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Financial & Managerial Accounting

Financial and Managerial Accounting 15e

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***Financial and Managerial Accounting*, 15e**
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Preface

Roadmap for Success

Warren/Jones/Tayler *Financial and Managerial Accounting*, *15e*, provides a sound pedagogy for giving students a solid foundation in business and accounting. Warren/Jones/Tayler covers the fundamentals AND motivates students to learn by showing how accounting is important to businesses.

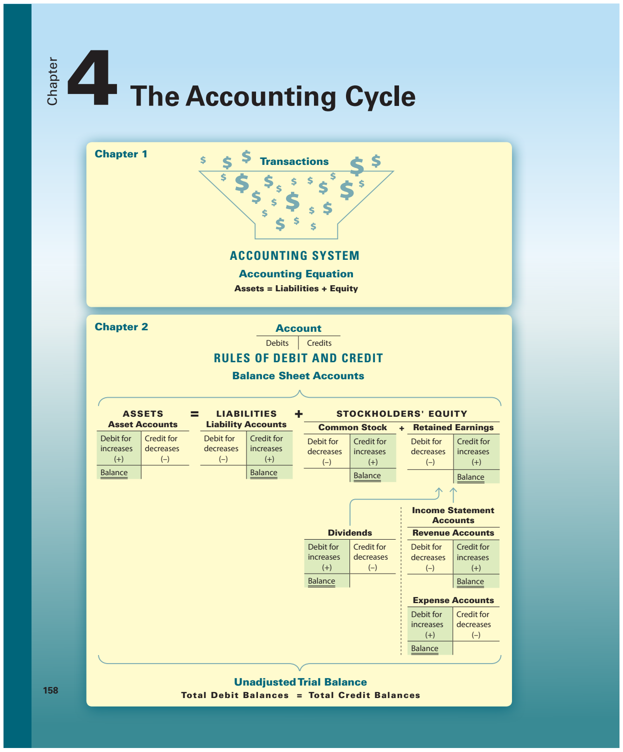
Warren/Jones/Tayler is successful because it reaches students with a combination of new and tried-and-tested pedagogy.

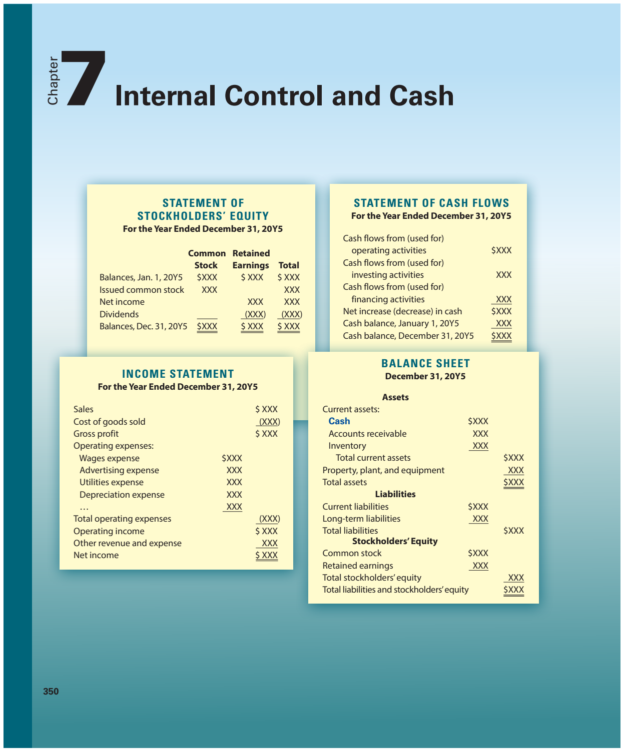
This revision includes a range of new and existing features that help Warren/Jones/Tayler provide students with the context to see how accounting is valuable to business. These include:

- New! Certified Management Accountant (CMA®) Examination Questions
- New! Make a Decision section
- New! Pathways Challenge

Warren/Jones/Tayler also includes a thorough grounding in the fundamentals that any business student will need to be successful. These key features include:

- Stepwise approach to accounting cycle
- Presentation style designed around the way students learn
- At the start of each chapter, **a schema, or roadmap, shows students what they are going to learn and how it is connected to the larger picture**. In the early chapters, the schema illustrates how the steps in the accounting cycle are interrelated. In later financial chapters, the schema shows how each chapter's topics are connected to the financial statements.





- The schema for the managerial chapters illustrates how the chapter content lays the foundation with managerial concepts and principles. Then it moves students through developing the information and ultimately into evaluating and analyzing information in order to make decisions.

Chapter 15 Introduction to Managerial Accounting

Principles
Chapter 15 *Introduction to Managerial Accounting*

Developing Information

COST SYSTEMS		COST ALLOCATIONS	
Chapter 16	*Job Order Costing*	Chapter 19	*Support Departments*
Chapter 17	*Process Costing*	Chapter 19	*Joint Costs*
Chapter 18	*Activity-Based Costing*		

Decision Making

PLANNING AND EVALUATING TOOLS		STRATEGIC TOOLS	
Chapter 20	*Cost-Volume-Profit Analysis*	Chapter 26	*Capital Investment Analysis*
Chapter 21	*Variable Costing*	Chapter 27	*Lean Manufacturing*
Chapter 22	*Budgeting Systems*	Chapter 27	*Activity Analysis*
Chapter 23	*Standard Costing and Variances*	Chapter 28	*The Balanced Scorecard*
Chapter 24	*Decentralized Operations*	Chapter 28	*Corporate Social Responsibility*
Chapter 25	*Differential Analysis*		

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Best Buy

Assume that in September you purchased a Sony HDTV from **Best Buy (BBY)**. At the same time, you purchased a Denon surround sound system for $599.99. You liked your surround sound so well that in November you purchased an identical Denon system on sale for $549.99 for your bedroom TV. Over the holidays, you moved to a new apartment and in the process of unpacking discovered that one of the Denon surround sound systems was missing. Luckily, your renters or homeowners insurance policy will cover the theft; but the insurance company needs to know the cost of the system that was stolen.

The Denon systems were identical. However, to respond to the insurance company, you will need to identify which system was stolen. Was it the first system, which cost $599.99, or was it the second system, which cost $549.99? Whichever assumption you make may determine the amount that you receive from the insurance company.

Businesses such as Best Buy make similar assumptions when identical merchandise is purchased at different costs. For example, Best Buy may have purchased thousands of Denon surround sound systems over the past year at different costs. At the end of a period, some of the Denon systems will still be in inventory, and some will have been sold. But which costs relate to the sold systems, and which costs relate to the Denon systems still in inventory? Best Buy's assumption about inventory costs can involve large dollar amounts and, thus, can have a significant impact on the financial statements. For example, Best Buy reported $5,051 million of inventory and net income of $897 million for a recent year.

This chapter discusses such issues as how to determine the cost of merchandise in inventory and the cost of goods sold. However, this chapter begins by discussing the importance of control over inventory.

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Best Buy uses scanners to screen customers as they leave the store for merchandise that has not been purchased. In addition, Best Buy stations greeters at the store's entrance to keep customers from bringing in bags that can be used to shoplift merchandise. *Link to Best Buy*

- **Link to the "opening company" of each chapter** calls out examples of how the concepts introduced in the chapter are connected to the opening company. **This shows how accounting is used in the real world by real companies.**

- **New! Pathways Challenge** encourages students' interest in accounting and emphasizes the critical thinking aspect of accounting. A suggested answer to the Pathways Challenge is provided at the end of the chapter.

Pathways Challenge

This is Accounting!

Economic Activity

Verizon Communications Inc. (VZ) is the largest wireless service provider in the United States with over 114 million retail subscribers. To deliver its products and services, Verizon must have access to spectrum—the radio frequencies that carry sound, data, and video to wireless devices. However, spectrum is a limited resource that the Federal Communications Commission (FCC) licenses to businesses for a period of 10 years, subject to renewal. In a recent year, Verizon acquired almost $10 billion in wireless licenses.

Critical Thinking/Judgment

How should Verizon account for its acquisition of wireless licenses?
What is the useful life of a wireless license?
Should Verizon expense (amortize) the cost of its wireless licenses?

Suggested answer at end of chapter.

Pathways Challenge

This is Accounting!

Information/Consequences

Because a wireless license does not exist physically, **Verizon**'s **(VZ)** wireless licenses are intangible assets. All of the costs of acquiring a wireless license should be recorded as an asset. In a recent year, Verizon reported almost $87 billion of wireless licenses, representing 35% of its total assets.

Even though the FCC license is granted for a 10-year period, Verizon considers this license to have an indefinite useful life. This is because the license is subject to renewal at a low cost and, historically, the FCC has renewed Verizon's licenses.

Verizon does not expense (amortize) the cost of its wireless licenses. Instead, the licenses are reviewed for any impaired value.

Suggested Answer

- Located in each chapter, **Why It Matters** shows students how accounting is important to businesses with which they are familiar. A Concept Clip icon indicates which Why It Matters features have an accompanying concept clip video in CNOWv2.

CONCEPT CLIP

Why It Matters

CONCEPT CLIP

Fixed Assets

Fixed assets often represent a significant portion of a company's total assets. The table that follows shows the fixed assets as a percent of total assets for some select companies across a variety of industries. As can be seen, the type of industry will impact the proportion of fixed assets to total assets. Retail has the highest percent of fixed assets to total assets, while social media and software are on the lower end of the scale. High-tech service companies often use fewer fixed assets to deliver their services than will companies that use stores, equipment, planes, cell towers, or theme parks.

Company	Industry	Percent of Fixed Assets to Total Assets
McDonald's Corporation (MCD)	Food Retail	69%
Target Corporation (TGT)	Merchandise Retail	63%
Delta Air Lines, Inc. (DAL)	Transportation	48%
Verizon Communications Inc. (VZ)	Communications	35%
The Walt Disney Company (DIS)	Entertainment	30%
Facebook, Inc. (FB)	Social Media	13%
Microsoft Corporation (MSFT)	Software	9%

Fixed assets have important properties that require management attention:

- Fixed assets require a long-term commitment. Mistakes in acquiring fixed assets can be very costly and difficult to reverse; thus, managers must take special care in acquiring fixed assets.
- Fixed assets wear out over time and need to be replaced. Managers must monitor fixed assets and know when to replace fixed assets due to wear and tear or obsolescence.
- Fixed assets need to be maintained during use. Managers need to develop maintenance programs to keep the investment in fixed assets productive.
- Fixed assets often require significant funds to purchase. Managers must acquire funding internally or by other sources to finance the purchase of fixed assets.

- To aid comprehension and to demonstrate the impact of transactions, **journal entries include the net effect of the transaction on the accounting equation**.

