CENGAGE

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

# 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:

Assets = Liabilities + Stockholders' Equity

$125,000 = $75,000 + Stockholders' Equity

Stockholders' Equity = $125,000 − $75,000 = **$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:

Assets = Liabilities + Stockholders' Equity

($125,000 + $44,000) = Liabilities + ($50,000 + $15,000)

Liabilities = ($125,000 + $44,000) − ($50,000 + $15,000)

= $169,000 − $65,000 = **$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.

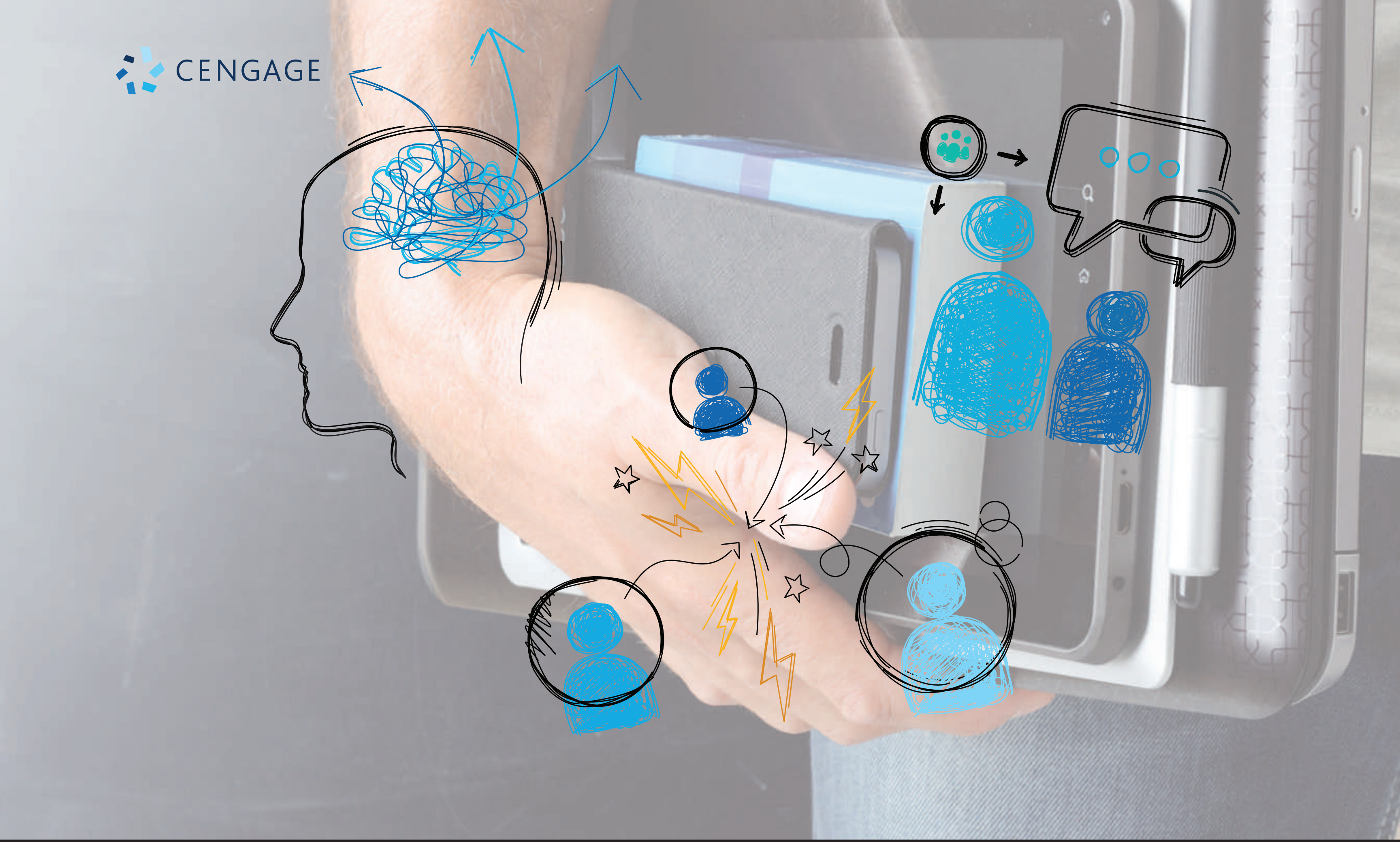
  - New PowerPoints, with a more interactive focus

