.

## HEADING OF AN INCOME STATEMENT

|   |                    |
|---|--------------------|
| 1 | 1. Name of Company |
| 2 | 2. Name of Report  |
| 3 | 3. Date of Report  |

Encore Music  
Income Statement  
For Month Ended August 31, 20--

The income statement's date shows that this income statement reports information for the

one-month period from August 1 through August 31.

### STEP 1 Preparing the heading of an income statement

1. Center the name of the company, *Encore Music*, on the first line.
2. Center the name of the report, *Income Statement*, on the second line.
3. Center the date of the report, *For Month Ended August 31, 20--*, on the third line.

The diagram illustrates a single-line income statement with the following components and callouts:

- 1. Revenue**: Points to the Revenue line item.
- 2. Account Title**: Points to the Sales account title.
- 3. Revenue Amount**: Points to the value 441,100.
- 4. Expenses**: Points to the Expenses section header.
- 5. Account Titles**: Points to the list of expense account titles.
- 6. Expense Amount**: Points to the amount for Advertising Expense (27,300).
- 7. Single Line**: Points to the single-line format of the statement.
- 8. Total Expenses**: Points to the Total Expenses line item.
- 9. Total of Expenses**: Points to the sum of all expense amounts (331,200).
- 10. Calculate Net Income**: Points to the calculation of Net Income (109,900).
- 11. Single Line**: Points to the single-line format of the statement.
- 12. Net Income**: Points to the Net Income line item.
- 13. Record Net Income**: Points to the recording of Net Income.
- 14. Double Lines**: Points to the double lines used to highlight the Net Income.

|                       |         | % OF SALES |
|-----------------------|---------|------------|
| Revenue:              |         |            |
| Sales                 | 441,100 | 3          |
| Expenses:             |         |            |
| Advertising Expense   | 27,300  |            |
| Insurance Expense     | 10,000  |            |
| Miscellaneous Expense | 10,000  |            |
| Rent Expense          | 25,000  |            |
| Supplies Expense      | 25,640  |            |
| Utilities Expense     | 11,500  |            |
| Total Expenses        | 331,200 |            |
| Net Income            | 109,900 |            |

Information from the work sheet's Account Title column and Income Statement Debit column is used to prepare the expenses section.

1. Write the name of the first section, *Revenue*, at the extreme left of the wide column on the first line.
2. Write the title of the revenue account, *Sales*, on the next line, indented about one centimeter.
3. Record the balance of the account, \$4,411.00, on the same line in the second amount column.
4. Write the name of the second section, *Expenses*, on the next line at the extreme left of the wide column.
5. Write the title of each expense account in the wide column, indented about one centimeter.
6. Record the balance of each expense account in the first amount column on the same line as the account title.
7. Rule a single line across the first amount column under the last expense account balance to indicate addition.
8. Write the words *Total Expenses* on the next blank line in the wide column, indented about one centimeter.
9. Record the amount of total expenses, \$3,312.00, on the same line in the second amount column.
10. Calculate and verify the amount of net income using two methods:
  - a. Calculate net income from information on the income statement, as shown.

|            |   |            |   |            |
|------------|---|------------|---|------------|
| Total      | — | Total      | = | Net        |
| Revenue    |   | Expenses   |   | Income     |
| \$4,411.00 | — | \$3,312.00 | = | \$1,099.00 |