A = L + E
+ −

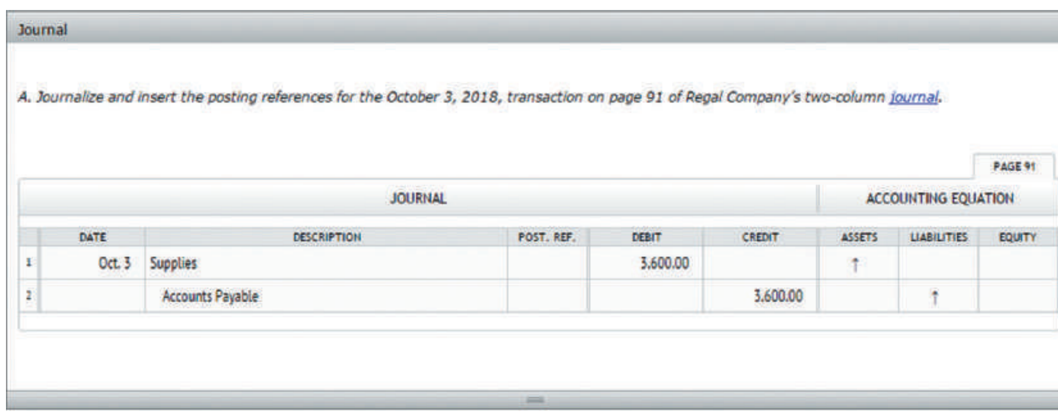
20Y8				
Jan. 3	Inventory		2,510	
	Cash			2,510
	Purchased inventory from Bowen Co.			

Purchases of inventory on account are recorded as follows:

A = L + E
+ +

Jan. 4	Inventory	9,250	
	Accounts Payable—Thomas Corporation		9,250
	Purchased inventory on account.		

- **The link between the journal entry and the accounting equation is also included in the accompanying CengageNOWv2 course** in the accounting cycle chapters, reminding students of the link—but not requiring them to actively make the link.



Journal

A. Journalize and insert the posting references for the October 3, 2018, transaction on page 91 of Regal Company's two-column journal.

PAGE 91

	JOURNAL					ACCOUNTING EQUATION		
	DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT	ASSETS	LIABILITIES	EQUITY
1	Oct. 3	Supplies		3,600.00		↑		
2		Accounts Payable			3,600.00		↑	

- To aid learning and problem solving, throughout each chapter **Check Up Corners** provide students with step-by-step guidance on how to solve problems. Problem-solving tips help students avoid common errors.

Check Up Corner 9-2 Selling Fixed Assets

On the first day of the year, Firefall Company purchased equipment at a cost of $340,000. The equipment was expected to have a useful life of four years, a residual value of $20,000, and is depreciated at a straight-line rate of 25%. Firefall sold the equipment at the beginning of the fourth year when the balance in the accumulated depreciation account was $240,000. Journalize the entry to record the sale if the equipment was sold for:

a. $95,000
b. $105,000

Solution:

a. Equipment sold for $95,000:

Cash	95,000	
Accumulated Depreciation—Equipment	240,000	
Loss on Sale of Equipment	5,000	
Equipment		340,000

Selling Price – Book Value =
$95,000 – $100,000

Accumulated Depreciation at the End of Year 3

b. Equipment sold for $105,000:

Cash	105,000	
Accumulated Depreciation—Equipment	240,000	
Equipment		340,000
Gain on Sale of Equipment		5,000

Selling Price – Book Value =
$105,000 – $100,000

Check Up Corner

- **Analysis for Decision Making** highlights how companies use accounting information to make decisions and evaluate their business. This provides students with context of why accounting is important to companies.

Analysis for Decision Making

Fixed Asset Turnover Ratio

Objective 7
Describe and illustrate the fixed asset turnover ratio to assess the efficiency of a company's use of its fixed assets.

The **fixed asset turnover ratio** measures the number of sales dollars earned per dollar of fixed assets. The higher the ratio, the more efficiently a company is using its fixed assets in generating sales. The ratio is computed as follows:

$$\text{Fixed Asset Turnover Ratio} = \frac{\text{Sales}}{\text{Average Book Value of Fixed Assets}}$$

To illustrate, the following data (in millions) were taken from a recent financial statement of **McDonald's Corporation (MCD)**:

Sales	$24,621.9
Fixed assets (net):	
Beginning of year	21,257.6
End of year	23,117.6

McDonald's fixed asset turnover ratio for the year is computed as follows (rounded to one decimal place):

$$\text{Fixed Asset Turnover Ratio} = \frac{\text{Sales}}{\text{Average Book Value of Fixed Assets}}$$

$$= \frac{\$24{,}621.9}{(\$21{,}257.6 + \$23{,}117.6) \div 2}$$

$$= \frac{\$24{,}621.9}{\$22{,}187.6} = 1.1$$

Is 1.1 efficient? To answer this question, McDonald's fixed asset turnover ratio can be compared to other quick-service restaurant companies, as shown in Exhibit 14. **Yum! Brands (YUM)** operates KFC, Pizza Hut, and Taco Bell quick-service restaurants. The other restaurants are likely familiar by name.

- **Make a Decision** in the end-of-chapter material gives students a chance to analyze real-world business decisions.

Make a Decision
Fixed Asset Turnover Ratio

REAL WORLD

MAD 9-1 Analyze and compare Amazon.com to Netflix **Obj. 7**

Amazon.com, Inc. (AMZN) is the world's leading Internet retailer of merchandise and media. Amazon also designs and sells electronic products, such as e-readers. **Netflix, Inc. (NFLX)** is one of the world's leading Internet television networks. Both companies compete in the digital media and streaming space. However, Netflix is more narrowly focused in the digital streaming business than is Amazon.

Sales and average book value of fixed assets information (in millions) are provided for Amazon and Netflix for a recent year as follows:

	Amazon.com	Netflix
Sales	$135,987	$8,830
Average book value of fixed assets	25,476	212

a. Compute the fixed asset turnover ratio for each company. Round to one decimal place.
b. Which company is more efficient in generating sales from fixed assets?
c. Interpret your results.

REAL WORLD

MAD 9-2 Analyze and compare Alaska Air, Delta Air Lines, and Southwest Airlines **Obj. 7**

Alaska Air Group (ALK), **Delta Air Lines (DAL)**, and **Southwest Airlines (LUV)** reported the following financial information (in millions) in a recent year:

	Alaska Air Group	Delta Air Lines	Southwest Airlines
Sales	$5,931	$39,639	$20,425
Average book value of fixed assets	5,234	23,707	16,323

a. Determine the fixed asset turnover ratio for each airline. Round to one decimal place.
b. Based on the fixed asset turnover ratio, which airline appears to be the most efficient in the use of its fixed assets?
c. The most important fixed asset to an airline is the aircraft. Given this, what factors might influence the efficient use of fixed assets for an airline?

- At the end of each chapter, **Let's Review** is a new chapter summary and self-assessment feature that is designed to help busy students prepare for an exam. It includes a summary of each learning objective's key points, key terms, multiple-choice questions, exercises, and a sample problem that students may use to practice.
- Sample multiple-choice questions allow students to practice with the type of assessments they are likely to see on an exam.
- Short exercises and a longer problem allow students to apply their knowledge.
- **Answers** provided at the end of the Let's Review section let students check their knowledge immediately.
- **Take It Further** in the end-of-chapter activities allows instructors to assign other special activities related to ethics, communication, and teamwork.
- **NEW! Certified Management Accountant (CMA®) Examination Questions** help students prepare for the CMA exam so they can earn CMA certification.

CengageNOWv2

CengageNOWv2 is a powerful course management and online homework resource that provides control and customization to optimize the student learning experience. Included are many proven resources, such as algorithmic activities, a test bank, course management tools, reporting and assessment options, and much more.

NEW! Excel Online

Cengage and Microsoft have partnered in CNOWv2 to provide students with a uniform, authentic Excel experience. It provides instant feedback, built-in video tips, and easily accessible spreadsheet work. These features allow you to spend more time teaching college accounting applications, and less time troubleshooting Excel.

These new algorithmic activities offer pre-populated data directly in Microsoft Excel Online. Each student receives his or her own version of the problem to perform the necessary data calculations in Excel Online. Their work is constantly saved in Cengage cloud storage as a part of homework assignments in CNOWv2. It's easily retrievable so students can review their answers without cumbersome file management and numerous downloads/uploads.

Motivation: Set Expectations and Prepare Students for the Course

CengageNOWv2 helps motivate students and get them ready to learn by reshaping their misconceptions about the introductory accounting course and providing a powerful tool to engage students.

CengageNOWv2 Start-Up Center

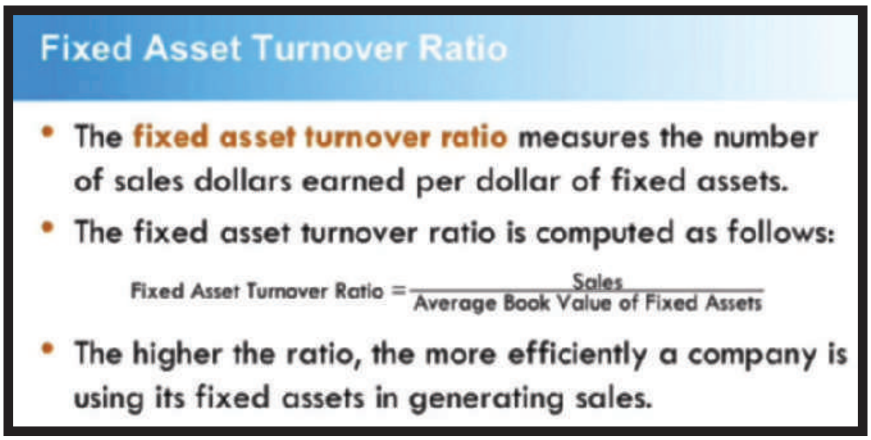
Students are often surprised by the amount of time they need to spend outside of class working through homework assignments in order to succeed. The CengageNOWv2 Start-Up Center will help students identify what they need to do and where they need to focus in order to be successful with a variety of new resources.

- What Is Accounting? Module ensures students understand course expectations and how to be successful in the introductory accounting course. This module consists of two assignable videos: *Introduction to Accounting* and *Success Strategies*. The Student Advice Videos offer advice from real students about what it takes to do well in the course.
- Math Review Module, designed to help students get up to speed with necessary math skills, includes math review assignments and Show Me How math review videos to ensure that students have an understanding of basic math skills.
- How to Use CengageNOWv2 Module focuses on learning accounting, not on a particular software system. Quickly familiarize your students with CengageNOWv2 and direct them to all of its built-in student resources.

Motivation: Prepare Them for Class

With all the outside obligations accounting students have, finding time to read the textbook before class can be a struggle. Point students to the key concepts they need to know before they attend class.

- **Video: Tell Me More.** Short Tell Me More lecture activities explain the core concepts of the chapter through an engaging auditory and visual presentation. Available either on a stand-alone basis or as an assignment, they are ideal for all class formats—flipped model, online, hybrid, or face-to-face.