  - 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

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

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

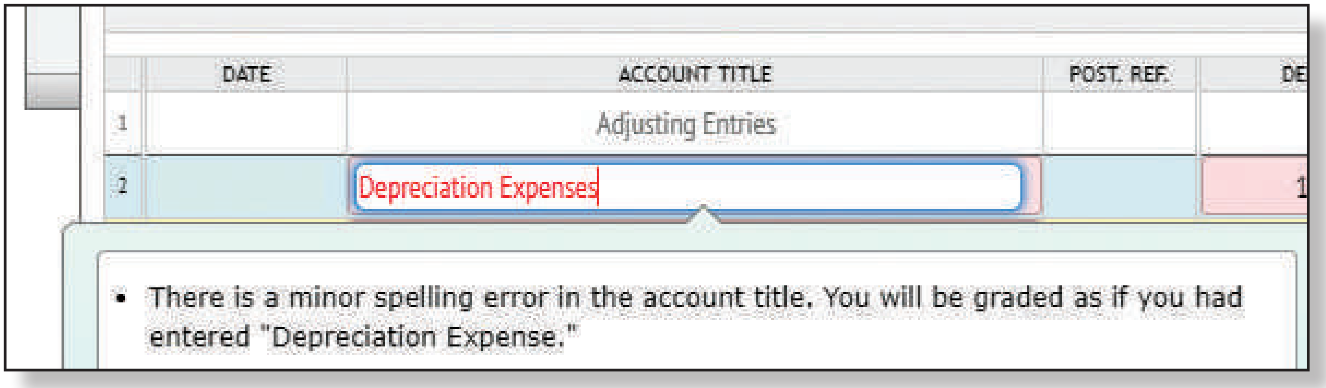
Chapter 1, Learning Objective 4:Show Me How: Accounting equation V3

Chapter 1, Learning Objective 4:Show Me How: Effect of transactions on accounting equation

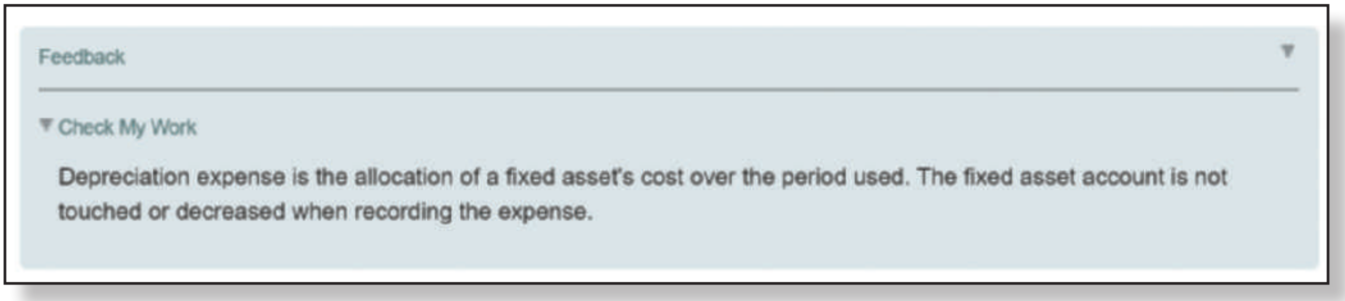
Chapter 1, Learning Objective 4:Show Me How: Nature of transactions

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.




- **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."

