

FIFTH EDITION

FINANCIAL ACCOUNTING

The Cornerstone of Business Decision Making



RICH // JONES // MYERS

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FINANCIAL ACCOUNTING

The Cornerstone of Business Decision Making

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***Financial Accounting: The Cornerstone
of Business Decision Making, Fifth Edition***

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*This book is dedicated to our students—past, present, and future—who are at
the heart of our passion for teaching.*

BRIEF CONTENTS

CHAPTER 1	Accounting and the Financial Statements	2
CHAPTER 1s	Reading a Company's Annual Report and Form 10-K	64
CHAPTER 2	The Accounting Information System	80
CHAPTER 3	Accrual Accounting	146
	Making the Connection: Integrative Exercise (Chapters 1–3)	217
CHAPTER 4	Internal Control and Cash	218
CHAPTER 5	Sales and Receivables	268
CHAPTER 6	Cost of Goods Sold and Inventory	320
CHAPTER 7	Operating Assets	398
	Making the Connection: Integrative Exercise (Chapters 4–7)	460
CHAPTER 8	Current and Contingent Liabilities	462
CHAPTER 9	Long-Term Liabilities	508
CHAPTER 10	Stockholders' Equity	562
	Making the Connection: Integrative Exercise (Chapters 8–10)	619
CHAPTER 11	The Statement of Cash Flows	620
CHAPTER 12	Financial Statement Analysis	690
APPENDIX 1	Data Analytics and Accounting Information	768
APPENDIX 2	Investments	776
APPENDIX 3	Time Value of Money	798
APPENDIX 4	International Financial Reporting Standards	824
APPENDIX 5	Financial Statement Information: The Kroger Co.	836
APPENDIX 6	Financial Statement Information: Sprouts Farmers Market, Inc.	848
Glossary		859
Index		867

The fifth edition of Financial Accounting: The Cornerstone of Business Decision Making

We have been teaching financial accounting for decades. We love it and believe that financial accounting is one of the most important courses in the business curriculum. As it is one of the first business courses students take, we work to share our love and enthusiasm for the material and to show each student that accounting is both *exciting* and *relatable* to their current life, as well as to their future—regardless of their major.

We wrote this book because there was no other book available that helped us balance between a couple of critical and often contradictory goals—creating a solution that will both help students read and study *and* also attract majors to the field by demonstrating the best aspects of accounting.

Here's our approach:

We wanted to create a solution that helps students read and study. Many—if not most—students have poor study habits. They often also have unrealistic beliefs about how much studying is needed for success in accounting. As a result, they show up unprepared. We help overcome this problem using a variety of strategies:

- **All examples within the fifth edition are consistent in format.** Providing students with complete information and clear, step-by-step solutions helps build confidence and is a resource that students will reference continually throughout the course.

EXAMPLE 1.1 USING THE FUNDAMENTAL ACCOUNTING EQUATION

On January 1, Gundrum Company reported assets of \$125,000 and liabilities of \$75,000. During the year, assets increased by \$44,000 and stockholders' equity increased by \$15,000.

Required:

1. What is the amount reported for stockholders' equity on January 1?
2. What is the amount reported for liabilities on December 31?

Solution:

1. Stockholders' equity on January 1 is \$50,000. This amount is calculated by rearranging the fundamental accounting equation as follows:

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

$$\$125,000 = \$75,000 + \text{Stockholders' Equity}$$

$$\text{Stockholders' Equity} = \$125,000 - \$75,000 = \underline{\underline{\$50,000}}$$

2. At December 31, liabilities are \$104,000. This amount is computed by adding the change to the appropriate balance sheet elements and then rearranging the fundamental accounting equation as follows:

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

$$(\$125,000 + \$44,000) = \text{Liabilities} + (\$50,000 + \$15,000)$$

$$\text{Liabilities} = (\$125,000 + \$44,000) - (\$50,000 + \$15,000)$$

$$= \$169,000 - \$65,000 = \underline{\underline{\$104,000}}$$

- Using our text and the integrated examples, you won't need to spend as much valuable class time teaching "how"; you can instead focus on "why."
- **Author-created "office hours"–style Show Me How (SMH) videos** walk students through solving a similar (but not identical) activity. These videos are linked to Many of the most assigned exercises within the homework and can be reviewed on a student's own time in the Adaptive Study Plan. Because these are author-created videos, the Show Me How videos cover the conceptual roots behind the problem but are careful not to give away the answer. It is important that students learn by doing the work.

- **The Adaptive Study Plan (ASP) in CengageNOWv2** is a turnkey preclass assignment allowing you to assign a self-paced module that reviews a chapter's learning objectives. In addition, students may access the ASP on their own time to study and review.

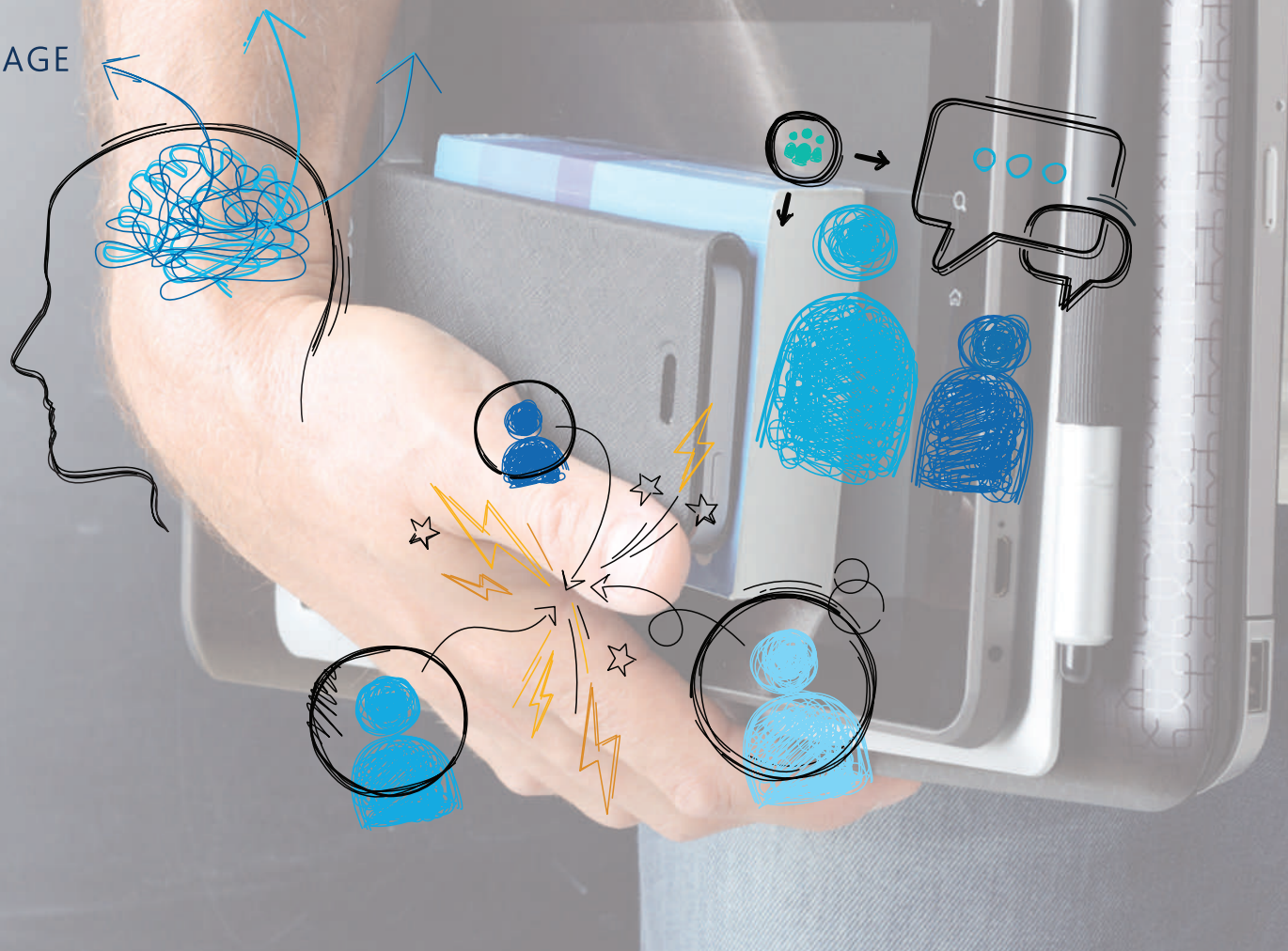
What's New in 5e?

We wanted to create a financial accounting solution that would illustrate the best aspects of accounting. Students often have preconceived notions that accounting is boring or irrelevant. We want to show that accounting is attractive and exciting. Here is how we tackled this challenge in a fresh way:

- **A focus on why accounting is important.** Right from the start, we strive to explain why accounting matters to students, and why it is relevant for *all* majors. This is carried throughout the narrative. We don't just explain "how"; we also explain "why." We've found that students learn better when they know why.
- **Earlier introduction to detailed financial statements (e.g., the multistep income statement)** allows for earlier discussions of why accounting is important and how it can be used. Students can start reading and using actual annual reports (10Ks) earlier.
- **A new supplement to Chapter 1 on Reading a Company's Annual Report and Form 10-K** introduces students to the contents of an annual report and Form 10-K. It describes what information can be found in each section and also briefly discusses earning announcements and non-GAAP reporting.
- **New annual report problems for every chapter.** A library of hundreds of author-created and fully algorithmic real-world annual report problems allows you to assign students annual report problems (on well-known companies such as Home Depot and Lowe's) without worrying about students copying their answers from one another.

We also always want to provide up-to-date content that you need to teach the way you want. Additional updates include the following:

- **A new appendix on data analytics** provides an introductory-level summary of what data analytics is and how it can be used to answer accounting questions. A series of exercises allows students to practice using data analytics techniques.
 - **New: Analytics cases.** Students need to understand how data may be used to make decisions; however, it is critical that they also understand the underlying accounting issue. Integrated Analytics cases help students learn Excel or Tableau and Analytics, as they also reinforce accounting skills such as the Aging of Accounts method. The authors' goal was to create cases that you can't effectively use without knowing the underlying accounting.
- New PowerPoints, with a more interactive focus
 - Updated test banks
 - Updated ASP quizzing
 - Additional Excel Online problems
 - Many new Tell Me More videos



Close the Gap

Between Homework and Exam Performance

with **CengageNOWv2**

We've talked with hundreds of accounting instructors across the country, and we are learning that online homework systems have created a new challenge in the accounting course.

We are hearing that students perform well on the homework but poorly on the exam, which leads instructors to believe that students are not truly learning the content, but rather are memorizing their way through the system.



CengageNOWv2 better prepares students for the exam by providing an online homework experience that is similar to what students will experience on the exam and in the real world.

Read on to see how CengageNOWv2 helps close this gap.

Closing the gap, one step at a time.



CengageNOWv2 (CNOWv2) is a powerful course management and online homework tool that helps students succeed in introductory accounting.

Here's how CNOWv2 can help you and your students:

Building business skills. Excel, Analytic, and other business skills are important, but there is a lot to cover in the Introductory Accounting course. CNOWv2 allows you to expose students to Excel and data analytics without requiring you to teach these topics.

- **The Excel Online problem type** seamlessly integrates Excel and algorithmically generates data sets into the classroom. Because it is online, all students will have the same version. You won't have to accommodate the hassles of differing versions and platforms.
- In addition, accompanying **Show Me How** videos on every Excel Online problem mean that you do not need to worry about teaching Excel. CNOWv2 walks students through how to solve a similar assignment.
- **Analytics cases.** Students need to understand how data may be used to make decisions; however, it is critical that they also understand the underlying accounting issue. Integrated Analytics cases help students learn Excel or Tableau and Analytics as they also reinforce accounting skills such as the Aging of Accounts method. The authors' goal was to create cases that you can't effectively use without knowing the underlying accounting.

Reading and interpreting 10K information. It is critical that students learn not just how to create accounting information but also how to use that information. Notably, all students (even the nonmajors) will be able to read and interpret an annual report or 10K and make some simple decisions.

- **Annual report problems.** A library of hundreds of author-created and fully algorithmic real-world annual report problems allow you to assign students annual report problems (on well-known companies such as Home Depot and Lowe's) without worrying about students copying their answers from one another.

The "10 o'clock at night" problem. Experience and usage data reveal that students typically complete homework at times when their instructors are not available to help. As a result, they get stuck and frustrated and give up. CNOWv2 has integrated tools to help students overcome this common roadblock.

- **Show Me How problem demonstration videos** walk students through how to solve a similar (but not identical) activity. These author-created videos are linked to hundreds of items within the homework and may also be reviewed on a student's own time in the Adaptive Study Plan.

Because these are author-created videos, the Show Me How videos cover the conceptual roots behind the problem but are careful not to give away the answer. It's important that students learn by doing the work.

In addition, the Show Me How videos are also available in new assignable (but ungraded) video assignments.

Chapter 1, Learning Objective 4: [Show Me How: Transactions](#)

Chapter 1, Learning Objective 4: [Show Me How: Accounting equation V3](#)

Chapter 1, Learning Objective 4: [Show Me How: Effect of transactions on accounting equation](#)

Chapter 1, Learning Objective 4: [Show Me How: Nature of transactions](#)

Chapter 1, Learning Objective 4: [Show Me How: Transactions \(Acct Eq\)](#)

- **Adaptive Feedback** in Blanksheet of Paper items provides custom feedback that is truly adaptive. Where many platforms provide generic feedback, CNOWv2's Adaptive Feedback gives feedback based on the exact entry that a student makes.

	DATE	ACCOUNT TITLE	POST. REF.	DE
1		Adjusting Entries		
2		Depreciation Expenses		1

- There is a minor spelling error in the account title. You will be graded as if you had entered "Depreciation Expense."

- **Check My Work Feedback** is available with all homework items in CNOWv2 and supplements Adaptive Feedback. This is generic feedback that is supplied to students when they click on "Check My Work."

Feedback

▼ Check My Work

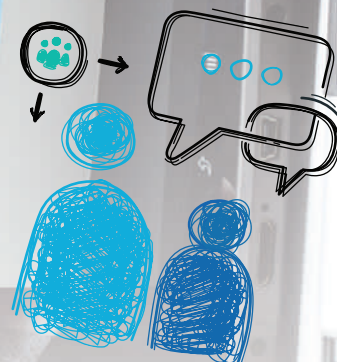
Depreciation expense is the allocation of a fixed asset's cost over the period used. The fixed asset account is not touched or decreased when recording the expense.

Students ace the homework but bomb the exam. Online homework is very popular in accounting, but students all too often try to game the system and guess their way through the homework. Then, when students get to the exam, they discover that they can't complete a journal entry or build a financial statement without the guidance and help of an online platform.

- **CNOWv2's Blanksheet of Paper problems** provide a much freer form and open environment without the drop-downs found in other systems. These items allow students to make mistakes and provide less handholding than traditional style activities.
- As these are purposely designed to be more challenging—and are generally all algorithmic—there is always a traditional drop-down style item if you would rather not assign a Blanksheet of Paper item.