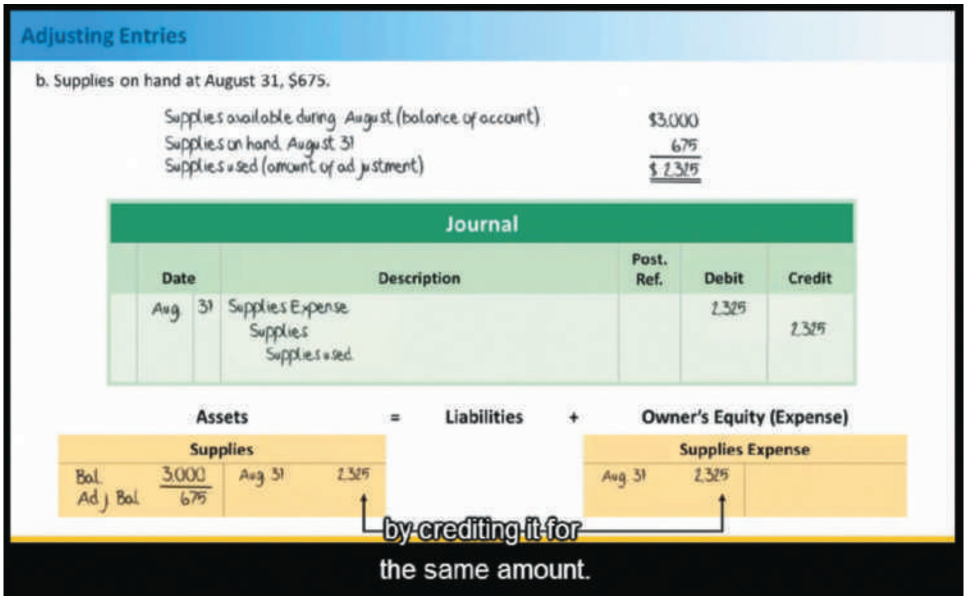


Provide Help Right When Students Need It

The best way to learn accounting is through practice, but students often get stuck when attempting homework assignments on their own.

- **Video: Show Me How.** Created for the most frequently assigned end-of-chapter items, Show Me How problem demonstration videos provide a step-by-step model of a similar problem. Embedded tips help students avoid common mistakes and pitfalls.

SHOW ME HOW



Help Students Go Beyond Memorization to True Understanding

Students often struggle to understand how concepts relate to one another. For most students, an introductory accounting course is their first exposure to both business transactions and the accounting system. While these concepts are already difficult to master individually, their combination and interdependency in the introductory accounting course often pose a challenge for students.

- **Mastery Problems.** Mastery Problems enable you to assign problems and activities designed to test students' comprehension and mastery of difficult concepts.

MindTap eReader

The MindTap eReader for Warren/Jones/Tayler's *Financial and Managerial Accounting* is the most robust digital reading experience available. Hallmark features include:

- Fully optimized for the iPad.
- Note taking, highlighting, and more.
- Embedded digital media.
- The MindTap eReader also features ReadSpeaker®, an online text-to-speech application that vocalizes, or "speech-enables," online educational content. This feature is ideally suited for both instructors and learners who would like to listen to content instead of (or in addition to) reading it.

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New to This Edition

In all chapters, the following improvements have been made:

- Chapter schemas have been revised throughout.
- *Link to, Analysis for Decision Making*, and *Make a Decision* page references added at the beginning of the chapter, as appropriate, allow students to easily locate the ties to the opening company throughout the chapter.
- New learning objective for Analysis for Decision Making.
- Stock ticker symbol has been inserted for all real-world (publicly listed) companies. This helps students to use financial websites to locate real company data.
- Years are now identified as 20Y1, 20Y2, …., 20Y9.
- New Pathways Challenge feature added, consistent with the work of the Pathways Commission. This feature emphasizes the critical thinking aspect of accounting. A Suggested Answer to the Pathways Challenge is provided at the end of the chapter.
- New Make a Decision section at the end of the Analysis for Decision Making directs students and instructors to the real-world company end-of-chapter materials related to Analysis for Decision Making. Also, the continuing company analysis is identified and referenced in this Make a Decision section.
- New exercise based on Analysis for Decision Making has been added to the Let's Review section of the chapter.
- New items have been added to the Take It Further section of the chapter.
- New Certified Management Accountant (CMA®) Examination Questions help students prepare for the CMA exam so they can earn CMA certification.

Chapter 1

- Enhancing characteristics added to discussion of GAAP.
- Discussion of fiscal year added to time period discussion of GAAP (moved from Chapter 6). This is consistent with use of fiscal years throughout Chapters 1–4 and with the fact that many publicly traded companies use fiscal years not ending in December 31.
- The statement of stockholders' equity replaces the retained earnings statement. This is consistent with the financial reporting of publicly held companies that report a statement of stockholders' equity rather than a retained earnings statement.
- Exhibit 8 revised to show the interrelationships of the statement of stockholders' equity with the income statement and balance sheet.

Chapter 2

- Revised the discussion of correcting entries and inserted new exhibit to better enhance student understanding.

Chapter 3

- Exhibit 1 (Accruals) has been revised to make it consistent with Exhibit 2 (Deferrals).
- The chapter has been changed so that accruals are discussed and illustrated first, followed by deferrals. Accruals are the simplest adjustment (no entry has been made). Thus, the chapter discussion now goes from simple to complex, which facilitates student understanding of this complex topic.

Chapter 4

- New learning objectives for Appendices 1 and 2.
- The statement of stockholders' equity replaces the retained earnings statement. This is consistent with the financial reporting of publicly held companies that report a statement of stockholders' equity rather than a retained earnings statement.
- Exhibit 1 revised to show the interrelationships of the statement of stockholders' equity with the income statement and balance sheet.
- Simplified and updated the closing process so that *two* rather than *four* closing entries are required. Doing so eliminates the temporary (clearing) account Income Summary, which students have difficulty understanding.
- Exhibit 8 (Accounting Cycle) revised and made more readable.

Chapter 5

- Chapter has been retitled as "Accounting for Retail Businesses." Using *Retail* in the title rather than *Merchandising* is more current terminology that students can identify with.
- Schema revised to only focus on the financial statements and the key accounts that will be discussed within the chapter.
- New learning objective and separate discussion for the adjusting process of a retail business.
- New learning objective and Appendix "Gross Method of Recording Sales Discounts." This gives instructors flexibility as to whether to cover the net or gross methods of accounting for sales discounts.
- Chart of Accounts for NetSolutions as a Retail Business (Exhibit 2) has been moved earlier in the chapter so that students can focus on the new accounts specific to retail businesses.
- Customer refunds, allowances, and returns discussion has been simplified to progress from simple to complex, as summarized in Exhibit 7.
- Closing process for a retail business has been revised to use a two-entry closing process.
- The statement of stockholders' equity replaces the retained earnings statement. This is consistent with the financial reporting of publicly held companies that report a statement of stockholders' equity rather than a retained earnings statement.

Chapter 6

- New Check Up Corner on weighted average inventory method has been added.
- New exhibit on weighted average flow of costs has been added.
- Weighted average illustration has been added to Check Up Corner 6-3.
- Added an illustration of the lower of cost or net realizable for inventory applied by different *classes* of inventory (Exhibit 10).

Chapter 7

- Presentation of bank reconciliation has been reformatted.

Chapter 9

- New Check Up Corner on selling fixed assets was added.
- Lease discussion was modified to reflect the latest accounting standard.

Chapter 10

- Simplified Exhibit 1 by removing cash/sales discounts.

Chapter 11

- Present value formulas have been added to Appendix 1, "Present Value Concepts and Pricing Bonds Payable."

Chapter 12

- Added brief discussion of different classes of common stock (Classes A, B, and C).

Chapter 15

- "Managerial Accounting in the Organization" section significantly revised to discuss horizonal and vertical business units; McAfee, Inc., is used as an illustration.
- New Why It Matters features the IMA and CMA.
- New Why It Matters features vertical and horizontal functions for service companies.
- Discussion of sustainability and accounting moved to new Chapter 28.

Chapter 16

- Discussion of sustainability and accounting moved to new Chapter 28.
- Added one new Analysis for Decision Making item.

Chapter 17

- Why It Matters feature (Sustainable Papermaking) moved to Chapter 28.

- Lean manufacturing discussion with related homework items moved to Chapter 27.
- Added one new Analysis for Decision Making item.

Chapter 18

- Added Learning Objective 7: Describe and illustrate the use of activity-based costing information in decision making.

Chapter 19—NEW Chapter

- Learning Objectives:
  - Describe support departments and support department costs.
  - Describe the allocation of support department costs using a single plantwide rate, multiple department rates, and activity-based costing.
  - Allocate support department costs to production departments using the direct method, sequential method, and reciprocal services method.
  - Describe joint products and joint costs.
  - Allocate joint costs using the physical units, weighted average, market value at split-off, and net realizable value methods.
  - Describe and illustrate the use of support department and joint cost allocations to evaluate the performance of production managers.

Chapter 20

- Added one new Analysis for Decision Making item.

Chapter 21

- Contribution margin analysis deleted from chapter.
- Revenue variance portion added as an appendix to Chapter 23.

Chapter 22

- Added one new Analysis for Decision Making item.

Chapter 23

- Added new appendix on revenue variances.
- Nonfinancial performance measures (previously Learning Objective 6) moved to Chapter 28.
- Added four new revenue variance exercises.
- Added one new Analysis for Decision Making item.

Chapter 24

- Balanced scorecard discussion moved to Chapter 28.
- Added one new Analysis for Decision Making item.

Chapter 25

- Total cost and variable cost concepts for product pricing were moved to an end-of-chapter appendix.
- Added one new Make a Decision item.

Chapter 26

- Analysis for Decision Making on capital investment for sustainability has been moved to Chapter 28.
- Added new Analysis for Decision Making entitled "Uncertainty: Sensitivity and Expected Value Analyses."
- Added six new Make a Decision items.

Chapter 27

- Added Objective 4: Describe and illustrate the use of lean principles and activity analysis in a service or administrative setting.

Chapter 28—NEW Chapter

- Learning Objectives:
  - Describe the concept of a performance measurement system.
  - Describe and illustrate the basic elements of a balanced scorecard.
  - Describe and illustrate the balance scorecard, including the use and impact of strategy maps, measure maps, strategic learning, scorecard cascading, and cognitive biases.
  - Describe corporate social responsibility (CSR), including methods of measuring and encouraging social responsibility using the balanced scorecard.
  - Use capital investment analysis to evaluate CSR projects.

Appendix D Investments

- The investments appendix has been updated to be consistent with *Financial Instruments, Subtopic 825-10, FASB Accounting Standards Update*, Financial Accounting Standards Board, Norwalk, CT, January 2016.

Acknowledgements

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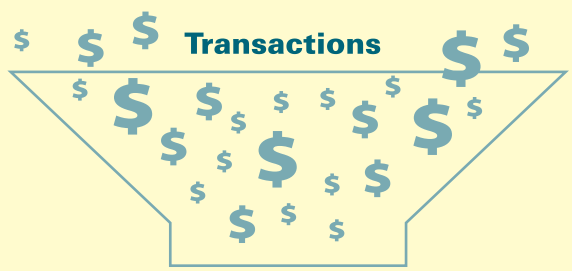
Chapter 1



ACCOUNTING SYSTEM

Accounting Equation

Assets = Liabilities + Equity

Chapter 2

ANALYZING TRANSACTIONS

Chapter 3

THE ADJUSTING PROCESS

Chapter 4

THE ACCOUNTING CYCLE

Twitter, Inc.