- CHAPTER 8 Financial Statements for a Proprietorship 177

# COMPONENT PERCENTAGE ANALYSIS OF AN INCOME STATEMENT

| Encore Music                    |  |  |   |   |   |   |   |   |            |
|---------------------------------|--|--|---|---|---|---|---|---|------------|
| Income Statement                |  |  |   |   |   |   |   |   |            |
| For Month Ended August 31, 20-- |  |  |   |   |   |   |   |   |            |
|                                 |  |  |   |   |   |   |   |   | % OF SALES |
| Revenue:                        |  |  |   |   |   |   |   |   |            |
| Sales                           |  |  |   |   |   | 4 | 4 | 1 | 100.0      |
| Expenses:                       |  |  |   |   |   |   |   |   |            |
| Advertising Expense             |  |  | 2 | 7 | 3 | 0 | 0 |   |            |
| Insurance Expense               |  |  | 1 | 0 | 0 | 0 |   |   |            |
| Miscellaneous Expense           |  |  | 1 | 0 | 0 |   |   |   |            |
| Rent Expense                    |  |  | 2 | 5 | 0 | 0 |   |   |            |
| Supplies Expense                |  |  | 2 | 5 | 6 | 4 | 0 |   |            |
| Utilities Expense               |  |  | 1 | 1 | 5 | 0 |   |   |            |
| Total Expenses                  |  |  |   |   |   | 3 | 3 | 1 | 75.1       |
| Net Income                      |  |  |   |   |   | 1 | 0 | 9 | 24.9       |

For a service business, the revenue reported on an income statement includes two components: (1) total expenses and (2) net income. To make decisions about future operations, a manager analyzes relationships between these two income statement components and the total sales. The percentage relationship between one financial statement item and the total that includes that item is called a **component percentage**. On an income statement, component percentages are calculated by dividing the amount of each component by the total amount of sales. Encore Music calculates a component percentage for total expenses and net income. The relationship between each component and total sales is shown in a separate column on the income statement at the right of the amount columns.

## Acceptable Component Percentages

For a component percentage to be useful, Ms. Treviño needs to know what component percentages are acceptable for businesses similar to Encore Music. Various industry organizations publish average percentages for similar businesses. In the future, Ms. Treviño could also compare Encore Music's component percentages from one fiscal period with the percentages of previous fiscal periods.

## Total Expenses Component Percentage

The total expenses component percentage, based on information from the August income statement, is calculated as shown. For businesses similar to Encore Music, an acceptable total expenses component percentage is not more than 80.0%. Therefore, Encore Music's percentage, 75.1%, is less than 80.0% and is acceptable.

$$\begin{array}{l} \div \times \\ \div \times \end{array} \quad \begin{array}{l} \text{Total} \\ \text{Expenses} \end{array} \div \begin{array}{l} \text{Total} \\ \text{Sales} \end{array} = \begin{array}{l} \text{Total Expenses} \\ \text{Component Percentage} \end{array}$$

$$\$3,312.00 \div \$4,411.00 = 75.1\%$$

## Net Income Component Percentage

The net income component percentage, based on information from the August income statement, is calculated as shown. For businesses similar to Encore Music, an acceptable net income component percentage is not less than 20.0%. Therefore Encore Music's percentage, 24.9%, is greater than 20.0% and is acceptable.

$$\begin{array}{l} \div \times \\ \div \times \end{array} \quad \begin{array}{l} \text{Net} \\ \text{Income} \end{array} \div \begin{array}{l} \text{Total} \\ \text{Sales} \end{array} = \begin{array}{l} \text{Net Income} \\ \text{Component Percentage} \end{array}$$

$$\$1,099.00 \div \$4,411.00 = 24.9\%$$

## INCOME STATEMENT WITH TWO SOURCES OF REVENUE AND A NET LOSS

**HighNote**  
**Income Statement**  
 For Month Ended August 31, 20--

|                          |                       |                 | % OF SALES    |
|--------------------------|-----------------------|-----------------|---------------|
| <b>1. Revenue</b>        | <b>Revenue:</b>       |                 |               |
|                          | Sales—Lessons         | 2360.00         |               |
|                          | Sales—Repairs         | 1250.00         |               |
|                          | <b>Total Revenue</b>  | <b>3610.00</b>  | <b>100.0</b>  |
| <b>2. Account Titles</b> | <b>Expenses:</b>      |                 |               |
|                          | Advertising Expense   | 1100.00         |               |
|                          | Insurance Expense     | 341.00          |               |
|                          | Rent Expense          | 1450.00         |               |
|                          | Supplies Expense      | 1575.00         |               |
|                          | <b>Total Expenses</b> | <b>4466.00</b>  | <b>123.7</b>  |
|                          | <b>Net Loss</b>       | <b>(856.00)</b> | <b>(23.7)</b> |

**5. Total Sales**

**3. Revenue Amounts**

**4. Total of Sales**

**6. Net Loss**

**7. Record Net Loss**

Encore Music receives revenue from only one source, the sale of services for music lessons. HighNote receives revenue from two sources, the sale of services for music lessons and the sale of services to repair musical instruments. The business's owner wants to know how much revenue is earned from each source. Therefore, the business uses two revenue accounts: **Sales—Lessons** and **Sales—Repairs**.