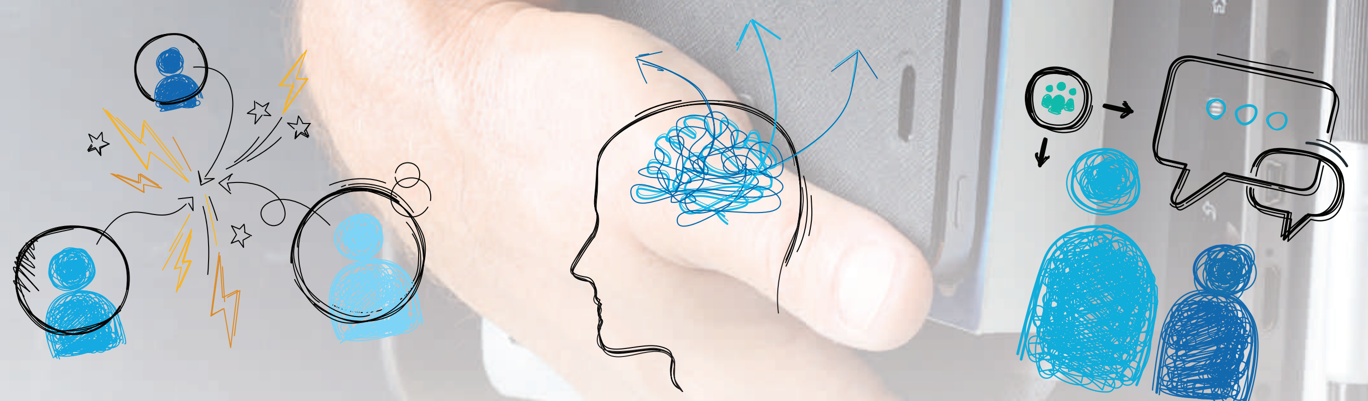



**Students ace the homework but bomb the exam.** Online homework is very popular in accounting, but students all too often try to game the system and guess their way through the homework. Then, when students get to the exam, they discover that they can't complete a journal entry or build a financial 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.

MindTap eReader. The MindTap eReader is the most robust digital reading experience available. Fully optimized for the iPad. Note-taking, highlighting, and more. Offline access to smartphones. The MindTap eReader also features ReadSpeaker®, an online text-to-speech application that vocalizes, or "speechenables," online educational content.

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- All videos are created with closed captioning and transcripts available for download.
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For more information on accessibility, please visit www.cengage.com/accessibility.

# SUPERIOR SUPPLEMENTS

CENGAGENOWv2

## SOLUTIONS MANUAL

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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**DR. LINDA A. MYERS** is a Distinguished Professor of Accounting and holder of the Haslam Chair of Business at the University of Tennessee, Knoxville (UTK). She graduated from the University of Michigan and has published more than 40 peer-reviewed articles in *The Accounting Review*, *Journal of Accounting and Economics*, *Journal of Accounting Research*, *Contemporary Accounting Research*, *Review of Accounting Studies*, and *Accounting, Organizations and Society*, among others. She has also received the AAA's Notable Contribution to the Auditing Literature Award, the AAA's Financial Accounting and Reporting Section Best Paper Award, and the Financial Executives Research Foundation's Award for the Outstanding *Accounting Review* Article. Her research has been cited in the *New York Times* and *The Economist*, as well as by the Public Company Accounting Oversight Board and the U.S. Securities and Exchange Commission, and she has been quoted on National Public Radio's *Marketplace Business*. Professor Myers serves as an Editor at *Contemporary Accounting Research*, *Auditing: A Journal of Practice & Theory*, *Accounting Horizons*, *Journal of International Accounting Research*, and *CAFR*, as well as an Associate Editor at *Journal of Accounting, Auditing & Finance*, and on the Editorial Boards of *The Accounting Review* and *European Accounting Research*. She has taught financial accounting, managerial accounting, and Ph.D. seminars at McMaster University, University of Illinois, Texas A&M University, University of Arkansas, and UTK and currently serves as Director of the Ph.D. Program in Accounting at UTK. When she is not traveling around the globe, Professor Myers enjoys playing board games, cooking and entertaining, and spending time with her husband and her two children.