When two teams pair up for a game of football, there is often a lot of noise. The band plays, the fans cheer, and fireworks light up the scoreboard. Obviously, the fans are committed and care about the outcome of the game. Just like fans at a football game, the owners of a business want their business to "win" against their competitors in the marketplace. While having your football team win can be a source of pride, winning in the marketplace goes beyond pride and has many tangible benefits. Companies that are winners are better able to serve customers, provide good jobs for employees, and make money for their owners.

Twitter, Inc. (TWTR) is one of the most visible companies on the Internet. It provides a real-time information network where members can post messages, called tweets, for free. Millions post tweets every day throughout the world.

Do you think Twitter is a successful company? Does it make money? How would you know? Accounting helps to answer these questions.

This textbook introduces you to accounting, the language of business. Chapter 1 begins by discussing what a business is, how it operates, and the role that accounting plays.

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Link to Twitter . . . . Pages 4, 5, 6, 7, 10, 11, 13, 21, 23

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What's Covered

Introduction to Accounting and Business

Nature of Business
- Types of Business (Obj. 1)
- Role of Accounting (Obj. 1)
- Ethics (Obj. 1)

Nature of Accounting
- Managerial and Financial Accounting (Obj. 1)
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Analyzing Business Transactions
- Generally Accepted Accounting Principles (Obj. 2)
- Accounting Equation (Obj. 3)
- Transactions (Obj. 4)

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- Income Statement (Obj. 5)
- Statement of Stockholders' Equity (Obj. 5)
- Balance Sheet (Obj. 5)
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Learning Objectives

Obj. 1 Describe the nature of business and the role of accounting and ethics in business.

Obj. 2 Describe generally accepted accounting principles, including the underlying assumptions and principles.

Obj. 3 State the accounting equation and define each element of the equation.

Obj. 4 Describe and illustrate how business transactions can be recorded in terms of the resulting change in the elements of the accounting equation.

Obj. 5 Describe the financial statements of a corporation and explain how they interrelate.

Analysis for Decision Making

Obj. 6 Describe and illustrate the use of the ratio of liabilities to stockholders' equity in evaluating a company's financial condition.

Objective 1
Describe the nature of business and the role of accounting and ethics in business.

Nature of Business and Accounting

A **business**[1] is an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers. Businesses come in all sizes, from a local coffee house to **Starbucks (SBUX)**, which sells over $15 billion of coffee and related products each year.

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

Types of Businesses

Three types of businesses operating for profit include service, retail, and manufacturing businesses. Some examples of each type of business follow:

- **Service businesses** provide services rather than products to customers.
  - **Delta Air Lines (DAL)** (transportation services)
  - **The Walt Disney Company (DIS)** (entertainment services)
- **Retail businesses** sell products they purchase from other businesses to customers.
  - **Wal-Mart Stores, Inc. (WMT)** (general merchandise)
  - **Amazon.com (AMZN)** (Internet books, music, videos, ...)
- **Manufacturing businesses** change basic inputs into products that are sold to customers.
  - **Ford Motor Company (F)** (cars, trucks, vans)
  - **Merck & Co., Inc. (MRK)** (pharmaceutical drugs)

Link to Twitter **Twitter** is a service company that provides a platform for individuals to send text messages called tweets.

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

Role of Accounting in Business

The role of accounting in business is to provide information for managers to use in operating the business. In addition, accounting provides information to other users in assessing the economic performance and condition of the business.

Thus, **accounting** can be defined as an information system that provides reports to users about the economic activities and condition of a business. You could think of accounting as the "language of business." This is because accounting is the means by which businesses' financial information is communicated to users.

note:
Accounting is an information system that provides reports to users about the economic activities and condition of a business.

Twitter communicates to investors in an annual report that includes accounting information.

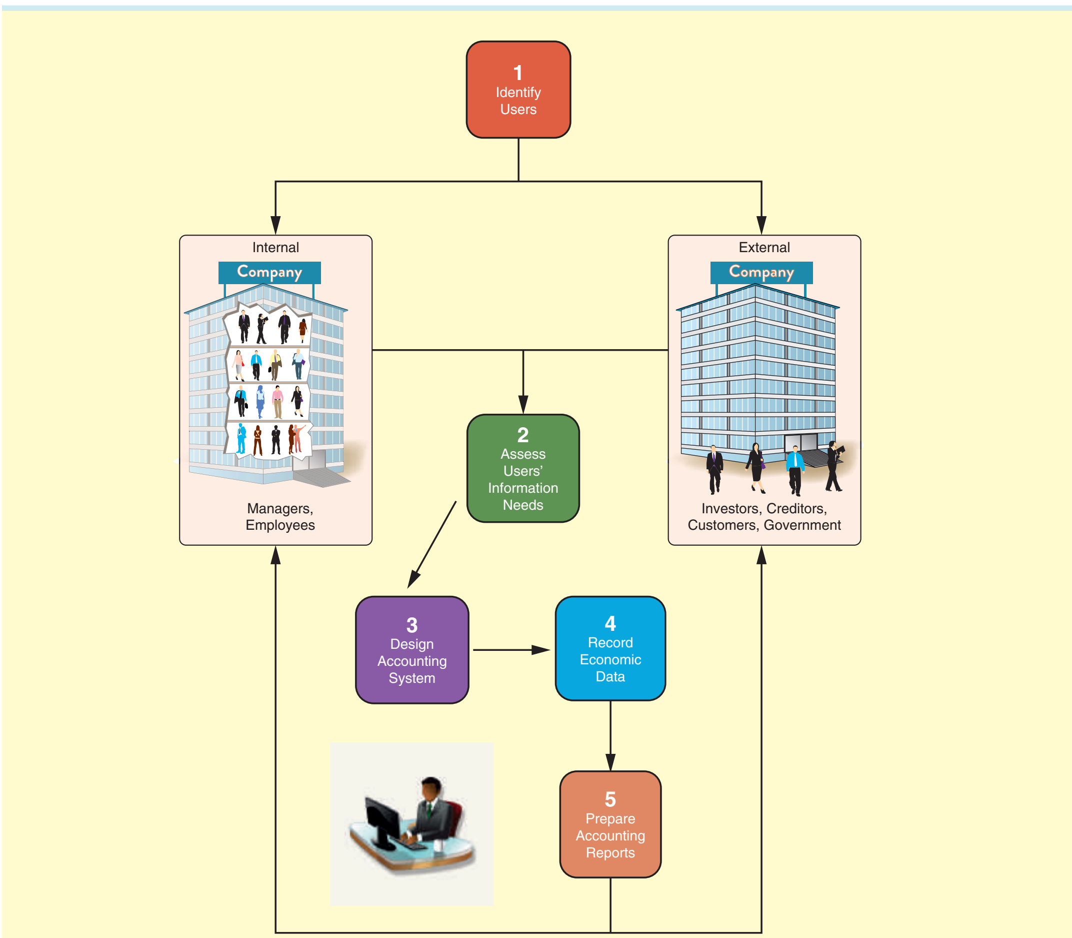
Link to Twitter

The process by which accounting provides information to users is as follows:

1. Identify users.
2. Assess users' information needs.
3. Design the accounting information system to meet users' needs.
4. Record economic data about business activities and events.
5. Prepare accounting reports for users.

As illustrated in Exhibit 1, users of accounting information can be divided into two groups: internal users and external users.

Exhibit 1
Accounting as an Information System



Managerial Accounting Internal users of accounting information include managers and employees. These users are directly involved in managing and operating the business. The area of accounting that provides internal users with information is called **managerial accounting**, or **management accounting**.

The objective of managerial accounting is to provide relevant and timely information for managers' and employees' decision-making needs. Often, such information is sensitive and is not distributed outside the business. Examples of sensitive information might include information about customers, prices, and plans to expand the business. Managerial accountants employed by a business are employed in **private accounting**.

Financial Accounting External users of accounting information include investors, creditors, customers, and the government. These users are not directly involved in managing and operating the business. The area of accounting that provides external users with information is called **financial accounting**.

The objective of financial accounting is to provide relevant and timely information for the decision-making needs of users outside of the business. For example, financial reports on the operations and condition of the business are useful for banks and other creditors in deciding whether to lend money to the business. **General-purpose financial statements** are one type of financial accounting report that is distributed to external users. The term *general-purpose* refers to the wide range of decision-making needs that these reports are designed to serve. Later in this chapter, general-purpose financial statements are described and illustrated.

Link to Twitter **Twitter** is a service company that provides a platform for individuals to send text messages called tweets.

Role of Ethics in Accounting and Business

ETHICS

The objective of accounting is to provide relevant, timely information for user decision making. Accountants must behave in an ethical manner so that the information they provide users will be trustworthy and, thus, useful for decision making. Managers and employees must also behave in an ethical manner in managing and operating a business. Otherwise, no one will be willing to invest in or loan money to the business.

Ethics are moral principles that guide the conduct of individuals. Unfortunately, business managers and accountants sometimes behave in an unethical manner. Many of the managers of the companies listed in Exhibit 2 engaged in accounting or business fraud. These ethical violations led to fines, firings, and lawsuits. In some cases, managers were criminally prosecuted, convicted, and sent to prison.

Exhibit 2 Accounting and Business Frauds

Company	Nature of Accounting or Business Fraud	Result
Computer Associates International, Inc.	Fraudulently inflated its financial results.	CEO and senior executives indicted. Five executives pled guilty. $225 million fine.
Enron	Fraudulently inflated its financial results.	Bankruptcy. Senior executives criminally convicted. More than $60 billion in stock market losses.
HealthSouth	Overstated performance by $4 billion in false entries.	Senior executives criminally convicted.
Qwest Communications International, Inc.	Improperly recognized $3 billion in false receipts.	CEO and six other executives criminally convicted of "massive financial fraud." $250 million SEC fine.
Xerox Corporation	Recognized $3 billion in sales prior to when it should have been recorded.	$10 million fine to SEC. Six executives forced to pay $22 million.

What went wrong for the managers and companies listed in Exhibit 2? The answer normally involved one or both of the following two factors:

- **Failure of Individual Character:** Ethical managers and accountants are honest and fair. However, managers and accountants often face pressures from supervisors to meet company and investor expectations. In many of the cases in Exhibit 2, managers and accountants justified small ethical violations to avoid such pressures. However, these small violations became big violations as the company's financial problems became worse.

- **Culture of Greed and Ethical Indifference:** By their behavior and attitude, senior managers set the company culture. In most of the companies listed in Exhibit 2, the senior managers created a culture of greed and indifference to the truth.

As a result of the accounting and business frauds shown in Exhibit 2, Congress passed laws to monitor the behavior of accounting and business. For example, the **Sarbanes-Oxley Act (SOX)** was enacted. SOX established a new oversight body for the accounting profession called the **Public Company Accounting Oversight Board (PCAOB)**. In addition, SOX established standards for independence, corporate responsibility, and disclosure.

How does one behave ethically when faced with financial or other types of pressure? Guidelines for behaving ethically follow:[2]

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

Twitter's "Code of Business Conduct and Ethics" can be found at https://investor.twitterinc.com/corporate-governance.cfm.