When an income statement is prepared for HighNote, both revenue accounts are listed. The revenue section of HighNote differs from the income statement prepared by Encore Music.

If total expenses exceed total revenue, a net loss is reported on an income statement. HighNote reported a net loss on its August income statement.

## **S** Preparing the revenue section of an income statement with two sources of revenue

1. Write the section heading, *Revenue*;, at the left of the wide column.
2. Write the titles of both revenue accounts in the wide column, indented about one centimeter.
3. Record the balance of each account in the first amount column on the same line as the account title.
4. Total the two revenue account balances. Write the total amount on the next line in the second amount column.
5. Write the words *Total Revenue* in the wide column, indented about one centimeter on the same line as the total revenue amount.

### Preparing the net loss section of an income statement

6. Write the words *Net Loss* at the extreme left of the wide column.
7. Subtract the total expenses from the revenue to calculate the net loss. Record the amount of net loss in the second amount column in parentheses. An amount written in parentheses on a financial statement indicates a negative amount.

## **T**ERM REVIEW

component percentage

## **A**UDIT YOUR UNDERSTANDING

1. List the four sections of an income statement.
2. What is the formula for calculating the total expenses component percentage?
3. What is the formula for calculating the net income component percentage?

## **W**ORK TOGETHER

### **Preparing an income statement**

A partial work sheet of Darlene's Delivery Service for the month ended July 31 of the current year is given in the *Working Papers*. Also given is a blank form for completing an income statement. Your instructor will guide you through the following example.

4. Prepare an income statement for the month ended July 31 of the current year. Calculate and record the component percentages for total expenses and net income. Round percentage calculations to the nearest 0.1%.

## **O**N YOUR OWN

### **Preparing an income statement**

A partial work sheet of Keith's Copies for the month ended February 28 of the current year is given in the *Working Papers*. Also given is a blank form for completing an income statement. Work this problem independently.

5. Prepare an income statement for the month ended February 28 of the current year. Calculate and record the component percentages for total expenses and net income. Round percentage calculations to the nearest 0.1%.

## 8-2 Balance Sheet Information on a Work Sheet

### BALANCE SHEET

| ACCOUNT TITLE |   | BALANCE SHEET |         |    |
|---------------|---|---------------|---------|----|
|               |   | DEBIT         | CREDIT  |    |
| 1             | Cash                                      | 827200        |         | 1  |
| 2             | Petty Cash                                | 20000         |         | 2  |
| 3             | Accounts Receivable—Kids Time             | 10000         |         | 3  |
| 4             | Accounts Receivable—Learn N Play          | 2000          |         | 4  |
| 5             | Supplies                                  | 218700        |         | 5  |
| 6             | Prepaid Insurance                         | 110000        |         | 6  |
| 7             | Accounts Payable—Ling Music Supplies      |               | 136000  | 7  |
| 8             | Accounts Payable—Sullivan Office Supplies |               | 2000    | 8  |
| 9             | Barbara Treviño, Capital                  |               | 1000000 | 9  |
| 10            | Barbara Treviño, Drawing                  | 60000         |         | 10 |
| 19            |   | 1247900       | 1138000 | 19 |
| 20            | Net Income                                |               | 109900  | 20 |
| 21            |   | 1247900       | 1247900 | 21 |

A balance sheet reports financial information on a *specific date*, indicating the financial *condition* of a business. The financial condition of a business refers to its financial strength. If a business has adequate available assets and few liabilities, that business is financially strong. If the business's financial condition is not strong, adverse changes in the economy might cause the business to fail.

