

SURVEY OF ^{9E} ACCOUNTING

WITH WARREN'S METRIC ANALYSIS



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AMANDA G. FARMER

SURVEY OF ^{9E} ACCOUNTING

WITH *WARREN'S METRIC ANALYSIS*

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Survey of Accounting, Ninth Edition
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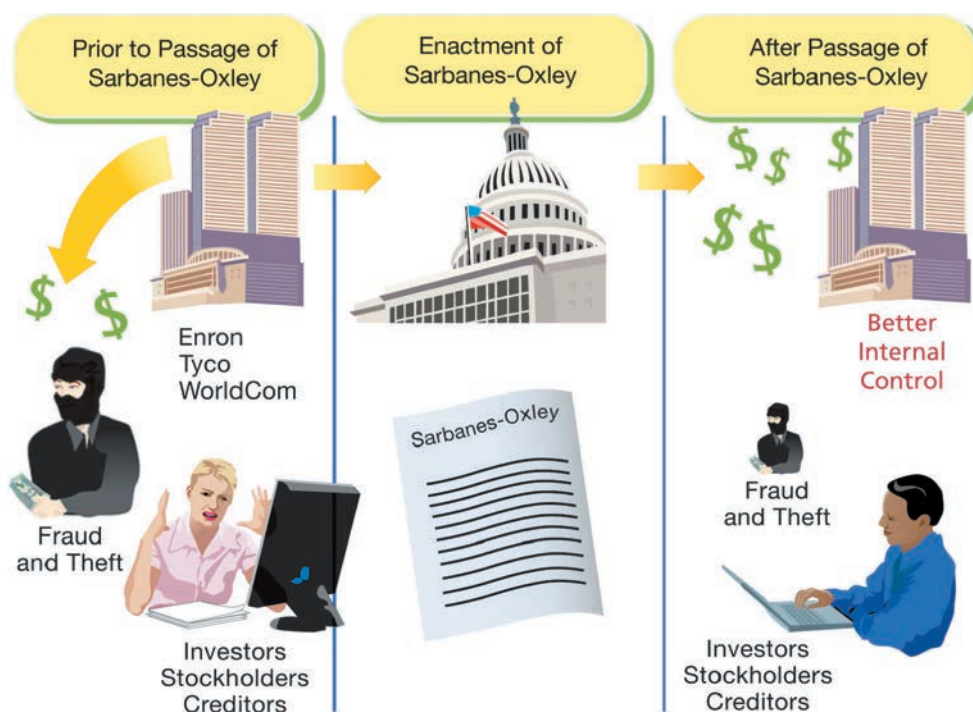
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Survey of Accounting, Ninth Edition, is designed for a one-term introductory accounting course. Written for students who have no prior knowledge of accounting, this text emphasizes how managers, investors, and other business stakeholders use accounting reports. It provides an overview of the basic topics in financial and managerial accounting, without the extraneous accounting principles topics that must be skipped or otherwise modified to fit into a one-term course.

Hallmark Features

The Ninth Edition of this text continues to emphasize elements designed to help instructors and enhance the learning experience of students. These features include the following:

- **Integrated Financial Statement Framework** shows how transactions impact each of the three primary financial statements and stresses the integrated nature of accounting.
- **Infographic art** examples help students visualize important accounting concepts within the chapter.



- **Illustrative Problems** help students apply what they learn by walking them through problems that cover the most important concepts addressed within the chapter.

Illustrative Problem

McCollum Company, a furniture wholesaler, acquired new equipment at a cost of \$150,000 at the beginning of the fiscal year. The equipment has an estimated life of five years and an estimated residual value of \$12,000. Ellen McCollum, the president, has requested information regarding alternative depreciation methods.

Instructions

Determine the annual depreciation for each of the five years of estimated useful life of the equipment, the accumulated depreciation at the end of each year, and the book value of the equipment at the end of each year by (a) the straight-line method and (b) the double-declining-balance method.

Solution

	Year	Depreciation Expense	Accumulated Depreciation, End of Year	Book Value, End of Year
a.	1	\$27,600*	\$ 27,600	\$122,400
	2	27,600	55,200	94,800
	3	27,600	82,800	67,200
	4	27,600	110,400	39,600
	5	27,600	138,000	12,000
* $\$27,600 = (\$150,000 - \$12,000) \div 5$				
b.	1	\$60,000**	\$ 60,000	\$ 90,000
	2	36,000	96,000	54,000
	3	21,600	117,600	32,400
	4	12,960	130,560	19,440
	5	7,440***	138,000	12,000

** $\$60,000 = \$150,000 \times 40\%$

***The asset is not depreciated below the estimated residual value of \$12,000.

- **“Integrity, Objectivity, and Ethics in Business”** features describe real-world dilemmas, helping students apply accounting concepts within an ethical context, using integrity and objectivity.



Integrity, Objectivity, and Ethics in Business

Tips on Preventing Employee Fraud in Small Companies

- Do not have the same employee write company checks and keep the books. Look for payments to vendors you don't know or payments to vendors whose names appear to be misspelled.
- If your business has a computer system, restrict access to accounting files as much as possible. Also, keep a backup copy of your accounting files and store it at an off-site location.
- Be wary of any employee working in finance that declines to take vacations. They may be afraid that a replacement will uncover fraud.
- Require and monitor supporting documentation (such as vendor invoices) before signing checks.
- Track the number of credit card bills you sign monthly.
- Limit and monitor access to important documents and supplies, such as blank checks and signature stamps.
- Check W-2 forms against your payroll annually to make sure you're not carrying any fictitious employees.
- Rely on yourself, not on your accountant, to spot fraud.

Source: Steve Kaufman, "Embezzlement Common at Small Companies," Knight-Ridder Newspapers, reported in *Athens Daily News/Athens Banner-Herald*, March 10, 1996, p. 4D.

- **“Business Insight Make Money”** vignettes emphasize practical ways in which businesses apply accounting concepts when generating profit strategies.

Got the Flu? Why Not Chew Some Gum?

*Business
Insight*

Facing a slumping market for sugared chewing gum—such as Juicy Fruit™ and Doublemint™—**Wm. Wrigley Jr. Company**, a subsidiary of **Mars Incorporated**, is reinventing itself by expanding its product lines and introducing new chewing gum applications. Wrigley’s new products include sugarless breath mints and more powerful flavored mint chewing gum, like Extra Polar Ice™. In addition, Wrigley is experimenting with health-care applications of chewing gum. For example, the company founded the Wrigley Science Institute™ with the objective of promoting scientific research on the benefits of chewing gum. Specifically, the Institute sponsors research in such areas as weight reduction, management and stress relief, and cognitive focus. The Institute provides grants to leading researchers who investigate the role of chewing gum in health and wellness.

Source: Wrigley.com and *USA Today*, “Wrigley Wants Science to Prove Gum-Chewing Benefits,” by Dave Carpenter, The Associated Press, March 28, 2006.

- The **“International Connections”** feature, in select chapters, highlights key differences between international accounting standards and U.S. GAAP.

International Connection

Adoption or Convergence?

The largest public accounting firms, known as the Big Four, have pushed for the “adoption” of IFRS in the United States within a relatively short period of time. Such a strategy of adoption would generate millions of dollars of consulting and accounting work within the United States for the Big Four: Deloitte Touche Tohmatsu, PwC (PriceWaterhouse Coopers), Ernst & Young, and KPMG.

In contrast, others have argued for a strategy of gradual “convergence” to IFRS over time. Currently, it appears that regulators within the United States and the FASB are favoring convergence rather than adoption. For example, the FASB and IASB have completed several projects to converge U.S. and IFRS standards.¹

1. FASB.org, “Progress Report on IASB-FASB Convergence Work,” April 21, 2011.

- **An attractive design** engages students and clearly presents the material. The Integrated Financial Statement Framework benefits from this pedagogically sound use of color, as each statement within the framework is shaded to reinforce the integrated nature of accounting.

Integrated Financial Statement (IFS) Approach

This framework clearly demonstrates the impact of transactions on the balance sheet, income statement, and the statement of cash flows and the corresponding relationship among these financial statements. The IFS framework moves the student from the simple to the complex and explains the how and why of financial statements.

Chapter 1 introduces students to this integration in the form of actual company financials from **The Hershey Company (HSY)**, a well-known manufacturer of chocolates.

Exhibit 10 Integrated Financial Statements

The Hershey Company Balance Sheet December 31				
Assets	=	Liabilities	+	Stockholders' Equity
Cash \$ 588				
				\$7,032 Retained Earnings
				299 Common Stock
<u>\$7,703</u>	=	<u>\$6,296</u>	+	<u>\$1,407</u>
		\$7,703 Total Liabilities + Stockholders' Equity		

The Hershey Company Statement of Cash Flows For the Year Ended Dec. 31		The Hershey Company Income Statement For the Year Ended Dec. 31		The Hershey Company Statement of Stockholders' Equity For the Year Ended Dec. 31				
Operating act.	\$1,600	Revenues	\$7,791		Common Stock	Retained Earnings	Other Items	Total
Investing act.	(1,503)	Expenses	(6,613)					
Financing act.	111	Net income	<u>\$1,178</u>					
Increase in cash	\$ 208				Bal. Jan. 1	\$299	\$6,371	\$(5,378) \$ 932
Cash, Jan. 1	380				Net income		1,178	1,178
Cash, Dec. 31	<u>\$ 588</u>				Dividends		(564)	(564)
					Other items		47	(186) (139)
					Bal. Dec. 31	<u>\$299</u>	<u>\$7,032</u>	<u>\$(5,924)</u> <u>\$1,407</u>

Chapter 2 begins with an example format of the integrated framework used throughout the financial chapters. Early in the course, students will gain a greater understanding of how important trends or events can impact a company's financial statements, which add valuable insight into the financial condition of a business.

Exhibit 1 Integrated Financial Statement Framework**Integrated Financial Statement Framework**

BALANCE SHEET				
	Assets	=	Liabilities	+ Stockholders' Equity
	Assets	=	Liabilities	+ Common Stock + Retained Earnings
Transaction	XXX		XXX	XXX
	XXX			
	XXX		XXX	XXX

STATEMENT OF CASH FLOWS	
+/- Operating activities	XXX
+/- Investing activities	XXX
+/- Financing activities	XXX
Increase or decrease in cash	XXX
Beginning cash	XXX
Ending cash	XXX

INCOME STATEMENT	
Revenues	XXX
Expenses	XXX
Net income or loss	XXX

The primary focus in Chapter 2 is on cash transactions, which helps eliminate confusion for students who may have difficulty determining whether an event or transaction should be recorded.

Transaction d

During the first month of operations, Family Health Care earned patient fees of \$5,500, receiving the fees in cash.

The effects of this transaction on Family Health Care's financial statements are recorded as follows:

1. Under the Statement of Cash Flows column, Cash from Operating activities is increased by \$5,500.
2. Under the Balance Sheet column, Cash under Assets is increased by \$5,500. To balance the accounting equation, Retained Earnings under Stockholders' Equity is also increased by \$5,500.
3. Under the Income Statement column, Fees earned is increased by \$5,500.

This transaction illustrates an inflow of cash from operating activities by earning revenues (fees earned) of \$5,500. Retained Earnings is increased under Stockholders' Equity by \$5,500 because fees earned contribute to net income and net income increases stockholders' equity. Since fees earned are a type of revenue, Fees earned of \$5,500 is also entered under the Income Statement column.

The effects of this transaction on Family Health Care's financial statements are shown below.

Financial Statement Effects

	BALANCE SHEET								
	Assets			=	Liabilities	+	Stockholders' Equity		
	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings
Balances	4,000		12,000		10,000		6,000		
d. Fees earned	5,500								5,500
Balances	9,500		12,000		10,000		6,000		5,500
STATEMENT OF CASH FLOWS					INCOME STATEMENT				
d. Operating	5,500					d. Fees earned	5,500		

Ninth Edition: Learning Approach and Enhancements

Warren's Metric Analyses

The Ninth Edition incorporates Warren's Metric Analyses throughout the text. It uses common business metrics to assess a company's financial condition and performance. Metrics are assessed at three levels: the Transaction Level, Financial Statement Level, and Managerial Decision-Making Level.

An example of metric analysis at each of these levels are as follows:

Transaction Level

To illustrate, assume that on January 3, TechSource sells merchandise for \$1,800 that cost \$1,200 for cash. The effect on the accounts and financial statements of this cash sale is as follows:

Financial Statement Effects

BALANCE SHEET				
	Assets		= Liabilities	+ Stockholders' Equity
	Cash	+ Inventory	=	Retained Earnings
Jan 3.	1,800	(1,200)		600

STATEMENT OF CASH FLOWS	
Jan. 3. Operating	1,800

INCOME STATEMENT	
Jan. 3. Sales	1,800
Cost of goods sold	(1,200)
Gross profit	600

Transaction Metric Effects

The effects of the cash sale on the liquidity and profitability metrics are as follows:

LIQUIDITY	
Working Capital	\$600

PROFITABILITY	
Gross Profit Percent (33%)	Increases ability to achieve minimum of 20%

Since Cash increased by \$1,800 and Inventory decreased by \$1,200, working capital increased by \$600 (\$1,800 – \$1,200). We assume that TechSource desires a minimum overall gross profit percent of 20%. Since the gross profit percent for this sale is 33% [(\$1,800 – \$1,200) ÷ \$1,800], this sale increases TechSource's ability to achieve its overall minimum gross profit percent of 20%.

Financial Statement Level

The **accounts receivable turnover** is computed as follows:

$$\text{Accounts Receivable Turnover} = \frac{\text{Sales}}{\text{Average Accounts Receivable}}$$

Although accounts receivable are just related to "credit" sales, total sales is normally used to compute accounts receivable turnover. This is because credit sales are normally not reported to external users. The average accounts receivable is computed as the beginning accounts receivable plus the ending accounts receivable for the period divided by two.

To illustrate, assume the following data for Downing Inc. for the year ending December 31, 20Y4:

Sales for 20Y4	\$9,125,000
Accounts Receivable, Jan. 1, 20Y4	400,000
Accounts Receivable, Dec. 31, 20Y4	600,000

The accounts receivable turnover of 18.3 for Downing Inc. is computed as follows:

$$\text{Accounts Receivable Turnover} = \frac{\$9,125,000}{(\$400,000 + \$600,000) \div 2} = \frac{\$9,125,000}{\$500,000} = 18.3^*$$

* Rounded to one decimal place.