Link to Twitter

Opportunities for Accountants

Numerous career opportunities are available for students majoring in accounting. Currently, the demand for accountants exceeds the number of new graduates entering the job market. This is partly due to the increased regulation of business caused by the accounting and business frauds shown in Exhibit 2. Also, more and more businesses have come to recognize the importance and value of accounting information.

As indicated earlier, accountants employed by a business are employed in private accounting. Private accountants have a variety of possible career options within a company. Some of these career options are shown in Exhibit 3 along with their starting salaries. As shown in Exhibit 3, several private accounting careers have certification options. Accountants who provide audit services, called *auditors*, verify the accuracy of financial records, accounts, and systems.

Ethics: Don't Do It!

Bernie Madoff

Bernard L. "Bernie" Madoff was sentenced to 150 years in prison for defrauding thousands of investors in one of the biggest frauds in American history. Madoff's fraud started several decades earlier when he began a "Ponzi scheme" in his investment management firm, Bernard L. Madoff Investment Securities LLC.

In a Ponzi scheme, the investment manager uses funds received from new investors to pay a return to existing investors, rather than basing returns on the investments' actual performance. As long as the investment manager is able to attract new investors, he or she will have new funds to pay existing investors and continue the fraud. While most Ponzi schemes collapse quickly when the investment manager runs out of new investors, Madoff's reputation, popularity, and personal contacts provided a steady stream of investors, which allowed the fraud to survive for decades.

Source: Bernie Madoff

[2] Many companies have ethical standards of conduct for managers and employees. In addition, the Institute of Management Accountants and the American Institute of Certified Public Accountants have professional codes of conduct, which can be obtained from their Web sites at www.imanet.org and www.aicpa.org, respectively.

Exhibit 3 Accounting Career Paths and Salaries

Accounting Career Track	Description	Career Options	Annual Starting Salaries*	Certification
Private Accounting	Accountants employed by companies, government, and not-for-profit entities.	Bookkeeper	$40,000	
		Payroll clerk	$40,000	Certified Payroll Professional (CPP)
		General accountant	$51,000	
		Budget analyst	$53,000	
		Cost accountant	$55,000	Certified Management Accountant (CMA)
		Internal auditor	$62,000	Certified Internal Auditor (CIA)
		Information technology auditor	$71,000	Certified Information Systems Auditor (CISA)
Public Accounting	Accountants employed individually or within a public accounting firm in audit, tax, or management advisory services.	Large firms (over $250 million in revenue)	$68,000	Certified Public Accountant (CPA)
		Mid-size firms ($25–$250 million in revenue)	$61,000	Certified Public Accountant (CPA)
		Small firms (less than $25 million in revenue)	$56,000	Certified Public Accountant (CPA)

*Average salaries rounded to the nearest thousand. Salaries may vary by size of company and region.
Source: Robert Half *2017 U.S. Salary Guide (Finance and Accounting)*, Robert Half International, Inc. (www.roberthalf.com/workplace-research/salary-guides).

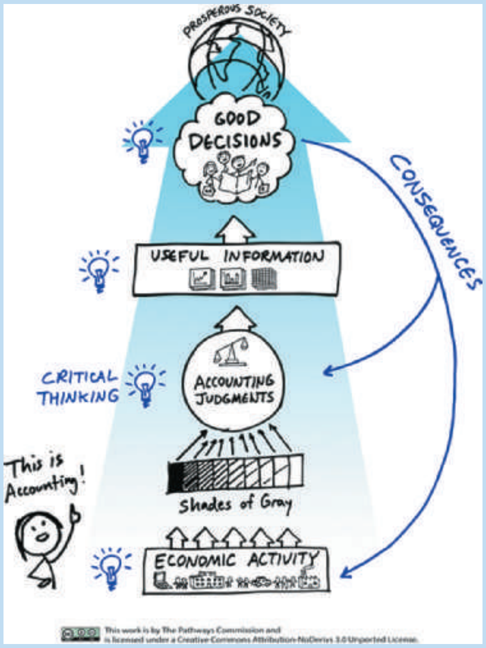
Accountants and their staff who provide services on a fee basis are said to be employed in **public accounting**. In public accounting, an accountant may practice as an individual or as a member of a public accounting firm. Public accountants who have met a state's education, experience, and examination requirements may become **Certified Public Accountants (CPAs)**. CPAs typically perform general accounting, audit, or tax services. As can be seen in Exhibit 3, CPAs have slightly better starting salaries than private accountants. Career statistics indicate, however, that these salary differences tend to disappear over time. The American Institute of Certified Public Accountants (AICPA) provides information and resources for students interested in accounting at www.startheregoplaces.com.

Because all functions within a business use accounting information, experience in private or public accounting provides a solid foundation for a career. Many positions in industry and in government agencies are held by individuals with accounting backgrounds.

Why It Matters CONCEPT CLIP

Pathways Commission

The Pathways Commission recently issued its study titled *Charting a National Strategy for the Next Generation of Accountants*. The Commission was made up of diverse members and was jointly sponsored by the American Institute of Certified Public Accountants (AICPA) and the American Accounting Association (AAA). The Commission emphasized the importance of accounting for a prosperous society and good decision making. The Commission also emphasized that accountants must be critical thinkers who are comfortable addressing the shades of gray required by accounting judgments.



Source: *Charting a National Strategy for the Next Generation of Accountants,* The Pathways Commission, July 2012.

Generally Accepted Accounting Principles (GAAP)

Objective 2
Describe generally accepted accounting principles, including the underlying assumptions and principles.

Financial information in the United States is based on **generally accepted accounting principles (GAAP)**. GAAP is a collection of *accounting standards*, *principles*, and *assumptions* that define how financial information will be reported.

- **Accounting standards** are the rules that determine the accounting for individual business transactions.
- **Accounting principles** and **assumptions** provide the framework upon which accounting standards are constructed.

Within the United States, the **Financial Accounting Standards Board (FASB)** has the primary responsibility for developing accounting standards. The FASB maintains an electronic database, called the **Accounting Standards Codification**, that contains all the accounting standards that make up GAAP. Changes in the FASB Codification are made using **Accounting Standards Updates**.

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

Outside the United States, most countries use accounting standards and principles adopted by the **International Accounting Standards Board (IASB)**. The IASB issues *International Financial Reporting Standards* (IFRS). Major differences between FASB and IASB accounting principles are identified throughout the chapters of this text and in Appendix C.

Characteristics of Financial Information

The primary goal of financial accounting is to provide information that is useful for decision making. To be useful, financial reports must possess two important characteristics: *relevance* and *faithful representation*.

- **Relevant** information has the potential to impact decision making.
- **Faithful representation** means that the information accurately reflects an entity's economic activity or condition.

The characteristics of relevant and faithful representation are enhanced by the following:

- **Comparability** allows users to identify similarities and differences among reported items.
- **Verifiability** allows users to agree on the meaning of reported items.
- **Timeliness** requires distribution of financial reports in time to influence a user's decision.
- **Understandability** requires clear and concise financial reports that facilitate user interpretation and analysis.

International Connection

IFRS International Financial Reporting Standards (IFRS)

IFRS are considered to be more "principles-based" than U.S. GAAP, which is considered to be more "rules-based." For example, U.S. GAAP consists of approximately 17,000 pages, which include numerous industry-specific accounting rules. In contrast, IFRS allow more judgment in deciding how business transactions are recorded. Many believe that the strong regulatory and litigation environment in the United States is the cause for the more rules-based GAAP approach. Regardless, IFRS and GAAP share many common principles.*

*Differences between U.S. GAAP and IFRS are further discussed and illustrated in Appendix C.

Assumptions

Financial accounting and generally accepted accounting principles are based upon the following assumptions:

- Monetary unit
- Time period
- Business entity
- Going concern

The **monetary unit assumption** requires that financial reports be expressed in a single money unit, or currency. This provides a common measurement of the effects of economic events and transactions on an entity. The monetary unit used is normally determined by the country in which the company operates. For example, in the United States, the U.S. dollar is used as the monetary unit.

The **time period assumption** allows a company to report its economic activities on a regular basis for a specific period of time. In doing so, financial condition and changes in financial condition are reported periodically on a consistent basis. In the United States, reports are normally required on a yearly basis supplemented with quarterly reports.

Link to Twitter

Twitter publishes quarterly as well as yearly financial reports that are available at https://investor.twitterinc.com.

The annual accounting period adopted by a company is called its **fiscal year**. The fiscal year most commonly used is the calendar year beginning January 1 and ending December 31. However, other periods are not unusual, especially for companies organized as corporations. For example, a corporation may adopt a fiscal year that ends when business activities have reached the lowest point in its annual operating cycle, which allows more time to prepare financial reports. Such a fiscal year is called the **natural business year**. For example, a company's fiscal year could begin August 1, 20Y7, and end on July 31, 20Y8, as follows:

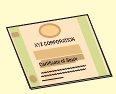
The **business entity assumption** limits the economic data in financial reports to that directly related to the activities of the business. In other words, the business is viewed as an entity separate from its owners, creditors, or other businesses. For example, the accountant for a business with one owner would record the activities of the business only and would not record the personal activities, property, or debts of the owner.

A business entity may take the form of a proprietorship, partnership, corporation, or limited liability company (LLC). Each of these forms and their major characteristics are listed in Exhibit 4.

The three types of businesses discussed earlier—service, retail, and manufacturing—may be organized as proprietorships, partnerships, corporations, or limited liability companies.

Because of the large amount of resources required to operate a manufacturing business, most manufacturers such as **Ford Motor Company (F)** are corporations. Most large retailers such as **Wal-Mart Stores (WMT)** and **The Home Depot (HD)** are also corporations. Companies

Exhibit 4 Forms of Business Entities

Form of Business Entity	Characteristics and Advantages	Examples
 **Proprietorship** is owned by one individual.	• 70% of business entities in the United States. • Easy and inexpensive to organize. • Resources are limited to those of the owner. • Used by small businesses.	• A & B Painting
 **Partnership** is owned by two or more individuals.	• 10% of business organizations in the United States (combined with limited liability companies). • Combines the skills and resources of more than one person.	• Jones & Smith, Architects
 **Corporation** is organized under state or federal statutes as a separate legal taxable entity.	• Generates 90% of business revenues. • 20% of the business organizations in the United States. • Ownership is divided into shares called stock. • Can obtain large amounts of resources by issuing stock. • Used by large businesses.	• **Alphabet Inc. (GOOG)** • **Apple Inc. (AAPL)** • **Ford Motor Company (F)**
 **Limited liability company (LLC)** combines the attributes of a partnership and a corporation.	• 10% of business organizations in the United States (combined with partnerships). • Often used as an alternative to a partnership. • Has tax and legal liability advantages for owners.	• **Boston Basketball Partners, LLC**

Although **Twitter** is organized as a corporation in Delaware, its principal offices are in San Francisco. *Link to Twitter*

organized as corporations often include Inc. as part of their name to indicate that they are incorporated. For example, Twitter's legal name is **Twitter, Inc.**

The **going concern assumption** requires that financial reports be prepared assuming that the entity will continue operating into the future. This assumption justifies reporting items such as equipment, buildings, and land at their initial or historical cost rather than liquidation or forced sale values.