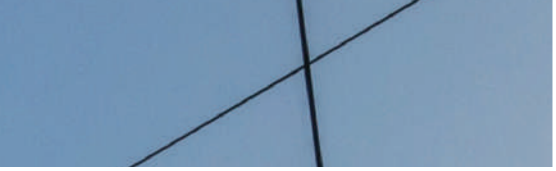
# CONTENTS

# 1 Accounting and the Financial Statements

Andrej Sokolow/picture alliance/Getty Images

**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.



# 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?

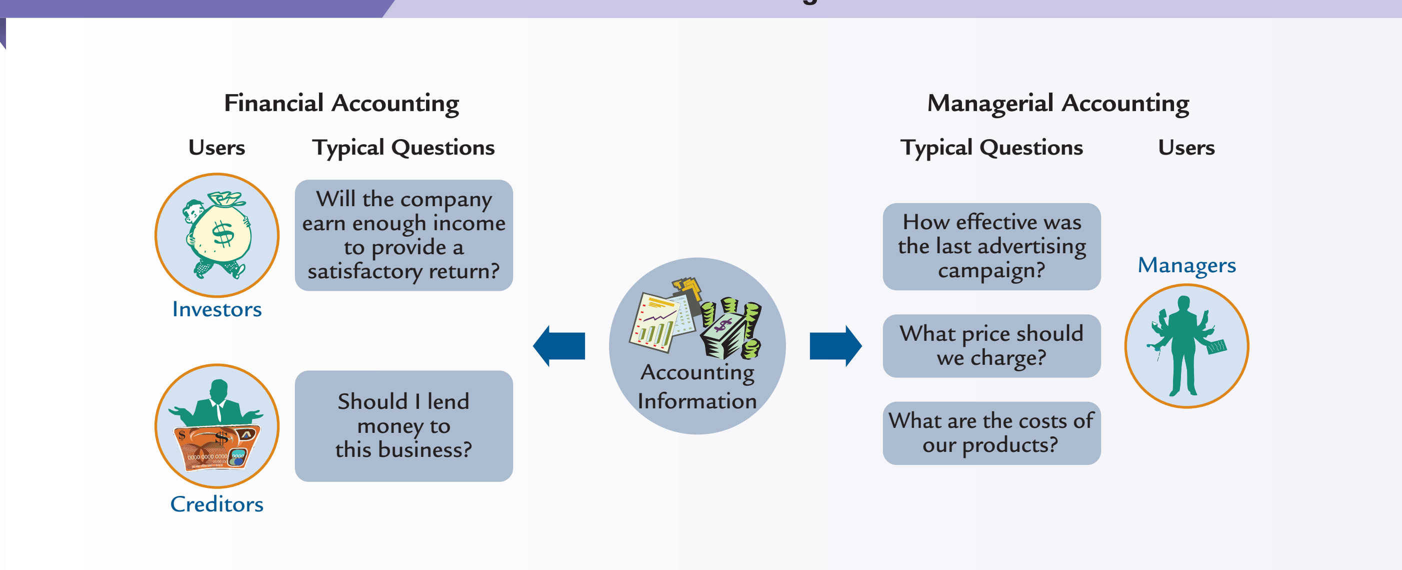
Our economy is comprised of many different businesses. Some companies, such as **Apple Inc.**, focus on providing goods, which for Apple take many forms including desktop and laptop computers, iPads, iPhones, Apple Watches, and downloadable music. Other companies are primarily concerned with providing 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.

**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.

# BUSINESSES: FORMS AND ACTIVITIES

**OBJECTIVE 2**
Identify the forms of business organizations and the types of business 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

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**

- Easily formed (+)
- Tax advantages (+)
- Controlled by owner (+)
- Personal liability (−)
- Limited life (−)

**Partnership**

- Access to the resources and skills of partners (+)
- Tax advantages (+)
- Shared control (−)
- Personal liability (−)

**Corporation**

- Easier to raise money (+)
- Easier to transfer ownership (+)
- Limited liability (+)
- More complex to organize (−)
- Higher taxes (−)