Ensuring students show up to class and ready to learn. Accounting is a tough class. Students can't just show up to class and learn. They need to be exposed to the course material so that they (and you) can have a productive class.

- **The Adaptive Study Plan** is a turnkey preclass assignment that allows instructors to assign a self-paced module that reviews a chapter's learning objectives. In addition, students may access the ASP on their own time to study and review.
- Rest assured that your students will each have a unique class prep experience. The Adaptive Study Plan's quiz questions are drawn from pools. Each time students take the quiz, they will receive unique questions. There are pools of both qualitative and quantitative questions per learning objective. Additionally, the quantitative questions are algorithmic.



And that's not all...

You might also want to learn about the MindTap eReader, our LMS integration options, and more.

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SUPERIOR SUPPLEMENTS



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Author-written and carefully verified multiple times to ensure accuracy and consistency with the text, the Solutions Manual contains answers to all Discussion Questions, Multiple-Choice Exercises, Brief Exercises, Exercises, Problem Sets and Cases that appear in the text. These solutions help you easily plan, assign, and efficiently grade assignments. All solutions are given in simplified Excel spreadsheets and also available in PDF format. The Solutions Manual is available electronically for instructors only on the password-protected portion of the text's website at <http://login.cengage.com>.

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CONTENTS

CHAPTER 1

Accounting and the Financial Statements 2

Why is Accounting Important? 4

Who Uses Accounting information 4

Exhibit 1.1 The Demand for Accounting Information 4

Businesses: Forms and Activities 5

Forms of Business Organization 5

Exhibit 1.2 Forms of Business Organization 6

Business Activities 7

Exhibit 1.3 Business Activities 7

Communication of Accounting Information 8

Exhibit 1.4 Questions Answered by Financial Statements 8

The Four Basic Financial Statements 9

Exhibit 1.5 Financial Statement Time Periods 9

The Fundamental Accounting Equation 10

Example 1.1 Using the Fundamental Accounting Equation 10

The Classified Balance Sheet 11

Exhibit 1.6 Common Balance Sheet Classifications 11

Exhibit 1.7 Classified Balance Sheet of Apple Inc. 12

Current Assets 13

Noncurrent Assets 13

Current Liabilities 14

Long-Term Liabilities and Stockholders' Equity 14

Preparing a Classified Balance Sheet 14

Example 1.2 Preparing a Classified Balance Sheet 15

Using Balance Sheet Information 16

The Income Statement 17

Elements of the Income Statement 17

Exhibit 1.8 Income Statement of Apple Inc. 17

Income Statement Formats 18

Example 1.3 Preparing a Single-Step Income Statement 19

Exhibit 1.9 Multiple-Step Income Statement for Apple Inc. 20

Exhibit 1.10 Typical Nonoperating Items 21

Example 1.4 Preparing a Multiple-Step Income Statement 21

Using Income Statement Information 22

Retained Earnings Statement 23

Exhibit 1.11 Retained Earnings Statement for Apple Inc. 24

Preparing a Retained Earnings Statement 24

Example 1.5 Preparing a Retained Earnings Statement 24

Use of the Retained Earnings Statement 25

Statement of Cash Flows 25

Exhibit 1.12 Statement of Cash Flows 25

Elements of the Statement of Cash Flows 26

Use of the Statement of Cash Flows 26

Relationships Among The Statements 26

Exhibit 1.13 Relationships Among the Financial Statements 27

Professional Ethics 28

Exhibit 1.14 Guidelines in Ethical Decision-Making 28

CHAPTER 1s

Reading a Company's Annual Report and Form 10-K 64

What's in the Annual Report? 65

Highlights from Form 10-K 67

Part 1 of Form 10-K 67

Summary 75

Earnings Announcements 75

Non-GAAP EPS 75

CHAPTER 2

The Accounting Information System 80

Exhibit 2.1 Year-Over-Year Revenue Growth 82

Fundamental Accounting Concepts 82

The Conceptual Framework 83

Exhibit 2.2 Qualitative Characteristics of Useful Information 83

Qualitative Characteristics of Useful Information 83

Exhibit 2.3 Qualitative Characteristics of Accounting Information 84

Assumptions 85

Principles 85

Example 2.1 Applying the Conceptual Framework 86

Measuring Business Activities: The Accounting Cycle 87

Exhibit 2.4 The Accounting Cycle 87

Economic Events 87

Exhibit 2.5 Transaction Identification 88

The Expanded Accounting Equation 88

Exhibit 2.6 The Expanded Accounting Equation 89

Step 1: Analyze Transactions 89

Example 2.2 Performing Transaction Analysis 90

Transaction 1: Issuing Common Stock 90

Transaction 2: Borrowing Cash 90

Transaction 3: Purchase of Equipment for Cash 91

Transaction 4: Purchasing Insurance 91

Transaction 5: Purchase of Supplies on Credit 91

Transaction 6: Providing Services for Cash 92

Transaction 7: Providing Services on Credit 92

Transaction 8: Receipt of Cash in Advance 92

Transaction 9: Payment of a Liability	93
Transaction 10: Collection of a Receivable	93
Transaction 11: Payment of Salaries	93
Transaction 12: Payment of Utilities	94
Transaction 13: Payment of a Dividend	94
Overview of Transactions for HiTech Communications Inc.	94
Exhibit 2.7 Summary of Transactions for HiTech Communications Inc.	95
Double-Entry Accounting	95
Accounts	96
Exhibit 2.8 Typical Accounts	96
Exhibit 2.9 Form of a T-Account	97
Debit and Credit Procedures	97
Example 2.3 Determining Increases or Decreases to a Balance Sheet Account	98
Example 2.4 Determining Increases or Decreases To Revenues, Expenses, Gains, Losses, and Dividends Declared	99
Exhibit 2.10 Summary of Debit and Credit Procedures	100
Step 2: Journalize Transactions	101
Example 2.5 Making a Journal Entry	101
Example 2.6 Making a Compound Journal Entry	102
Transaction 1: Issuing Common Stock	103
Transaction 2: Borrowing Cash	103
Transaction 3: Purchase of Equipment for Cash	103
Transaction 4: Purchasing Insurance	103
Transaction 5: Purchase of Supplies on Credit	103
Transaction 6: Providing Services for Cash	104
Transaction 7: Providing Services for Credit	104
Transaction 8: Receipt of Cash in Advance	104
Transaction 9: Payment of a Liability	104
Transaction 10: Collection of a Receivable	104
Transaction 11: Payment of Salaries	105
Transaction 12: Payment of Utilities	105
Transaction 13: Payment of a Dividend	105
Step 3: Post to the Ledger	105
Exhibit 2.11 The Posting Process for HiTech Communications Inc.	106
Exhibit 2.12 General Ledger Accounts of HiTech Communications (T-account view)	107
Step 4: Prepare a Trial Balance	107
Example 2.7 Preparing a Trial Balance	108
CHAPTER 3	
Accrual Accounting	146
Exhibit 3.1 Excerpt from FedEx's Financial Statements	147
Completing the Accounting Cycle	148
Accrual versus Cash Basis of Accounting	148
Key Elements of Accrual Accounting	148
Exhibit 3.2 Key Elements of Accrual Accounting	149
Time-Period Assumption	149
The Revenue Recognition Principle	149
Exhibit 3.3 Annual Report Excerpt: Lowe's Revenue Recognition Policy	149
Exhibit 3.4 Annual Report Excerpt: FedEx's Revenue Recognition Policy	150
The Expense Recognition Principle	150
Cash-Basis versus Accrual-Basis Accounting	150
Example 3.1 Applying the Revenue Recognition and Expense Recognition Principles	151
Exhibit 3.5 Instances of Accounting Abuses	152
Accrual Accounting and Adjusting Entries	153
Which Transactions Require Adjustment?	153
Example 3.2 Determining Which Transactions Require Adjustment	153
Step 5: Adjusting the Accounts	154
Exhibit 3.6 Types of Adjusting Entries	154
Accrued Revenues	154
Exhibit 3.7 Accrued Revenues	155
Example 3.3 Recording Accrued Revenues	155
Accrued Expenses	156
Exhibit 3.8 Accrued Expenses	156
Example 3.4 Recording Accrued Expenses	156
Deferred (Unearned) Revenues	157
Exhibit 3.9 Deferred (Unearned) Revenues	158
Example 3.5 Adjusting Deferred (Unearned) Revenues	158
Deferred (Prepaid) Expenses	159
Exhibit 3.10 Deferred (Prepaid) Expenses	159
Example 3.6 Adjusting Deferred (Prepaid) Expenses	159
Example 3.7 Adjusting for Depreciation	161
Exhibit 3.11 Financial Statement Presentation of Accumulated Depreciation	161
Summary of Financial Statement Effects of Adjusting Entries	162
Exhibit 3.12 Effects of Adjusting Entries on the Financial Statements	162
Comprehensive Example	162
Exhibit 3.13 Trial Balance	163
Exhibit 3.14 General Ledger of HiTech Communications	165
Step 6: Preparing the Financial Statements	166
Exhibit 3.15 Adjusted Trial Balance	167
Exhibit 3.16 Relationships Among the Financial Statements	168
Step 7: Closing the Accounts	169
Example 3.8 Closing the Accounts	169
Exhibit 3.17 The Closing Process	170
Summary of the Accounting Cycle	171
Exhibit 3.18 The Accounting Cycle	171
Appendix 3A: Using a Worksheet to Prepare Financial Statements	171
Step 1: Unadjusted Trial Balance	172
Step 2: Adjusting Entry Columns	172

Step 3: Adjusted Trial Balance	172
Step 4: Income Statement	172
Step 5: Retained Earnings Statement	172
Exhibit 3.19 Worksheet	173
Step 6: Balance Sheet	174
Exhibit 3.20 Kenny's Laundry Adjusted Account Balances	181
Exhibit 3.21 Financial Statements for Kenny's Laundry	182

MAKING THE CONNECTION: INTEGRATIVE EXERCISE (CHAPTERS 1–3) 217

CHAPTER 4

Internal Control and Cash 218

Role of Internal Control 220

Exhibit 4.1 Relationship of Objectives, the Entity, and the Components of Internal Control	221
Exhibit 4.2 Section 302 Certification by W. Rodney McMullen (CEO of The Kroger Co.) Taken from SEC Filings (Exhibit 31.1 of 10-K) for the Year Ended February 1, 2020	222

Components of Internal Control 223

Control Environment and Ethical Behavior	223
Risk Assessment	224
Control Activities	225
Information and Communication	226
Monitoring	227
Relationship between Control Activities and the Accounting System	227
Exhibit 4.3 Relationship Between the Accounting System and Control Procedures	228

Accounting and Reporting Cash 228

Exhibit 4.4 Balance Sheet Reporting of Cash for Sprouts Farmers Market, Inc. and Subsidiaries	229
---	-----

Cash Controls 229

Reconciliation of Accounting Records to Bank Statement	231
Exhibit 4.5 Bank Statement	232
Exhibit 4.6 T-Account for Cash, Prior to Reconciliation	233
Example 4.1 Performing a Bank Reconciliation	234
Example 4.2 Making Adjusting Entries as a Result of the Bank Reconciliation	235
Cash Over and Short	236
Example 4.3 Recording Cash Over and Short	236
Petty Cash	237
Example 4.4 Accounting for Petty Cash	237

Operating Cycle 239

Exhibit 4.7 The Operating Cycle	239
Cash Management	240
Buying Inventory	240
Paying for Inventory	240

Selling Inventory	240
Short-Term Investments	240

CHAPTER 5

Sales and Receivables 268

Timing of Revenue Recognition 270

Amount of Revenue Recognized 271

Sales Discounts	271
Example 5.1 Recording Receivables Using the Net Method	272
Sales Returns and Allowances	273
Example 5.2 Sales Allowances	273

Types of Receivables 274

Accounting for Bad Debts 274

Direct Write-Off Method	275
Allowance Method	275
Example 5.3 Allowance for Doubtful Accounts	275
Example 5.4 Estimating Bad Debt Expense Using the Percentage of Credit Sales Method	276
Example 5.5 Estimating the Allowance for Doubtful Accounts Using the Aging Method	278
Bad Debts from a Management Perspective	279

Cash Management Principles Related to Accounts Receivable 280

Factoring Receivables	280
Credit Cards	280
Debit Cards	281

Notes Receivable 281

Exhibit 5.1 Principal and Interest in Loan Repayments	282
Example 5.6 Accounting for Notes Receivable	283

Internal Control for Sales 284

Exhibit 5.2 Internal Controls for Recording Sales Revenue	284
---	-----

Analyzing Sales and Receivables 285

Sales	285
Receivables	285
Example 5.7 Calculating the Gross Profit Margin, Operating Margin, Net Profit Margin, and Accounts Receivable Turnover Ratios	286

Appendix 5A: Recording Receivables Using the Gross Method 287

CHAPTER 6

Cost of Goods Sold and Inventory 320

Exhibit 6.1 Composition of Wal-Mart's Current Assets	321
Nature of Inventory and Cost of Goods Sold 322	
Exhibit 6.2 Relative Composition of Inventory for Different Companies	322

Types of Inventory and Flow of Costs	323
Exhibit 6.3 Inventory Disclosure of Intel	324
Exhibit 6.4 Flow of Inventory Costs	324
Cost of Goods Sold Model	325
Exhibit 6.5 Cost of Goods Sold Model	325
Example 6.1 Applying the Cost of Goods Sold Model	326
Inventory Systems	326
Recording Inventory Transactions— Perpetual System	328
Accounting for Purchases of Inventory	328
Exhibit 6.6 Sample Invoice	328
Exhibit 6.7 Shipping Terms	330
Example 6.2 Recording Purchase Transactions in a Perpetual Inventory System	331
Exhibit 6.8 Calculation of Net Purchases	332
Accounting for Sales of Inventory	332
Example 6.3 Recording Sales Transactions in a Perpetual Inventory System	333
Costing Inventory	334
Inventory Costing Methods	335
Exhibit 6.9 Allocation of Inventory Costs	336
Specific Identification	336
Example 6.4 Applying the Specific Identification Method	336
First-In, First-Out (FIFO)	338
Example 6.5 Applying the FIFO Inventory Costing Method	338
Last-In, First-Out (LIFO)	339
Example 6.6 Applying the LIFO Inventory Costing Method	339
Average Cost	340
Example 6.7 Applying the Average Cost Inventory Costing Method	341
Analysis of Inventory Costing Methods	342
Illustrating Relationships: Financial Statement Effects of Alternative Costing Methods	343
Exhibit 6.10 Financial Statement Effects of Alternative Inventory Costing Methods	343
Exhibit 6.11 Financial Statement Effects of Alternative Inventory Costing Methods	344
Income Tax Effects of Alternative Costing Methods	344
Consistency in Application	345
Lower of Cost or Net Realizable Value Rule	345
Example 6.8 Valuing Inventory at Lower of Cost or Net Realizable Value	346
Analyzing Inventory	348
Example 6.9 Calculating the Gross Profit and Inventory Turnover Ratios	348
LIFO Reserve Adjustments	349
Exhibit 6.12 LIFO Reserve Disclosure	350