Pathways Challenge

This is Accounting!

Economic Activity

Over 20 years ago, **Starbucks (SBUX)** and **Pepsi (PEP)** created a business, called **The North American Coffee Partnership**. The business combined Starbucks' expertise in coffee with Pepsi's ability to manufacture, market, and sell ready-to-drink coffee products. Its first product, Frappuccino, took off and today the business dominates the ready-to-drink market with over $1.5 billion in annual sales.

Critical Thinking/Judgment

Should the $1.5 million in annual sales be reported as part of Starbucks' annual report?
Should the $1.5 million in annual sales be reported as part of Pepsi's annual report?
Should the $1.5 million in annual sales be reported as part of a separate business's annual report?

Suggested answer at end of chapter.

Principles

In addition to the preceding characteristics and assumptions, the following four principles are an integral part of financial accounting:

- Measurement
- Historical cost
- Revenue recognition
- Expense recognition

The **measurement principle** determines the amount that will be recorded and reported. The measurement principle requires that amounts be *objective* and verifiable. An amount is objective if it is based upon independent, unbiased evidence. An amount is *verifiable* if it can be confirmed by a third party. Transactions between two independent parties, called **arm's-length transactions**, provide amounts that are objective and verifiable.

To illustrate, assume that Aaron Publishers purchased the following building from Schenk Enterprises on February 20, 20Y1, for $150,000:

Price listed by Schenk Enterprises on January 1, 20Y1	$160,000
Aaron Publishers' initial offer to buy on January 31, 20Y1	140,000
Aaron Publishers' purchase price on February 20, 20Y1	150,000
Estimated selling price on December 31, 20Y3	220,000
Assessed value for property taxes, December 31, 20Y3	190,000

Aaron Publishers would record the building at the February 20, 20Y1, purchase price of $150,000. This amount is both objective and verifiable, as it was the result of a transaction between two independent parties. Recording an item at its initial transaction price is called the **historical cost principle** or **cost principle**. Under the historical cost principle, amounts do not normally change until another transaction occurs.

To illustrate, the fact that the preceding building has an estimated selling price of $220,000 on December 31, 20Y3, indicates that the building's value has increased. However, the $220,000 is not recorded in the accounting records because Aaron Publishers has not sold the building. If, however, Aaron sells the building on January 9, 20Y4, for $240,000, a profit of $90,000 ($240,000 – $150,000) would be recorded by Aaron Publishers.

Revenue is the amount earned (received) from providing services or selling goods to customers. The **revenue recognition principle** determines when revenue is recorded in the accounting records. Normally, revenue is recorded when the services have been performed or goods are delivered to the customer.

Expenses are amounts used to generate revenue. The **expense recognition principle**, sometimes called the *matching principle*, requires expenses to be recorded in the same period as the related revenue. Doing so allows the reporting of a profit or loss for the period.

Objective 3
State the accounting equation and define each element of the equation.

The Accounting Equation

The resources owned by a business are its **assets**. Examples of assets include cash, land, buildings, and equipment. The rights or claims to the assets are divided into two types: (1) the rights of creditors and (2) the rights of owners. The rights of creditors are the debts of the business and are called **liabilities**. The rights of owners are called **equity**. Since stockholders own a corporation, equity is called **stockholders' equity**. For a proprietorship, partnership, or limited liability company, equity is called **owner's equity**.

The following equation shows the relationship among assets, liabilities, and equity:

Assets = Liabilities + Equity

This equation is called the **accounting equation**. Liabilities usually are shown before equity in the accounting equation because creditors have first rights to the assets.

Throughout this text, we use the corporate form of business. However, most of the concepts and principles described and illustrated also apply to proprietorships, partnerships, and limited liability companies.

Given any two amounts, the accounting equation may be solved for the third unknown amount. To illustrate, if the assets owned by a corporation amount to $100,000 and the liabilities amount to $30,000, the stockholders' equity is equal to $70,000, computed as follows:

Assets	–	Liabilities	=	Stockholders' Equity
$100,000	–	$30,000	=	$70,000

Twitter's accounting equation for a recent year is: Assets ($6,870 million) = Liabilities ($2,265 million) + Stockholders' Equity ($4,605 million).

Link to Twitter

Business Transactions and the Accounting Equation

Objective 4
Describe and illustrate how business transactions can be recorded in terms of the resulting change in the elements of the accounting equation.

Paying a monthly bill, such as a telephone bill of $168, affects a business's financial condition because it now has less cash on hand. Such an economic event or condition that directly changes an entity's financial condition or its results of operations is a **business transaction**. For example, purchasing land for $50,000 is a business transaction. In contrast, a change in a business's credit rating does not directly affect cash or any other asset, liability, or stockholders' equity amount.

Why It Matters

The Accounting Equation

The accounting equation serves as the basic foundation for the accounting systems of all companies. The accounting equation is used by the smallest business, such as the local convenience store, to the largest business, such as **The Coca-Cola Company (KO)**. Some examples taken from recent financial reports of well-known companies follow:

Company	Assets*	=	Liabilities	+	Stockholders' Equity
Alphabet Inc. (GOOG)	$147,461	=	$27,130	+	$120,331
The Coca-Cola Company (KO)	$90,093	=	$64,539	+	$25,554
DuPont (DD)	$41,166	=	$31,173	+	$9,993
eBay (EBAY)	$17,785	=	$11,209	+	$6,576
McDonald's (MCD)	$37,939	=	$30,851	+	$7,088
Microsoft Corporation (MSFT)	$193,694	=	$121,697	+	$71,997
Southwest Airlines Co. (LUV)	$21,312	=	$13,954	+	$7,358
Wal-Mart Stores, Inc. (WMT)	$199,581	=	$119,035	+	$80,546

*Amounts are shown in millions of dollars.

note:
All business transactions can be stated in terms of changes in the elements of the accounting equation.

All business transactions can be stated in terms of changes in the elements of the accounting equation. How business transactions affect the accounting equation can be illustrated by using some typical transactions. As a basis for illustration, a business organized by Chris Clark is used.

Assume that on November 1, 20Y3, Chris Clark organizes a corporation that will be known as **NetSolutions**. The first phase of Chris's business plan is to operate NetSolutions as a service business assisting individuals and small businesses in developing Web pages and installing computer software. Chris expects this initial phase of the business to last one to two years. During this period, Chris plans on gathering information on the software and hardware needs of customers. During the second phase of the business plan, Chris plans to expand NetSolutions into a personalized retailer of software and hardware for individuals and small businesses.

Each transaction during NetSolutions' first month of operations is described in the following paragraphs. The effect of each transaction on the accounting equation is then shown.

Transaction a *Nov. 1, 20Y3 Chris Clark deposited $25,000 in a bank account in the name of NetSolutions in exchange for shares of common stock in the corporation.*

A corporation issues **common stock** to investors as proof of their ownership rights.[3]

This transaction increases Cash under Assets (on the left side of the equation) by $25,000. To balance the equation, Common Stock under Stockholders' Equity (on the right side of the equation) increases by the same amount.

The effect of this transaction on NetSolutions' accounting equation is as follows:

Assets	=	**Stockholders' Equity**
Cash		Common Stock
a. 25,000	=	25,000

The preceding accounting equation is only for the business, NetSolutions. Under the business entity assumption, Chris's personal assets, such as a home or personal bank account, and personal liabilities are excluded from the equation.

Transaction b *Nov. 5, 20Y3 NetSolutions paid $20,000 for the purchase of land as a future building site.*

The land is located in a business park with access to transportation facilities. Chris Clark plans to rent office space and equipment during the first phase of the business plan. During the second phase, Chris plans to build an office and a warehouse for NetSolutions on the land.

The purchase of the land changes the makeup of the assets, but it does not change the total assets. The items in the equation prior to this transaction and the effect of the transaction follow. The new amounts are called *balances*.

	Assets			=	**Stockholders' Equity**
	Cash	+	Land		Common Stock
Bal.	25,000			=	25,000
b.	−20,000		+20,000		
Bal.	5,000		20,000		25,000
	25,000			=	25,000

Transaction c *Nov. 10, 20Y3 NetSolutions purchased supplies for $1,350 and agreed to pay the supplier in the near future.*

You have probably used a credit card to buy clothing or other merchandise. In this type of transaction, you received clothing for a promise to pay your credit card bill in the future. That is, you received an asset and incurred a liability to pay a future bill. NetSolutions entered into a similar transaction by purchasing

[3] To simplify, we assume that NetSolutions issued no-par stock. Types of stock as well as par and stated values are discussed in Chapter 12.

supplies for $1,350 and agreeing to pay the supplier in the near future. This type of transaction is called a purchase *on account* and is often described as follows: *Purchased supplies on account, $1,350.*

The liability created by a purchase on account is called an **account payable**. Items such as supplies that will be used in the business in the future are called **prepaid expenses**, which are assets. Thus, the effect of this transaction is to increase assets (Supplies) and liabilities (Accounts Payable) by $1,350, as follows:

	Assets			=	**Liabilities + Stockholders' Equity**	
	Cash +	Supplies +	Land	=	Accounts Payable +	Common Stock
Bal.	5,000		20,000			25,000
c.		+1,350			+1,350	
Bal.	5,000	1,350	20,000		1,350	25,000
		26,350		=	26,350	

Nov. 18, 20Y3 *NetSolutions received cash of $7,500 for providing services to customers.* **Transaction d**

You may have earned money by painting houses or mowing lawns. If so, you received money for rendering services to a customer. Likewise, a business earns money by selling goods or services to its customers. This amount is called revenue.

During its first month of operations, NetSolutions received cash of $7,500 for providing services to customers. The receipt of cash increases NetSolutions' assets and also increases stockholders' equity in the business. The revenues of $7,500 are recorded in a Fees Earned column to the right of Common Stock. The effect of this transaction is to increase Cash and Fees Earned by $7,500, as follows:

	Assets			=	**Liabilities +**	**Stockholders' Equity**	
	Cash +	Supplies +	Land	=	Accounts Payable +	Common Stock +	Fees Earned
Bal.	5,000	1,350	20,000		1,350	25,000	
d.	+7,500						+7,500
Bal.	12,500	1,350	20,000		1,350	25,000	7,500
		33,850		=		33,850	

Different terms are used for the various types of revenues. As illustrated for NetSolutions, revenue from providing services is recorded as **fees earned**. Revenue from the sale of merchandise is recorded as **sales**. Other examples of revenue include rent, which is recorded as **rent revenue**, and interest, which is recorded as **interest revenue**.

Instead of receiving cash at the time services are provided or goods are sold, a business may accept payment at a later date. Such revenues are described as *fees earned on account* or *sales on account*. For example, if NetSolutions had provided services on account instead of for cash, transaction (d) would have been described as follows: *Fees earned on account, $7,500.*

In such cases, the firm has an asset, called an **account receivable**, which is a claim against the customer. The effect of the transaction increases Accounts Receivable and Fees Earned. When customers pay their accounts, Cash increases and Accounts Receivable decreases.