Information about assets, liabilities, and owner's equity might be obtained from the general ledger accounts or from a work sheet.

However, the information is easier to use if reported in an organized manner such as on a balance sheet.

Information needed to prepare Encore Music's balance sheet is obtained from two places on the work sheet. Account titles are obtained from the work sheet's Account Title column. Account balances are obtained from the work sheet's Balance Sheet columns.

A balance sheet has four sections: (1) heading, (2) assets, (3) liabilities, and (4) owner's equity.

### HEADING OF A BALANCE SHEET

|                 |   |                    |
|-----------------|---|--------------------|
| Encore Music    | 1 | 1. Name of Company |
| Balance Sheet   | 2 | 2. Name of Report  |
| August 31, 20-- | 3 | 3. Date of Report  |

#### **S** Preparing the heading of a balance sheet

1. Center the name of the company, *Encore Music*, on the first line.
2. Center the name of the report, *Balance Sheet*, on the second line.
3. Center the date of the report, *August 31, 20—*, on the third line.



**1. Assets**

**2. Account Titles**

**3. Asset Amounts**

**4. Liabilities**

**5. Account Titles**

**6. Liability Amounts**

**7. Single Line**

**8. Total Liabilities**

**9. Total of Liabilities**

| Assets                   |           | Liabilities                        |                  |
|--------------------------|-----------|------------------------------------|------------------|
| Cash                     | 8 272 00  | Accts. Pay.—Ling Music Supplies    | 13 600 00        |
| Petty Cash               | 200 00    | Accts. Pay.—Sullivan Off. Supplies | 2000             |
| Accts. Rec.—Kids Time    | 1 000 00  | <b>Total Liabilities</b>           | <b>13 800 00</b> |
| Accts. Rec.—Learn N Play | 2000      |                                    |                  |
| Supplies                 | 21 870 00 |                                    |                  |
| Prepaid Insurance        | 1 100 00  |                                    |                  |

The information needed to prepare the assets section is obtained from the work sheet's Account Title column and the Balance Sheet Debit column. The information needed to prepare the liabilities section is obtained from the work sheet's Account Title column and the Balance Sheet Credit column.

- 1.** Write the title of the first section, *Assets*, in the middle of the left wide column.
- 2.** Write the titles of all asset accounts under the heading.
- 3.** Record the balance of each asset account in the left amount column on the same line as the account title.
- 4.** Write the title of the next section, *Liabilities*, in the middle of the right wide column.
- 5.** Write the titles of all liability accounts under the heading.
- 6.** Record the balance of each liability account in the right amount column on the same line as the account title.
- 7.** Rule a single line across the right amount column under the last amount, to indicate addition.
- 8.** Write the words *Total Liabilities* in the right wide column on the next blank line, indented about 1 centimeter.
- 9.** Record the total of all liabilities, \$1,380.00, in the right amount column.



# CULTURAL DIVERSITY

a flow of positive energies throughout a building and to find the most favorable places to live and work. *Feng shui* dictates how a room or house should be set up. Each angle in the building corresponds to a sphere of life—including health, love, and money. Some U.S. companies are using the *feng shui* philosophy in designing their facilities.

# OWNER'S EQUITY SECTION OF A BALANCE SHEET

| Encore Music<br>Balance Sheet<br>August 31, 20-- |          |                                    |          |
|--|----------|------------------------------------|----------|
| Assets   |          | Liabilities                        |          |
| Cash   | 8272.00  | Accts. Pay.—Ling Music Supplies    | 1360.00  |
| Petty Cash                                       | 200.00   | Accts. Pay.—Sullivan Off. Supplies | 20.00    |
| Accts. Rec.—Kids Time                            | 1000.00  | Total Liabilities                  | 1380.00  |
| Accts. Rec.—Learn N Play                         | 200.00   | Owner's Equity                     |          |
| Supplies   | 2187.00  | Barbara Treviño, Capital           | 10499.00 |
| Prepaid Insurance                                | 1100.00  |                                    |          |
| Total Assets                                     | 11879.00 | Total Liab. and Owner's Eq.        | 11879.00 |