Managerial Decision Level

In computing process yield, output is measured as the percentage of units from a process that pass inspection (quality control). It is computed as follows:

$$\text{Process Yield} = \frac{\text{Units Passing Inspection}}{\text{Units Entering Process}}$$

To illustrate, assume that during August 12,000 units were entered into a machining process and 10,800 units coming out of the process passed inspection. The process yield of 90% is computed as follows:

$$\text{Process Yield} = \frac{\text{Units Passing Inspection}}{\text{Units Entering Process}} = \frac{10,800 \text{ units}}{12,000 \text{ units}} = 90\%$$

Process yield measures the efficiency of a process. In the preceding illustration, 10% of the units input into the machining process are either scrapped or reworked. A company's objective is to maximize process yield and reach a goal of zero defects.

To accompany the addition of Warren's Metric Analyses, end-of-chapter problems have been added to test the students' knowledge and understanding of the concepts.

Metric Analyses are clearly identified with a separate screen of color. This allows for quick identification of the analyses through the chapters and text. This separate screen of color also identifies the end-of-chapter section for assigning homework.

Other Enhancements

- Retained Earnings Statement is REPLACED with Statement of Stockholders Equity throughout the text. This will reflect what students will see in business and also allows for real-world examples of statements of stockholder's equity for in-class illustrations or homework.
- Financial transactions are analyzed using liquidity of profitability metric. To familiarize students with this important tool, the financial chapters incorporate a variety of liquidity and profitability depending on the chapter content.
- Each Managerial Accounting Chapter includes one metric used by managers in operating a business. Many of these metrics are operational in nature and include margin of safety, cost per unit, process yield, and utilization rate.
- This edition includes updated or replaced chapter openers to feature recent, intriguing developments in accounting. The author has woven connections to the opening company highlighted in each chapter throughout each chapter. This now promotes a stronger connection for students, allowing them to gain additional insight into the opening company and its relationship to the chapter content.
- For this edition, when Real Publicly Traded Companies appear throughout the book, their (TICKERS) symbol is also represented. This allows students to easily look up company's financial data on the Internet.

Technology

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- Course management tools and flexible assignment options



- Reporting and grade book options
- Tell Me More eLectures
- Show Me How Demonstration Videos
- Quick Lessons

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Term	Interest Rate	Market Rate Scenario	Value
1 year	0.5%	If the market rate doubles	\$995
		If the market rate halves	\$1,002
5 years	15%	If the market rate doubles	\$931
		If the market rate halves	\$1,037
30 years	3.0%	If the market rate doubles	\$587
		If the market rate halves	\$1,360

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CengageNOWv2 helps you motivate students and prepare them for class with a host of resources. These resources were developed with visual learners and those that don't like to read textbooks in mind. Available in the Study Tools tab in CengageNOWv2, students may access these resources on demand. Each resource is fully assignable and gradable!

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By using these resources, you have a powerful suite of content to help you ensure students can familiarize themselves with content prior to coming to class, which is an excellent way to help you flip the classroom!

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- Explanations are available after the assignment has been submitted and provide a detailed description of how the student should have arrived at the solution.

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Adjusting Entries

b. Supplies on hand at August 31, \$675.

Supplies available during August (balance of account)	\$3,000
Supplies on hand, August 31	675
Supplies used (amount of adjustment)	<u>\$ 2,325</u>

Journal				
Date	Description	Post. Ref.	Debit	Credit
Aug 31	Supplies Expense		2,325	
	Supplies			2,325
	Supplies used			

Assets		=	Liabilities	+	Owner's Equity (Expense)
Supplies					Supplies Expense
Bal.	3,000				Aug 31
Adj. Bal.	675				2,325

by crediting it for the same amount.

Journal

Journalize the December 31 adjusting entry to record the depreciation. Refer to the Chart of Accounts for exact wording of account titles.

How does grading work?

DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT
	Adjusting Entries			
Dec 31	Depreciation Expense		7,500.00	
	Accumulated Depreciation-Equipment			7,400

The amount for this account is incorrect.

Line.

- The amount for this account is incorrect, although you've entered the amount in the correct column. [-2]

Transaction

- The debits and credits do not balance. [-0]

This transaction was matched to the first transaction (lines 2-3) of the solution. This line was matched to the second line in the transaction.



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- **Solutions Manual** The Solutions Manual contains answers to all exercises, problems, and cases that appear in the text. As always, the solutions are author-written and verified multiple times for numerical accuracy and consistency with the core text.

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Your comments and suggestions as you use this text are sincerely appreciated.

Carl S. Warren and Amanda G. Farmer

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Brief Contents

1	The Role of Accounting in Business	1
2	Basic Accounting Systems: Cash Basis	45
3	Basic Accounting Systems: Accrual Basis	86
4	Accounting for Retail Operations	142
5	Internal Control and Cash	196
6	Receivables and Inventories	235
7	Fixed Assets, Natural Resources, and Intangible Assets	278
8	Liabilities and Stockholders' Equity	319
9	Metric-Analysis of Financial Statements	361
10	Accounting Systems for Manufacturing Operations.....	408
11	Cost-Volume-Profit Analysis.....	462
12	Differential Analysis and Product Pricing	508
13	Budgeting and Standard Costs	547
14	Decentralized Operations	600
15	Capital Investment Analysis.....	640
Appendix A	Double-Entry Accounting Systems.....	677
Appendix B	Process Cost Systems	691
Online Appendix C	Factory Overhead Variances (available for download from Cengage.com)	A-1
Glossary	704
Subject Index	714
Company Index	724

1 The Role of Accounting in Business 1

Nature of Business and Accounting 2

- Types of Businesses 2
- Forms of Business 3
- How Do Businesses Make Money? 4
- Business Stakeholders 5

Business Activities 7

- Financing Activities 7
- Investing Activities 8
- Operating Activities 8

What Is Accounting and Its Role in Business? 9

Financial Statements 10

- Income Statement 11
- Statement of Stockholders' Equity 12
- Balance Sheet 13
- Statement of Cash Flows 13
- Integrated Financial Statements 15

Accounting Concepts 16

- Business Entity Concept 17
- Cost Concept 18
- Going Concern Concept 18
- Matching Concept 19
- Objectivity Concept 19
- Unit of Measure Concept 19
- Adequate Disclosure Concept 19
- Accounting Period Concept 20
- Responsible Reporting 20

Metric-Based Analysis: Return on Assets 22

- Types of Metrics 22
- Level of Application 22
- Return on Assets 23

2 Basic Accounting Systems: Cash Basis 45

Elements of an Accounting System 46

- Rules 46
- Framework 47
- Controls 48

Recording a Corporation's First Period of Operations 49

- Transaction (a) 49

- Transaction (b) 50
- Transaction (c) 51
- Transaction (d) 52
- Transaction (e) 53
- Transaction (f) 54

Financial Statements for a Corporation's First Period of Operations 57

- Income Statement 57
- Statement of Stockholders' Equity 58
- Balance Sheet 59
- Statement of Cash Flows 59
- Integration of Financial Statements 59

Recording a Corporation's Second Period of Operations 60

Financial Statements for a Corporation's Second Period of Operations 62

- Income Statement 62
- Statement of Stockholders' Equity 62
- Balance Sheet 63
- Statement of Cash Flows 63
- Integration of Financial Statements 64

Metric-Based Analysis: Common-Sized Statements 65

3 Basic Accounting Systems: Accrual Basis 86

Accrual Accounting Concepts 87

Family Health Care's November Transactions 88

- Transaction a 89
- Transaction b 91
- Transaction c 91
- Transaction d 92
- Transaction e 93
- Transaction f 94
- Transaction g 94
- Transaction h 95
- Transaction i 96
- Transaction j 97
- Transaction k 97
- Transaction l 98

The Adjustment Process 99

- Deferrals and Accruals 99
- Adjustments for Family Health Care 101
- Adjustment a1 101

- Adjustment a2 102
- Adjustment a3 103
- Adjustment a4 104
- Adjustment a5 105
- Adjustment a6 105

Financial Statements 106

- Income Statement 108
- Statement of Stockholders' Equity 109
- Balance Sheet 110
- Statement of Cash Flows 112
- Integration of Financial Statements 113

Accrual and Cash Basis of Accounting 113

- Cash Basis of Accounting 114
- Accrual Basis of Accounting 114
- Family Health Care Transactions 114
- Why the Accrual Basis Is Required by GAAP 115
- The Accounting Cycle 116

Metric-Based Analysis: Quick Ratio 116

Appendix 117

4 Accounting for Retail Operations 142

Nature of Retail Operations 143

- Operating Cycle 143
- Financial Statements 144

Purchase Transactions 144

- Perpetual and Periodic Inventory Systems 145
- Purchase of Merchandise for Cash 146
- Purchase of Merchandise on Account 146
- Purchase Returns and Allowances 149

Sales Transactions 151

- Customer Discounts 152
- Customer Refunds and Allowances 153
- Merchandise Returns 155

Freight and Sales Taxes 156

- Freight 156
- Sales Taxes 157

Dual Nature of Merchandise Transactions 158

Adjustments for Retail Operations 160

- Inventory Shrinkage 161
- Customer Refunds, Allowances, and Returns 162

Financial Statements for a Retail Business 163

- Multiple-Step Income Statement 163
- Sales 164
- Cost of Goods Sold 164
- Gross Profit 164
- Operating Income 165
- Other Revenue and Expense 165
- Single-Step Income Statement 165

- Statement of Stockholders' Equity 166
- Balance Sheet 166
- Statement of Cash Flows 167

Metric-Based Analysis: Markup Percent 169

Appendix 1 170

- Transactions 170
- Adjusting Entry 172
- Subsequent Period 173

Appendix 2 174

- Cash Flows from Operating Activities 175
- Cash Flows Used for Investing Activities 176
- Cash Flows Used for Financing Activities 177

5 Internal Control and Cash 196

Sarbanes-Oxley Act 197

Internal Control 199

- Objectives of Internal Control 199
- Elements of Internal Control 199
- Control Environment 200
- Risk Assessment 200
- Control Procedures 201
- Monitoring 202
- Information and Communication 203
- Limitations of Internal Control 203

Cash Controls Over Receipts and Payments 204

- Control of Cash Receipts 204
- Control of Cash Payments 206

Bank Accounts 207

- Bank Statement 207
- Using the Bank Statement as a Control Over Cash 209

Bank Reconciliation 210

- Bank Section of Reconciliation 211
- Company Section of Reconciliation 211
- Verify that Adjusted Balances Are Equal 211

Special-Purpose Cash Funds 213

Financial Statement Reporting of Cash 215

Metric-Based Analysis: Ratio of Cash to Monthly Cash Expenses 215

6 Receivables and Inventories 235

Classification of Receivables 236

- Accounts Receivable 236
- Notes Receivable 236
- Other Receivables 238

Uncollectible Receivables 238

Direct Write-Off Method for Uncollectible Accounts 239

Allowance Method for Uncollectible Accounts 242

Write-Offs to the Allowance Account 243

Estimating Uncollectibles 245

Retail Inventory 250

Inventory Cost Flow Assumptions 251

Comparing Inventory Costing Methods 253

First-In, First-Out (FIFO) Method 253

Last-In, First-Out (LIFO) Method 253

LIFO and Taxes 254

Weighted Average Cost Method 254

Financial Statement Effects 255

Reporting Receivables and Inventory 256

Receivables 257

Inventory 258

Metric-Based Analysis: Accounts Receivable Turnover and Inventory Turnover 260

Accounts Receivable Turnover 260

Inventory Turnover 261

7 Fixed Assets, Natural Resources, and Intangible Assets 278

Nature of Fixed Assets 279

Classifying Costs 280

The Cost of Fixed Assets 281

Fixed Asset Leases 283

Accounting for Depreciation 283

Factors in Computing Depreciation Expense 284

Straight-Line Method 285

Double-Declining-Balance Method 287

Comparing Depreciation Methods 288

Partial Year Depreciation 289

Maintenance, Repair, and Improvement Costs 290

Depreciation for Federal Income Tax 292

Disposal of Fixed Assets 292

Discarding Fixed Assets 292

Selling Fixed Assets 294

Natural Resources 296

Intangible Assets 298

Patents 298

Copyrights and Trademarks 299

Goodwill 300

Financial Reporting for Fixed Assets and Intangible Assets 302

Metric-Based Analysis: Asset Turnover 304

8 Liabilities and Stockholders' Equity 319

Financing Corporations 320

Current Liabilities 322

Accounts Payable and Accruals 322

Notes Payable 323

Payroll 324

Bonds 326

Contingent Liabilities 329

Probable and Estimable 329

Probable and Not Estimable 329

Reasonably Possible 329

Remote 330

Disclosure of Contingent Liabilities 330

Stock 331

Common and Preferred Stock 332

Issuance of Stock 332

Treasury Stock 333

Dividends 334

Cash Dividends 335

Stock Dividends 337

Stock Splits 338

Reporting Liabilities and Stockholders' Equity 339

Financial Statement Metric-Analysis: Debt and Price-Earnings Ratios 341

Debt Ratio 341

Price-Earnings Ratio 341

9 Metric-Analysis of Financial Statements 361

Analysis of Financial Statements 362

Usefulness of Financial Statements 362

Methods of Analysis 363

Global Analysis 363

Horizontal Analysis 363

Vertical Analysis 366

Common-Sized Statements 368

Component Analysis: Liquidity Metrics 368

Current Position Analysis 369

Accounts Receivable Metrics 371

Inventory Metrics 372

Component Analysis: Solvency Metrics 374

Net Assets 374

Debt Ratio 374

Ratio of Liabilities to Stockholders' Equity 374

Ratio of Fixed Assets to Long-Term Liabilities 375

Times Interest Earned 375

Component Analysis: Profitability Metrics 376

- Asset Turnover 376
- Return on Total Assets 377
- Return on Stockholders' Equity 377
- Return on Common Stockholders' Equity 378
- Earnings per Share on Common Stock 379
- Price-Earnings Ratio 380
- Dividends per Share 380
- Dividend Yield 381
- Summary of Metrics 381

Corporate Annual Reports 383

- Management's Discussion and Analysis 383
- Report on Internal Control 384
- Audit Report 384

Appendix 385

- Discontinued Operations 385
- Errors and Changes in Generally Accepted Accounting Principles 386

10 Accounting Systems for Manufacturing Operations 408

Managerial Accounting 409

Manufacturing Operations and Costs 410

- Direct Materials Cost 411
- Direct Labor Cost 412
- Factory Overhead Cost 412
- Prime Costs and Conversion Costs 413
- Product Costs and Period Costs 413

Cost Accounting Systems 415

- Job Cost Systems 415
- Process Cost Systems 415

Job Order Cost Systems for Manufacturing Operations 415

- Materials Cost 417
- Factory Labor Cost 418
- Factory Overhead Cost 420
- Work in Process 424
- Finished Goods 426
- Sales and Cost of Goods Sold 426
- Period Costs 427
- Summary of Cost Flows for Quixote Guitars 427