Effects of Inventory Errors	350
Exhibit 6.13 Effect of an Inventory Error	351
Example 6.10 Analyzing Inventory Errors	352
Appendix 6A: Periodic Inventory System	352
Example 6.11 Recording Purchase Transactions in a Periodic Inventory System	353
Exhibit 6.14 Perpetual versus Periodic Inventory Systems	354
Appendix 6B: Inventory Costing Methods and the Periodic Inventory System	354
First-In, First-Out (FIFO)	355
Example 6.12 Applying the FIFO Inventory Costing Method in a Periodic Inventory System	355
Last-In, First-Out (LIFO)	356
Example 6.13 Applying the LIFO Inventory Costing Method in a Periodic Inventory System	356
Average Cost Method	356
Example 6.14 Applying the Average Cost Inventory Costing Method in a Periodic Inventory System	357

CHAPTER 7

Operating Assets 398

Understanding Operating Assets	400
Exhibit 7.1 Percentages of Operating Assets in Relation to Total Assets	400
Acquisition of Property, Plant, and Equipment	401
Measuring the Cost of a Fixed Asset	401
Exhibit 7.2 Typical Costs of Acquiring Property, Plant, and Equipment	402
Recording the Cost of a Fixed Asset	402
Example 7.1 Recording the Purchase of a Fixed Asset for Cash or Debt	403
Example 7.2 Recording the Purchase of a Fixed Asset for Noncash Consideration	403
Depreciation	404
Exhibit 7.3 Excerpt from Verizon's Annual Report	405
Information Required for Measuring Depreciation	405
Exhibit 7.4 Components of Depreciation Expense	405
Exhibit 7.5 Excerpt from Verizon's Annual Report	406
Depreciation Methods	407
Straight-Line Method	407
Example 7.3 Computing Depreciation Expense Using the Straight-Line Method	408
Exhibit 7.6 Straight-Line Pattern of Depreciation	409
Declining Balance Method	409
Example 7.4 Computing Depreciation Expense Using the Declining Balance Method	410
Exhibit 7.7 Declining Balance Pattern of Depreciation	410
Units-of-Production Method	411
Example 7.5 Computing Depreciation Expense Using the Units-of-Production Method	411

Exhibit 7.8 Units-of-Production Pattern of Depreciation	412
Choosing Between Depreciation Methods	413
Exhibit 7.9 Depreciation Patterns over Time	413
Depreciation for Partial Years	414
Depreciation and Income Taxes	414
Expenditures after Acquisition	415
Revenue Expenditures	415
Capital Expenditures	415
Exhibit 7.10 Types of Expenditures	416
Revision of Depreciation	416
Example 7.6 Revising Depreciation Expense	417
Impairments	417
Disposal of Fixed Assets	417
Example 7.7 Recording the Disposition of Property, Plant, and Equipment	418
Analyzing Fixed Assets	420
Example 7.8 Analyzing Fixed Asset Ratios	420
Intangible Assets	421
Acquisition of Intangible Assets	422
Exhibit 7.11 Common Types of Intangible Assets	422
Subsequent Accounting for Intangible Assets	423
Example 7.9 Accounting for Intangible Assets	423
Natural Resources	424
Example 7.10 Accounting for Depletion of a Natural Resource	425
Exhibit 7.12 Disclosure of Natural Resource by Miller Mining Company	426
Appendix 7A: Impairment of Property, Plant, and Equipment	426
Example 7.11 Recording an Impairment of Property, Plant, and Equipment	427
MAKING THE CONNECTION: INTEGRATIVE EXERCISE (CHAPTERS 4–7)	460

CHAPTER 8

Current and Contingent Liabilities 462

Current and Contingent Liabilities	464
Recognition and Measurement of Liabilities	465
Exhibit 8.1 Characteristics of Liabilities	466
Recognition of Liabilities	466
Measurement of Liabilities	466
Current Liabilities	467
Exhibit 8.2 Current Liability Sections from Two Balance Sheets	467
Accounts Payable	468
Accrued Liabilities	468
Notes Payable	469
Example 8.1 Recording Notes Payable and Accrued Interest	469

Exhibit 8.3 Effect of Borrowing Money on the Annual Income Statement and Balance Sheet	470
Current Portion of Long-Term Debt	472
Other Payables	472
Example 8.2 Recording Liabilities at the Point of Sale	472
Exhibit 8.4 Employer Payroll Taxes and Withheld Earnings	474
Example 8.3 Recording Payroll Taxes	474
Example 8.4 Recording Unearned Revenues	476
Contingent Liabilities	477
Exhibit 8.5 Recognition of Contingent Liabilities	477
Exhibit 8.6 Disclosure of Contingencies	478
Warranties	479
Example 8.5 Recording Warranty Liabilities	479
Exhibit 8.7 Excerpt from Note 23 to the Financial Statements	480
Analyzing Current Liabilities	480
Example 8.6 Calculating Liquidity Ratios	481

CHAPTER 9

Long-Term Liabilities 508

Exhibit 9.1 Excerpt from Whirlpool's 2019 10-K (Note 4)	510
Bonds Payable and Notes Payable	511
Types of Bonds	511
Exhibit 9.2 Long-Term Debt Terms	512
Selling New Debt Securities	512
Exhibit 9.3 The Relationships Between Stated Interest Rate and Yield	513
Accounting for Long-Term Debt	514
Exhibit 9.4 Cash Flows for a Bond	514
Recording Issuance	514
Exhibit 9.5 Balance Sheet Presentation	514
Example 9.1 Recording the Issuance of Bonds	515
Recognizing Interest Expense and Repayment of Principal	515
Interest Amortization Methods	516
The Straight-Line Method	516
Debt with Regular Interest Payments Sold at Par	516
Example 9.2 Recording Interest Expense for Bonds Sold at Par	516
Debt with Regular Interest Payments Sold at a Premium or Discount	517
Example 9.3 Recording Interest Expense for Bonds Sold at a Discount Using the Straight-Line Method	518
Exhibit 9.6 Carrying Value over the Life of a Bond Issued at a Discount	519
Example 9.4 Recording Interest Expense for Bonds Sold at a Premium Using the Straight-Line Method	520

- Exhibit 9.7 Carrying Value over the Life of a Bond
Issued at a Premium 521
- Accruing Interest 522

The Effective Interest Rate Method: Recognizing Interest Expense and Repayment of Principal 523

- Example 9.5** Recording Interest Expense for Bonds Sold at a Discount Using the Effective Interest Rate Method 524
- Example 9.6** Recording Interest Expense for Bonds Sold at a Premium Using the Effective Interest Rate Method 525
- Installment Debt 526
- Exhibit 9.8 Long-Term Debt Carrying Value Using Straight-Line and Effective Interest Methods to Amortize Premium and Discount 526

Pros and Cons of Debt Financing 527

- Tax Deductible Interest Expense 527
- Leverage 527
- Exhibit 9.9 Effects of Financing with Debt 528
- Inflation 528
- Payment Schedule 528

Leases 528

Ratio Analysis 530

- Example 9.7** Calculating and Analyzing Long-Term Debt Ratios 531

Appendix 9A: Pricing Long-Term Debt 532

- Example 9.8** Determining the Market Value of a Bond 533

CHAPTER 10

Stockholders' Equity 562

- Exhibit 10.1 Elements of Stockholders' Equity—Amazon.com, Inc. 565

Raising Capital within a Corporation 565

- Authorization to Issue Stock 565
- Exhibit 10.2 Determination of Share Quantities 567
- Common Stock 567
- Preferred Stock 567
- Comparison of Common and Preferred Stock 568

Accounting for Issuance of Common and Preferred Stock 569

- Example 10.1** Recording the Sale of Common and Preferred Stock 569
- Stated Capital and No-Par Stock 571
- Warrants 571
- Options 571

Accounting for Distributions to Stockholders 572

- Stock Repurchases (Treasury Stock) 573
- Exhibit 10.3 Excerpt from Coca-Cola's 2019 10-K (Balance Sheet) 573
- Example 10.2** Accounting for Treasury Stock 574
- Dividends 576

- Exhibit 10.4 Dividends 576

Example 10.3 Recording Cash Dividends 576

Example 10.4 Recording Small and Large Stock Dividends 578

- Exhibit 10.5 Microsoft's Stock Price History 579

Example 10.5 Calculating Cumulative Preferred Dividends 581

Accounting for Retained Earnings and Accumulated Other Comprehensive Income 582

- Restrictions on Retained Earnings 583
- Exhibit 10.6 Excerpt from Deere & Co. 2019 10-K 583
- Accounting for Accumulated Other Comprehensive Income 584

Equity Analysis 585

- Stockholder Profitability Ratios 585
- Example 10.6** Calculating Stockholder Profitability Ratios 586
- Stockholder Payout 586
- Example 10.7** Calculating Stockholder Payout Ratios 587
- Interpreting Ratios 587

MAKING THE CONNECTION: INTEGRATIVE EXERCISE (CHAPTERS 8–10) 619

CHAPTER 11

The Statement of Cash Flows 620

Role of the Statement of Cash Flows 622

Cash Flow Classifications 623

- Exhibit 11.1 How the Statement of Cash Flows Links the Two Balance Sheets 623
- Cash Flows from Operating Activities 623
- Cash Flows from Investing Activities 624
- Cash Flows from Financing Activities 624
- Noncash Investing and Financing Activities 625
- Exhibit 11.2 Classification of Cash Flows 625
- Example 11.1** Classifying Business Activities 626
- Format of the Statement of Cash Flows 626
- Exhibit 11.3 Format of the Statement of Cash Flows 627

Analyzing the Accounts for Cash

Flow Data 628

- Example 11.2** Classifying Changes in Balance Sheet Accounts 629
- Exhibit 11.4 Cash Flow Classifications and Changes in Balance Sheet Accounts 629

Preparing a Statement of Cash Flows 630

Preparing Cash Flows from Operating Activities 630

- Exhibit 11.5 Statement of Cash Flows for Alphabet 631
- The Direct Method 632
- The Indirect Method 632
- Applying the Indirect Method 632

Exhibit 11.6 Financial Statements for Brooke Sportswear 633

Example 11.3 Calculating Net Cash Flow from Operating Activities: Indirect Method 634

Exhibit 11.7 Adjustments Required to Calculate Cash Flow from Operating Activities 635

Preparing Cash Flows from Investing Activities 637

Analyzing Investing Activities 638

Exhibit 11.8 Analyzing Investing Activities 638

Example 11.4 Reporting Net Cash Flow from Investing Activities 640

Preparing Cash Flows from Financing Activities 640

Analyzing Financing Activities 640

Example 11.5 Reporting Net Cash Flow from Financing Activities 642

Exhibit 11.9 Statement of Cash Flows for Brooke Sportswear 643

Using the Statement of Cash Flows 643

Examining the Statement of Cash Flows 643

Comparing the Statement of Cash Flows from Several Periods 644

Example 11.6 Analyzing Free Cash Flow and Cash Flow Adequacy 645

Comparing the Statement of Cash Flows to Similar Companies 646

Appendix 11A: The Direct Method 646

Cash Collected from Customers 646

Other Cash Collections 646

Cash Paid to Suppliers 647

Cash Paid for Operating Expenses 647

Cash Paid for Interest and Income Taxes 648

Other Items 649

Applying the Direct Method 649

Example 11.7 Calculating Net Cash Flows from Operating Activities: Direct Method 650

Appendix 11B: Using a Spreadsheet to Prepare the Statement of Cash Flows 650

Net Income 651

Adjusting for Noncash Items 651

Adjusting for Gains and/or Losses Due to Investing and Financing Activities 651

Adjusting for Changes in Current Assets and Current Liabilities 651

Exhibit 11.10 Spreadsheet to Prepare Statement of Cash Flows 652

Adjusting for Cash Inflows and Outflows Associated with Financing Activities 653

Completing the Statement of Cash Flows 653

CHAPTER 12

Financial Statement Analysis 690

Use of Financial Statements in Decisions 692

Customer Decisions 692

Exhibit 12.1 Users of Financial Statements and Typical Questions 693

Supplier Decisions 693

Employment Decisions 693

Credit Decisions 694

Investment Decisions 694

SEC Filings 694

Exhibit 12.2 The Most Important SEC Filings 695

Format and Content of Form 10-K 695

Analyzing Financial Statements with Cross Sectional and Time Series Analysis 697

Cross Sectional Analysis 697

Time Series Analysis 697

Cross Sectional and Time Series Analysis Illustrated 697

Example 12.1 Interpreting Cross Sectional and Time Series (or Trend) Analysis 698

Analyzing the Financial Statements with Horizontal and Vertical Analysis 699

Horizontal Analysis 699

Example 12.2 Preparing Common Size Statements for Horizontal Analysis 699

Vertical Analysis 700

Example 12.3 Preparing Common Size Statements for Vertical Analysis 701

Analyzing the Financial Statements with Ratio Analysis 705

Short-Term Liquidity Ratios 705

Exhibit 12.3 The Kroger Co. Income Statement and Balance Sheet 708

Example 12.4 Calculating and Interpreting Short-Term Liquidity Ratios 709

Debt Management Ratios 710

Example 12.5 Calculating and Interpreting Debt Management Ratios 712

Asset Efficiency Ratios 714

Example 12.6 Calculating and Interpreting Asset Efficiency Ratios 716

Profitability Ratios 717

Example 12.7 Calculating and Interpreting Profitability Ratios 719

Stockholder Ratios 720

Example 12.8 Calculating and Interpreting Stockholder Ratios 722

Dupont Analysis	723
Example 12.9 Performing and Interpreting a Dupont Analysis	725
Summary of Financial Ratios	725
Exhibit 12.4 Summary of Financial Ratios	726
Data for Ratio Comparisons	727

APPENDIX 1

Data Analytics and Accounting Information 768

What Is Data Analytics?	769
Data Analytics Example	770
Analysis Using Excel to Calculate FIFO and LIFO Cost	771
Requirements	771
Concept Questions	771
Activity	771
Analysis Using the Accounts Receivable Aging Method	773
Requirements	773
Concept Questions	773
Activity	773

APPENDIX 2

Investments 776

Classifying and Accounting for Debt Investments	777
Amortized Cost Method	778
Example A2.1 Accounting for Held-to-Maturity Investments	778
Fair Value Method	779
Example A2.2 Accounting for Trading and Available-for-Sale Investments	779
Example A2.3 Recognizing Changes in Fair Value	781
Accounting for Equity Investments	782
Passive Investments: Fair Value Method	783
Example A2.4 Recording Passive Equity Investments	783
Significant Influence: Equity Method	784
Example A2.5 Applying the Equity Method	784
Control: Consolidated Financial Statements	786
Exhibit A2.1 Worksheet for Preparing the Consolidated Balance Sheet	786
Summary	787
Exhibit A2.2 Accounting for Investments in Debt and Equity Securities	787
Business Combinations	787