Only the amount of current capital is reported on Encore Music's balance sheet. The amounts needed to calculate the current capital

|                 |   |            |   |
|-----------------|---|------------|---|
| Capital Account | + | Net        | - |
| Balance         |   | Income     |   |
| \$10,000.00     | + | \$1,099.00 | - |

The title of the owner's capital account is obtained from the work sheet's Account Title column. Encore Music's balance sheet prepared on August 31 is shown in the illustration.

|                 |   |          |   |
|-----------------|---|----------|---|
| Capital Account | - | Net      | - |
| Balance         |   | Loss     |   |
| \$12,000.00     | - | \$200.00 | - |

are found in the work sheet's Balance Sheet Debit and Credit columns. The amount of current capital is calculated as shown.

|                 |   |             |
|-----------------|---|-------------|
| Drawing Account | = | Current     |
| Balance         |   | Capital     |
| \$600.00        | = | \$10,499.00 |

When a business has a net loss, current capital is calculated as shown. The current capital is reported on the balance sheet in the same way as when the business has a net income.

|                 |   |             |
|-----------------|---|-------------|
| Drawing Account | = | Current     |
| Balance         |   | Capital     |
| \$500.00        | = | \$11,300.00 |

## STEPS

### Preparing the owner's equity section of a balance sheet

- Write the title of the section, *Owner's Equity*, in the middle of the right wide column on the next line below Total Liabilities.
- Write the title of the owner's capital account, *Barbara Treviño, Capital*, on the next line.
- Record the current amount of owner's equity, \$10,499.00, in the right amount column.
- Determine which amount column is longer. For Encore Music, the longer column is the left amount column. Rule a single line under the last amount in the left amount column: Prepaid Insurance, \$1,100.00. Rule a single line in the right amount column on the same line as in the left amount column.
- Write the words *Total Assets* on the next line, in the left wide column.
- Record the amount of total assets, \$11,879.00, in the left amount column.
- Write the words *Total Liab. and Owner's Eq.* in the right wide column on the same line as *Total Assets*.
- Record the amount of total liabilities and owner's equity, \$11,879.00, in the right amount column.
- Compare the totals of the two amount columns. Because the totals are the same on both sides of Encore Music's balance sheet, \$11,879.00, the balance sheet is in balance.
- Rule double lines across both the left and right amount columns just below the column totals to show that the totals have been verified as correct.

## OWNER'S EQUITY REPORTED IN DETAIL ON A BALANCE SHEET

The diagram illustrates the calculation of ending capital using a T-account. The account is divided into two columns: the left column for debits and the right column for credits. The entries are as follows:

| Owner's Equity                       |           |           |
|--------------------------------------|-----------|-----------|
| Beginning Capital                    | 10,000.00 |           |
| Net Income                           | 1,099.00  |           |
| Less Barbara Treviño, Drawing        | 600.00    | 499.00    |
| Barbara Treviño, Capital, August 31  |           | 10,499.00 |
| Total Liabilities and Owner's Equity |           | 11,879.00 |

The diagram includes the following numbered callouts:

- Beginning Capital
- Beginning Capital Amount
- Net Income
- Drawing
- Single Line
- Difference
- Ending Capital
- Current Capital Amount
- Total Liabilities and Owner's Equity

Encore Music's balance sheet reports the current capital on August 31 but does not show how this amount was calculated. Encore Music is a small business with relatively few changes in owner's equity to report. Therefore, Barbara Treviño decided that the business does not need to report all the details in the owner's equity

section. However, some businesses prefer to report the details about how owner's equity is calculated.

If Encore Music were to report details about owner's equity, the owner's equity section of the balance sheet would be prepared as shown in the illustration.