Why It Matters

Round-Tripping

Accounting principles require that a transaction have *commercial substance*. Commercial substance means that the transaction has an economic impact on the entity. An example of a transaction lacking commercial substance is round-tripping. Round-tripping is a situation whereby a company "sells" goods and services to another company and then, under a prearranged agreement, the customer resells the exact same goods and services back to the original company. Round-tripping has been used by companies to artificially inflate their sales. However, such agreements do not have commercial substance, since there is no economic change to either company after the round-trip. Thus, round-tripped sales are not transactions from an accounting perspective.

Transaction e *Nov. 30, 20Y3 NetSolutions paid the following expenses during the month: wages, $2,125; rent, $800; utilities, $450; and miscellaneous, $275.*

During the month, NetSolutions spent cash or used up other assets in earning revenue. Assets used in this process of earning revenue are called expenses. Expenses include supplies used and payments for employee wages, utilities, and other services.

NetSolutions paid the following expenses during the month: wages, $2,125; rent, $800; utilities, $450; and miscellaneous, $275. Miscellaneous expenses include small amounts paid for such items as postage, coffee, and newspapers. The effect of expenses is the opposite of revenues in that expenses reduce assets and stockholders' equity. Like fees earned, the expenses are recorded in columns to the right of Common Stock. However, since expenses reduce stockholders' equity, the expenses are entered as negative amounts. The effect of this transaction is as follows:

	Assets			=	**Liabilities +**	**Stockholders' Equity**					
	Cash	+ Supplies +	Land		Accounts Payable +	Common Stock	+ Fees Earned −	Wages Exp. −	Rent Exp. −	Utilities Exp. −	Misc. Exp.
Bal.	12,500	1,350	20,000	=	1,350	25,000	7,500				
e.	−3,650							−2,125	−800	−450	−275
Bal.	8,850	1,350	20,000		1,350	25,000	7,500	−2,125	−800	−450	−275
	30,200			=	30,200						

Businesses usually record each revenue and expense transaction as it occurs. However, to simplify, NetSolutions' revenues and expenses are summarized for the month in transactions (d) and (e).

Transaction f *Nov. 30, 20Y3 NetSolutions paid creditors on account, $950.*

When you pay your monthly credit card bill, you decrease the cash and decrease the amount you owe to the credit card company. Likewise, when NetSolutions paid $950 to creditors during the month, it reduced assets and liabilities, as follows:

	Assets			=	**Liabilities +**	**Stockholders' Equity**					
	Cash	+ Supplies +	Land		Accounts Payable +	Common Stock	+ Fees Earned −	Wages Exp. −	Rent Exp. −	Utilities Exp. −	Misc. Exp.
Bal.	8,850	1,350	20,000	=	1,350	25,000	7,500	−2,125	−800	−450	−275
f.	−950				−950						
Bal.	7,900	1,350	20,000		400	25,000	7,500	−2,125	−800	−450	−275
	29,250			=	29,250						

Paying an amount on account is different from paying an expense. The paying of an expense reduces stockholders' equity, as illustrated in transaction (e). Paying an amount on account reduces the amount owed on a liability.

Transaction g *Nov. 30, 20Y3 Chris Clark determined that the cost of supplies on hand at the end of the month was $550.*

The cost of the supplies on hand (not yet used) at the end of the month is $550. Thus, $800 ($1,350 − $550) of supplies must have been used during the month. This decrease in supplies is recorded as an expense, as follows:

	Assets			=	**Liabilities +**	**Stockholders' Equity**						
	Cash	+ Supplies +	Land		Accounts Payable +	Common Stock	+ Fees Earned −	Wages Exp. −	Rent Exp. −	Supplies Exp. −	Utilities Exp. −	Misc. Exp.
Bal.	7,900	1,350	20,000	=	400	25,000	7,500	−2,125	−800		−450	−275
g.		−800								−800		
Bal.	7,900	550	20,000		400	25,000	7,500	−2,125	−800	−800	−450	−275
	28,450			=	28,450							

Nov. 30, 20Y3 Paid dividends, $2,000. **Transaction h**

Dividends are distributions of earnings to stockholders. The payment of dividends decreases cash and stockholders' equity. Like expenses, dividends are recorded in a separate column to the right of Common Stock as a negative amount. The effect of the payment of dividends of $2,000 is as follows:

	Assets			=	Liabilities +	Stockholders' Equity							
	Cash +	Supp. +	Land	=	Accounts Payable +	Common Stock	− Dividends +	Fees Earned −	Wages Exp. −	Rent Exp. −	Supplies Exp. −	Utilities Exp. −	Misc. Exp.
Bal.	7,900	550	20,000	=	400	25,000		7,500	−2,125	−800	−800	−450	−275
h.	−2,000						−2,000						
Bal.	5,900	550	20,000		400	25,000	−2,000	7,500	−2,125	−800	−800	−450	−275
	26,450			=	26,450								

Dividends should not be confused with expenses. Dividends do not represent assets or services used in the process of earning revenues. Instead, dividends are considered a distribution of earnings to stockholders.

Summary

The transactions of **NetSolutions** are summarized in Exhibit 5. Each transaction is identified by letter, and the balance of each accounting equation element is shown after every transaction.

Exhibit 5 Summary of Transactions for NetSolutions

	Assets			=	Liabilities +	Stockholders' Equity							
	Cash +	Supp. +	Land	=	Accounts Payable +	Common Stock	− Dividends +	Fees Earned −	Wages Exp. −	Rent Exp. −	Supplies Exp. −	Utilities Exp. −	Misc. Exp.
a.	+25,000					+25,000							
b.	−20,000		+20,000										
Bal.	5,000		20,000			25,000							
c.		+1,350			+1,350								
Bal.	5,000	+1,350	20,000		+1,350	25,000							
d.	+7,500							+7,500					
Bal.	12,500	1,350	20,000		1,350	25,000		7,500					
e.	−3,650								−2,125	−800		−450	−275
Bal.	8,850	1,350	20,000		1,350	25,000		7,500	−2,125	−800		−450	−275
f.	−950				−950								
Bal.	7,900	1,350	20,000		400	25,000		7,500	−2,125	−800		−450	−275
g.		−800									−800		
Bal.	7,900	550	20,000		400	25,000		7,500	−2,125	−800	−800	−450	−275
h.	−2,000						−2,000						
Bal.	5,900	550	20,000		400	25,000	−2,000	7,500	−2,125	−800	−800	−450	−275
	26,450			=	26,450								

You should note the following:

- The effect of every transaction *is an increase or a decrease in one or more of the accounting equation elements.*
- The two sides of the accounting equation are *always equal.*
- The stockholders' equity is *increased by amounts invested by stockholders (common stock).*
- The stockholders' equity is *increased by revenues and decreased by expenses.*
- The stockholders' equity is *decreased by dividends paid to stockholders.*

Classifications of Stockholders' Equity

Stockholders' equity is classified as:

- Common Stock
- Retained Earnings

Common stock is shares of ownership distributed to investors of a corporation. It represents the portion of stockholders' equity contributed by investors. For **NetSolutions**, shares of common stock of $25,000 were distributed to Chris Clark in exchange for investing in the business.

Retained earnings is the stockholders' equity created from business operations through revenue and expense transactions. For NetSolutions, retained earnings of $3,050 were created by its November operations (revenue and expense transactions), computed as follows:

NetSolutions Retained Earnings
November Operations
(Revenue and Expense Transactions)

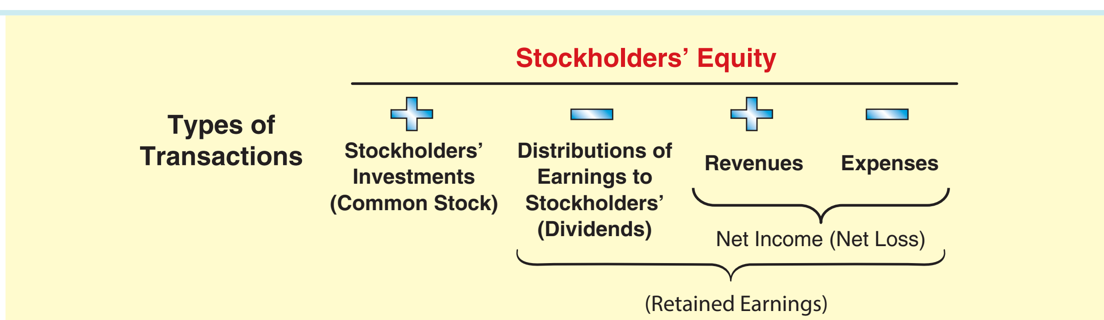
	Fees Earned	–	Wages Exp.	–	Rent Exp.	–	Supplies Exp.	–	Utilities Exp.	–	Misc. Exp.
Transaction d.	+7,500										
Transaction e.			−2,125		−800				−450		−275
Transaction g.							−800				
Balance, Nov. 30	7,500		−2,125		−800		−800		−450		−275

$$\underbrace{7{,}500 - 2{,}125 - 800 - 800 - 450 - 275}_{\$3{,}050}$$

Stockholders' equity created by investments by stockholders (common stock) and by business operations (retained earnings) are reported separately. Since dividends are distributions of earnings to stockholders, dividends reduce retained earnings. NetSolutions paid $2,000 in dividends during November, thus reducing retained earnings to $1,050 ($3,050 − $2,000).

The effects of investments by stockholders, dividends, revenues, and expenses on stockholders' equity are illustrated in Exhibit 6.

Exhibit 6
Effects of Transactions on Stockholders' Equity



Check Up Corner 1-1 Business Transactions and the Accounting Equation

Drive Time Delivery is a local delivery service operating in Cleveland, Ohio. On February 1, Drive Time has the following balances: Cash, $32,500; Accounts Receivable, $5,000; Accounts Payable, $2,500; Common Stock, $32,500; Fees Earned, $5,000; Wages Expense, $2,500.

Drive Time Delivery completed the following transactions during February:

a. Received cash from owner as an additional investment in common stock, $20,000.
b. Paid creditors on account, $2,000.
c. Received cash from customers on account, $5,000.
d. Billed customers for delivery services on account, $18,000.
e. Paid wages expense, $10,000.
f. Paid utilities expense, $3,000.
g. Paid dividends, $4,500.

Indicate the effect that each of these transactions has on the following accounting equation elements: Cash, Accounts Receivable, Accounts Payable, Common Stock, Dividends, Fees Earned, Wages Expense, Utilities Expense.

Solution:

Each transaction affects one or more accounting equation elements.

	Assets		= Liabilities +	Stockholders' Equity				
	Cash +	Accounts Receivable =	Accounts Payable +	Common Stock −	Dividends +	Fees Earned −	Wages Expense −	Utilities Expense
Bal.	32,500	5,000	2,500	32,500		5,000	−2,500	
a.	20,000			20,000				
b.	−2,000		−2,000					
c.	5,000	−5,000						
d.		18,000				18,000		
e.	−10,000						−10,000	
f.	−3,000							−3,000
g.	−4,500				−4,500			
Bal.	38,000	18,000	500 +	52,500	−4,500	23,000	−12,500	−3,000
	$\underbrace{\qquad\qquad}_{56{,}000}$		=	$\underbrace{\qquad\qquad}_{56{,}000}$				

Check Up Corner

Financial Statements

Objective 5
Describe the financial statements of a corporation and explain how they interrelate.