APPENDIX 3

Time Value of Money 798

Compound Interest Calculations	799
Example A3.1 Computing Future Values Using Compound Interest	800
Present Value of Future Cash Flows	801
Exhibit A3.1 Cash Flow Diagram	801
Interest and the Frequency of Compounding	802
Exhibit A3.2 Effect of Interest Periods on Compound Interest	802
Four Basic Compound Interest Problems	802
Computing the Future Value of a Single Amount	802
Exhibit A3.3 Future Value of a Single Amount: An Example	803
Example A3.2 Computing Future Value of a Single Amount	804
Computing the Present Value of a Single Amount	805
Exhibit A3.4 Present Value of a Single Amount: An Example	805
Example A3.3 Computing Present Value of a Single Amount	806
Computing the Future Value of an Annuity	807
Exhibit A3.5 Future Value of an Annuity: An Example	807
Example A3.4 Computing Future Value of an Annuity	808
Present Value of an Annuity	809
Exhibit A3.6 Present Value of an Annuity: An Example	809
Example A3.5 Computing Present Value of an Annuity	810
Exhibit A3.7 Future Value of a Single Amount	819
Exhibit A3.8 Present Value of a Single Amount	820
Exhibit A3.9 Future Value of an Annuity	821
Exhibit A3.10 Present Value of an Annuity	822

APPENDIX 4

International Financial Reporting Standards 824

International Financial Reporting	825
What Are IFRS?	825
Who Develops IFRS?	825
Exhibit A4.1 Structure of the IASB	826
How Long Has the IASB Been Issuing Standards?	826
Exhibit A4.2 Key Dates in the Development of IFRS	826
What Organizations Have Played a Role in the Development of IFRS?	827
Who Uses IFRS?	827
Exhibit A4.3 IFRS Around the World	827
When Are IFRS Expected to Be Used in the United States?	828
What Are the Advantages of IFRS?	828

Are There Potential Problems with Adopting IFRS?	828
What Do Financial Statements Look Like Under IFRS?	829
Exhibit A4.4 Financial Statements Prepared Under IFRS	829

Key Differences Between IFRS and U.S. GAAP 830

What Similarities and Differences Exist?	831
Exhibit A4.5 Comparison of IFRS and U.S. GAAP	831
Where Can I Go to Find Out More About IFRS?	832

APPENDIX 5

Financial Statement Information: The Kroger Co. 836

Report of Independent Registered Public Accounting Firm 838

Opinions on the Financial Statements and Internal Control over Financial Reporting	838
Basis for Opinions	838
Definition and Limitations of Internal Control over Financial Reporting	839
Critical Audit Matters	839

APPENDIX 6

Financial Statement Information: Sprouts Farmers Market, Inc. 848

Report of Independent Registered Public Accounting Firm 850

Opinions on the Financial Statements and Internal Control over Financial Reporting	850
Basis for Opinions	850
Definition and Limitations of Internal Control over Financial Reporting	851
Critical Audit Matters	851

Glossary 859

Index 867

1

Accounting and the Financial Statements

After studying Chapter 1, you should be able to:

- 1 Explain the nature of accounting.
- 2 Identify the forms of business organizations and the types of business activities.
- 3 Describe the relationships shown by the fundamental accounting equation.
- 4 Prepare a classified balance sheet and explain the information it communicates.
- 5 Prepare an income statement and explain the information it communicates.
- 6 Prepare the retained earnings statement and explain the information it communicates.
- 7 Identify the information communicated by the statement of cash flows.
- 8 Describe the relationships among the financial statements.
- 9 Explain the importance of ethics in providing useful financial information.

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EXPERIENCE FINANCIAL ACCOUNTING

with Apple

In 1976, Steve Jobs and Steve Wozniak, the founders of **Apple Inc.**, began building personal computers in Jobs' parents' garage. Apple revolutionized the personal computer industry by making machines that were smaller, cheaper, user-friendly, and accessible to everyday consumers. As an industry leader, Apple appeared invincible. However, after a series of product failures, many analysts predicted the end of one of the computer industry's most prominent companies. With the introduction of revolutionary products such as the iMac, the iPod, the iTunes Store, and the iPhone, Apple has become the world's largest company by market value, with a stock price of over \$300 per share at the beginning of 2020.

What type of information can help someone predict the successes (and failures) of a company like Apple? A good place to start is with a company's annual report (commonly referred to as Form 10-K). The accounting profession creates a valuable and essential economic resource—relevant and reliable financial information that people use to make important economic decisions that span a wide range of activities, including whether to invest in or loan money to a company. This financial information is provided in the form of financial statements—a summary of the results of a company's operations. The objective of this text is to help you read and interpret a company's annual report so that you can better use financial information to make important business decisions. Ultimately, your success in business will be influenced by how well you understand the accounting information contained in a company's annual report.



Source: Apple Inc. 2019 10-K.

OBJECTIVE 1

Explain the nature of accounting.

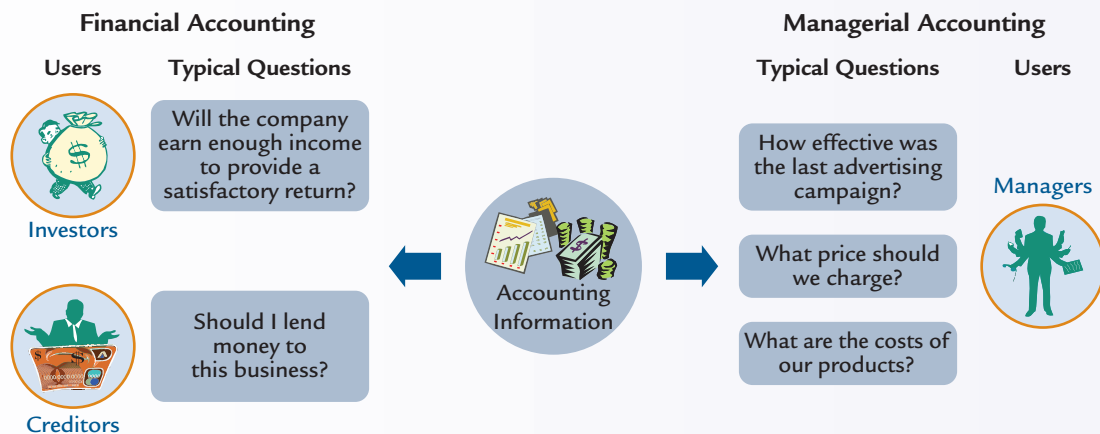
WHY IS ACCOUNTING IMPORTANT?

Our economy is comprised of many different businesses. Some companies, such as **Apple Inc.**, focus on providing goods, which for Apple take many forms including desktop and laptop computers, iPads, iPhones, Apple Watches, and downloadable music. Other companies are primarily concerned with providing services. For example, **The Walt Disney Company** offers a variety of entertainment services from theme parks to motion pictures to streaming videos. While most entities, like Apple and Disney, exist in order to earn a profit, some are organized to achieve some other benefit to society (e.g., school districts exist to meet the educational needs of a community). Regardless of their objective, all entities use accounting to plan future operations, make decisions, and evaluate performance.

Accounting is an information system that identifies, measures, records, and communicates financial information about a company's business activities so decision-makers can make informed decisions. Without adequate information users will not be able to judge a business's economic opportunities and risks. Accounting is the "language of business" because it communicates information about the economic activities of a company that helps people make better decisions.

WHO USES ACCOUNTING INFORMATION

The demand for accounting information comes from both inside and outside the business and is summarized in Exhibit 1.1. Inside the business, managers use accounting information to help them plan and make decisions about the company. For example, managers use accounting information to help decide which actions to take, predict the consequences of their actions, and control the operations of the company. Accounting that is designed to meet the needs of internal users is called managerial accounting.

EXHIBIT 1.1**The Demand for Accounting Information**

Outside the business, investors (owners) use accounting information to evaluate the future prospects of a company and decide where to invest their money. Creditors (lenders) use accounting information to evaluate whether to loan money to a company. Other external users include governmental agencies that use accounting information to determine

taxes owed by companies, to implement regulatory objectives, and to make policy decisions; labor unions that are negotiating wage increases for its members; and financial analysts offering buy or sell recommendations to clients. Accounting information that satisfies the needs of external decision-makers is termed **financial accounting** and is the focus of this book.

The objectives of financial accounting involve providing decision-makers with information that assists them in assessing the amounts, timing, and uncertainties of a company's future cash flows. This information is provided through four basic financial statements: the balance sheet, the income statement, the retained earnings statement, and the statement of cash flows.

In this chapter, we will discuss the basic functioning of the accounting system within a business. We will address the following questions:

- What forms do businesses take?
- What are the basic business activities?
- How does the accounting system report these activities?
- How can decision-makers use the information provided by the accounting system?

Regardless of your major or future plans, knowledge of accounting and the ability to use accounting information will be critical to your success in business.

BUSINESSES: FORMS AND ACTIVITIES

Accounting is an information system that identifies, measures, records, and communicates financial information about an accounting entity. An accounting entity is a business that has an identity separate from that of its owners and managers and for which accounting records are kept.

FORMS OF BUSINESS ORGANIZATION

This text emphasizes accounting for entities which take one of three forms: sole proprietorship, partnership, or corporation.

Sole Proprietorship A **sole proprietorship** is a business owned by one person. Sole proprietorships, which account for more than 70% of all businesses, are usually small, local businesses such as restaurants, photography studios, retail stores, or website developers. This organizational form is popular because it is simple to set up and gives the owner control over the business. While a sole proprietorship is an accounting entity separate from its owner, the owner is personally responsible for the debt of the business. Sole proprietorships can be formed or dissolved at the wishes of the owner.

Partnership A **partnership** is a business owned jointly by two or more individuals. Small businesses and many professional practices of physicians, lawyers, and accountants are often organized as partnerships. Relative to sole proprietorships, partnerships provide increased access to financial resources as well as access to the individual skills of each of the partners. The partnership entity does not pay taxes. Instead, each partner pays taxes at his or her individual rate. Similar to sole proprietorships, partnerships are accounting entities separate from the partners; however, the partners are jointly responsible for all the debt of the partnership.¹

Corporation A **corporation** is a business organized under the laws of a particular state. A corporation, such as **Apple**, is owned by one or more persons called *stockholders*, whose



Next Level

How will accounting affect my life?

ANSWER:

Accounting will impact many aspects of your daily life. The business that sells you goods or services uses accounting to keep track of how much money it received as well as the cost of operating the business. Calculating the amount of tax that is owed to the government requires accounting. When you invest your money, you should use accounting to understand a company's business and its prospects for the future. Plans that you make for the future often involve accounting to determine how much money you will need.

OBJECTIVE 2

Identify the forms of business organizations and the types of business activities.

¹ Many professional partnerships and multiple-owner businesses have been reorganized as *limited liability partnerships* (LLPs) or *limited liability corporations* (LLCs), which limit each partner's (owner's) liability to his or her investment in the partnership (business).

EXHIBIT 1.2

Forms of Business Organization

Sole Proprietorship



Partnership



Corporation



ownership interests are represented by shares of stock. A primary advantage of the corporate form is the ability to raise large amounts of money (capital) by issuing shares of stock. Unlike a sole proprietorship or a partnership, a corporation is an “artificial person” and the stockholders’ legal responsibility for the debt of the business is limited to the amount they invested in the business. In addition, shares of stock can be easily transferred from one owner to another through capital markets without affecting the corporation that originally issued the stock. The ability to raise capital by selling new shares, the limited legal liability of owners, and the transferability of the shares give the corporation an advantage over other forms of business organization. However, the requirements to form a corporation are more complex compared to the other forms of business organization. In addition, owners of corporations generally pay more taxes than owners of sole proprietorships or partnerships for two reasons:

- First, the corporate income tax rate is greater than the individual income tax rate.
- Second, a corporation’s income is taxed twice—at the corporate level as income is earned, and at the individual level as earnings are distributed to stockholders. This is known as double taxation.

Exhibit 1.2 illustrates the advantages and disadvantages of each form of organization. While the combined number of sole proprietorships and partnerships greatly exceeds that



YOU DECIDE Choice of Organizational Form

You are an entrepreneur who has decided to start a campus-area bookstore. In order to start your business, you have to choose among three organizational forms—sole proprietorship, partnership, or corporation. You have enough personal wealth to finance 40% of the business, but you must get the remaining 60% from other sources.

How does the choice of organizational form impact your control of the business and ability to obtain the needed funds?

The choice of organizational form can greatly impact many aspects of a business’s operations. Each form has certain advantages and disadvantages that you should carefully consider.

- **Sole proprietorship:** A sole proprietorship would give you the most control of your business. However, you would be forced to obtain the additional 60% of funds

needed from a bank or other creditor. It is often difficult to get banks to support a new business.

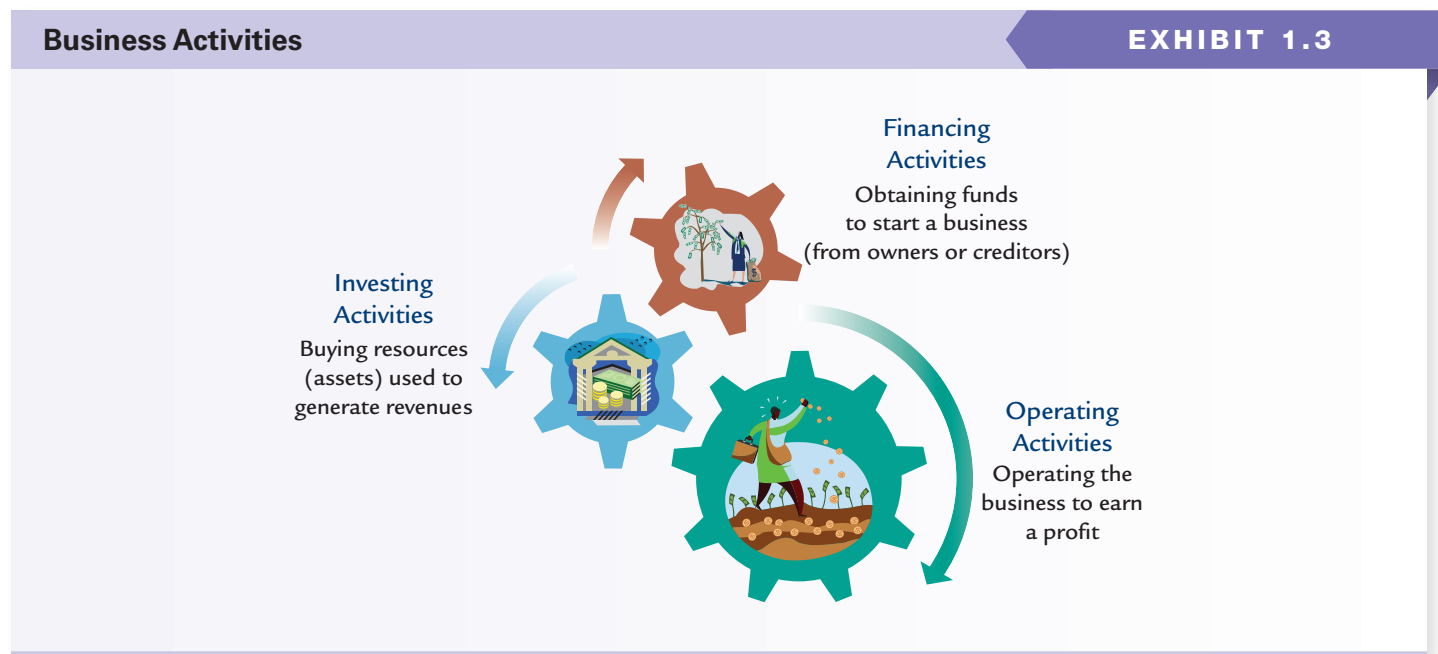
- **Partnership:** If you choose to form a partnership, you would still have access to bank loans. In addition, you would also have the ability to obtain the additional funds from your partner or partners. In this situation, the partners would then have a 60% interest in the business, which may be an unacceptable loss of control.
- **Corporation:** If you choose to form a corporation, you could obtain the needed funds by issuing stock to investors. While a 60% interest may still be transferred to the stockholders, if the stock were widely dispersed among many investors, you might still retain effective control of the business with a 40% interest.