### **S** Preparing the owner's equity section reported in detail on a balance sheet

1. Write the words *Barbara Treviño, Capital, August 1* on the first line under the words *Owner's Equity*.
2. Record the owner's capital account balance on August 1, \$10,000.00, in the wide column.
3. Write the words *Net Income* on the next line. Record the net income, \$1,099.00, in the wide column to the left of the capital account balance.
4. Write the words *Less Barbara Treviño, Drawing* on the next line. Record the balance of the drawing account, \$600.00, in the wide column.
5. Rule a single line under the amount.
6. Subtract the balance of the drawing account from the net income. Record the difference, \$499.00, in the wide column to the right of the drawing account balance.
7. Write the words *Barbara Treviño, Capital, August 31* on the next line.
8. Add the August 1 capital amount, \$10,000.00, and the difference between the net income and the drawing account, \$499.00. Record the sum, \$10,499.00, in the right amount column.
9. Write the words *Total Liabilities and Owner's Equity* on the next line. Record the amount of total liabilities and owner's equity, \$11,879.00, in the right amount column.

# REMEMBER

Capital is not copied from the work sheet to the balance sheet. Capital is calculated using beginning capital, plus net income or minus net loss, minus drawing.

## **A**UDIT YOUR UNDERSTANDING

1. List the four sections on a balance sheet.
2. What is the formula for calculating current capital?

## **W**ORK TOGETHER

### **Preparing a balance sheet**

A partial work sheet of Ken's Carpet Cleaning for the month ended April 30 of the current year is given in the *Working Papers*. Also given is a blank form for completing a balance sheet. Your instructor will guide you through the following example.

3. Prepare a balance sheet for April 30 of the current year.

## **O**N YOUR OWN

### **Preparing a balance sheet**

A partial work sheet of Jane's Sewing Machine Repair for the month ended October 31 of the current year is given in the *Working Papers*. Also given is a blank form for completing a balance sheet. Work this problem independently.

4. Prepare a balance sheet for October 31 of the current year.

After completing this chapter, you can

1. Define an important accounting term related to financial statements for a service business organized as a proprietorship.
2. Identify accounting concepts and practices related to preparation of financial statements for a service business organized as a proprietorship.
3. Prepare an income statement for a service business organized as a proprietorship and analyze an income statement using component percentages.
4. Prepare a balance sheet for a service business organized as a proprietorship.

## EXPLORE ACCOUNTING

### COMPARATIVE AND INTERIM FINANCIAL STATEMENTS

A corporation that trades its stock on a U.S. stock exchange must submit an annual report to the Securities and Exchange Commission (SEC). The SEC has specific requirements as to what must be included in the financial statements.

One requirement is that the financial statements included in the annual report must show amounts for more than one year. The balance sheet must show ending balances for the current and the previous year. The income statement and statement of stockholder's equity must show amounts for the current year and the two previous years. Financial statements providing information for multiple

fiscal periods are called *comparative financial statements*.

These statements make it possible for a user to compare performance from year to year. For example, the net income for the current year can be compared to the net income for the two previous years. In this way, the user can determine if there is a positive or negative trend occurring in net income. On the balance sheet, the ending cash balance for the current year can be compared to the ending cash balance from the previous year to determine if the amount of cash on hand is increasing or decreasing.

Businesses that are required to submit an annual report to the SEC must also submit a quarterly report. This report is not as detailed as the annual report, but it must include the

financial statements for the quarter. Financial statements providing information for a time period shorter than the fiscal year are called *interim financial statements*. Users of financial information are able to evaluate the progress of the firm every three months rather than waiting an entire year. The importance of interim financial statements can be verified by the fact that the results reported in these statements are often summarized and reported in financial news sources, such as the *Wall Street Journal* and CNBC.

**Activity:** Contact a corporation near you. Ask if the business prepares interim financial statements and, if it does, find out how often these statements are prepared.