Job Order Cost Systems for Service Businesses 429

Just-in-Time Processing 430

- Traditional Production Process 430
- Just-in-Time Production Process 431

Activity-Based Costing 432

Metric-Based Analysis: Cost per Unit 436

11 Cost-Volume-Profit Analysis 462

Cost Behavior 463

- Variable Costs 463
- Fixed Costs 465
- Mixed Costs 466
- Summary of Cost Behavior Concepts 468

Cost-Volume-Profit Relationships 469

- Contribution Margin 470
- Contribution Margin Ratio 470
- Unit Contribution Margin 471

Cost-Volume-Profit Equations 472

- Break-Even Point 472
- Target Profit 477

Cost-Volume-Profit Graphs 479

- Cost-Volume-Profit (Break-Even) Graph 479
- Profit-Volume Graph 480

Special Relationships 483

- Sales Mix Considerations 483
- Operating Leverage 485

Cost-Volume-Profit Assumptions 487

Metric-Based Analysis: Margin of Safety 487

12 Differential Analysis and Product Pricing 508

Nature of Differential Analysis 509

Applying Differential Analysis 511

- Lease or Sell 511
- Discontinue a Segment or Product 513
- Make or Buy 514
- Replace Equipment 516
- Process or Sell 517
- Accept Business at a Special Price 518

Setting Normal Product Selling Prices 519

- Total Cost Concept 520
- Target Costing Method 522

Metric-Based Analysis: Contribution Margin per Unit of Production Constraint 524

- Production Constraints and Profits 524
- Production Constraints and Pricing 525

Appendix 526

- Product Pricing: Product Cost and Variable Cost Concepts 526
- Product Cost Concept 526
- Variable Cost Concept 528
- Choosing a Cost-Plus Approach Cost Concept 530

13 Budgeting and Standard Costs 547

Nature and Objectives of Budgeting 548

- Objectives of Budgeting 548
- Human Behavior and Budgeting 549
- Budgeting Systems 551
- Computerized Budgeting Systems 553

Master Budget 554

- Income Statement Budgets 555
- Budgeted Income Statement 561
- Balance Sheet Budgets 562
- Budgeted Balance Sheet 565

Standards 565

- Setting Standards 565
- Types of Standards 566
- Reviewing and Revising Standards 566
- Criticisms of Standard Costs 567

Budgetary Performance Reporting 567

- Budget Performance Report 568
- Manufacturing Cost Variances 569

Direct Materials and Direct Labor Variances 570

- Direct Materials Variances 570
- Direct Labor Variances 573

Metric-Based Analysis: Process Yield and Utilization Rate 575

- Process Yield 575
- Utilization Rate 576

14 Decentralized Operations 600

Operational Responsibility 601

- Centralized Operations 601
- Decentralized Operations 601
- Responsibility Accounting 603

Responsibility Accounting for Cost Centers 603

Responsibility Accounting for Profit Centers 605

- Service Department Charges 605
- Profit Center Reporting 608

Responsibility Accounting for Investment Centers 608

- Return on Investment 609
- Residual Income 613

Metric-Based Analysis: Balanced Scorecard 614

- Innovation and Learning 614
- Internal Processes 615
- Customer Service 615
- Financial 615

Appendix: Transfer Pricing 616

- Market Price Approach 617
- Negotiated Price Approach 617
- Cost Price Approach 620

15 Capital Investment Analysis 640

Nature of Capital Investment Analysis 641

Methods Not Using Present Values 642

- Average Rate of Return Method 642
- Cash Payback Method 644

Methods Using Present Values 645

- Present Value Concepts 645

Factors That Complicate Capital Investment Analysis 653

- Income Tax 654
- Unequal Proposal Lives 654
- Lease Versus Capital Investment 654
- Uncertainty 655
- Changes in Price Levels 656
- Qualitative Considerations 656

Capital Rationing 657

Metric-Based Analysis: Financial Leverage 658

Appendix A: Double-Entry Accounting Systems 677

Rules of Debit and Credit 678

The Journal 679

Illustration of Double-Entry Accounting 679

Posting to the Ledger 681

Trial Balance and Financial Statements 682

Review of Double-Entry Accounting 683

Appendix B: Process Cost Systems 691

Comparing Job Order and Process Cost Systems 691

Cost Flows for a Process Manufacturer 693

Weighted Average Cost Method 694

- Determining Costs Using the Weighted Average Cost Method 694

Cost Flows for a Process Cost System 696

Using the Cost of Production Report for Decision Making 698

- Soda Butte Beverage Company 698

Online Appendix C: Factory Overhead Variances (available for download from Cengage.com) A-1

- The Factory Overhead Flexible Budget A-1
- Variable Factory Overhead Controllable Variance A-2
- Fixed Factory Overhead Volume Variance A-3
- Reporting Factory Overhead Variances A-5
- Factory Overhead Account A-5

Glossary 704

Subject Index 714

Company Index 724

Chapter 1

The Role of Accounting in Business

What's Covered:

Topics: The Role of Accounting in Business

Nature of Business

- Types of Business (Obj. 1)
- Forms of Business (Obj. 1)
- Business Strategies (Obj. 1)
- Business Stakeholders (Obj. 1)
- Business Activities (Obj. 2)

Role of Accounting

- Financial and Managerial Accounting (Obj. 3)
- Income Statement (Obj. 4)
- Statement of Changes in Stockholders' Equity (Obj. 4)
- Balance Sheet (Obj. 4)
- Statement of Cash Flows (Obj. 4)
- Accounting Concepts (Obj. 5)

Metric-Based Analysis

- Types of Analyses (Obj. 6)
- Return on Assets (Obj. 6)

Learning Objectives

- Obj.1** Describe the types and forms of businesses, how businesses make money, and business stakeholders.
- Obj.2** Describe the three business activities of financing, investing, and operating.
- Obj.3** Define accounting and describe its role in business.

- Obj.4** Describe and illustrate the basic financial statements and how they are integrated.
- Obj.5** Describe eight accounting concepts underlying financial reporting.
- Obj.6** Describe types of metrics and analyze a company's performance using return on assets.

Chapter Metrics

Use the following metrics to analyze transactions and financial statements

TRANSACTIONS*

Liquidity: N/A

Profitability: N/A

FINANCIAL STATEMENTS

Return on Assets

*There are no transactions in this chapter.

Snap Inc.



How much are you willing to pay for stock of a company that has never been traded on a public market? Investors must come up with an answer to this question for companies that offer stock to the public for the first time, which is called an *initial public offering*.

In the United States, before such companies can offer stock for sale, they must file a prospectus (Form S-1) with the Securities and Exchange Commission. The prospectus includes background information on the company, including its business strategy and the range of prices that the stock is expected to sell for in the market. Also included in the prospectus are the company's financial statements for the past three years.

Snap Inc. (SNAP) is a camera company with the objective of reinventing the camera by providing people an ability to communicate and express themselves with pictures. Snap's primary product is Snapchat, which is a camera application that allows people to send Snaps (images, emojis, and

videos). On average, more than 180 million people use Snapchat daily creating more than three billion snaps.

In its prospectus filed with the Securities and Exchange Commission in 2017, Snap Inc. indicated that it anticipated a price for its Class A common stock of between \$14.00 and \$16.00 per share. At the end of its first day of trading, its stock closed at \$24.48 per share and had traded as high at \$26.05 per share. At \$24 per share, Snap Inc.'s stock is worth more than \$30 billion.

Was Snap Inc.'s stock really worth \$24.48 at the end of its first day of trading on March 2, 2017? To answer this question, investors analyze Snap Inc.'s financial condition and performance using public information, including its financial statements.

In this chapter, the nature, types, and activities of businesses, such as Snap Inc., are described and illustrated. In addition, the roles of accounting in business—including financial statements, basic accounting concepts, and how to use metrics to evaluate a business's performance—are also described and illustrated.

* As of the close of the market on June 27, 2019, Snap Inc. common stock was trading at \$14.66 per share.

Objective 1

Describe the types and forms of businesses, how businesses make money, and business stakeholders.

Nature of Business and Accounting

A **business**¹ is an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers. Businesses come in all sizes, from a local coffee house to **Starbucks (SBUX)**, which sells over \$22 billion of coffee and related products each year.

The objective of most businesses is to earn a profit. **Profit** is the difference between the amounts received from customers for goods or services and the amounts paid for the inputs used to provide the goods or services. In this text, we focus on businesses operating to earn a profit. However, many of the same concepts and principles also apply to not-for-profit organizations such as hospitals, churches, and government agencies.

Types of Businesses

Three types of businesses operated for profit include service, merchandising, and manufacturing businesses. Each type of business and some examples are described below.

Service businesses provide services rather than products to customers.

Delta Air Lines (DAL) (transportation services)

The Walt Disney Company (DIS) (entertainment services)

Merchandising businesses sell products they purchase from other businesses to customers.

Walmart (WMT) (general merchandise)

Amazon.com (AMZN) (books, music, videos)

1. A complete glossary of terms appears at the end of the text.

Manufacturing businesses change basic inputs into products that are sold to customers.

General Motors Corporation (GM) (cars, trucks, vans)

Intel Corp (INTC) (computer microprocessors)

Snap Inc. is a service business that provides users an ability to communicate and express themselves to family and friends with short videos and images.

*Snap Inc.
Connection*

Forms of Business

A business is normally organized in one of the following four forms:

- proprietorship
- partnership
- corporation
- limited liability company

A **proprietorship** is owned by one individual. More than 70% of the businesses in the United States are organized as proprietorships. The frequency of this form is due to the ease and low cost of organizing. The primary disadvantage of proprietorships is that the financial resources are limited to the individual owner's resources. In addition, the owner has unlimited liability to creditors for the debts of the company.

A **partnership** is owned by two or more individuals. About 10% of the businesses in the United States are organized as partnerships. Like a proprietorship, a partnership may outgrow the financial resources of its owners. Also, the partners have unlimited liability to creditors for the debts of the company.

A **corporation** is organized under state or federal statutes as a separate legal entity. The ownership of a corporation is divided into shares of stock. A corporation issues the stock to individuals or other companies, who then become owners or stockholders of the corporation. A primary advantage of the corporate form is the ability to obtain large amounts of resources by issuing shares of stock. In addition, the stockholders' liability to creditors for the debts of the company is limited to their investment in the corporation.

Snap Inc. is organized as a corporation in Delaware even though its offices are in Venice, California. Many companies incorporate in Delaware because of its favorable legal and business environment.

*Snap Inc.
Connection*

A **limited liability company (LLC)** combines attributes of a partnership and a corporation. The primary advantage of the limited liability company form is that it operates similar to a partnership, but its owners' (or members') liability for the debts of the company is limited to their investment. Many professional practices such as lawyers, doctors, and accountants are organized as limited liability companies.

In addition to the ease of formation, ability to raise capital, and liability for the debts of the business, other factors such as taxes and legal life of the business should be considered when forming a business. For example, corporations are taxed as separate legal entities, while the income of sole proprietorships, partnerships, and limited liability companies is passed through to the owners and taxed on the owners' tax returns. As separate legal entities, corporations also continue on, regardless of the lives of the individual owners. In contrast, sole proprietorships, partnerships, and limited liability companies may terminate their existence with the death of an individual owner.

The characteristics of sole proprietorships, partnerships, corporations, and limited liability companies are summarized below.

Organizational Form	Ease of Formation	Legal Liability	Taxation	Limitation on Life of Entity	Access to Capital
Proprietorship	Simple	No limitation	Nontaxable (pass-through) entity	Yes	Limited
Partnership	Simple	No limitation	Nontaxable (pass-through) entity	Yes	Average
Corporation	Complex	Limited liability	Taxable entity	No	Extensive
Limited liability company	Moderate	Limited liability	Nontaxable (pass-through) entity by election	Yes	Average

The three types of businesses we discussed earlier—manufacturing, merchandising, and service—may be proprietorships, partnerships, corporations, or limited liability companies. However, businesses that require a large amount of resources, such as many manufacturing businesses, are corporations. Likewise, most large retailers such as **Walmart (WMT)** and **Target (TGT)** are corporations.

Because most large businesses are corporations, they tend to dominate the economic activity in the United States. For this reason, this text focuses on the corporate form of organization. However, many of the concepts and principles discussed also apply to proprietorships, partnerships, and limited liability companies.

How Do Businesses Make Money?

The objective of a business is to earn a profit by providing goods or services to customers. How does a company decide which products or services to offer its customers? Many factors influence this decision. Ultimately, however, the decision is based on how the company plans to gain an advantage over its competitors and, in doing so, maximize its profits.

Companies try to maximize their profits by generating high revenues while maintaining low costs, which results in high profits. However, a company's competitors are also trying to do the same, and thus, a company can only maximize its profits by gaining an advantage over its competitors.

Generally, companies gain an advantage over their competitors by using one of the following strategies:

- A **low-cost strategy**, where a company designs and produces products or services at a lower cost than its competitors. Such companies often sell no-frills, standardized products and services.
- A **premium-price strategy**, where a company tries to design and produce products or services that serve unique market needs, allowing it to charge premium prices. Such companies often design and market their products so that customers perceive their products or services as having a unique quality, reliability, or image.

Walmart (WMT) and **Southwest Airlines (LUV)** are examples of companies using a low-cost strategy. **John Deere (DE)** and **Tiffany (TIF)** are examples of companies using a premium-price strategy.

Since business is highly competitive, it is difficult for a company to sustain a competitive advantage over time. For example, a competitor of a company using a low-cost strategy may copy the company's low-cost methods or develop new methods that achieve even lower costs. Likewise, a competitor of a company using a premium-price strategy may develop products that are perceived as more desirable by customers.

Examples of companies utilizing low-cost and premium-price strategies include:

- Local pharmacies who develop personalized relationships with their customers. By doing so, they are able to charge premium (higher) prices. In contrast, Walmart's pharmacies use the low-cost emphasis and compete on cost.
- Grocery stores such as **Kroger (KR)** develop relationships with their customers by issuing preferred customer cards. These cards allow the stores to track consumer preferences and buying habits for use in purchasing and advertising campaigns.

- **Honda (HMC)** promotes the reliability and quality ratings of its automobiles and thus charges premium prices. In contrast, **Kia Motors (KRX)** uses a low-cost strategy.
- **Harley-Davidson (HOG)** emphasizes that its motorcycles are “Made in America” and promotes its “rebel” image as a means of charging higher prices.

Companies sometimes struggle to find a competitive advantage. For example, **JCPenney (JCP)** and **Macy's (M)** have difficulty competing on low costs against **Walmart (WMT)**, **Kohl's (KSS)**, **T.J. Maxx (TJX)**, and **Target (TGT)**. At the same time, JCPenney and Macy's have difficulty charging premium prices against competitors such as **The GAP (GPS)** and **Urban Outfitters (UOF)**. Likewise, **Delta Air Lines (DAL)** and **United Airlines (UA)** have difficulty competing against low-cost airlines such as **Southwest (LUV)**. At the same time, Delta and United don't offer any unique services for which their passengers are willing to pay a premium price.