The choice of organizational form involves the consideration of many different factors.

of corporations, the majority of business in the United States is conducted by corporations. Therefore, this book emphasizes the corporate form of organization.

BUSINESS ACTIVITIES

Regardless of the form of a business, all businesses engage in activities that can be categorized as financing, investing, or operating activities. These activities are illustrated in Exhibit 1.3.



Financing Activities A company's financing activities include obtaining the funds necessary to begin and operate a business. These funds come from either issuing stock or borrowing money. Most companies use both types of financing to obtain funds.

When a corporation borrows money from another entity such as a bank, it must repay the amount borrowed. The person to whom the corporation owes money is called a **creditor**. This obligation to repay a creditor is termed a **liability** and can take many forms. A common way for a corporation to obtain cash is to borrow money with the promise to repay the amount borrowed plus interest at a future date. Such borrowings are commonly referred to as *notes payable*. A special form of note payable that is used by corporations to obtain large amounts of money is called a *bond payable*.

In addition to borrowing money from creditors, a corporation may issue shares of stock to investors in exchange for cash. The dollar amount paid to a corporation for these shares is termed *common stock* and represents the basic ownership interest in a corporation. In a recent annual report, **Apple** reported it had issued 4,433,236,000 shares of common stock. The corporation is not obligated to repay the stockholder the amount invested; however, many corporations distribute a portion of their earnings to stockholders on a regular basis. These distributions are called *dividends*.

Creditors and stockholders have a claim on the **assets**, or economic resources, of a corporation. However, the claims on these resources differ. In the case of financial difficulty or distress, the claims of the creditors (liabilities) must be paid prior to the claims of the stockholders (called **stockholders' equity**). Stockholders' equity is considered a residual interest in the assets of a corporation that remain after deducting its liabilities.

Investing Activities Once a corporation has obtained funds through its financing activities, it buys assets (resources) that enable it to operate. For example, **Apple** recently reported \$37,378 million in land, buildings, machinery, and equipment that it uses in its operations. A corporation may also obtain intangible assets that lack physical substance, such as copyrights and patents. The purchase and sale of the assets that are used in operations (commonly referred to as operating assets) are a corporation's investing activities.

Regardless of its form, assets are future economic benefits that a corporation controls. The assets purchased by a corporation vary depending on the type of business that the corporation engages in, and the composition of these assets is likely to vary across different companies and different industries. For example, in a recent annual report, property, plant, and equipment made up approximately 11% of **Apple**'s total assets. This is typical of many technology companies. In contrast, property, plant, and equipment made up 74.4% of the total assets of **Southwest Airlines**, a company that relies heavily on airplanes to produce revenue.

Operating Activities Once a corporation has acquired the assets that it needs, it can begin to operate. While different businesses have different purposes, they all want to generate revenue. **Revenue** is the increase in assets that results from the sale of products or services. For example, **Apple** recently reported sales revenue of \$260,174 million. In addition to revenue, assets such as *cash*, *accounts receivable* (the right to collect an amount due from customers), *supplies*, and *inventory* (products held for resale) often result from operating activities.

To earn revenue, a corporation will incur various costs or expenses. **Expenses** are the cost of assets used, or the liabilities created, in the operation of the business. **Apple** reported expenses of \$161,782 million related to the cost of iPhones, iPads, Apple Watches, and other products sold.

The liabilities that arise from operating activities can be of different types. For example, if a corporation purchases goods on credit from a supplier, the obligation to repay the supplier is called an *account payable*. In a recent annual report, **Apple** reported \$46,236 million of accounts payable. Other examples of liabilities created by operating activities include *wages payable* (amounts owed to employees for work performed) and *income taxes payable* (taxes owed to the government).

The results of a company's operating activities can be determined by comparing revenues to expenses. If revenues are greater than expenses, a corporation has earned **net income**. If expenses are greater than revenues, a corporation has incurred a **net loss**.

OBJECTIVE 3

Describe the relationships shown by the fundamental accounting equation.

COMMUNICATION OF ACCOUNTING INFORMATION

A company's business activities are summarized and reported in a set of standardized reports called **financial statements**. The role of financial statements is to provide information that helps investors, creditors, and others make judgments that serve as the basis for the various decisions they make. Financial statements help answer questions such as those shown in Exhibit 1.4.

EXHIBIT 1.4

Questions Answered by Financial Statements

How well did the company perform during the year?

From what sources did a company's cash come and for what did the company use cash during the year?



What are the economic resources of the company and the claims against those resources?

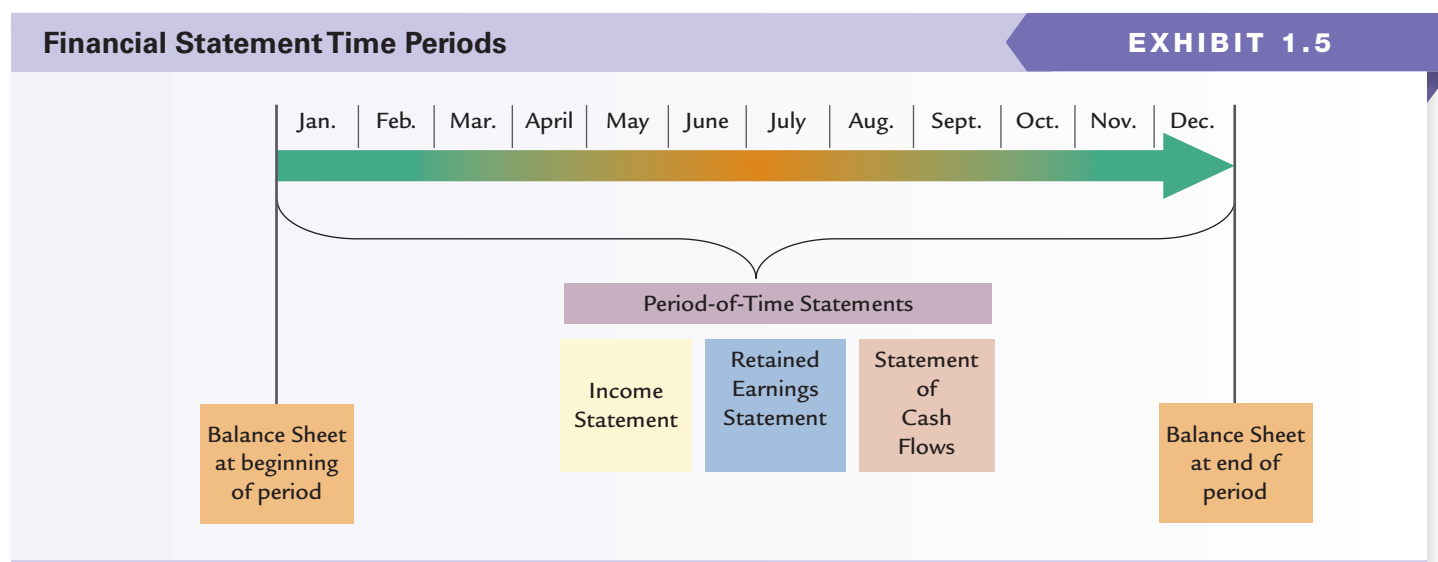
How much better off is the company at the end of the year compared to the beginning of the year?

THE FOUR BASIC FINANCIAL STATEMENTS

Companies prepare four basic financial statements:

- The **balance sheet** reports the resources (assets) owned by a company and the claims against those resources (liabilities and stockholders' equity) at a specific point in time.
- The **income statement** reports how well a company has performed (revenues, expenses, and income) over a period of time.
- The **retained earnings statement** reports how much of the company's income was retained in the business and how much was distributed to owners over a period of time.²
- The **statement of cash flows** reports the sources and uses of a company's cash over a period of time.

These four financial statements are prepared and issued at the end of an accounting period. While the accounting period can be a year, companies may prepare financial statements for any point or period of time. Most companies prepare financial statements at the end of each month, quarter, and year to satisfy the users' needs for timely information. Note that the balance sheet is a point-in-time description, whereas the other financial statements are period-of-time descriptions that explain the business activities between balance sheet dates as shown in Exhibit 1.5.



In order to make it easier to use financial statements over time and across companies, a common set of rules and conventions have been developed to guide the preparation of financial statements. These rules and conventions, called **generally accepted accounting principles (GAAP)**, were developed by several different organizations over a number of years. In the United States, the **Securities and Exchange Commission (SEC)** has the power to set accounting rules for publicly traded companies. However, the SEC has delegated this authority to the **Financial Accounting Standards Board (FASB)**. While the FASB

² Information contained in the retained earnings statement is often included in a more comprehensive statement of changes in stockholders' equity, which describes changes in all components of stockholders' equity. This statement is presented in Chapter 10.

is the primary accounting standard setter in the United States, the FASB has been working closely with the **International Accounting Standards Board (IASB)** in its development of **international financial reporting standards (IFRS)**. While this text focuses on U.S. GAAP, major differences between U.S. GAAP and IFRS are discussed in Appendix 4 at the end of this text.

While financial statements prepared under GAAP provide the kind of information users want and need, the financial statements do not interpret this information. The financial statement user must use his or her general knowledge of business and accounting to interpret the financial statements as a basis for decision-making.

THE FUNDAMENTAL ACCOUNTING EQUATION

To understand financial statements, it is necessary that you understand how the accounting system records, classifies, and reports information about business activities. The **fundamental accounting equation** illustrates the foundation of the accounting system.

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

The fundamental accounting equation captures two basic features of any company. The left side of the accounting equation shows the assets, or economic resources of a company. The right side of the accounting equation indicates the claims on the company's assets. These claims may be the claims of creditors (liabilities) or they may be the claims of owners (stockholders' equity). The implication of the fundamental accounting equation is that a company's resources (its assets) must always be equal to the claims on those resources (its liabilities and stockholders' equity). **EXAMPLE 1.1** illustrates this key relationship.

EXAMPLE 1.1 USING THE FUNDAMENTAL ACCOUNTING EQUATION

On January 1, Gundrum Company reported assets of \$125,000 and liabilities of \$75,000. During the year, assets increased by \$44,000 and stockholders' equity increased by \$15,000.

Required:

1. What is the amount reported for stockholders' equity on January 1?
2. What is the amount reported for liabilities on December 31?

Solution:

1. Stockholders' equity on January 1 is \$50,000. This amount is calculated by rearranging the fundamental accounting equation as follows:

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

$$\$125,000 = \$75,000 + \text{Stockholders' Equity}$$

$$\text{Stockholders' Equity} = \$125,000 - \$75,000 = \underline{\underline{\$50,000}}$$

2. At December 31, liabilities are \$104,000. This amount is computed by adding the change to the appropriate balance sheet elements and then rearranging the fundamental accounting equation as follows:

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

$$(\$125,000 + \$44,000) = \text{Liabilities} + (\$50,000 + \$15,000)$$

$$\text{Liabilities} = (\$125,000 + \$44,000) - (\$50,000 + \$15,000)$$

$$= \$169,000 - \$65,000 = \underline{\underline{\$104,000}}$$

The fundamental accounting equation will be used to capture all of the economic activities recorded by an accounting system.

THE CLASSIFIED BALANCE SHEET

The purpose of the balance sheet is to report the financial position of a company (its assets, liabilities, and stockholders' equity) at a specific point in time. The relationship between the elements of the balance sheet is given by the fundamental accounting equation:

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

Note that the balance sheet gets its name because the economic resources of a company (assets) must always equal, or be in balance with, the claims against those resources (liabilities and stockholders' equity).

The balance sheet is organized, or classified, to help users identify the fundamental economic similarities and differences between the various items within the balance sheet. These classifications help users answer questions such as:

- how a company obtained its resources
- whether a company will be able to pay its obligations when they become due

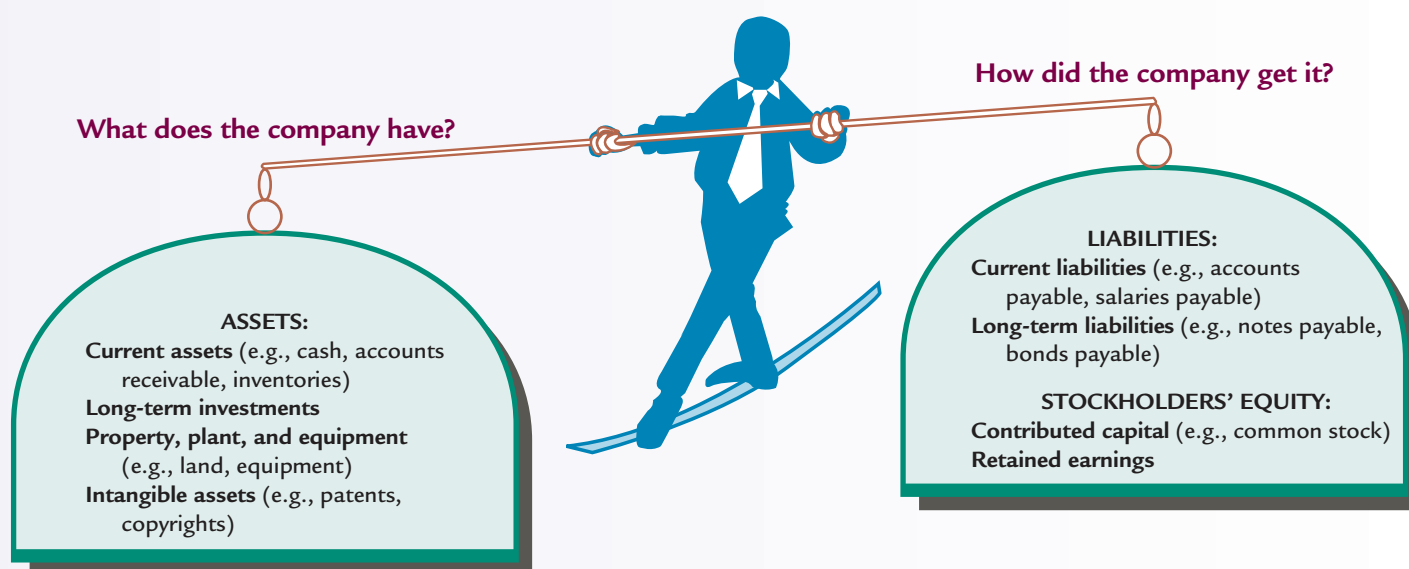
While companies often use different classifications and different levels of detail on their balance sheets, some common classifications are shown in Exhibit 1.6.