# 8-1

## APPLICATION PROBLEM Preparing an income statement

A form is given in the *Working Papers*. The following information is obtained from the work sheet of Robbie's Rugcare for the month ended August 31 of the current year.

| ACCOUNT TITLE            | INCOME STATEMENT |        | BALANCE SHEET |         |
|--------------------------|------------------|--------|---------------|---------|
|                          | DEBIT            | CREDIT | DEBIT         | CREDIT  |
|                          |                  |        |               |         |
| 11 Sales                 |                  | 570700 |               |         |
| 12 Advertising Expense   | 90000            |        |               |         |
| 13 Insurance Expense     | 2000             |        |               |         |
| 14 Miscellaneous Expense | 26700            |        |               |         |
| 15 Supplies Expense      | 50000            |        |               |         |
| 16 Utilities Expense     | 154200           |        |               |         |
| 17                       | 322900           | 570700 | 1154700       | 906900  |
| 18 Net Income            | 247800           |        |               | 247800  |
| 19                       | 570700           | 570700 | 1154700       | 1154700 |
| 20                       |                  |        |               |         |

### Instructions:

1. Prepare an income statement for the month ended August 31 of the current year.
2. Calculate and record the component percentages for total expenses and net income. Round percentage calculations to the nearest 0.1%.

# 8-2

## APPLICATION PROBLEM Preparing a balance sheet

A form is given in the *Working Papers*. The following information is obtained from the work sheet of Robbie's Rugcare for the month ended August 31 of the current year.

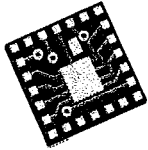
| ACCOUNT TITLE                  | BALANCE SHEET |         |
|--------------------------------|---------------|---------|
|                                | DEBIT         | CREDIT  |
|                                |               |         |
| 1 Cash                         | 875200        |         |
| 2 Accts. Rec.—Crystal Thompson | 20000         |         |
| 3 Accts. Rec.—Robert Boje      | 17500         |         |
| 4 Supplies                     | 40000         |         |
| 5 Prepaid Insurance            | 22000         |         |
| 6 Accts. Pay.—Daniel Supplies  |               | 44200   |
| 7 Accts. Pay.—Irene's Irons    |               | 67600   |
| 8 Roberta Greenstein, Capital  |               | 795100  |
| 9 Roberta Greenstein, Drawing  | 180000        |         |
| 10 Income Summary              |               |         |
| 17                             | 1154700       | 906900  |
| 18 Net Income                  |               | 247800  |
| 19                             | 1154700       | 1154700 |
| 20                             |               |         |

### Instructions:

Prepare a balance sheet for August 31 of the current year.

# 8-3

## MASTERY PROBLEM Preparing financial statements with a net loss



Forms are given in the *Working Papers*. The following information is obtained from the work sheet of Mancini Hair Care for the month ended September 30 of the current year.

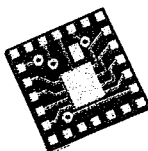
|    | ACCOUNT TITLE              | INCOME STATEMENT |        | BALANCE SHEET |         |    |
|----|----------------------------|------------------|--------|---------------|---------|----|
|    |                            | DEBIT            | CREDIT | DEBIT         | CREDIT  |    |
| 1  | Cash                       |                  |        | 767800        |         | 1  |
| 2  | Petty Cash                 |                  |        | 10000         |         | 2  |
| 3  | Accts. Rec.—Jennifer Balsa |                  |        | 16400         |         | 3  |
| 4  | Supplies                   |                  |        | 69000         |         | 4  |
| 5  | Prepaid Insurance          |                  |        | 70000         |         | 5  |
| 6  | Accts. Pay.—Alto Supplies  |                  |        |               | 73300   | 6  |
| 7  | Jon Mancini, Capital       |                  |        |               | 950000  | 7  |
| 8  | Jon Mancini, Drawing       |                  |        | 50000         |         | 8  |
| 9  | Income Summary             |                  |        |               |         | 9  |
| 10 | Sales                      |                  | 459600 |               |         | 10 |
| 11 | Advertising Expense        | 55000            |        |               |         | 11 |
| 12 | Insurance Expense          | 17500            |        |               |         | 12 |
| 13 | Miscellaneous Expense      | 5800             |        |               |         | 13 |
| 14 | Supplies Expense           | 150000           |        |               |         | 14 |
| 15 | Utilities Expense          | 271400           |        |               |         | 15 |
| 16 |                            | 499700           | 459600 | 983200        | 1023300 | 16 |
| 17 | Net Loss                   |                  | 40100  | 40100         |         | 17 |
| 18 |                            | 499700           | 499700 | 1023300       | 1023300 | 18 |
| 19 |                            |                  |        |               |         | 19 |
| 20 |                            |                  |        |               |         | 20 |