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

## YOUDECIDE 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.

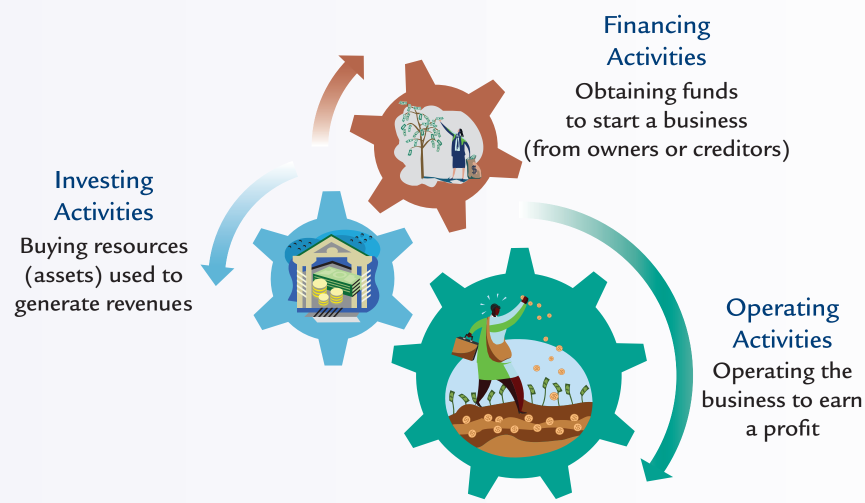
**The choice of organizational form involves the consideration of many different factors.**

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.

**Business Activities** 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?

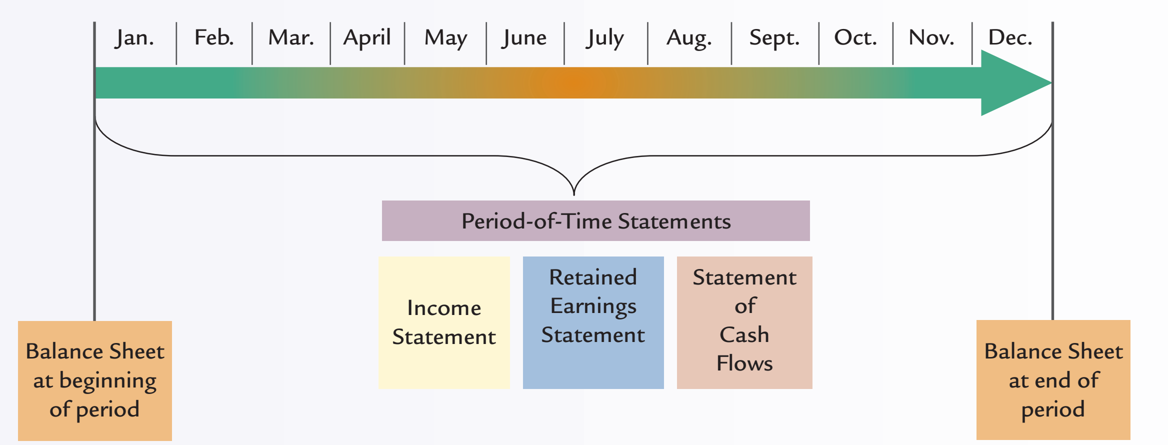
## THE FOUR BASIC FINANCIAL STATEMENTS

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.

**Financial Statement Time Periods** 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.

Assets = Liabilities + 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:

Assets = Liabilities + Stockholders' Equity

$125,000 = $75,000 + Stockholders' Equity

Stockholders' Equity = $125,000 − $75,000 = **$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:

Assets = Liabilities + Stockholders' Equity

($125,000 + $44,000) = Liabilities + ($50,000 + $15,000)

Liabilities = ($125,000 + $44,000) − ($50,000 + $15,000)

= $169,000 − $65,000 = **$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

**OBJECTIVE 4**

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

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:

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

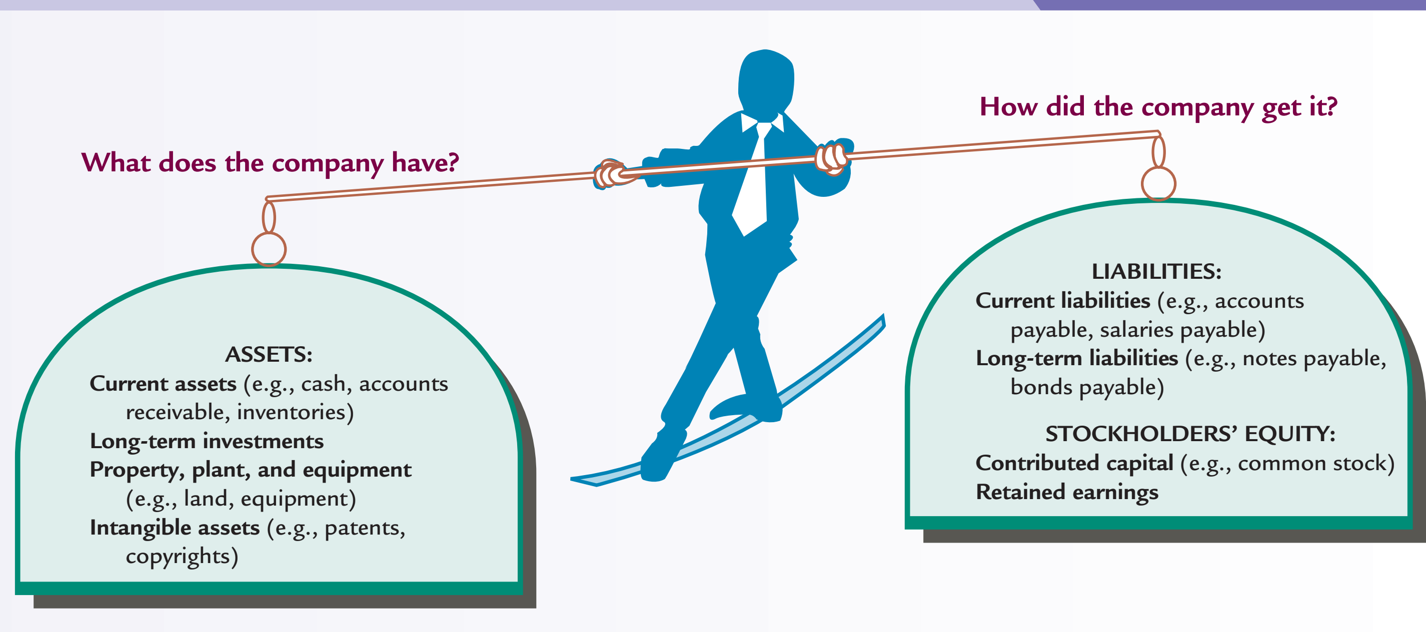
Note that the balance sheet gets its name because the economic resources of a company (assets) must always equal, or be in balance with, the claims against those resources (liabilities and stockholders' equity).

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.

**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 | | $ 338,516 |
| **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 | | $ 338,516 |

*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 million ÷ $338,516 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.<br>Balance Sheet<br>December 31<br>ASSETS | | | |
|---|---|---|---|
| Current assets: | | | Step 1 |
| Cash | $ 2,500 | | |
| Accounts receivable | 4,200 | | |
| Inventories | 2,300 | | |
| Total current assets | | $ 9,000 | |
| Property, plant, and equipment: | | | |
| Land | $12,100 | | Step 2 |
| Equipment | 21,000 | | |
| Less: accumulated depreciation | (5,800) | | |
| Total property, plant, and equipment | | 27,300 | |
| Intangible assets: | | | |
| Patents | | 2,500 | |
| Total assets | | $38,800 | |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | | |
| Current liabilities: | | | |
| Accounts payable | $ 3,750 | | |
| Salaries payable | 1,200 | | |
| Total current liabilities | | $ 4,950 | Step 3 |
| Long-term liabilities: | | | |
| Notes payable | | 8,100 | |
| Total liabilities | | $13,050 | |
| Stockholders' equity: | | | |
| Common stock | $14,450 | | Step 4 |
| Retained earnings | 11,300 | | |
| Total stockholders' equity | | 25,750 | |
| Total liabilities and stockholders' equity | | $38,800 | Step 5 |

## 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:

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

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:

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

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.

### YOU DECIDE 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 | $64,000 | Total | $73,000 |

**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

**OBJECTIVE 5**
Prepare an income statement and explain the information it communicates.

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.