Exhibit 1 summarizes low-cost and premium-price strategies with common examples of companies that employ each strategy.

Business Strategy	Industry					
	Airline	Freight	Automotive	Retail	Financial Services	Hotel
Low cost	Southwest	Union Pacific	Hyundai	Sam's Club	Ameritrade	Super 8
Premium price	Virgin Atlantic	FedEx	BMW	Talbot's	Morgan Stanley	Ritz-Carlton

Exhibit 1

Business Strategies and Industries

Snap Inc.'s strategy is to provide an innovative, free platform for people to express themselves through images. Snap believes that images contain more context and richer information than text alone. Snap generates revenues (monetizes itself) primarily through advertising.

*Snap Inc.
Connection*

Business Stakeholders

A **business stakeholder** is a person or entity with an interest in the economic performance and well-being of a company. For example, owners, suppliers, customers, and employees are all stakeholders in a company.

Business stakeholders can be classified into one of the four categories illustrated in Exhibit 2.

Business Stakeholder	Interest in the Business	Examples
Capital market stakeholders	Providers of major financing for the business	Banks, owners, stockholders
Product or service market stakeholders	Buyers of products or services and vendors to the business	Customers and suppliers
Government stakeholders	Collect taxes and fees from the business and its employees	Federal, state, and city governments
Internal stakeholders	Individuals employed by the business	Employees and managers

Exhibit 2

Business Stakeholders

Capital market stakeholders provide the financing for a company to begin and continue its operations. Banks and other long-term creditors have an economic interest in receiving the amount loaned plus interest. Owners want to maximize the economic value of their investments.

Product or service market stakeholders purchase the company's products or services or sell their products or services to the company. Customers have an economic interest in the

continued success of the company. For example, customers who purchase advance tickets on **Delta Air Lines (DAL)** are depending on Delta continuing in business. Likewise, suppliers depend on continued success of their customers. For example, if a customer fails or cuts back on purchases, the supplier's business will also decline.

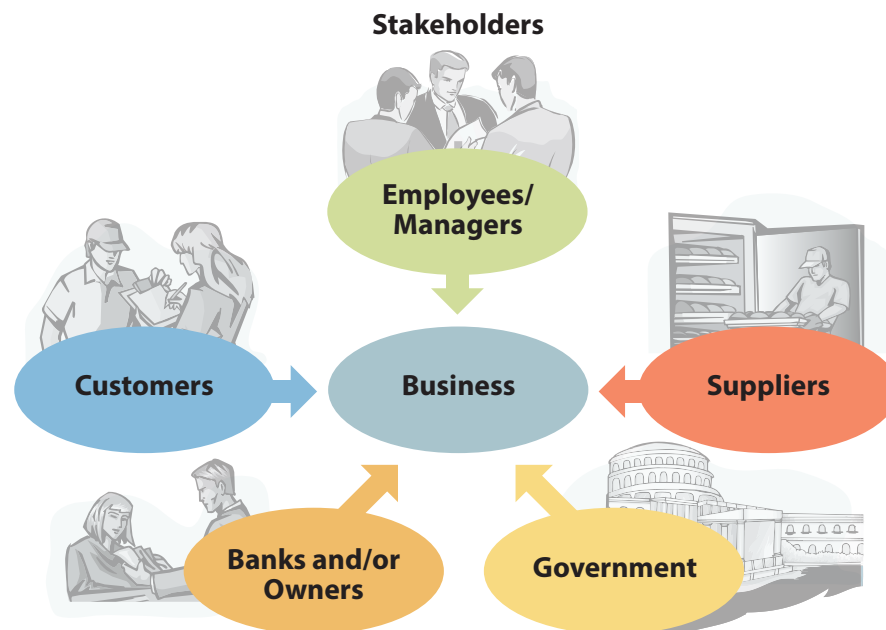
Government stakeholders, such as federal, state, county, and city governments, collect taxes from companies. The better a company does, the more taxes the government collects. In addition, workers who are laid off by a company can file claims for unemployment compensation, which results in a financial burden for the state and federal governments.

Internal stakeholders, such as managers and employees, depend upon the continued success of the company for keeping their jobs. Managers of companies that perform poorly are often fired by the owners. Likewise, during economic downturns companies often lay off workers. Business stakeholders are illustrated in Exhibit 3.

Snap Inc. Connection

Snap Inc.'s stakeholders include common stockholders, bondholders, network members, employees, and U.S. and state governments who receives taxes.

Exhibit 3
Business
Stakeholders



Integrity, Objectivity, and Ethics in Business

The Hershey Trust Company

Milton Snavely Hershey founded **The Hershey Company (HSY)** after serving as a candy apprentice in Philadelphia, running a failing candy shop, and finally succeeding at caramel making. Milton started The Hershey Company in the early 1900s after selling his caramel company.

Milton and his wife, Catherine, couldn't have children, and in 1909, they created the Milton Hershey School. After Catherine's death, Milton willed virtually his entire fortune, including his interest in The Hershey Company, to the School. Today, the School provides free education, meals, clothing, health care, and a home to almost 2,000 children in financial and social need. The School is run by The Hershey Trust Company,

which is the largest shareholder of The Hershey Company.

A public uproar was created in 2002 when the trustees of The Hershey Trust Company tried to sell their controlling stock interest in The Hershey Company. As a result of the public outcry, the majority of the trustees were forced to resign.

Source: Adapted from www.thehersheycompany.com.



Finnbarr Webster/Alamy Stock Photo

Business Activities

All companies engage in the following three business activities:

- **Financing activities** to obtain the necessary funds (monies) to organize and operate the company
- **Investing activities** to obtain assets such as buildings and equipment to begin and operate the company
- **Operating activities** to earn revenues and profits

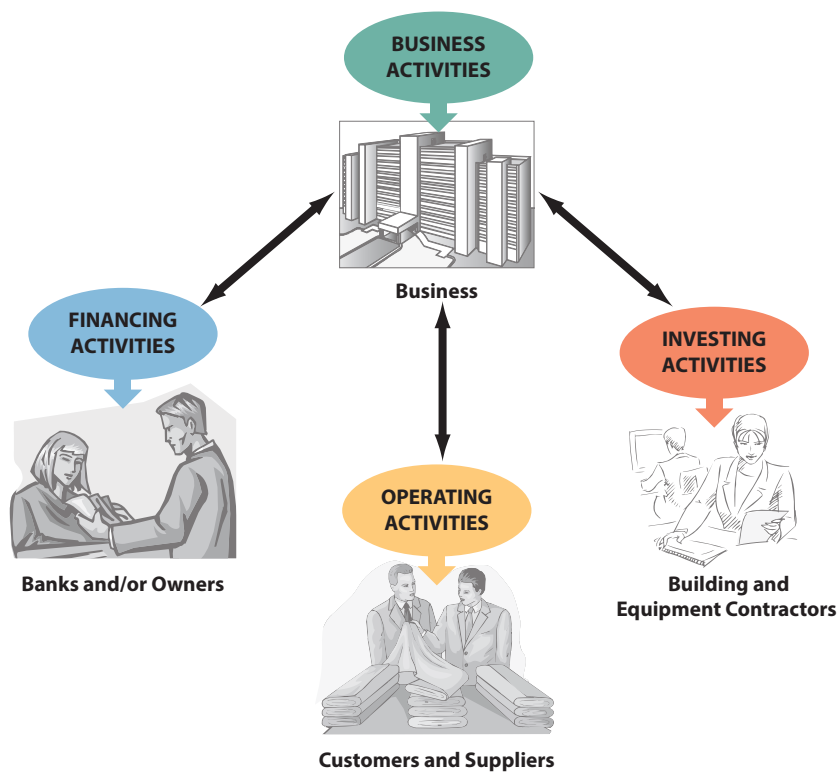
The preceding business activities are illustrated in Exhibit 4.

Objective 2

Describe the three business activities of financing, investing, and operating.

Exhibit 4

Business Activities



Financing Activities

Financing activities involve obtaining funds to begin and operate a business. Companies obtain financing through the use of capital markets by:

- borrowing
- issuing shares of ownership

When a company borrows money, it incurs a liability. A **liability** is a legal obligation to repay the amount borrowed according to the terms of the borrowing agreement. When a company borrows from a vendor or supplier, the liability is called an **account payable**. In such cases, the company promises to pay according to the terms set by the vendor or supplier. Most vendors and suppliers require payment within a relatively short time, such as 30 days.

On a recent balance sheet, Snap Inc. reported \$71.2 million of accounts payable.

*Snap Inc.
Connection*

A company may also borrow money by issuing bonds. *Bonds* are sold to investors and require repayment normally with interest. The amount of the bonds, called the *face value*, usually requires repayment several years in the future. Thus, bonds are a form of long-term financing. The interest on the bonds, however, is normally paid semiannually. Bond obligations are reported as **bonds payable**, and any interest that is due is reported as **interest payable**.

Many companies borrow by issuing notes payable. A **note payable** requires payment of the amount borrowed plus interest. Notes payable are similar to bonds except that they may be issued on either a short-term or a long-term basis.

A company may finance its operations by issuing shares of ownership. For a corporation, shares of ownership are issued in the form of shares of stock. Although corporations may issue a variety of different types of stock, the basic type of stock issued to owners is called **common stock**.² Investors who purchase the stock are referred to as **stockholders**.

The claims of creditors and stockholders on the assets of a corporation are different. **Assets** are the resources owned by a corporation (company). Creditors have first claim on the company's assets. Only after the creditors' claims are satisfied do the stockholders have a right to the corporate assets.

Creditors normally receive timely payments, which may include interest. In contrast, stockholders are not entitled to regular payments. However, many corporations distribute earnings to stockholders on a regular basis. These distributions of earnings to stockholders are called **dividends**.

*Snap Inc.
Connection*

In a recent year, Snap Inc. engaged in the financing activity of issuing stock.

Investing Activities

Investing activities involve using the company's assets to obtain additional assets to start and operate the business. Depending upon the nature of the business, a variety of different assets must be acquired.

Most businesses need assets such as machinery, buildings, computers, office furnishings, trucks, and automobiles. These assets have physical characteristics and as such are **tangible assets**. Long-term tangible assets such as machinery, buildings, and land are reported separately as property, plant, and equipment. Short-term tangible assets such as cash and inventories are reported separately.

A business may also need **intangible assets**. For example, a business may obtain patent rights to use in manufacturing a product. Long-term assets such as patents, goodwill, and copyrights are reported separately as intangible assets.

A company may also prepay for items such as insurance or rent. Such items, which are assets until they are consumed, are reported as **prepaid expenses**. In addition, rights to payments from customers who purchase merchandise or services on credit are reported as **accounts receivable**.

*Snap Inc.
Connection*

For a recent year, Snap Inc. engaged in investing activities such as the purchasing of property and equipment.

Operating Activities

Operating activities involve using assets to earn revenues and profits. The management of a company does this by implementing one of the business strategies discussed earlier.

2. Other types of stock are discussed in Chapter 8, "Liabilities and Stockholders' Equity."

Revenue is the increase in assets from selling products or services. Revenues are normally identified according to their source. For example, revenues received from selling products are called **sales**. Revenues received from providing services are called **fees earned**.

In a recent year, Snap Inc. reported \$825 million of revenue.

*Snap Inc.
Connection*

To earn revenue, a business incurs costs, such as wages of employees, salaries of managers, rent, insurance, advertising, freight, and utilities. Costs used to earn revenue are called **expenses** and are identified and reported in a variety of ways. For example, the cost of products sold is referred to as the **cost of goods sold**, **cost of merchandise sold**, or **cost of sales**. Other expenses are normally classified as either selling expenses or administrative expenses. **Selling expenses** include those costs directly related to the selling of a product or service. For example, selling expenses include such costs as sales salaries, sales commissions, freight, and advertising costs. **Administrative expenses** include other costs not directly related to the selling such as officer salaries and other costs of the corporate office.

By comparing the revenues for a period to the related expenses, it can be determined whether the company has earned net income or incurred a net loss. **Net income** results when revenues exceed expenses. A **net loss** results when expenses exceed revenues.

In a recent year, Snap Inc. reported loss from operations of \$3.5 billion and a net loss of \$3.4 billion after taxes.

*Snap Inc.
Connection*

As discussed next, the major role of accounting is to provide stakeholders with information on the financing, investing, and operating activities of businesses. Financial statements are one source of such information.

What Is Accounting and Its Role in Business?

The *role of accounting* is to provide information about the financing, investing, and operating activities of a company to its stakeholders. For example, accounting provides information for managers to use in operating the business. In addition, accounting provides information to other stakeholders, such as creditors, for assessing the economic performance and condition of the company.

Accounting is often called the “language of business.” In a general sense, **accounting** is defined as an information system that provides reports to stakeholders about the economic activities and condition of a business. This text focuses on accounting and its role in business. However, many of the concepts discussed also apply to individuals, governments, and not-for-profit organizations. For example, individuals must account for their hours worked, checks written, and bills paid. Stakeholders for individuals include creditors, dependents, and the government.

A primary purpose of accounting is to summarize the financial performance of a business for external stakeholders, such as banks and governmental agencies. The branch of accounting that is associated with preparing reports for users external to the business is called **financial accounting**. Accounting also can be used to guide management in making financing, investing, and operations decisions for the company. This branch of accounting is called **managerial accounting**. Financial and managerial accounting may overlap. For example, financial reports for external stakeholders are often used by managers in

Objective 3

Define accounting and describe its role in business.

assessing the potential impact of their decisions on the company. The head of the accounting department in a company is called **comptroller** or **chief financial officer (CFO)**.

*Snap Inc.
Connection*

The interim Chief Financial Officer of Snap Inc. is Lara Sweet, who has a Bachelor of Science (BS) degree in accounting from George Mason University.

The two major objectives of financial accounting are:

- To report the financial condition of a business at a point in time
- To report changes in the financial condition of a business over a period of time

The relationship between these two financial accounting objectives is shown in Exhibit 5.

Exhibit 5

Objectives
of Financial
Accounting

Financial Condition
at January 1, 20Y6



Change in
Financial Condition
for Year Ending
December 31, 20Y6



Financial Condition
at December 31, 20Y6



The first objective can be thought of as a still photograph (snapshot) of the company's financial (economic) condition as of a point in time. The second objective can be thought of as a moving picture (video) of the company's financial (economic) performance over time.

The objectives of accounting are achieved by (1) recording the economic events affecting a business and then (2) summarizing the impact of these events on the business in financial reports, called **financial statements**.

Objective 4

Describe and illustrate the basic financial statements and how they are integrated.