### Instructions:

1. Prepare an income statement for the month ended September 30 of the current year.
2. Calculate and record the component percentages for total expenses and net loss. Place the percentage for net loss in parentheses to show that it is for a net loss. Round percentage calculations to the nearest 0.1%.
3. Prepare a balance sheet for September 30 of the current year.

# 8-4

## CHALLENGE PROBLEM Preparing financial statements with two sources of revenue and a net loss



Forms are given in the *Working Papers*. The information on the next page is obtained from the work sheet of LawnMow for the month ended October 31 of the current year.

### Instructions:

1. Prepare an income statement for the month ended October 31 of the current year.
2. Calculate and record the component percentages for total expenses and net loss. Place the percentage for net loss in parentheses to show that it is for a net loss. Round percentage calculations to the nearest 0.1%.
3. Prepare a balance sheet for October 31 of the current year.

|               |                           | 5                | 6      | 7             | 8      |
|---------------|---------------------------|------------------|--------|---------------|--------|
| ACCOUNT TITLE |                           | INCOME STATEMENT |        | BALANCE SHEET |        |
|               |                           | DEBIT            | CREDIT | DEBIT         | CREDIT |
| 1             | Cash                      |                  |        | 189800        |        |
| 2             | Accts. Rec.—Sandra Rohe   |                  |        | 9500          |        |
| 3             | Supplies                  |                  |        | 65000         |        |
| 4             | Prepaid Insurance         |                  |        | 120000        |        |
| 5             | Accts. Pay.—Corner Garage |                  |        |               | 5800   |
| 6             | Accts. Pay.—Broadway Gas  |                  |        |               | 11000  |
| 7             | Accts. Pay.—Esko Repair   |                  |        |               | 21500  |
| 8             | Ryo Morrison, Capital     |                  |        |               | 400000 |
| 9             | Ryo Morrison, Drawing     |                  |        | 10000         |        |
| 10            | Income Summary            |                  |        |               |        |
| 11            | Sales—Lawn Care           |                  | 490000 |               |        |
| 12            | Sales—Shrub Care          |                  | 250000 |               |        |
| 13            | Advertising Expense       | 39000            |        |               |        |
| 14            | Insurance Expense         | 40000            |        |               |        |
| 15            | Miscellaneous Expense     | 55000            |        |               |        |
| 16            | Rent Expense              | 330000           |        |               |        |
| 17            | Supplies Expense          | 320000           |        |               |        |
| 18            |                           | 784000           | 740000 | 394300        | 438300 |
| 19            | Net Loss                  |                  | 44000  | 44000         |        |
| 20            |                           | 784000           | 784000 | 438300        | 438300 |
| 21            |                           |                  |        |               |        |
| 22            |                           |                  |        |               |        |



## INTERNET ACTIVITY

Point your browser to

<http://accounting.swpc.com>

Choose **First-Year Course**, choose **Activities**, and complete the activity for Chapter 8.

## Applied Communication

Assume that you are the owner of a proprietorship, and you have just hired a new assistant. In the past, your assistants have had difficulty understanding the importance of financial statements to your business.

**Instructions:** Write down what you would say to your assistant about the importance of income statements and balance sheets in making financial decisions. Your statements should be no longer than one or two paragraphs.

## Cases for Critical Thinking

**Case 1** Romelle Woods and Ahti Indihar each own small businesses. Ms. Woods prepares an income statement and balance sheet at the end of each day for her business, in order to make business decisions. Mr. Indihar prepares an income statement and balance sheet for his business only at the end of each one-year fiscal period, when preparing tax reports. Which owner is using the better procedure? Explain your answer.