## 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.<br>Income Statement<br>For the fiscal year ended Sept. 28, 2019<br>(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.<br>Income Statement<br>For the year ended December 31 | | | |
|---|---|---|---|
| | | | Step 1 |
| Revenues: | | | Step 2 |
| Sales revenue | $50,600 | | |
| Interest income | 1,200 | | |
| 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 | 2,000 | | |
| Total expenses | | (46,940) | |
| Net income | | $ 4,860 | Step 4 |

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

**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 | Other Expenses and Losses |
|---|---|
| Interest income on investments | Interest expense from loans |
| Dividend income from investments in stock of other companies | Losses from disposal of property, plant, and equipment |
| Rent revenue | Losses from accidents or vandalism |
| Gains on disposal of property, plant, and equipment | 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.<br>Income Statement<br>For the year ended December 31 | | | |
|---|---|---|---|
| Sales revenue | $ 50,600 | | Step 2 |
| Cost of goods sold | (31,300) | | |
| Gross margin | | $ 19,300 | |
| Operating expenses: | | | Step 3 |
| Salaries expense | $ 8,800 | | |
| Rent expense | 2,100 | | |
| Depreciation expense | 1,500 | | |
| Insurance expense | 700 | | |
| Total operating expenses | | (13,100) | |
| Income from operations | | $ 6,200 | |
| Other income and expenses: | | | |
| Interest income | $ 1,200 | | Step 4 |
| Interest expense | (540) | | |
| Total other income and expenses | | 660 | |
| Income before income taxes | | $ 6,860 | |
| Income taxes expense | | (2,000) | Step 5 |
| Net income | | $ 4,860 | |

Step 1: heading (Hightower Inc. / Income Statement / For the year ended December 31)

## 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

**OBJECTIVE 6**

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

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

- directly, though 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.

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

*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.<br>Retained Earnings Statement<br>For the year ended December 31 | | Step 1 |
|---|---|---|
| Retained earnings, January 1 | $ 9,440 | Step 2 |
| Add: Net income | 4,860 | Step 3 |
| Less: Dividends declared | (3,000) | Step 4 |
| Retained earnings, December 31 | **$11,300** | |

## 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

**OBJECTIVE 7**

Identify the information communicated by the 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.

**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 | | $50,224 |

**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.

## EXHIBIT 1.13

### Relationships Among the Financial Statements

Beginning of the Period → End of the Period

**Hightower Inc.**
**Balance Sheet**
**Jan. 1**

| | |
|---|---|
| **Assets:** | |
| Cash | $ 2,030 |
| Other assets | 32,360 |
| Total assets | $ 34,390 |
| **Liabilities:** | |
| Total liabilities | $ 10,500 |
| **Stockholders' equity:** | |
| Common stock | 14,450 |
| Retained earnings | 9,440 |
| Total liabilities & stockholders' equity | $ 34,390 |

**Hightower Inc.**
**Income Statement**
**For the year ended Dec. 31**

| | |
|---|---|
| Revenues | $51,800 |
| Expenses | 46,940 |
| Net income | $ 4,860 |

**Hightower Inc.**
**Retained Earnings Statement**
**For the year ended Dec. 31**

| | |
|---|---|
| Retained earnings, Jan. 1 | $ 9,440 |
| Add: Net income | 4,860 |
| Less: Dividends declared | (3,000) |
| Retained earnings, Dec. 31 | $11,300 |

**Hightower Inc.**
**Statement of Cash Flows**
**For the year ended Dec. 31**

| | |
|---|---|
| Net cash provided from operating activities | $3,470 |
| Net cash used by investing activities | (4,800) |
| Net cash provided from financing activities | 1,800 |
| Net change in cash | $ 470 |
| Cash, Jan. 1 | 2,030 |
| Cash, Dec. 31 | $2,500 |

**Hightower Inc.**
**Balance Sheet**
**Dec. 31**

| | |
|---|---|
| **Assets:** | |
| Cash | $ 2,500 |
| Other assets | 36,300 |
| Total assets | $38,800 |
| **Liabilities:** | |
| Total liabilities | $13,050 |
| **Stockholders' equity:** | |
| Common stock | 14,450 |
| Retained earnings | 11,300 |
| Total liabilities & stockholders' equity | $38,800 |

**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**

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| Recognize the Ethical Issue | Use your personal ethics to recognize the problem. | Gather the facts. | Look to written codes of conduct for guidance. |
| Analyze Your Options | Consider the impact on the affected person or groups. | Is the action respectful of others' rights? | Is the action fair and just? |
| Make a Decision | Choose the best option that fulfills your ethical responsibilities. | Recognize that there may be more than one "right" answer. | |

## 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

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

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

## 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

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

## 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.