OBJECTIVE 4

Prepare a classified balance sheet and explain the information it communicates.

Common Balance Sheet Classifications

EXHIBIT 1.6



Let's examine the balance sheet classifications in more detail by looking at **Apple's** balance sheet shown in Exhibit 1.7 (p. 12).

With regard to the heading of the financial statement, several items are of interest:

- **Company name:** The company for which the accounting information is collected and reported is clearly defined.
- **Financial statement type:** The title of the financial statement follows the name of the company.

- *Date:* The specific date of the statement is listed. **Apple** operates on a fiscal year that ends in September. A **fiscal year** is an accounting period that runs for 1 year. While many companies adopt a fiscal year that corresponds to the calendar year, others adopt a fiscal year that more closely corresponds with their business cycle.
- *Amounts:* **Apple** reports its financial results rounded to the nearest million dollars. Large companies often round the amounts presented for a more clear presentation. For Apple, the reported cash amount of \$48,844 is actually \$48,844,000,000.

EXHIBIT 1.7**Classified Balance Sheet of Apple Inc.**

Apple Inc. Balance Sheet Sept. 28, 2019 (in millions of dollars)		
ASSETS		
Current assets:		
Cash	\$ 48,844	
Marketable securities	51,713	
Accounts receivable, net	22,926	
Inventories	4,106	
Other current assets	35,230	
Total current assets		\$ 162,819
Long-term investments		105,341
Property, plant, and equipment:		
Land and buildings	\$ 17,085	
Machinery, equipment, and other	78,872	
Less: accumulated depreciation	(58,579)	
Total property, plant, and equipment		37,378
Intangible and other noncurrent assets		32,978
Total assets		<u>\$ 338,516</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 46,236	
Other payable	37,720	
Unearned revenue	5,522	
Other current liabilities	16,240	
Total current liabilities		\$ 105,718
Long-term liabilities		142,310
Total liabilities		\$ 248,028
Stockholders' equity:		
Contributed capital	\$ 45,174	
Retained earnings	45,898	
Other equity*	(584)	
Total stockholders' equity		90,488
Total liabilities and stockholders' equity		<u>\$ 338,516</u>

*The (\$584) million of other equity reported by Apple represents accumulated other comprehensive income. Accumulated other comprehensive income is discussed in Chapter 10.

Source: Apple Inc. 2019 10-K.

CURRENT ASSETS

The basic classification of a company's assets is between current and noncurrent items. **Current assets** consist of cash and other assets that are reasonably expected to be converted into cash within 1 year or one operating cycle, whichever is longer. The **operating cycle** of a company is the average time it takes a company to purchase goods, resell the goods, and collect the cash from customers. Because most companies have operating cycles less than 1 year, companies typically designate 1 year as the dividing line between current and noncurrent items. Common types of current assets are:

- Cash
- Marketable securities—short-term investments in the debt and stock of other companies as well as government securities
- Accounts receivable—the right to collect an amount due from customers
- Inventories—goods or products held for resale to customers
- Other current assets—a “catch-all” category that includes items such as prepaid expenses (advance payments for rent, insurance, and other services) and supplies

Current assets are listed on the balance sheet in order of liquidity or nearness to cash. That is, the items are reported in the order in which the company expects to convert them into cash.

NONCURRENT ASSETS

Assets that are not classified as current are classified as long-term or noncurrent assets. These include long-term investments; property, plant, and equipment; intangible assets; and other noncurrent assets.

Long-Term Investments Long-term investments are similar to short-term investments, except that the company expects to hold the investment for longer than 1 year. This category also includes land or buildings that a company is not currently using in operations. **Apple** reported long-term investments of \$105,341 million.

Property, Plant, and Equipment Property, plant, and equipment represents the tangible, long-lived, productive assets used by a company in its operations to produce revenue. This category includes land, buildings, machinery, manufacturing equipment, office equipment, and furniture. **Apple** reported property, plant, and equipment of \$37,378 million, representing 11% ($\$37,378 \text{ million} \div \$338,516 \text{ million}$) of its total assets. Property, plant, and equipment is originally recorded at the cost to obtain the asset. Because property, plant, and equipment helps to produce revenue over a number of years, companies assign, or allocate, a portion of the asset's cost as an expense in each period in which the asset is used. This process is called *depreciation*. The *accumulated depreciation* shown on Apple's balance sheet represents the total amount of depreciation that the company has expensed over the life of its assets. Because accumulated depreciation is subtracted from the cost of an asset, it is called a *contra-asset*. The difference between the cost and the accumulated depreciation is the asset's *book value* (or *carrying value*).

Intangible and Other Noncurrent Assets Intangible assets are similar to property, plant, and equipment in that they provide a benefit to a company over a number of years; however, these assets lack physical substance. Examples of intangible assets include patents, copyrights, trademarks, and goodwill.

Other noncurrent assets is a catch-all category that includes items such as deferred charges (long-term prepaid expenses) and other long-term miscellaneous items.



Next Level

Many classifications on the balance sheet are essentially subtotals. Is it really important to place accounts within the right category or is it enough to simply understand if they are assets, liabilities, or stockholders' equity?

ANSWER:

It is critical that you be able to identify accounts as assets, liabilities, or stockholders' equity accounts. However, the classifications are also important. Financial accounting is concerned with communicating useful information to decision-makers. These classifications provide decision-makers with information about the structure of assets, liabilities, and stockholders' equity that assists them in understanding a company's financial position.

CURRENT LIABILITIES

Current liabilities are closely related to current assets. **Current liabilities** consist of obligations that will be satisfied within 1 year or the operating cycle, whichever is longer. These liabilities can be satisfied through the payment of cash or by providing goods or services. **Current liabilities are typically listed in the order in which they will be paid** and include:

- Accounts payable—an obligation to repay a vendor or supplier for merchandise supplied to the company
- Salaries payable—an obligation to pay an employee for services performed
- Unearned revenue—an obligation to deliver goods or perform a service for which a company has already been paid
- Interest payable—an obligation to pay interest on money that a company has borrowed
- Income taxes payable—an obligation to pay taxes on a company's income

LONG-TERM LIABILITIES AND STOCKHOLDERS' EQUITY

Long-term liabilities are the obligations of the company that will require payment beyond 1 year or the operating cycle, whichever is longer. Common examples are:

- Notes payable—an obligation to repay cash borrowed at a future date
- Bonds payable—a form of an interest-bearing note payable issued by corporations in an effort to attract a large amount of investors

Stockholders' equity is the last major classification on a company's balance sheet. Stockholder's equity arises primarily from two sources:

- **Contributed capital**—the owners' contributions of cash and other assets to the company (includes the common stock of a company)
- **Retained earnings**—the accumulated net income of a company that has not been distributed to owners in the form of dividends

If a firm has been profitable for many years, and if its stockholders have been willing to forgo large dividends, retained earnings may be a large portion of equity. **Apple** reported approximately \$45,898 million of retained earnings, representing approximately 51% of its total stockholders' equity.

Together, a company's liabilities and equity make up the **capital** of a business. **Apple** has debt capital, capital raised from creditors, of \$248,028 million (total liabilities). Of this, \$105,718 million comes from current creditors, while \$142,310 million comes from long-term creditors. Apple's equity capital, which is the capital of the stockholders, is \$90,488 million (total stockholders' equity).

PREPARING A CLASSIFIED BALANCE SHEET

Using the fundamental accounting equation and the common classifications of balance sheet items, a company will prepare its balance sheet by following five steps:

- Step 1.** Prepare a heading that includes the name of the company, the title of the financial statement, and the time period covered.
- Step 2.** List the assets of the company in order of their liquidity or nearness to cash. Use appropriate classifications. Add the assets and double underline the total.
- Step 3.** List the liabilities of the company in order of their time to maturity. Use appropriate classifications.
- Step 4.** List the stockholders' equity balances with appropriate classifications.
- Step 5.** Add the liabilities and stockholders' equity and double underline the total.

In general, only the first items in a column as well as any subtotals or totals have dollar signs. Also when multiple items exist within a classification, these items are grouped together in a

separate column (to the left of the main column) and their total is placed in the main column.

EXAMPLE 1.2 illustrates the steps in the preparation of a classified balance sheet.

EXAMPLE 1.2 PREPARING A CLASSIFIED BALANCE SHEET

Hightower Inc. reported the following account balances at December 31:

Inventories	\$ 2,300	Accounts receivable	\$ 4,200	Accounts payable	\$ 3,750
Land	12,100	Cash	2,500	Common stock	14,450
Salaries payable	1,200	Equipment	21,000	Patents	2,500
Retained earnings	11,300	Accumulated depreciation	5,800	Notes payable, long-term	8,100

Required:

Prepare Hightower's balance sheet at December 31.

Solution:

Hightower Inc. Balance Sheet December 31			}	Step 1		
ASSETS						
Current assets:			}			
Cash	\$ 2,500					
Accounts receivable	4,200					
Inventories	<u>2,300</u>					
Total current assets		\$ 9,000				
Property, plant, and equipment:			}	Step 2		
Land	\$12,100					
Equipment	21,000					
Less: accumulated depreciation	<u>(5,800)</u>					
Total property, plant, and equipment		27,300				
Intangible assets:			}			
Patents		<u>2,500</u>				
Total assets		<u>\$38,800</u>				
LIABILITIES AND STOCKHOLDERS' EQUITY			}			
Current liabilities:					}	Step 3
Accounts payable	\$ 3,750					
Salaries payable	<u>1,200</u>					
Total current liabilities		\$ 4,950				
Long-term liabilities:			}	Step 4		
Notes payable		<u>8,100</u>				
Total liabilities		\$13,050				
Stockholders' equity:					}	Step 5
Common stock	\$14,450					
Retained earnings	<u>11,300</u>					
Total stockholders' equity		25,750				
Total liabilities and stockholders' equity		<u>\$38,800</u>				

USING BALANCE SHEET INFORMATION

The balance sheet conveys important information about the structure of assets, liabilities, and stockholders’ equity, which is used to judge a company’s financial health. For example, the relationship between current assets and current liabilities gives investors and creditors insights into a company’s **liquidity**—the ability to pay obligations as they become due. Two useful measures of liquidity are *working capital* and the *current ratio*. Working capital and current ratios for a company are helpful when compared to other companies in the same industry. It is even more helpful to look at the trend of these measures over several years.

Working Capital Working capital is a measure of liquidity, computed as:

Working Capital = Current Assets – Current Liabilities

Because current liabilities will be settled with current assets, **Apple’s** working capital of \$57,101 million (\$162,819 million – \$105,718 million) signals that it has adequate funds with which to pay its current obligations. Because working capital is expressed in a dollar amount, the information it can convey is limited. For example, comparing Apple’s working capital to **Intel’s** working capital of \$8,929 million would be misleading since Apple is \$201,992 million larger (in terms of assets).

Current Ratio The **current ratio** is an alternative measure of liquidity that allows comparisons to be made between different companies and is computed as:

Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

For example, **Apple’s** current ratio of 1.54 (\$162,819 million ÷ \$105,718 million) can be compared with its competitors (e.g., Intel’s current ratio is 1.40).³ Apple’s current ratio tells us that for every dollar of current liabilities, Apple has \$1.54 of current assets. When compared to **Intel**, Apple is slightly more liquid.

YOUDECIDE

Assessing the Creditworthiness of a Prospective Customer

You are the regional credit manager for Nordic Equipment Company. Thin Inc., a newly organized health club, has offered to purchase \$50,000 worth of exercise equipment by paying the full amount plus 9% interest in 6 months. At your request, Thin provides the following figures from its balance sheet:

Current Assets		Current Liabilities	
Cash	\$ 10,000	Accounts payable	\$25,000
Accounts receivable	50,000	Notes payable	30,000
Supplies	4,000	Current portion of mortgage payable	18,000
Total	<u>\$64,000</u>	Total	<u>\$73,000</u>

Based on what you know about Thin’s current assets and liabilities, do you allow the company to purchase the equipment on credit?

In making your decision, it is important to consider the relationship between a company’s current assets and its current liabilities. Observe that Thin’s current liabilities exceed current assets by \$9,000 (\$64,000 – \$73,000) resulting in negative working capital. In addition, Thin’s current ratio is 0.88 (\$64,000 ÷ \$73,000). By all indications, Thin is suffering from liquidity issues. Finally, there is no evidence presented that Thin’s liquidity problem will improve. If Thin does fail to pay its liabilities, it is possible that the existing creditors could force Thin to sell its assets in order to pay off the debt. In such situations, it is possible that you will not receive the full amount promised. Unless Thin can demonstrate how it will pay its current short-term obligations, short-term credit should not be extended.

Allowing a company to purchase assets on credit requires evaluating the debtor’s ability to repay the loan out of current assets.

3 Information for Intel was obtained from a recent Form 10-K of Intel.

THE INCOME STATEMENT

The income statement reports the results of a company's operations—the sale of goods and services and the associated cost of operating the company—for a given period. The long-term survival of a company depends on its ability to produce net income by earning revenues in excess of expenses. Income enables a company to pay for the capital it uses (dividends to stockholders and interest to creditors) and attract new capital necessary for continued existence and growth. Investors buy and sell stock and creditors loan money based on their beliefs about a company's future performance. The past income reported on a company's income statement provides investors with information about a company's ability to earn future income.

OBJECTIVE 5

Prepare an income statement and explain the information it communicates.

ELEMENTS OF THE INCOME STATEMENT

The income statement consists of two major items:

- Revenues and gains
- Expenses and losses

An income statement for **Apple** is presented in Exhibit 1.8.

Income Statement of Apple Inc.

EXHIBIT 1.8

Apple Inc. Income Statement For the fiscal year ended Sept. 28, 2019 (in millions of dollars)		
Revenues:		
Net sales	\$260,174	
Interest and dividend income	4,961	
Other income	422	\$ 265,557
Expenses:		
Cost of goods sold	\$161,782	
Selling, general, and administrative expenses	18,245	
Research and development	16,217	
Interest expense	3,576	
Income taxes expense	10,481	(210,301)
Net income		\$ 55,256

Source: Apple Inc. 2019 10-K.