Financial Statements

Financial statements report the financial condition of a business at a point in time and changes in the financial condition over a period of time. The four basic financial statements and their relationship to the objectives of financial accounting are listed below.

Financial Statement	Financial Accounting Objective
Income Statement	Reports change in financial condition
Statement of Stockholders' Equity	Reports change in financial condition
Balance Sheet	Reports financial condition
Statement of Cash Flows	Reports change in financial condition

The order in which each financial statement is prepared and the nature of each statement is described below.

Order Prepared	Financial Statement	Description of Statement
1	Income Statement	A summary of the revenue and expenses for a specific period of time, such as a month or a year.
2	Statement of Stockholders' Equity	A summary of the changes in the stockholders' equity in the corporation for a specific period of time, such as a month or a year.
3	Balance Sheet	A list of the assets, liabilities, and stockholders' equity as of a specific date, usually at the close of the last day of a month or a year.
4	Statement of Cash Flows	A summary of the cash receipts and cash payments for a specific period of time, such as a month or a year.

The preceding four financial statements are described and illustrated in Exhibits 6 through 9 using **The Hershey Company (HSY)**. These illustrations will introduce you to the financial statements that you will be studying throughout this text. The data for the statements are adapted from a recent annual report of The Hershey Company.³

Income Statement

The **income statement** reports the change in financial condition due to the operations of the company. The time period covered by the income statement may vary depending upon the needs of stakeholders. Public corporations are required to file quarterly and annual income statements with the Securities and Exchange Commission (SEC). The income statement for a year ending December 31 for The Hershey Company is shown in Exhibit 6.

Since the objective of business operations is to generate revenues, the income statement begins by listing the revenues for the period. During the year, Hershey generated sales of \$7,791 million. These sales are listed under "Revenues." The numbers shown in Exhibit 6 are expressed in millions of dollars. It is common for large companies to express their financial statements in thousands or millions of dollars.

Exhibit 6 Income Statement: The Hershey Company

The Hershey Company Income Statement For the Year Ended December 31 (in millions)		
Revenues:		
Sales		\$7,791
Expenses:		
Cost of sales	\$4,216	
Selling and administrative expenses	1,875	
Interest expense	139	
Income taxes expense	239	
Other expenses	144	(6,613)
Net income		<u>\$ 1,178</u>

3. The financial statements for Hershey shown in Exhibits 6–9 are for the year ended December 31, 2018. The most recent statements may be found at <http://www.sec.gov/edgar/searchedgar/companysearch.html>, enter Hershey's stock market symbol HSY in the Fast Search box, enter 10-K in the Filing Type box, and click on the latest 10-K.

Following the revenues, the expenses used in generating the revenues are listed. For Hershey, these expenses include cost of sales, selling and administrative, interest, income taxes, and other expenses. By reporting the expenses and the related revenues for a period, the expenses are said to be matched against the revenues. This is known in accounting as the *matching concept*, which is discussed later in this chapter.

When revenues exceed expenses for a period, the company has *net income*. If expenses exceed revenues, the company has a *net loss*. Net income means that the business increased its net assets through its operations. That is, the assets created by the revenues exceeded the assets used in generating those revenues.

The objective of most companies is to maximize net income or profit. A net loss means that the business decreased its net assets through its operations. While a business might survive in the short run by reporting net losses, in the long run a business must earn net income to survive.

Exhibit 6 shows that Hershey earned net income of \$1,178 million. Is this good or bad? Certainly, net income is better than a net loss. However, the stakeholders must assess net income according to their objectives. For example, a creditor might be satisfied that the net income is sufficient to ensure that it will be repaid. In contrast, a stockholder might assess the corporation's profitability as less than its competitors' profits and thus be disappointed. Throughout this text, various methods of assessing corporate performance will be described and illustrated.

Statement of Stockholders' Equity

The **statement of stockholders' equity** reports the changes in financial condition due to changes in stockholders' equity for a period. Changes to stockholders' equity normally involve common stock and retained earnings. **Retained earnings** are the portion of a corporation's net income retained in the business. A corporation may retain all of its net income for expanding operations, or it may pay a portion or all of its net income as dividends. For example, high-growth companies often do not distribute dividends but instead retain profits for future expansion. In contrast, more mature corporations normally pay a regular dividend.

*Snap Inc.
Connection*

Snap Inc. doesn't intend to pay cash dividends in the foreseeable future. Instead, it retains its cash to use in the development of its operations.

Since retained earnings depend upon net income, the period covered by the statement of stockholders' equity is the same period as the income statement. The statement of stockholders' equity for Hershey for the year ended December 31 is shown in Exhibit 7.

Exhibit 7 Statement of Stockholders' Equity

The Hershey Company Statement of Stockholders' Equity For the Year Ended December 31 (in millions)				
	Common Stock	Retained Earnings	Other Items	Total
Balances, January 1	\$299	\$6,371	\$(5,738)	\$ 932
Net income		1,178		1,178
Dividends		(564)		(564)
Other items		47	(186)	(139)
Balances, December 31	<u>\$299</u>	<u>\$7,032</u>	<u>\$(5,924)</u>	<u>\$1,407</u>

There was no change in common stock during the year. During the year, Hershey earned net income of \$1,178 million and distributed (declared) dividends of \$564 million. Dividends are reported in the statement of stockholders' equity rather than the income statement. This is because dividends are not an expense but a distribution of net income to stockholders. In addition to net income and dividends, Hershey reported an unusual (other) item of \$47 million as an addition to its retained earnings. This other item is related to the effects of a 2017 Congressional reform of the U.S. corporate taxes, which were allowed to be reclassified into retained earnings. Thus, during the year, Hershey's retained earnings increased from \$6,371 to \$7,032 ($\$6,371 + \$1,178 - \$564 + \47).

Exhibit 7 includes a column for other equity items. Items in this category include paid-in capital (amounts contributed in excess of the par value of stock) and treasury stock (repurchased common stock) that will be discussed in a later chapter.

Balance Sheet

The balance sheet reports the financial condition *as of a point in time*. This is in contrast to the income statement, statement of stockholders' equity, and statement of cash flows, which report changes in financial condition *for a period of time*. The financial condition of a business as of a point in time is measured by its total assets and claims or rights to those assets.

The claims on a company's assets consist of rights of creditors and stockholders. The rights of creditors are *liabilities*. The rights of stockholders are referred to as **stockholders' equity** or **owners' equity**. Thus, the financial condition of a business can be expressed in equation form as:

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

This equation is called the **accounting equation**. This equation is the foundation of accounting information systems, which are discussed in later chapters.

The **balance sheet**, sometimes called the **statement of financial condition**, is prepared using the accounting equation. The balance sheet is prepared by listing the accounting equation in vertical rather than horizontal form as follows:

- Step 1.** Each *asset* is listed and added to arrive at *total assets*.
- Step 2.** Each *liability* is listed and added to arrive at *total liabilities*.
- Step 3.** Each *stockholders' equity* item is listed and added to arrive at *total stockholders' equity*.
- Step 4.** Total liabilities and total stockholders' equity is added to arrive at *total liabilities and stockholders' equity*.
- Step 5.** Total assets must equal total liabilities and stockholders' equity.

The accounting equation must balance in Step 5; hence, the name balance sheet. The balance sheet for The Hershey Company as of December 31 is shown in Exhibit 8.

Exhibit 8 reports total assets of \$7,703 million equal its total liabilities of \$6,296 million plus its total stockholders' equity of \$1,407 million.

Statement of Cash Flows

The **statement of cash flows** reports the change in financial condition due to the changes in cash during a period. The statement of cash flows is organized around the three business activities of financing, investing, and operating. Any changes in cash must be related to one or more of these activities.

The *net cash flows from operating activities* is reported first. This is because cash flows from operating activities is a primary focus of the company's stakeholders. In the short term, creditors use cash flows from operating activities to assess whether the company's operating activities are generating enough cash to repay them. In the long term, a company cannot survive unless it generates positive cash flows from operating activities. Thus, cash flows from operating activities is also a focus of employees, managers, suppliers, customers, and other stakeholders who are interested in the long-term success of the company.

Exhibit 8 Balance Sheet: The Hershey Company

The Hershey Company Balance Sheet December 31 (in millions)	
Assets	
Cash	\$ 588
Accounts receivable	594
Inventories	785
Prepaid expenses	272
Property, plant, and equipment	2,130
Intangibles	3,080
Other assets	254
Total assets	<u>\$7,703</u>
Liabilities	
Accounts payable	\$ 502
Accrued liabilities	713
Notes and other debt	4,904
Income taxes payable	177
Total liabilities	<u>\$6,296</u>
Stockholders' Equity	
Common stock	\$ 299
Retained earnings	7,032
Repurchased capital stock and other equity items	(5,924)
Total stockholders' equity	<u>\$1,407</u>
Total liabilities and stockholders' equity	<u>\$7,703</u>

The *net cash flows from investing activities* is reported second. This is because investing activities directly impact the operations of the company. Cash receipts from selling property, plant, and equipment are reported in this section. Likewise, any purchases of property, plant, and equipment are reported as cash payments. Companies that are expanding rapidly, such as start-up companies, normally report negative net cash flows from investing activities. In contrast, companies that are downsizing or selling segments of the business may report positive net cash flows from investing activities.

The *net cash flows from financing activities* is reported third. Any cash receipts from issuing debt or stock are reported in this section as cash receipts. Likewise, cash payments of debt and dividends are reported in this section.

The statement of cash flows is completed by adding the net cash flows from operating, investing, and financing activities to determine the *net increase or decrease in cash* for the period. This net increase or decrease in cash is then added to the *cash at the beginning of the period* to arrive at the *cash at the end of the period*.

The statement of cash flows for The Hershey Company for the year ended December 31 is shown in Exhibit 9.

During the year, Hershey's *operating activities* generated a positive net cash flow of \$1,600 million. Hershey's *investing activities* used \$1,503 million of cash to purchase property, plant, equipment, and other long-term assets. Hershey's *financing activities* generated \$111 million of cash. This cash was used to pay dividends, pay debt, and purchase its own stock. A company may purchase its own common stock if the corporate management believes its stock is undervalued or for providing stock to employees or managers as part of an incentive (stock option) plan.⁴ Hershey also received cash by borrowing from creditors.

4. The accounting for a company's purchase of its own stock, termed treasury stock, is discussed in a later chapter.

Exhibit 9 Statement of Cash Flows: The Hershey Company

The Hershey Company Statement of Cash Flows For the Year Ended December 31 (in millions)	
Cash flows from (used for) operating activities:	
Net cash flows from operating activities	\$1,600
Cash flows from (used for) investing activities:	
Investments in property, plant, equipment, and other long-term assets	(1,503)
Cash flows from (used for) financing activities:	
Cash receipts from financing activities, including debt	\$1,846
Dividends paid to stockholders	(564)
Repurchase of stock	(248)
Other, including repayment of debt	(923)
Net cash flows from financing activities	111
Net increase in cash during year	\$ 208
Cash as of January 1	380
Cash as of December 31	<u>\$ 588</u>

During the year, Hershey increased its cash by \$208 million. This increase is added to the cash at the beginning of the period of \$380 million to arrive at net cash at the end of the period of \$588 million.

Overall, Hershey's statement of cash flows indicates that Hershey generated \$1,600 million in cash flows from its operations. It used this cash to expand its operations and pay dividends to stockholders. Thus, Hershey appears to be in a strong operating position.

Integrated Financial Statements

The financial statements are prepared in the following order:

1. income statement
2. statement of stockholders' equity
3. balance sheet
4. statement of cash flows

Preparing the financial statements in the preceding order is important because the financial statements are integrated as follows:⁵

1. The income statement and statement of stockholders' equity are integrated. The net income or net loss reported on the income statement also appears on the statement of stockholders' equity as either an addition (net income) to or deduction (net loss) from the beginning retained earnings.
2. The statement of stockholders' equity and the balance sheet are integrated. The common stock and retained earnings at the end of the period on the statement of stockholders' equity also appear on the balance sheet.
3. The balance sheet and statement of cash flows are integrated. The cash on the balance sheet also appears as the end-of-period cash on the statement of cash flows.

5. Depending upon the method of preparing cash flows from operating activities, net income may also appear on the statement of cash flows. This method of preparing the statement of cash flows is called the indirect method. This method is illustrated in a later chapter. In addition, Chapter 2 illustrates how cash flows from operating activities may equal net income.

To illustrate, The Hershey Company's financial statements in Exhibits 6, 7, 8, and 9 are integrated as follows:

1. *Net income* of \$1,178 million is also reported on the statement of stockholders' equity as an addition to the beginning retained earnings.
2. *Retained earnings* of \$7,032 million and common stock of \$299 as of December 31 are also reported on the balance sheet.
3. *Cash* of \$588 million on the December 31 balance sheet is also reported as the end-of-period cash on the statement of cash flows.

The preceding integrations are shown in Exhibit 10. These integrations are important in analyzing (1) financial statements and (2) the impact of transactions on the financial statements. In addition, these integrations serve as a check on whether the financial statements have been prepared correctly. For example, if the ending cash on the statement of cash flows doesn't agree with the balance sheet cash, then an error has occurred.

Exhibit 10 Integrated Financial Statements

The Hershey Company Balance Sheet December 31				
Assets	=	Liabilities	+	Stockholders' Equity
Cash \$ 588				
.		.		.
.		.		\$7,032 Retained Earnings
.		.		299 Common Stock
<u>\$7,703</u>	=	<u>\$6,296</u>	+	<u>\$1,407</u>
		\$7,703		
		Total Liabilities + Stockholders' Equity		

The Hershey Company Statement of Cash Flows For the Year Ended Dec. 31		The Hershey Company Income Statement For the Year Ended Dec. 31		The Hershey Company Statement of Stockholders' Equity For the Year Ended Dec. 31				
Operating act.	\$1,600	Revenues	\$7,791		Common Stock	Retained Earnings	Other Items	Total
Investing act.	(1,503)	Expenses	(6,613)					
Financing act.	111	Net income	<u>\$1,178</u>					
Increase in cash	\$ 208							
Cash, Jan. 1	380							
Cash, Dec. 31	<u>\$ 588</u>							

Bal. Jan. 1	\$299	\$6,371	\$(5,378)	\$ 932
Net income		1,178		1,178
Dividends		(564)		(564)
Other items		47	(186)	(139)
Bal. Dec. 31	<u>\$299</u>	<u>\$7,032</u>	<u>\$(5,924)</u>	<u>\$1,407</u>

Objective 5

Describe eight accounting concepts underlying financial reporting.

Accounting Concepts

The four corporate financial statements described and illustrated in the preceding section were prepared using accounting "rules," called **generally accepted accounting principles (GAAP)**. Generally accepted accounting principles (GAAP) are necessary so that stakeholders

can compare companies across time. If the management of a company could prepare financial statements as they saw fit, the comparability between companies and across time would be impossible.