Examining the heading of the income statement, notice that it follows the same general format as the balance sheet—it indicates the name of the company, the title of the financial statement, and the time period covered by the statement. However, the income statement differs from the balance sheet in that it covers a period of time instead of a specific date.

Revenues and Gains **Revenues** are the increase in net assets that result from the sale of products or services. Revenues can arise from different sources and have different names depending on the source of the revenue. *Sales revenue* (or *service revenue* for companies that provide services) arises from the principal activity of the business. For **Apple**, its sales revenue comes from sales of hardware (such as computers, iPhones, iPads, and Apple Watches), software (operating systems), peripheral products and accessories, digital content (such as iTunes store sales),

and service and support (AppleCare and Apple Pay). Apple, like most other companies, recognizes sales revenue when it satisfies its obligation to its customer by transferring goods or performing services. This normally happens in the period that a sale occurs.

Gains are increases in net assets that occur from peripheral or incidental transactions. Thus, gains may be thought of as revenues from sources other than the sale of products or services. For example, Apple may recognize a gain when it sells one of its buildings. For simplicity, in this chapter, we will use the term “revenues” to refer to both revenues and gains.

Expenses and Losses **Expenses** are the cost of resources used to earn revenues during a period. Expenses have different names depending on their function. **Apple’s** income statement in Exhibit 1.8 reports five different expenses:

- *Cost of goods sold* (often called *cost of sales*)—the cost to the seller of all goods sold during the accounting period.⁴
- *Selling, general, and administrative expenses*—the expenses that a company incurs in selling goods, providing services, or managing the company that are not directly related to production. These expenses include advertising expenses; salaries paid to salespersons or managers; depreciation on administrative buildings; and expenses related to insurance, utilities, property taxes, and repairs.
- *Research and development expense*—the cost of developing new products.
- *Interest expense*—expense incurred as a result of borrowing money from creditors. Interest is often referred to as the time value of money.
- *Income taxes expense*—the income taxes paid on the company’s pretax income.

Losses are decreases in net assets that occur from peripheral or incidental transactions. Thus, losses may be thought of as expenses that are not associated with revenues. For example, a company may suffer a loss from flood damage. For simplicity, in this chapter, we will use the term “expenses” to refer to expenses and losses.

Net Income Net income, or net earnings, is the difference between total revenues and expenses. **Apple** reported net income of \$55,256 million (\$265,557 million – \$210,301 million). If total expenses are greater than total revenues, the company would report a net loss.

INCOME STATEMENT FORMATS

Companies prepare their income statements in one of two different formats: single-step income statements or multiple-step income statements.

Single-Step Income Statement In a single-step income statement, there are only two categories: total revenues and total expenses. Total expenses are subtracted from total revenues in a *single step* to arrive at net income. The advantage of a single-step income statement is its simplicity.

PREPARING A SINGLE-STEP INCOME STATEMENT The preparation of a single-step income statement involves four steps:

- Step 1.** Prepare a heading that includes the name of the company, the title of the financial statement, and the time period covered.
- Step 2.** List the revenues of the company, starting with sales revenue (or service revenue) and then listing other revenue items. Add the revenues to get total revenue.
- Step 3.** List the expenses of the company, usually starting with cost of goods sold. Add the expenses to get total expenses.
- Step 4.** Subtract the expenses from the revenues to get net income (or net loss if expenses exceed revenues). Double-underline net income.

⁴ We will discuss procedures for calculating cost of goods sold in Chapter 6.

In general, only the first items in a column as well as any subtotals or totals have dollar signs. Also when multiple items exist within a classification, these items are grouped together in a separate column (to the left of the main column) and their total is placed in the main column.

EXAMPLE 1.3 shows how to prepare a single-step income statement.

EXAMPLE 1.3 PREPARING A SINGLE-STEP INCOME STATEMENT

Hightower Inc. reported the following account balances for the year ending December 31:

Cost of goods sold	\$31,300	Interest expense	\$ 540
Salaries expense	8,800	Sales revenue	50,600
Insurance expense	700	Depreciation expense	1,500
Interest income	1,200	Rent expense	2,100
Income taxes expense	2,000		

Required:

Prepare a single-step income statement for Hightower for the year ending December 31.

Solution:

Hightower Inc. Income Statement For the year ended December 31			Step 1
Revenues:			Step 2
Sales revenue	\$50,600		
Interest income	<u>1,200</u>		
Total revenues		\$ 51,800	
Expenses:			Step 3
Cost of goods sold	\$31,300		
Salaries expense	8,800		
Rent expense	2,100		
Depreciation expense	1,500		
Insurance expense	700		
Interest expense	540		
Income taxes expense	<u>2,000</u>		Step 4
Total expenses		(46,940)	
Net income		<u>\$ 4,860</u>	

Multiple-Step Income Statement A second income statement format is the *multiple-step income statement*. The multiple-step income statement organizes revenues and expenses into multiple categories. The resulting subtotals highlight important relationships between revenues and expenses that financial statement users find useful. A multiple-step income statement contains three important subtotals: gross margin, income from operations, and net income. A multiple-step income statement for **Apple** is shown in Exhibit 1.9.

EXHIBIT 1.9

Multiple-Step Income Statement for Apple Inc.

Apple Inc. Income Statement For the fiscal year ended Sept. 28, 2019 (in millions of dollars)		
Net sales	\$ 260,174	
Cost of goods sold	<u>(161,782)</u>	
Gross margin		\$ 98,392
Operating expenses:		
Research and development expense	\$ 16,217	
Selling, general, and administrative expenses	<u>18,245</u>	
Total operating expenses		<u>(34,462)</u>
Income from operations		\$ 63,930
Other income and expense:		
Interest and dividend income	\$ 4,961	
Interest expense	<u>(3,576)</u>	
Other income	<u>422</u>	<u>1,807</u>
Income before income taxes		\$ 65,737
Income taxes expense		<u>(10,481)</u>
Net income		<u>\$ 55,256</u>

Source: Apple Inc. 2019 10-K.

GROSS MARGIN A company's **gross margin (or gross profit)** is calculated as:

$$\text{Gross Margin} = \text{Net Sales} - \text{Cost of Goods Sold}$$

Gross margin represents the initial profit made from selling a product, but it is *not* a measure of total profit because other operating expenses have not yet been subtracted. However, gross margin is closely watched by managers and other financial statement users. A change in a company's gross margin can give insights into a company's current pricing and purchasing policies, thereby providing insight into the company's future performance.

INCOME FROM OPERATIONS **Income from operations** is computed as:

$$\text{Income from Operations} = \text{Gross Margin} - \text{Operating Expenses}$$

Operating expenses are the expenses the business incurs in selling goods or providing services and managing the company. Operating expenses typically include research and development expenses, selling expenses, and general and administrative expenses. Income from operations indicates the level of profit produced by the principal activities of the company. **Apple** can increase its income from operations by either increasing its gross margin or decreasing its operating expenses.

NONOPERATING ACTIVITIES A multiple-step income statement reports nonoperating activities in a section which is frequently called *other income and expenses*. **Nonoperating activities** are revenues and expenses from activities other than the company's principal operations. They include gains and losses from the sale of equipment and other items that were not acquired for resale. For many companies, the most important nonoperating item is interest and investment income. Exhibit 1.10 lists some common nonoperating items.

Typical Nonoperating Items

EXHIBIT 1.10

Other Revenues and Gains



Interest income on investments
Dividend income from investments in stock of other companies
Rent revenue
Gains on disposal of property, plant, and equipment

Other Expenses and Losses



Interest expense from loans
Losses from disposal of property, plant, and equipment
Losses from accidents or vandalism
Losses from employee strikes
Income taxes expense

NET INCOME Nonoperating items are subtracted from income from operations to obtain income before taxes. Income taxes expense is then subtracted to obtain net income. Regardless of whether a single-step or multiple-step format is used, notice that there is no difference in the amount of the revenue or expense items reported. That is, net income is the same under either format. The only difference is how the revenues and expenses are classified.

PREPARING A MULTIPLE-STEP INCOME STATEMENT The preparation of a multiple-step income statement involves five steps:

- Step 1.** Prepare a heading that includes the name of the company, the title of the financial statement, and the time period covered.
- Step 2.** Compute gross profit as the difference between net sales and cost of goods sold.
- Step 3.** Compute income from operations by subtracting operating expenses from gross profit.
- Step 4.** Compute income before income taxes by subtracting nonoperating activities from income from operations.
- Step 5.** Compute net income (or net loss) by subtracting income taxes expense from income before income taxes. Double-underline net income.

EXAMPLE 1.4 shows how to prepare a multiple-step income statement.

EXAMPLE 1.4 PREPARING A MULTIPLE-STEP INCOME STATEMENT

Hightower Inc. reported the following account balances for the year ending December 31:

Cost of goods sold	\$31,300	Interest expense	\$ 540
Salaries expense	8,800	Sales revenue	50,600
Insurance expense	700	Depreciation expense	1,500
Interest income	1,200	Rent expense	2,100
Income taxes expense	2,000		

Required:

Prepare a multiple-step income statement for Hightower for the year ending December 31.

CONTINUED

EXAMPLE 1.4 PREPARING A MULTIPLE-STEP INCOME STATEMENT (CONTINUED)**Solution:**

Hightower Inc. Income Statement For the year ended December 31			}	Step 1
Sales revenue	\$ 50,600		}	Step 2
Cost of goods sold	<u>(31,300)</u>			
Gross margin		\$ 19,300		
Operating expenses:			}	Step 3
Salaries expense	\$ 8,800			
Rent expense	2,100			
Depreciation expense	1,500			
Insurance expense	<u>700</u>			
Total operating expenses		<u>(13,100)</u>		
Income from operations		\$ 6,200	}	Step 4
Other income and expenses:				
Interest income	\$ 1,200			
Interest expense	<u>(540)</u>			
Total other income and expenses		660	}	Step 5
Income before income taxes		\$ 6,860		
Income taxes expense		<u>(2,000)</u>		
Net income		<u>\$ 4,860</u>		

USING INCOME STATEMENT INFORMATION

A company's ability to generate current income is useful in predicting its ability to generate future income. When investors believe that future income will improve, they will buy stock. Similarly, creditors rely on their judgments of a company's future income to make loans. Investors' and creditors' estimates of the future profitability and growth of a company are aided by a careful examination of how a company has earned its revenue and managed its expenses.

Net Profit Margin A useful measure of a company's ability to generate profit is its **net profit margin** (sometimes called return on sales). Net profit margin shows the percentage of profit in each dollar of sales revenue (or service revenue) and is computed as:

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Sales (or Service) Revenue}}$$

This ratio provides an indication of management's ability to control expenses. Future income depends on maintaining (or increasing) market share while controlling expenses.



YOUDECIDE Assessing Future Profitability

You are looking to invest in one of two companies in the same industry—Graebel Inc. or Stanley Company. Your initial examination revealed that both companies reported the same amount of net income for 2024. Further analysis produced the following 5-year summary:

Graebel Inc.					
	2020	2021	2022	2023	2024
Sales revenue	\$625,000	\$750,000	\$820,000	\$920,000	\$1,000,000
Net income	\$ 30,000	\$ 36,000	\$ 40,000	\$ 45,000	\$ 50,000
Profit margin	4.8%	4.8%	4.9%	4.9%	5.0%

Stanley Company					
	2020	2021	2022	2023	2024
Sales revenue	\$1,025,000	\$975,000	\$940,000	\$1,020,000	\$1,040,000
Net income	\$ 51,000	\$ 48,000	\$ 46,000	\$ 49,000	\$ 50,000
Profit margin	5%	4.9%	4.9%	4.8%	4.8%

Which company is the better investment?

Investors seek those investments that will provide the largest return at the lowest risk. One factor associated with large returns is future profitability. Over the last 5 years, Graebel's sales and net income have steadily increased while Stanley's sales and net income have remained, on average, stable. Sales growth is an indicator of the possibility of increasing future income. Further, Graebel's increasing profit margin (compared to a decreasing profit margin for Stanley) indicates that Graebel is doing a better job at controlling its expenses relative to Stanley, enabling Graebel to earn more profit on each dollar of sales. While the future never can be predicted with certainty, the data suggest that, if current trends continue, Graebel will grow more rapidly than Stanley. Therefore, an investment in Graebel would probably yield the larger future return.

Accounting information can help you judge a company's potential for future profitability and growth.

RETAINED EARNINGS STATEMENT

The owners of a company contribute capital in one of two ways:

- directly, through purchases of common stock from the company
- indirectly, by the company retaining some or all of the net income earned each year rather than paying it out in dividends

As noted earlier, the income earned by the company but not paid out in the form of dividends is called retained earnings. The retained earnings statement summarizes and explains the changes in retained earnings during the accounting period.⁵ The beginning balance in retained earnings is increased by net income earned during the year and decreased by any dividends that were declared. Exhibit 1.11 shows the retained earnings statement for **Apple**.

Notice the heading is similar to the heading for the income statement in that it covers a period of time instead of a specific date. In addition, **Apple** declared \$14,129 million of dividends. While many companies, such as Apple, provide its stockholders with a return on their investment in the form of dividends, many growing companies choose not to pay dividends in order to reinvest its earnings and support future growth.

OBJECTIVE 6

Prepare the retained earnings statement and explain the information it communicates.

⁵ Some companies may choose to report a statement of stockholders' equity, which explains the changes in all of the stockholders' equity accounts. This statement is discussed more fully in Chapter 10.

EXHIBIT 1.11

Retained Earnings Statement for Apple Inc.

Apple Inc. Retained Earnings Statement For the fiscal year ended Sept. 28, 2019 (in millions of dollars)	
Retained earnings, Sept. 29, 2018	\$ 70,400
Add: Net income	55,256
	<u>\$125,656</u>
Less: Dividends declared	(14,129)
Other*	(65,629)
Retained earnings, Sept. 28, 2019	<u>\$ 45,898</u>

*The other items deducted in Apple's retained earnings statement are related to repurchases of common stock and common stock issued under Apple's stock plans. These items are beyond the scope of this text.

Source: Apple Inc. 2019 10-K.

PREPARING A RETAINED EARNINGS STATEMENT

The preparation of the retained earnings statement involves four steps:

- Step 1.** Prepare a heading that includes the name of the company, the title of the financial statement, and the time period covered.
- Step 2.** List the retained earnings balance at the beginning of the period obtained from the balance sheet.
- Step 3.** Add net income obtained from the income statement.
- Step 4.** Subtract any dividends declared during the period. Double-underline the total, which should equal retained earnings at the end of the period as reported on the balance sheet.

The preparation of a retained earnings statement is detailed in **EXAMPLE 1.5**.