Accounting principles and concepts develop from research, accepted accounting practices, and pronouncements of regulators. Within the United States, the **Financial Accounting Standards Board (FASB)** has the primary responsibility for developing accounting principles. The FASB publishes *Statements of Financial Accounting Standards* as well as interpretations of these *Standards*.

The **Securities and Exchange Commission (SEC)**, an agency of the U.S. government, also has authority over the accounting and financial disclosures for corporations whose stock is traded and sold to the public. The SEC normally accepts the accounting principles set forth by the FASB. However, the SEC may issue *Staff Accounting Bulletins* on accounting matters that may not have been addressed by the FASB.

Many countries outside the United States use generally accepted accounting principles adopted by the **International Accounting Standards Board (IASB)**. The IASB issues *International Financial Reporting Standards (IFRS)*. Significant differences currently exist between FASB and IASB accounting principles. However, the FASB and IASB are working together to reduce and eliminate these differences toward the goal of developing a single set of accounting principles. Such a set of worldwide accounting principles would help facilitate investment and business in an increasingly global economy.

Generally accepted accounting principles (GAAP) rely upon eight supporting accounting concepts, as shown in Exhibit 11. Throughout this text, emphasis is on accounting principles and concepts. In this way, you will gain an understanding of “why” as well as “how” accounting is applied in business. Such an understanding is essential for analyzing and interpreting financial statements.

Business Entity Concept

The **business entity concept** limits the economic data recorded in an accounting system to data related to the activities of that company. In other words, the company is viewed as an entity separate from its owners, creditors, or other companies. For example, a company with one owner records the activities of only that company and does not record the personal activities, property, or debts of the owner. A business entity may take the form of a proprietorship, partnership, corporation, or limited liability company (LLC).

To illustrate, the accounting for The Hershey Company, a corporation, is separate from the accounting of its stakeholders. In other words, the accounting for transactions and events of individual stockholders, creditors, or other Hershey stakeholders is not included in The Hershey Company’s financial statements. Only the transactions and events of the corporation are included.

International Connection

Adoption or Convergence?

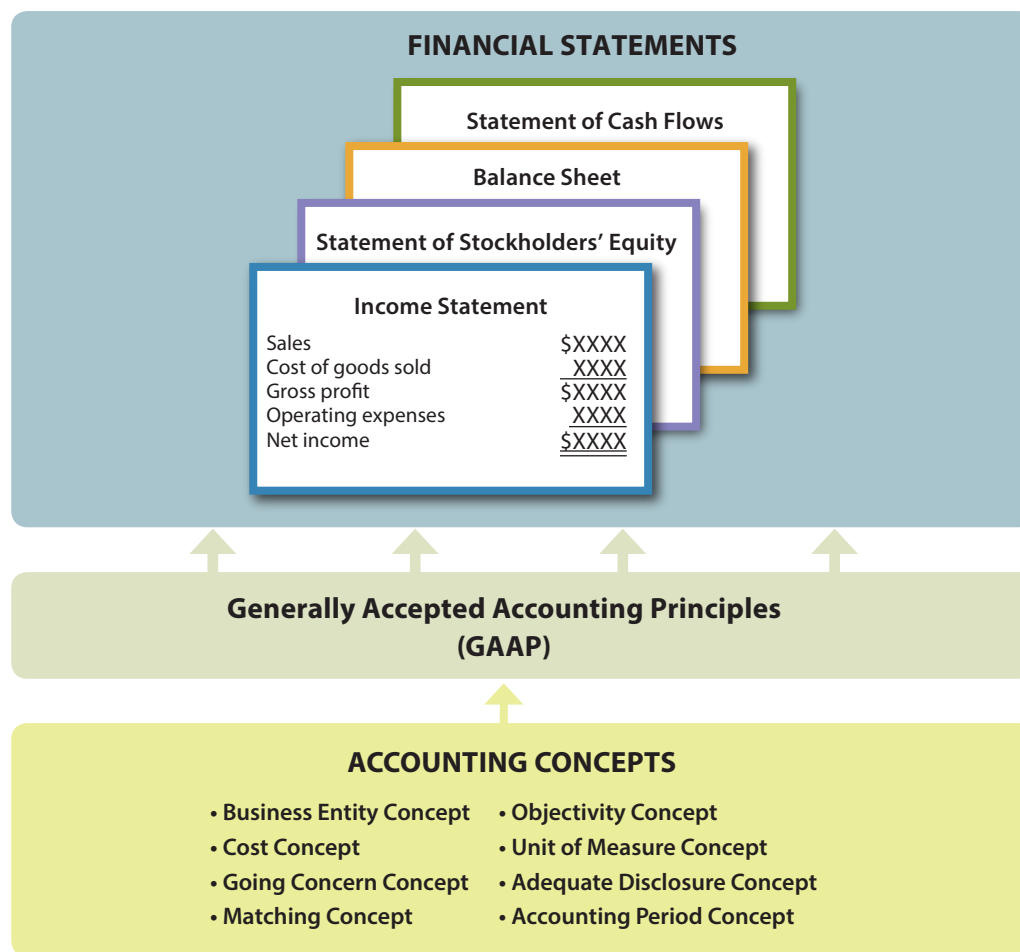
The largest public accounting firms, known as the Big Four, have pushed for the “adoption” of IFRS in the United States within a relatively short period of time. Such a strategy of adoption would generate millions of dollars of consulting and accounting work within the U.S. for the Big Four: Deloitte Touche Tohmatsu, PwC (PriceWaterhouseCoopers), Ernst & Young, and KPMG.

In contrast, others have argued for a strategy of gradual “convergence” to IFRS over time. Currently, it appears that regulators within the United States and the FASB are favoring convergence rather than adoption. For example, the FASB and IASB have completed several projects to converge U.S. and IFRS standards.¹

1. FASB.org, “Progress Report on IASB-FASB Convergence Work,” April 21, 2011.

Exhibit 11

Accounting
Principles and
Concepts



Cost Concept

The **cost concept** initially records assets in the accounting records at their cost or purchase price. To illustrate, assume that Aaron Publishers purchased the following land on August 3, 20Y4, for \$150,000:

Price listed by seller on March 1, 20Y4	\$160,000
Aaron Publishers' initial offer to buy on January 31, 20Y4	140,000
Estimated selling price on December 31, 20Y8	220,000
Assessed value for property taxes, December 31, 20Y8	190,000

Under the cost concept, Aaron Publishers records the purchase of the land on August 3, 20Y4, at the purchase price of \$150,000. The other amounts listed above have no effect on the accounting records.

The fact that the land has an estimated selling price of \$220,000 on December 31, 20Y8, indicates that the land has increased in value. However, to use the \$220,000 in the accounting records would be to record an illusory or unrealized profit. If Aaron Publishers sells the land on January 9, 20Y9, for \$240,000, a profit of \$90,000 (\$240,000 – \$150,000) is then realized and recorded. The new owner would record \$240,000 as its cost of the land.

Going Concern Concept

The **going concern concept** assumes that a company will continue in business indefinitely. This assumption is made because the amount of time that a company will continue in business is not known.

The going concern concept justifies the use of the cost concept for recording purchases, such as land. For example, in the preceding illustration Aaron Publishers plans to build a plant on the land. Since Aaron Publishers does not plan to sell the land, reporting changes in the market value of the land is irrelevant. That is, the amount Aaron Publishers could sell the land for if it went out of business is not important. This is because Aaron Publishers plans to continue its operations.

If, however, there is strong evidence that a company is planning on discontinuing its operations, then the accounting records are revised. To illustrate, the assets and liabilities of businesses in receivership or bankruptcy are valued from a quitting concern or liquidation point of view, rather than from the going concern point of view.

Matching Concept

The **matching concept** reports the revenues earned by a company for a period with the expenses incurred in generating the revenues. That is, expenses are *matched* against the revenues they generated.

Revenues are normally recorded at the time a product is sold or a service is rendered, which is referred to as the **revenue recognition principle**. At the point of sale, the sale price has been agreed upon, the buyer acquires ownership of the product or acquires the service, and the seller has a legal claim against the buyer for payment.

The expenses incurred in generating revenue should be reported in the same period as the related revenue. This is called the **expense recognition principle**. By matching revenues and expenses, net income or loss for the period can properly be determined and reported.

Snap Inc. recognizes (records) when persuasive evidence of an arrangement exists, the services have been provided or delivered, the fees are fixed or determinable, and collectability of the related receivable is reasonably assured.

*Snap Inc.
Connection*

Objectivity Concept

The **objectivity concept** requires that entries in the accounting records and the data reported on financial statements be based on verifiable or objective evidence. For example, invoices, bank statements, and a physical count of supplies on hand are all objective and verifiable. Thus, they can be used for entering amounts in the accounting system. In some cases, judgments, estimates, and other subjective factors may have to be used in preparing financial statements. In such situations, the most objective evidence available is used.

Unit of Measure Concept

In the United States, the **unit of measure concept** requires that all economic data be recorded in dollars. Other relevant, nonfinancial information may also be recorded, such as terms of contracts. However, it is only through using dollar amounts that the various transactions and activities of a business can be measured, summarized, reported, and compared. Money is common to all business transactions and thus is the unit of measurement for financial reporting.

Adequate Disclosure Concept

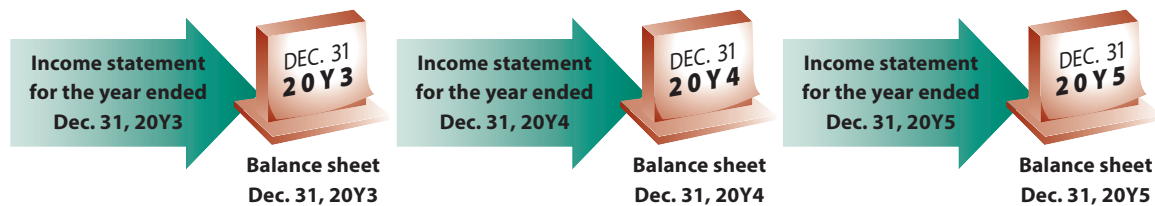
The **adequate disclosure concept** requires that the financial statements, including related notes, contain all relevant data a stakeholder needs to understand the financial condition and performance of the company. Nonessential data are excluded to avoid clutter.

Accounting Period Concept

The **accounting period concept** requires that accounting data be recorded and summarized in financial statements for periods of time. For example, transactions are recorded for a period of time such as a month or a year. The accounting records are then summarized and updated before preparing the financial statements.

The financial history of a company may be shown by a series of balance sheets and income statements. If the life of a company is expressed by a line moving from left to right, the financial history of the company may be graphed as shown in Exhibit 12.

Exhibit 12 Financial History of a Company



Responsible Reporting

The reliability of the financial reporting system is important to the economy and for the ability of businesses to raise money from investors. That is, stockholders and creditors require accurate financial reporting before they will invest their money. Scandals and financial reporting frauds threaten the confidence of investors. Exhibit 13 is a list of some financial reporting frauds and abuses.

The companies listed in Exhibit 13 were caught in the midst of ethical lapses that led to fines, firings, and criminal or civil prosecution. The second column of Exhibit 13 identifies the accounting concept that was violated in committing these unethical business practices. For example, the **WorldCom (WCOME)** fraud involved reporting various expense items as though they were assets. This is a violation of the matching concept and resulted in overstating income and assets. The third column of the exhibit identifies some of the results of these events. In most cases, senior and mid-level executives lost their jobs and were sued by upset stakeholders. In some cases, the executives also were criminally prosecuted and are serving prison terms.



Integrity, Objectivity, and Ethics in Business

Doing the Right Thing

Time magazine named three women as “Persons of the Year 2002.” Each of these not-so-ordinary women had the courage, determination, and integrity to do the right thing. Each risked their personal careers to expose shortcomings in their organizations. Sherron Watkins, an **Enron (ENRN)** vice president, wrote a letter to Enron’s chairman, Kenneth Lay, warning him of improper accounting that eventually led to Enron’s collapse.

Cynthia Cooper, an internal accountant, informed **WorldCom**’s Board of Directors of phony accounting that allowed WorldCom to cover up over \$3 billion in losses and forced WorldCom into bankruptcy. Coleen Rowley, an FBI staff attorney, wrote a memo to FBI Director Robert Mueller, exposing how the Bureau brushed off her pleas to investigate Zacarias Moussaoui, who was indicted as a co-conspirator in the September 11 terrorist attacks.

Exhibit 13 Accounting Frauds

Company	Concept Violated	Result
Adelphia	<i>Business Entity Concept:</i> Rigas family treated the company assets as their own.	Bankruptcy. Rigas family members convicted of fraud and lost their investment in the company.
AIG	<i>Business Entity Concept:</i> Compensation transactions with an offshore company that should have been disclosed on AIG's books.	CEO (Chief Executive Officer) resigned. AIG paid out \$126 million in fines.
AOL and PurchasePro	<i>Matching Concept:</i> Back-dated contracts to inflate revenues.	Civil charges filed against senior executives of both companies. Fined \$500 million.
Computer Associates	<i>Matching Concept:</i> Fraudulently inflating revenues.	CEO and senior executives indicted. Five executives pled guilty. Fined \$225 million.
Enron	<i>Business Entity Concept:</i> Treated transactions as revenue, when they should have been treated as debt.	Bankruptcy. Criminal charges against senior executives. Over \$60 billion in stock market losses.
Fannie Mae	<i>Accounting Period Concept:</i> Managing earnings by shifting expenses between periods.	CEO and CFO fired. \$9 billion in restated earnings.
HealthSouth	<i>Matching Concept:</i> \$4 billion in false entries to overstate revenues.	Senior executives faced regulatory and civil charges.
Quest	<i>Matching Concept:</i> Improper recognition of \$3 billion in revenue.	CEO and six other executives charged with "massive financial fraud." Fined \$250 million by SEC.
Tyco	<i>Adequate Disclosure Concept:</i> Failure to disclose secret loans to executives that were subsequently forgiven.	CEO forced to resign and was convicted in criminal proceedings.
WorldCom	<i>Matching Concept:</i> Improperly treated expenses as assets.	Bankruptcy. Criminal conviction of CEO and CFO. Over \$100 billion in stock market losses. Directors fined \$18 million.
Xerox	<i>Matching Concept:</i> Recognized \$3 billion in revenue in periods earlier than should have been recognized.	Fined \$10 million by SEC. Six executives fined \$22 million.

What went wrong for the managers and companies listed in Exhibit 13? The answer normally involved one or both of the following factors:

- **Failure of Individual Character.** Ethical managers and accountants are honest and fair. However, managers and accountants often face pressures from supervisors to meet company and investor expectations. In many of the cases in Exhibit 13, managers and accountants justified small ethical violations to avoid such pressures. However, these small violations became big violations as the company's financial problems became worse.
- **Culture of Greed and Ethical Indifference.** By their behavior and attitude, senior managers set the company culture. In most of the companies listed in Exhibit 13, the senior managers created a culture of greed and indifference to the truth.

Ponzi Schemes

A Ponzi scheme is a scam or fraudulent operation where to attract investors an individual or entity promises high returns with little or no risk. To meet their claims, the perpetrators (fraudsters) pay early investors with monies obtained from attracting new investors. To succeed, a Ponzi scheme requires a constant stream of money from new investors. Eventually, Ponzi schemes become so large that they collapse. One of the most recent Ponzi schemes was perpetrated by Bernard Madoff, who admitted to defrauding clients of up to \$50 billion over a number of years. He is serving a sentence of 150 years in prison.

*Business
Insight*

As a result of accounting and business frauds, the United States Congress passed laws to monitor the behavior of accounting and business. For example, the Sarbanes-Oxley Act of 2002 (SOX) was enacted. SOX established a new oversight body for the accounting profession called the Public Company Accounting Oversight Board (PCAOB). In addition, SOX established standards for independence, corporate responsibility, and disclosure.

How does one behave ethically when faced with financial or other types of pressure? Guidelines for behaving ethically are shown in Exhibit 14.

Exhibit 14

Guidelines for Ethical Conduct

1. Identify an ethical decision by using your personal ethical standards of honesty and fairness.
2. Identify the consequences of the decision and its effect on others.
3. Consider your obligations and responsibilities to those that will be affected by your decision.
4. Make a decision that is ethical and fair to those affected by it.

Many companies have ethical standards of conduct for managers and employees. In addition, the Institute of Management Accountants and the American Institute of Certified Public Accountants have professional codes of conduct.

Objective 6

Describe types of metrics and analyze a company's performance using return on assets.

Metric-Based Analysis: Return on Assets

In analyzing and assessing a company's financial condition and performance, a variety of quantitative measures may be used. Quantitative measures are referred to as **metrics**. Throughout this text, we use a variety of metrics to assess a company's financial condition and performance. In addition, the effects of management's decisions on metrics are also described and illustrated. We call this use of metrics to assess financial condition, performance, and decisions **metric-based analysis**.

Types of Metrics

The two basic types of metrics used in this text are ratios and amounts. For example, the return on assets ratio is described and illustrated in this chapter. An example of a metric amount is passenger miles flown by an airline or grade point average of a student.

*Snap Inc.
Connection*

Some metrics that Snap Inc. uses to assess its performance include average daily active users and average revenue per user.

Level of Application

We apply metric analysis at the following three levels:

1. Financial statement level
2. Transaction level
3. Managerial decision level

Financial statement level. Metric-based analysis is commonly applied at the financial statement level. At this level, various financial ratios are computed and analyzed. In the next section, we apply metric-based analysis at the financial statement level using the ratio return on assets (net income divided by average total assets).

Transaction level. We also apply metric-based analysis at the transaction level. When a company enters into a transaction, it changes the company's assets, liabilities, and stockholders' equity. Since we assume companies operate to maximize their profits, we assess the effects of a transaction on one or more of a company's profitability metrics.

Companies also attempt to maintain a minimum degree of liquidity so they can pay their liabilities and respond quickly to new opportunities to expand or enhance their operations. **Liquidity** refers to the degree to which a company has cash or assets that can be readily converted to cash. For example, investments in marketable securities can readily be converted to cash. In contrast, property, plant, and equipment are less liquid and could take months or years to convert to cash.

Liquidity differs from solvency. **Solvency** refers to the ability of a company to pay its long-term debts. Companies that cannot pay their debts are said to be insolvent, which usually involves filing for bankruptcy. Liquidity affects a company's ability to pay its debts. However, a company may have a large portion of assets that cannot be readily converted to cash but still be profitable and solvent.

In addition to assessing the effects of a transaction on one or more of a company's profitability metrics, we also assess the effects on one or more of a company's liquidity metrics. In Chapter 2, we begin our metric-based analysis of transactions by assessing the effects of each transaction on cash and net income. In later chapters, we expand this analysis to include a variety of profitability and liquidity metrics.

Managerial decision level. In the managerial chapters of this text, metric-basis analysis assesses the effects of decisions on a variety of operating metrics. For example, a managerial decision to increase selling prices (assuming no decrease in units sold) would decrease its break-even point, which is the level at which operations may neither profit nor experience a loss. In this case, the metric being assessed is the break-even point.

Return on Assets

In the remainder of this chapter, we describe and illustrate metric-based analysis at the financial statement level using return on assets. The return on assets is a profitability metric often used to compare a company's performance over time and with competitors.

Return on assets is normally expressed as a percent such as 12%. However, it may also be expressed as an amount per dollar invested. For example, a 12% return on assets could also be expressed as \$0.12 return per \$1 invested. In other words, the company is earning 12 cents per dollar invested.

The **return on assets** percentage is computed as follows:

$$\text{Return on Assets} = \frac{\text{Net Income}}{\text{Average Total Assets}}$$

To illustrate, return on assets is computed for **Apple Inc. (AAPL)** and **HP Inc. (HPO)** (formerly **Hewlett-Packard**). The computations use data (in millions) from recent financial statements.

	Apple Inc.	HP Inc.
Net income	\$ 48,351	\$ 2,526
Total assets at beginning of year	\$321,686	\$28,987
Total assets at end of year	\$375,319	\$32,913
Average total assets:		
Apple Inc. $[(\$321,686 + \$375,319) \div 2]$	\$348,503	
HP Inc. $[(\$28,987 + \$32,913) \div 2]$		\$30,950
Return on assets:*		
Apple Inc. $(\$48,351 \div \$348,503)$	13.9%	
HP Inc. $(\$2,526 \div \$30,950)$		8.2%

*Rounded to one decimal place.

As shown, Apple is 1.7 ($13.9\% \div 8.2\%$) times more profitable, as measured by return on assets, than is HP Inc. Apple's profitability is largely due to its innovative technology, including its iPad, iPhone, iPod, and Mac computers.

Comparing rates of return among companies that use different tax strategies or different methods of financing their operations may be misleading. In the case of companies using different tax strategies, tax expense may be added to net income to reduce the impact of taxes. Likewise, some companies finance their operations primarily by debt, while other companies finance their operations primarily by equity. In this case, interest expense may be added to net income to reduce the impact of differences in financing.

Key Points

1. Describe the types and forms of businesses, how businesses make money, and business stakeholders.

The three types of businesses operated for profit include manufacturing, merchandising, and service businesses. Such businesses may be organized as proprietorships, partnerships, corporations, and limited liability companies. A business may make money (profits) by gaining an advantage over its competitors using a low-cost or a premium-price emphasis. Under a low-cost emphasis, a business designs and produces products or services at a lower cost than its competitors. Under a premium-price emphasis, a business tries to design products or services that possess unique attributes or characteristics for which customers are willing to pay more. A business' economic performance is of interest to its stakeholders. Business stakeholders include four categories: capital market stakeholders, product or service market stakeholders, government stakeholders, and internal stakeholders.

2. Describe the three business activities of financing, investing, and operating.

All businesses engage in financing, investing, and operating activities. Financing activities involve obtaining funds to begin and operate a business. Investing activities involve obtaining the necessary resources to start and operate the business. Operating activities involve using the business's resources according to its business emphasis.

3. Define accounting and describe its role in business.

Accounting is an information system that provides reports to stakeholders about the economic activities and condition of a business. Accounting is the "language of business."

4. Describe and illustrate the basic financial statements and how they are integrated.

The principal financial statements of a corporation are the income statement, the statement of stockholders' equity, the balance sheet, and the statement of cash flows. The income statement reports a period's net income or net loss, which also appears on the statement of stockholders' equity. The ending reported on the statement of stockholders' equity is also reported on the balance sheet. The ending cash balance is reported on the balance sheet and the statement of cash flows.

5. Describe eight accounting concepts underlying financial reporting.

The eight accounting concepts discussed in this chapter include the business entity, cost, going concern, matching, objectivity, unit of measure, adequate disclosure, and accounting period concepts.

6. Describe types of metrics and analyze a company's performance using return on assets.

A metric is any quantitative measure. Metric analysis may be performed at the financial statement, transaction, or managerial decision level. At the financial statement level, return on assets is computed by dividing net income by average total assets. Return on assets is useful in assessing the percentage (rate) that a company is earnings on its invested assets. Return on assets can also be expressed as dollars earned for each dollar invested.

Key Terms

Accounting (9)	Financial Accounting Standards Board (FASB) (17)	Operating activities (7)
Accounting equation (13)	Financial statements (10)	Owner's equity (13)
Accounting period concept (20)	Financing activities (7)	Partnership (3)
Accounts payable (7)	Generally accepted accounting principles (GAAP) (16)	Premium-price strategy (4)
Accounts receivable (8)	Going concern concept (18)	Prepaid expenses (8)
Adequate disclosure concept (19)	Income statement (11)	Profit (2)
Administrative expenses (9)	Intangible assets (8)	Proprietorship (3)
Assets (8)	Interest payable (8)	Retained earnings (12)
Balance sheet (13)	International Accounting Standards Board (IASB) (17)	Return on assets (23)
Bonds payable (8)	Investing activities (7)	Revenue (9)
Business (2)	Liabilities (7)	Revenue recognition principle (19)
Business entity concept (17)	Limited liability company (LLC) (3)	Sales (9)
Business stakeholder (5)	Liquidity (23)	Securities and Exchange Commission (SEC) (17)
Chief financial officer (10)	Low-cost strategy (4)	Selling expenses (9)
Common stock (8)	Managerial accounting (9)	Service business (2)
Comptroller (10)	Manufacturing business (3)	Solvency (23)
Corporation (3)	Matching concept (19)	Statement of cash flows (13)
Cost concept (18)	Merchandising business (2)	Statement of financial condition (13)
Cost of goods sold (9)	Metric (22)	Statement of stockholders' equity (12)
Cost of merchandise sold (9)	Metric-based analysis (22)	Stockholders (8)
Cost of sales (9)	Net income (9)	Stockholders' equity (13)
Dividends (8)	Net loss (9)	Tangible assets (8)
Expenses (9)	Note payable (8)	Unit of measure concept (19)
Expense recognition principle (19)	Objectivity concept (19)	
Fees earned (9)		
Financial accounting (9)		

Illustrative Problem

The financial statements at the end of Spratlin Consulting's first month of operations follow.

SPRATLIN CONSULTING
Income Statement
For the Month Ended June 30, 20Y8

Fees earned		\$ 36,000
Operating expenses:		
Wages expense	\$12,000	
Rent expense	7,640	
Utilities expense	(a)	
Miscellaneous expense	1,320	
Total operating expenses		(23,120)
Net income		\$ (b)

SPRATLIN CONSULTING
Statement of Stockholders' Equity
For the Month Ended June 30, 20Y8

	Common Stock	Retained Earnings
Balances, June 1, 20Y8.....	\$ 0	\$ 0
Issued common stock	48,000	
Net income		(c)
Dividends.....		(d)
Balances, June 30, 20Y8	<u>\$48,000</u>	<u>\$(e)</u>

SPRATLIN CONSULTING
Balance Sheet
June 30, 20Y8

Assets	
Cash.....	\$ 5,600
Land.....	50,000
Total assets	<u>\$ (f)</u>
Liabilities	
Accounts payable	\$ 1,920
Stockholders' Equity	
Common stock.....	\$ (g)
Retained earnings.....	(h)
Total stockholders' equity.....	<u>\$ (i)</u>
Total liabilities and stockholders' equity	<u>\$ (j)</u>

SPRATLIN CONSULTING
Statement of Cash Flows
For the Month Ended June 30, 20Y8

Cash flows from operating activities:		
Cash received from customers.....	\$36,000	
Cash paid for operating expenses.....	(k)	
Net cash flows from operating activities		\$14,800
Cash flows from investing activities:		
Cash paid for acquisition of land.....		(l)
Cash flows from financing activities:		
Cash received from issuing common stock	\$48,000	
Dividends paid to stockholders.....	(7,200)	
Net cash flows from financing activities		(m)
Net increase in cash during month		\$ (n)
Cash as of June 1		0
Cash as of June 30		<u>\$ (n)</u>

Instructions

By analyzing how the four financial statements are integrated, determine the proper amounts for (a) through (n).

Solution

- Utilities expense, \$2,160 (\$23,120 – \$12,000 – \$7,640 – \$1,320)
- Net income, \$12,880 (\$36,000 – \$23,120)
- Net income, \$12,880 [same as (b)]
- Dividends, \$(7,200) (from statement of cash flows)
- Retained earnings, \$5,680 (\$12,880 – \$7,200)
- Total assets, \$55,600 (\$5,600 + \$50,000)
- Common stock, \$48,000 (from the statement of stockholders' equity or statement of cash flows)
- Retained earnings, \$5,680 [same as (e)]
- Total stockholders' equity, \$53,680 (\$48,000 + \$5,680)
- Total liabilities and stockholders' equity, \$55,600 (\$1,920 + \$53,680) [same as (f)]

- k. Cash paid for operating expenses, \$(21,200) (\$36,000 – \$14,800)
- l. Cash paid for acquisition of land, \$(50,000) (from balance sheet)
- m. Net cash flows from financing activities, \$40,800 (\$48,000 – \$7,200)
- n. Net increase in cash and June 30, 20Y8, cash balance, \$5,600 (\$14,800 – \$50,000 + \$40,800)

Self-Examination Questions

(Answers appear at the end of chapter.)

- A profit-making business operating as a separate legal entity and in which ownership is divided into shares of stock is known as a:
 - proprietorship.
 - service business.
 - partnership.
 - corporation.
- The resources owned by a business are called:
 - assets.
 - liabilities.
 - the accounting equation.
 - stockholders' equity.
- A listing of a business entity's assets, liabilities, and stockholders' equity as of a specific date is:
 - a balance sheet.
 - an income statement.
 - a statement of changes in stockholders' equity.
 - a statement of cash flows.
- If total assets are \$20,000 and total liabilities are \$12,000, the amount of stockholders' equity is:
 - \$32,000.
 - \$(32,000).
 - \$(8,000).
 - \$8,000.
- If revenue was \$45,000, expenses were \$37,500, and dividends were \$10,000, the amount of net income or net loss would be:
 - \$45,000 net income.
 - \$7,500 net income.
 - \$37,500 net loss.
 - \$2,500 net loss.