EXAMPLE 1.5 PREPARING A RETAINED EARNINGS STATEMENT

Hightower Inc. reported the following account balances for the year ending December 31:

Net income	\$4,860	Retained earnings, Jan. 1	\$ 9,440
Dividends declared	3,000	Retained earnings, Dec. 31	11,300

Required:

Prepare Hightower's retained earnings statement for the year ending December 31.

Solution:

Hightower Inc. Retained Earnings Statement For the year ended December 31		
Retained earnings, January 1	\$ 9,440	} Step 1
Add: Net income	4,860	} Step 2
Less: Dividends declared	(3,000)	} Step 3
Retained earnings, December 31	<u>\$11,300</u>	} Step 4



YOU DECIDE Dividend Policy Decisions

You are the manager of a fast-growing software engineering firm. Over the last 5 years, your company has doubled the amount of its income every year. This tremendous growth has been financed through funds obtained from stockholders and cash generated from operations. The company has virtually no debt.

How would you respond to stockholders who have recently complained that the company's policy not to pay dividends is preventing them from sharing in the company's success?

Retained earnings can be an important source of financing for many companies. When companies feel that they have

profitable growth opportunities, they should reinvest the earnings in the business instead of paying out the amount to stockholders as dividends. The reinvestment of these funds should result in higher stock prices (and increased wealth for the stockholders) as the company grows. If the company chose to pay a dividend, it would be forced to either abandon the growth opportunities or finance them through some other, more costly method (e.g., issuing debt).

When management feels that the company has growth opportunities that will increase the value of the company, the reinvestment of earnings is usually preferable.

USE OF THE RETAINED EARNINGS STATEMENT

The retained earnings statement is used to monitor and evaluate a company's dividend payouts to its shareholders. For example, some older investors seek out companies with high dividend payouts so that they will receive cash during the year. Other investors are more interested in companies that are reinvesting a sufficient amount of earnings that will enable them to pursue profitable growth opportunities. Finally, creditors are interested in a company's dividend payouts. If a company pays out too much in dividends, the company may not have enough cash on hand to repay its debt when it becomes due.

STATEMENT OF CASH FLOWS

The last of the major financial statements, the statement of cash flows, describes the company's cash receipts (cash inflows) and cash payments (cash outflows) for a period of time. The statement of cash flows for **Apple** is shown in Exhibit 1.12.

OBJECTIVE 7

Identify the information communicated by the statement of cash flows.

Statement of Cash Flows

EXHIBIT 1.12

Apple Inc. Statement of Cash Flows For the fiscal year ended Sept. 28, 2019 (in millions of dollars)		
Cash at the beginning of the year		25,913
Net cash provided from operating activities	\$ 69,391	
Net cash used by investing activities	45,896	
Net cash used by financing activities	(90,976)	
Net change in cash		\$ 24,311
Cash at the end of the year		<u>\$50,224</u>

Source: Apple Inc. 2019 10-K.

ELEMENTS OF THE STATEMENT OF CASH FLOWS

Cash flows are classified into one of three categories:

- **Cash flows from operating activities**—any cash flows directly related to earning income. This category includes cash sales and collections of accounts receivable as well as cash payments for goods, services, salaries, and interest.
- **Cash flows from investing activities**—any cash flow related to the acquisition or sale of investments and long-term assets such as property, plant, and equipment. Note that the cash flows from investing activities of a healthy, growing business often reflect an excess of expenditures over receipts.
- **Cash flows from financing activities**—any cash flow related to obtaining capital of the company. This category includes the issuance and repayment of debt, common stock transactions, and the payment of dividends.

The preparation of the statement of cash flows will be discussed in Chapter 11.

USE OF THE STATEMENT OF CASH FLOWS

Because cash is the lifeblood of any company and is critical to success, the statement of cash flows can be an important source of information as users attempt to answer how a company generated and used cash during a period. Such information is helpful as users assess the company's ability to generate cash in the future. Creditors can use the statement of cash flows to assess the creditworthiness of a company. A company with healthy cash flow—particularly if it comes from operating activities—is in a good position to repay debts as they come due and is usually a low-risk borrower. Stockholders are also interested in the adequacy of cash flows as an indicator of the company's ability to pay dividends and to expand its business. The statement of cash flows is covered in more detail in Chapter 11.

OBJECTIVE 8

Describe the relationships among the financial statements.

RELATIONSHIPS AMONG THE STATEMENTS

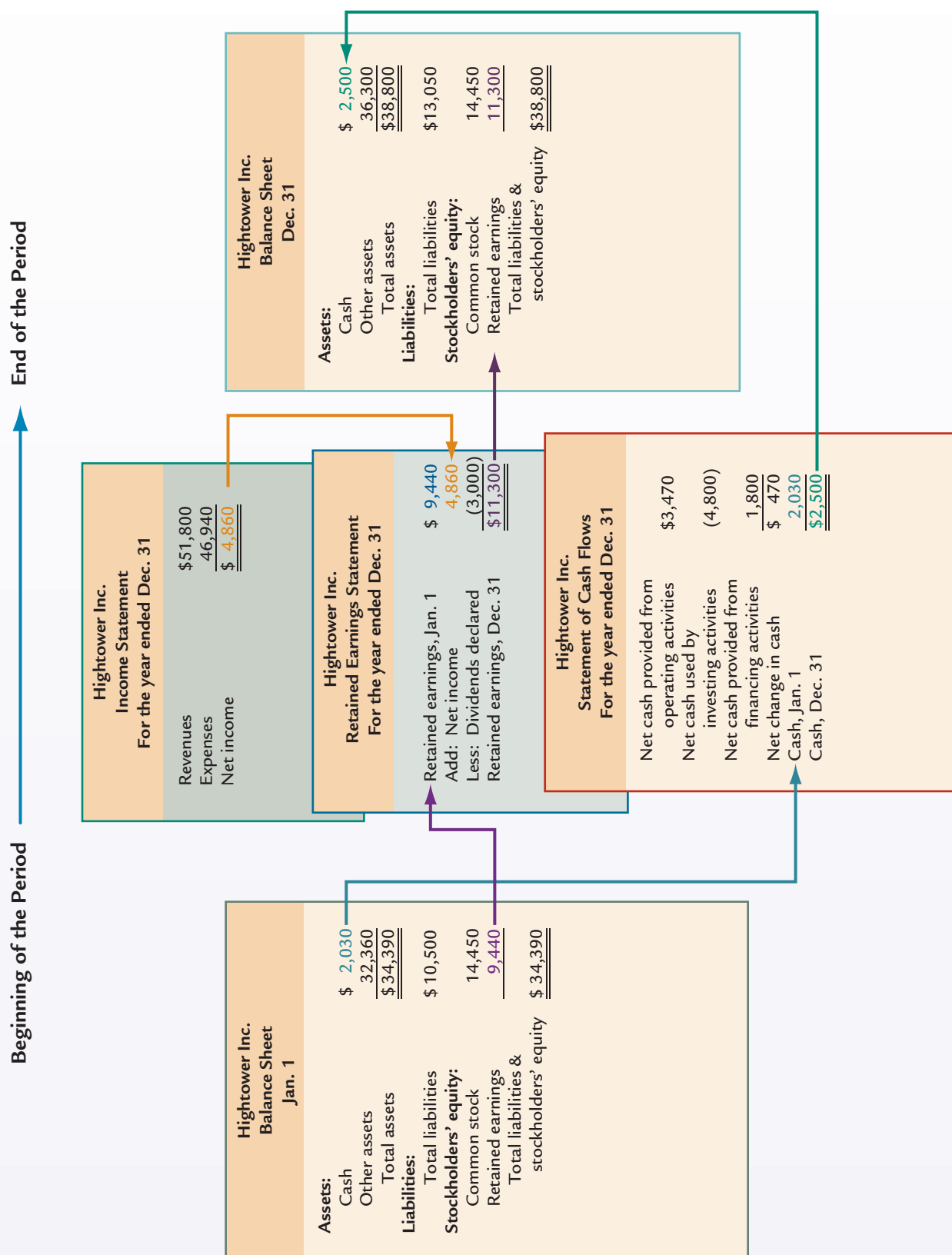
At this point, it is important to notice the natural relationships of the four basic financial statements and the natural progression from one financial statement to another. The accounting period begins with a balance sheet. During the year, the company earns net income from operating its business. Net income from the income statement increases retained earnings on the retained earnings statement. Ending retained earnings is then reported in the stockholders' equity section of the balance sheet at the end of the accounting period. Finally, the statement of cash flows explains the change in cash during the year. These relationships are shown in Exhibit 1.13 (p. 27).

The relationships create linkages between the financial statements, referred to as **articulation** of the financial statements. The three key linkages are as follows:

- The income statement links the beginning and ending balance sheet through the retained earnings account. Therefore, the income statement can be viewed as explaining, through retained earnings, the change in the financial position during the year.
- The statement of stockholders' equity links the beginning and ending balances of equity in the balance sheet.
- The statement of cash flows links the beginning and ending balances of cash in the balance sheet.

Relationships Among the Financial Statements

EXHIBIT 1.13



OBJECTIVE 9

Explain the importance of ethics in providing useful financial information.

PROFESSIONAL ETHICS

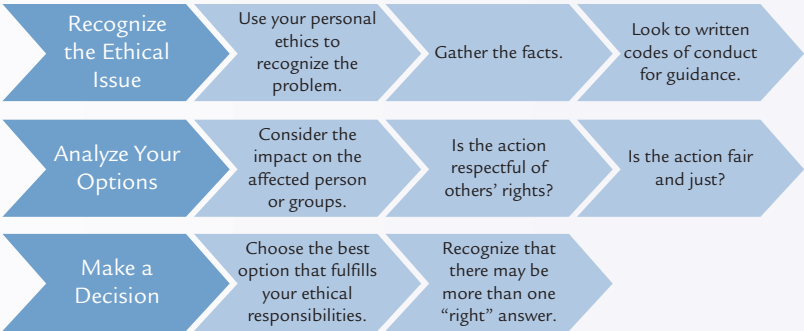
For the economy to function effectively and efficiently, users must have faith that the information reported in financial statements is accurate and dependable. Accountants are often under intense pressure to apply the accounting standards to present a company in a favorable light. However, accountants serve the greater good of society and have an ethical responsibility to all the users who make decisions based on the financial information presented. Confidence that standards of ethical behavior will be maintained—even when individuals have incentives to violate those standards—is crucial to the financial reporting process.

The American Institute of Certified Public Accountants (AICPA), recognizing that its members have an obligation of self-discipline above and beyond the requirements of generally accepted accounting principles, has adopted a code of professional conduct which provides ethical guidelines for accountants in the performance of their duties. These ethical principles require accountants to serve the public interest with integrity. For example, auditors should fulfill their duties with objectivity, independence, and due professional care. In no situation should an auditor yield to pressure from management to report positively on financial statements that overstate the company’s performance or prospects. Violation of these ethical standards can result in severe penalties, including revocation of an accountant’s license to practice as a certified public accountant.

Acting ethically is not always easy. The violation of ethical standards may not always bring clear and direct penalties; however, it often has subtle and long-lasting negative consequences for individuals and companies. Because of the important role of accounting in society, accountants are expected to maintain the highest level of ethical behavior. Throughout this book, you will be exposed to ethical dilemmas that we urge you to consider. As you analyze these cases, consider the guidelines in Exhibit 1.14.

EXHIBIT 1.14

Guidelines in Ethical Decision-Making





YOUDECIDE Career Analysis

As you consider various career options, keep in mind that virtually every organization must have an accounting system. Thus, accountants are employed in a wide range of businesses, including private companies, public accounting firms, governments, and banks. To help you evaluate whether an accounting career is right for you, consider the following question:

What skills and character traits are required for accountants?

Accountants must have well-developed analytical skills and must be effective communicators, both verbally and in writing. Most accounting assignments—whether in business, government, or public accounting—are team assignments in which team members must be able to communicate effectively and work quickly and cooperatively to a solution.

As a profession, accounting requires a high level of academic study and is subject to professional competence

requirements. Most members of public accounting firms, and many management accountants and consultants, are (or are in the process of becoming) Certified Public Accountants (CPAs). Other valuable professional certifications are the Certified Management Accountant (CMA), the Certified Internal Auditor (CIA), and the Certified Fraud Examiner (CFE) designations. All of these designations are designed to ensure that the accountants who offer their services are properly qualified and maintain a high level of personal integrity and ethical behavior.

While the career opportunities for accountants are virtually boundless, even if you choose a different career path, the knowledge and experience that you can gain from accounting will prove invaluable in your career.

Accountants must possess strong analytical and communication skills, demonstrate professional competency, and behave ethically.

REVIEW CENTER

LO1. Explain the nature of accounting.

KEY TAKEAWAYS

- Accounting is an information system that identifies, measures, records, and communicates financial information.
- The information is used both inside and outside of the business to make better decisions.
- Financial accounting focuses on the needs of external decision-makers.

KEY TERMS

Accounting, 4
Financial accounting, 5

LO2. Identify the forms of business organizations and the types of business activities.

KEY TAKEAWAYS

- The three forms of business organizations are as follows:
 - Sole proprietorship—owned by one person
 - Partnership—jointly owned by two or more individuals
 - Corporation—a separate legal entity organized under the laws of a particular state
- Regardless of the form of business, all businesses are involved in three activities:
 - Financing activities—obtaining funds (from either issuing stock or borrowing money) necessary to begin and operate the business
 - Investing activities—buying the assets that enable a business to operate
 - Operating activities—the activities of a business that generate a profit

KEY TERMS

Assets, 7	Net loss, 8
Corporation, 5	Partnership, 5
Creditor, 7	Revenue, 8
Expenses, 8	Sole proprietorship, 5
Liability, 7	Stockholders' equity, 7
Net income, 8	

KEY TAKEAWAYS

- The fundamental accounting equation captures all of the economic activities recorded by an accounting system.
- The left side of the accounting equation shows the assets, or economic resources, of a company.
- The right side of the accounting equation shows the claims on the company's assets (liabilities or stockholders' equity).

KEY TERMS

Balance sheet, 9

Financial Accounting Standards Board (FASB), 9

Financial statements, 8

Fundamental accounting equation, 10

Generally accepted accounting principles (GAAP), 9

Income statement, 9

International Accounting Standards Board (IASB), 10

International financial reporting standards (IFRS), 10

Retained earnings statement, 9

Securities and Exchange Commission (SEC), 9

Statement of cash flows, 9

KEY CALCULATION

Assets = Liabilities + Stockholders' Equity

EXAMPLE

EXAMPLE 1.1 Using the fundamental accounting equation, page 10

KEY TAKEAWAYS

- A balance sheet reports the resources (assets) owned by a company and the claims against those resources (liabilities and stockholders' equity) at a specific point in time.
- In order to help users identify the fundamental economic similarities and differences between the various items on the balance sheet, assets and liabilities are classified as either current or noncurrent (long-term). Stockholders' equity is classified as either contributed capital or retained earnings.

LO3. Describe the relationships shown by the fundamental accounting equation.

LO4. Prepare a classified balance sheet and explain the information it communicates.