Class Discussion Questions

- What is the objective of most businesses?
- What is the difference between a manufacturing business and a merchandising business? Give an example of each type of business.
- What is the difference between a manufacturing business and a service business? Is a restaurant a manufacturing business, a service business, or both?
- Why are most large companies like [Apple \(AAPL\)](#), [Pepsico \(PEP\)](#), [General Electric \(GE\)](#), and [Intel \(INTC\)](#) organized as corporations?
- Both [Kia Motors \(KRX\)](#) and [BMW \(BMW\)](#) produce and sell automobiles. Describe and contrast the business emphasis of KIA and BMW.
- Assume that a friend of yours operates a family-owned pharmacy. A Walmart Supercenter, scheduled to open in the next several months, will also offer pharmacy services. What business emphasis would your friend use to compete with the Super Walmart pharmacy?
- What services does [eBay \(EBAY\)](#) offer its customers?
- A business's stakeholders can be classified into capital market, product or service market, government, and internal stakeholders. Will the interests of all the stakeholders within a classification be the same? Use bankers and stockholders of the capital market as an example in answering this question.

9. The three business activities are financing, investing, and operating. Using **Southwest Airlines (LUV)**, give an example of each type of activity.
10. What is the role of accounting in business?
11. Briefly describe the nature of the information provided by each of the following financial statements: the income statement, the statement of stockholders' equity, the balance sheet, and the statement of cash flows. In your descriptions, indicate whether each of the financial statements covers a period of time or is for a specific date.
12. For a recent year ending January 31, **Target Corporation (TGT)** had revenues of \$72,618 million and total expenses of \$74,254 million. Did Target Corporation report a net loss or a net income?
13. What particular item of financial or operating data appears on both the income statement and the statement of stockholders' equity? What items appear on both the balance sheet and the statement of stockholders' equity? What item appears on both the balance sheet and statement of cash flows?
14. Billy Jessop is the owner of Valley Delivery Service. Recently, Billy paid interest of \$6,000 on a personal loan of \$75,000 that he used to begin the business. Should Valley Delivery Service record the interest payment? Explain.
15. On October 1, Wok Repair Service extended an offer of \$100,000 for land that had been priced for sale at \$150,000. On December 19, Wok Repair Service accepted the seller's counteroffer of \$110,000. Describe how Wok Repair Service should record the land.
16. Land with an assessed value of \$500,000 for property tax purposes is acquired by a business for \$600,000. Four years later, the plot of land has an assessed value of \$750,000 and the business receives an offer of \$975,000 for it. Should the monetary amount assigned to the land in the business records now be increased?

Exercises

Obj. 1

E1-1 Types of businesses

Indicate whether each of the following companies is primarily a service, merchandise, or manufacturing business. If you are unfamiliar with the company, you may use the Internet to locate the company's home page or use the finance Web site of Yahoo.com.

- | | |
|---------------------------|---------------------------|
| 1. AFLAC (AFL) | 9. Facebook (FB) |
| 2. Best Buy (BBY) | 10. Ford Motor (F) |
| 3. Boeing (BA) | 11. General Electric (GE) |
| 4. Caterpillar (CAT) | 12. Hilton Hotels |
| 5. Citigroup (C) | 13. H&R Block Inc. (HRD) |
| 6. CVS Health Corp. (CVS) | 14. Oracle (ORCL) |
| 7. DowDuPont Inc. (DWD) | 15. Target (TGT) |
| 8. Exxon Mobil (XOM) | |

Obj. 1

E1-2 Business emphasis

Identify the primary business emphasis of each of the following companies as (a) a low-cost emphasis or (b) a premium-price emphasis. If you are unfamiliar with the company, you may use the Internet to locate the company's home page or use the finance Web site of Yahoo.com.

- | | |
|-------------------------------------|-------------------------|
| 1. Allegiant Travel Services (ALGT) | 7. Lowe's (LOW) |
| 2. Best Buy (BBY) | 8. Nike (NKE) |
| 3. BMW | 9. Pepsi Co, Inc. (PEP) |
| 4. Dollar Tree (DLTR) | 10. Staples |
| 5. E*TRADE (ETFC) | 11. Sub-Zero |
| 6. Goldman Sachs Group (GS) | 12. Mercedes-Benz |

E1-3 Accounting equation

The total assets and total liabilities for a recent year of **Best Buy (BBY)** and **Gamestop (GME)** are shown below.

	Best Buy (in millions)	Gamestop (in millions)
Assets	\$13,856	\$4,976
Liabilities	9,147	2,722

Determine the stockholders' equity of each company.

✓ Best Buy, \$4,709

Obj. 4

**E1-4 Accounting equation**

The total assets and total liabilities for a recent year of **Apple (AAPL)** and **Microsoft (MSFT)** are shown here.

	Apple (in millions)	Microsoft (in millions)
Assets	\$375,319	\$258,848
Liabilities	241,272	176,130

Determine the stockholders' equity of each company.

✓ Apple, \$134,047

Obj. 4

E1-5 Accounting equation

Determine the missing amount for each of the following:

	Assets	=	Liabilities	+	Stockholders' Equity
a.	X	=	\$262,500	+	\$450,000
b.	\$1,320,000	=	X	+	\$787,500
c.	\$3,150,000	=	\$900,000	+	X

✓ a. \$712,500

Obj. 4

**E1-6 Accounting equation**

Determine the missing amounts (in millions) for the condensed balance sheets shown below.

	Costco (COST)	Target (TGT)	Walmart (WMT)
Assets	\$36,347	\$38,999	\$ (c)
Liabilities	25,268	(b)	123,700
Stockholders' equity	(a)	11,709	80,822

✓ a. \$11,079

Obj. 4

**E1-7 Net income and dividends**

The income statement of a corporation for the month of November indicates a net income of \$90,000. During the same period, \$100,000 in cash dividends were paid. Would it be correct to say that the business incurred a net loss of \$10,000 during the month? Discuss.

Obj. 4

Obj. 4

✓ **Company Chang:**
Net income,
\$225,000

E1-8 Net income and stockholders' equity for four businesses

Four different companies—Chang, Henry, Nagel, and Wilcox—show the same balance sheet data at the beginning and end of a year. These data, exclusive of the amount of stockholders' equity, are summarized as follows:

	Total Assets	Total Liabilities
Beginning of the year	\$775,000	\$400,000
End of the year	900,000	300,000

On the basis of the preceding data and the following additional information for the year, determine the net income (or loss) of each company for the year. (*Hint:* First determine the amount of increase or decrease in stockholders' equity during the year.)

Company Chang: No additional capital stock was issued, and no dividends were paid.

Company Henry: No additional capital stock was issued, but dividends of \$90,000 were paid.

Company Nagel: Capital stock of \$125,000 was issued, but no dividends were paid.

Company Wilcox: Capital stock of \$125,000 was issued, and dividends of \$90,000 were paid.

Obj. 4

✓ a. (1) \$4,575

E1-9 Accounting equation and income statement

Staples, Inc. (SPLS) is a leading office products distributor, with retail stores in the United States, Canada, Asia, Europe, and South America. The following financial statement data were adapted from recent financial statements of Staples:

	Year 2 (in millions)	Year 1 (in millions)
Total assets	\$ 8,271	\$10,172
Total liabilities	(1)	4,788
Total stockholders' equity	3,696	(2)
Sales	18,247	
Cost of goods sold	13,489	
Operating expenses	4,967	
Other expense (net)	143	
Income tax expense	107	

- Determine the missing data indicated for (1) and (2).
- Using the income statement data for Year 2, determine the amount of net income or loss.

Obj. 4

**E1-10 Balance sheet items**

From the following list of selected items taken from the records of Mermaid Stories, Inc. as of a specific date, identify those that would appear on the balance sheet.

- | | |
|------------------------|-----------------------|
| 1. Accounts Receivable | 6. Salaries Expense |
| 2. Common Stock | 7. Salaries Payable |
| 3. Cash | 8. Supplies |
| 4. Fees Earned | 9. Supplies Expense |
| 5. Rent Expense | 10. Utilities Expense |

Obj. 4

**E1-11 Income statement items**

Based on the data presented in Exercise 1-10, identify those items that would appear on the income statement.

E1-12 Financial statement items

Identify each of the following items as (a) an asset, (b) a liability, (c) revenue, (d) an expense, or (e) a dividend:

- | | |
|-------------------------------|---|
| 1. Amounts due from customers | 6. Equipment |
| 2. Amounts owed to suppliers | 7. Note payable owed to the bank |
| 3. Cash on hand | 8. Rent paid for the month |
| 4. Cash paid to stockholders | 9. Sales commissions paid to salespersons |
| 5. Cash sales | 10. Wages paid to employees |

Obj. 4

**E1-13 Statement of stockholders' equity**

Financial information related to All Seasons Company for the month ended June 30, 20Y7, is as follows:

Common stock, June 1, 20Y7	\$ 30,000
Stock issued in June	20,000
Net income for June	87,500
Dividends during June	15,000
Retained earnings, June 1, 20Y7	145,000

Obj. 4



✓ Retained earnings, June 30, 20Y7, \$217,500

Prepare a statement of stockholders' equity for the month ended June 30, 20Y7.

E1-14 Income statement

JLM Services was organized on August 1, 20Y5. A summary of the revenue and expense transactions for August follows:

Fees earned	\$2,550,000
Wages expense	1,612,500
Miscellaneous expense	41,250
Rent expense	240,000
Supplies expense	22,500

Obj. 4



✓ Net income: \$633,750

Prepare an income statement for the month ended August 31.

E1-15 Missing amounts from balance sheet and income statement data

One item is omitted in each of the following summaries of balance sheet and income statement data for four different corporations, AL, CO, KS, and MT.

Obj. 4

✓ (a) \$90,000

	AL	CO	KS	MT
Beginning of the year:				
Assets	\$400,000	\$300,000	\$550,000	\$ (d)
Liabilities	200,000	130,000	325,000	350,000
End of the year:				
Assets	800,000	460,000	660,000	1,200,000
Liabilities	450,000	110,000	360,000	700,000
During the year:				
Additional issue of capital stock	(a)	50,000	100,000	100,000
Dividends	50,000	20,000	(c)	90,000
Revenue	175,000	(b)	115,000	420,000
Expenses	65,000	70,000	130,000	480,000

Determine the missing amounts, identifying them by letter. [Hint: First determine the amount of increase or decrease in stockholders' equity during the year.]

Obj. 4

✓ b. \$53,000

E1-16 Balance sheets, net income

Financial information related to Montana Interiors for October and November 20Y8 is as follows:

	October 31, 20Y8	November 30, 20Y8
Accounts payable	\$ 40,000	\$ 65,000
Accounts receivable	75,000	118,000
Capital stock	60,000	60,000
Retained earnings	?	?
Cash	110,000	140,000
Supplies	15,000	20,000

- Prepare balance sheets for Montana Interiors as of October 31 and as of November 30, 20Y8.
- Determine the amount of net income for November, assuming that no additional capital stock was issued and no dividends were paid during the month.
- Determine the amount of net income for November, assuming that no additional capital stock was issued but dividends of \$20,000 were paid during the month.

Obj. 4

E1-17 Financial statements

Each of the following items is shown in the financial statements of **ExxonMobil Corporation**. Identify the financial statement (balance sheet or income statement) in which each item would appear.

- | | |
|-------------------------|----------------------------|
| a. Accounts payable | i. Marketable securities |
| b. Cash equivalents | j. Notes and loans payable |
| c. Crude oil inventory | k. Operating expenses |
| d. Equipment | l. Prepaid taxes |
| e. Exploration expenses | m. Retained earnings |
| f. Income taxes payable | n. Sales |
| g. Investments | o. Selling expenses |
| h. Long-term debt | |

Obj. 4

E1-18 Statement of cash flows

Indicate whether each of the following cash activities would be reported on the statement of cash flows as (a) an operating activity, (b) an investing activity, or (c) a financing activity.

- | | |
|------------------------------|---------------------------------|
| 1. Issued common stock | 6. Sold excess office equipment |
| 2. Paid rent | 7. Paid officers' salaries |
| 3. Paid for office equipment | 8. Paid for advertising |
| 4. Sold services | 9. Paid insurance |
| 5. Issued a note payable | 10. Paid dividends |

Obj. 4

E1-19 Statement of cash flows

Indicate whether each of the following activities would be reported on the statement of cash flows as (a) an operating activity, (b) an investing activity, or (c) a financing activity.

- | | |
|--|---------------------------|
| 1. Cash received from investment by stockholders | 3. Cash paid for expenses |
| 2. Cash received from fees earned | 4. Cash paid for land |

E1-20 Statement of cash flows**Obj. 4**

Looney Inc. was organized on July 1, Year 1. A summary of cash flows for July follows.

✓ **Net cash flows from operating activities, \$220,000**

Cash receipts:	
Cash received from customers	\$600,000
Cash received from issuance of common stock	200,000
Cash received from note payable	75,000
Cash payments:	
Cash paid out for expenses	\$380,000
Cash paid out for purchase of equipment	95,000
Cash paid as dividends	25,000

Prepare a statement of cash flows for the month ended July 31, Year 1.

E1-21 Using financial statements**Obj. 4**

A company's stakeholders often differ in their financial statement focus. For example, some stakeholders focus primarily on the income statement, while others focus primarily on the statement of cash flows or the balance sheet. For each of the following situations, indicate which financial statement would be the likely focus for the stakeholder. Choose either the income statement, balance sheet, or statement of cash flows, and justify your choice.

Situation 1: Assume that you are considering purchasing a personal computer from **Dell (DELL)**.

Situation 2: Assume that you are considering investing in **LinkedIn** (capital market stakeholder).

Situation 3: Assume that you are employed by **Campbell Soup Co. (CPB)** (product market stakeholder) and are considering whether to extend credit for a 60-day period to a new grocery store chain that has recently opened throughout the Midwest.

Situation 4: Assume that you are considering taking a job (internal stakeholder) with either **Sears** or **JCPenney (JCP)**.

Situation 5: Assume that you are a banker for **US Bank** (capital market stakeholder), and you are considering whether to grant a major credit line (loan) to **Target (TGT)**. The credit line will allow Target to borrow up to \$400 million for a five-year period at the market rate of interest.

E1-22 Financial statement items**Obj. 4**

Amazon.com, Inc. (AMZN) operates as an online retailer in North America and internationally. Both Amazon and third parties, via the Amazon.com Web site, sell products across various product categories.

The following items were adapted from a recent annual report of Amazon.com for the year ending December 31:

	In millions
1. Accounts payable	\$ 34,616
2. Accounts receivable	13,164
3. Cash	20,522
4. Cost of sales	111,934
5. Income tax expense	769
6. Interest expense	848
7. Inventories	16,047
8. Net cash provided by operating activities	18,434
9. Net cash flows used for investing activities	(27,819)
10. Net sales	177,866
11. Other expense	4
12. Other income	548
13. Property, plant, and other long-term assets	48,866
14. Operating expenses	61,826
15. Retained earnings (Dec. 31)	8,636