After transactions have been recorded and summarized, reports are prepared for users. The accounting reports providing this information are called **financial statements**. The primary financial statements of a corporation are the income statement, statement of stockholders' equity, balance sheet, and statement of cash flows. The order in which the financial statements are prepared and the nature of each statement are described in Exhibit 7.

Exhibit 7
Financial Statements

Order Prepared	Financial Statement	Description of Statement
1.	**Income statement**	A summary of the revenue and expenses *for a specific period of time*, such as a month or a year.
2.	**Statement of stockholders' equity**	A summary of the changes in stockholders' equity that have occurred *during a specific period of time,* such as a month or a year.
3.	**Balance sheet**	A list of the assets, liabilities, and stockholders' equity *as of a specific date*, usually at the close of the last day of a month or a year.
4.	**Statement of cash flows**	A summary of the cash receipts and cash payments for a *specific period of time*, such as a month or a year.

The four financial statements and their interrelationships are illustrated in Exhibit 8, The data for the statements are taken from the summary of **NetSolutions**' transactions in Exhibit 5.

All financial statements are identified by the name of the business, the title of the statement, and the *date* or *period of time*. The data presented in the income statement, the statement of stockholders' equity, and the statement of cash flows are for a period of time. The data presented in the balance sheet are for a specific date.

Exhibit 8 Financial Statements for NetSolutions

NetSolutions
Income Statement
For the Month Ended November 30, 20Y3

Fees earned		$ 7,500
Expenses:		
Wages expense	$2,125	
Rent expense	800	
Supplies expense	800	
Utilities expense	450	
Miscellaneous expense	275	
Total expenses		(4,450)
Net income		$ 3,050

NetSolutions
Statement of Stockholders' Equity
For the Month Ended November 30, 20Y3

	Common Stock	Retained Earning	Total
Balances, November 1, 20Y3	$ 0	$ 0	$ 0
Issued common stock	25,000		25,000
Net income		3,050	3,050
Dividends		(2,000)	(2,000)
Balances, November 30, 20Y3	$ 25,000	$ 1,050	$ 26,050

NetSolutions
Balance Sheet
November 30, 20Y3

Assets		
Cash		$ 5,900
Supplies		550
Land		20,000
Total assets		$26,450
Liabilities		
Accounts payable		$ 400
Stockholders' Equity		
Common stock	$25,000	
Retained earnings	1,050	
Total stockholders' equity		26,050
Total liabilities and stockholders' equity		$26,450

NetSolutions
Statement of Cash Flows
For the Month Ended November 30, 20Y3

Cash flows from (used for) operating activities:		
Cash received from customers	$ 7,500	
Cash paid for expenses and to creditors	(4,600)	
Net cash flows from operating activities		$ 2,900
Cash flows from (used for) investing activities:		
Cash paid for acquisition of land		(20,000)
Cash flows from (used for) financing activities:		
Cash received from issuing common stock	$ 25,000	
Cash dividends	(2,000)	
Net cash flows from financing activities		23,000
Net increase in cash		$ 5,900
Cash balance, November 1, 20Y3		0
Cash balance, November 30, 20Y3		$ 5,900

Income Statement

The income statement reports the revenues and expenses for a period of time, based on the revenue and expense recognition principles. These principles match revenues and their related expenses so that they are reported in the same period. The excess of the revenue over the expenses is called **net income**, **net profit**, or **earnings**. If the expenses exceed the revenue, the excess is a **net loss**.

note:

When revenues exceed expenses, it is referred to as ***net income, net profit,*** or ***earnings***. When expenses exceed revenues, it is referred to as ***net loss***.

For a recent year, **Twitter** reported a net loss of $521 million.

Link to Twitter

The revenue and expenses for **NetSolutions** were shown in Exhibit 5 as separate increases and decreases. Net income for a period increases the stockholders' equity (retained earnings) for the period. A net loss decreases stockholders' equity (retained earnings) for the period.

The revenue, expenses, and net income of $3,050 for NetSolutions are reported in the income statement in Exhibit 8. The order in which the expenses are listed in the income statement varies among businesses. Most businesses list expenses in order of size, beginning with the larger items. Miscellaneous expense is usually shown as the last item, regardless of the amount.

Statement of Stockholders' Equity

The statement of stockholders' equity reports the changes in stockholders' equity for a period of time. It is prepared *after* the income statement, because the net income or net loss for the period is reported in the Retained Earnings column. It is prepared *before* the balance sheet, because the amount of common stock and retained earnings at the end of the period is reported on the balance sheet. Because of this, the statement of stockholders' equity is viewed as the connecting link between the income statement and the balance sheet.

NetSolutions had three types of transactions during November that affected its stockholders' equity:

- Common stock of $25,000 issued to Chris Clark.
- Revenues and expenses, which resulted in net income of $3,050.
- Dividends of $2,000 paid to stockholders (Chris Clark).

These transactions are summarized in the statement of stockholders' equity for **NetSolutions** shown in Exhibit 8.

Changes in each stockholders' equity element are reported in a separate column on the statement of stockholders' equity. Since NetSolutions was organized on November 1, there are no beginning balances for Common Stock or Retained Earnings. During November, common stock of $25,000 was issued and thus, is entered in the Common Stock column. Net income of $3,050 and dividends of $2,000 are entered in the Retained Earnings column, yielding an ending balance of $1,050. Each change is carried over to the Total column. After all changes are entered, the columns are totaled, representing the final balances as of November 30. These ending balances for Common Stock and Retained Earnings and the total stockholders' equity are reported on the November 30, 20Y3, balance sheet shown in Exhibit 8.

The ending common stock and retained earnings balances for November become the beginning balances for December. To illustrate, assume that during December NetSolutions issued no common stock, earned net income of $4,055, and paid dividends of $2,000. The statement of stockholders' equity for December would be as follows:

NetSolutions
Statement of Stockholders' Equity
For the Month Ended December 31, 20Y3

	Common Stock	Retained Earnings	Total
Balances, December 1, 20Y3	$25,000	$ 1,050	$26,050
Net income		4,055	4,055
Dividends		(2,000)	(2,000)
Balances, December 31, 20Y3	$25,000	$ 3,105	$28,105

Instead of a statement of stockholders' equity, companies may report a **retained earnings statement**. This is often the case when a company has few (if any) common stock transactions. In such cases, only retained earnings changes from period to period.

To illustrate, a retained earnings statement for NetSolutions for December is as follows:

NetSolutions
Retained Earnings Statement
For the Month Ended December 31, 20Y3

Retained earnings, December 1, 20Y3		$1,050
Net income	$ 4,055	
Dividends	(2,000)	
Increase in retained earnings		2,055
Retained earnings, December 31, 20Y3		$3,105

Since most large companies report a statement of stockholders' equity, the statement of stockholders' equity will be used throughout the remainder of this text.

Balance Sheet

The balance sheet in Exhibit 8 reports the amounts of **NetSolutions**' assets, liabilities, and stockholders' equity as of November 30, 20Y3, in a vertical format. This form of balance sheet is commonly used and is called the **report form**.[4]

The asset and liability amounts are taken from the last line of the summary of transactions in Exhibit 5. The amounts for common stock, retained earnings, and total stockholders' equity are taken from the statement of stockholders' equity.

The Assets section of the balance sheet presents assets in the order that they will be converted into cash or used in operations. Cash is presented first, followed by receivables, supplies, prepaid insurance, and other assets. The assets of a more permanent nature are shown next, such as land, buildings, and equipment.

In the Liabilities section of the balance sheet in Exhibit 8, accounts payable is the only liability. When there are two or more liabilities, each should be listed and the total amount of liabilities presented as follows:

Liabilities		
Accounts payable	$12,900	
Wages payable	2,570	
Total liabilities		$15,470

[4] An alternative form of balance sheet reports assets, liabilities, and stockholders' equity in a horizontal format, called the account form.

Statement of Cash Flows

The statement of cash flows consists of the following three sections, as shown in Exhibit 8:

1. operating activities
2. investing activities
3. financing activities

Cash Flows from Operating Activities This section reports a summary of cash receipts and cash payments from operations. The net cash flow from operating activities normally differs from the amount of net income for the period. In Exhibit 8, **NetSolutions** reported net cash flows from operating activities of $2,900 and net income of $3,050. This difference occurs because revenues and expenses may not be recorded at the same time that cash is received from customers or paid to creditors.

Cash Flows from Investing Activities This section reports the cash transactions for the acquisition and sale of relatively permanent assets. Exhibit 8 reports that **NetSolutions** paid $20,000 for the purchase of land during November.

Cash Flows from Financing Activities This section reports the cash transactions related to cash investments by stockholders, borrowings, and dividends. Exhibit 8 shows that Chris Clark invested $25,000 in exchange for common stock of **NetSolutions**. NetSolutions also paid $2,000 of dividends during November.

For a recent year, **Twitter** reported $763 million of cash inflows from operating activities, $598 million of cash used for investing activities, $88 million of cash used for financing activities, and net increase in cash of $77 million.

Link to Twitter

Preparing NetSolutions' Statement of Cash Flows Preparing the statement of cash flows requires that each of the November cash transactions for **NetSolutions** be classified as an operating, investing, or financing activity. Using the summary of transactions shown in Exhibit 5, the November cash transactions for NetSolutions are classified as follows:

Transaction	Amount	Cash Flow Activity
a.	$25,000	Financing (Issued common stock)
b.	−20,000	Investing (Purchase of land)
d.	7,500	Operating (Fees earned)
e.	−3,650	Operating (Payment of expenses)
f.	−950	Operating (Payment of account payable)
h.	−2,000	Financing (Paid dividends)

Transactions (c) and (g) are not listed since they did not involve a cash receipt or payment. In addition, the payment of accounts payable in transaction (f) is classified as an operating activity because the account payable arose from the purchase of supplies, which are used in operations. Using the preceding classifications of November cash transactions, the statement of cash flows is prepared as shown in Exhibit 8.[5]

The ending cash balance shown on the statement of cash flows is also reported on the balance sheet as of the end of the period. To illustrate, the ending cash of $5,900 reported on the November statement of cash flows in Exhibit 8 is also reported as the amount of cash on hand in the November 30, 20Y3, balance sheet.

Since November is NetSolutions' first period of operations, the net cash flow for November and the November 30, 20Y3, cash balance are the same amount, $5,900, as shown in Exhibit 8. In later periods, NetSolutions will report in its statement of cash flows a beginning cash balance, an

[5] This method of preparing the statement of cash flows is called the "direct method." This method and the indirect method are discussed further in Chapter 13.

increase or a decrease in cash for the period, and an ending cash balance. For example, assume that for December NetSolutions has a decrease in cash of $3,835. The last three lines of NetSolutions' statement of cash flows for December would be as follows:

Decrease in cash	$(3,835)
Cash as of December 1, 20Y3	5,900
Cash as of December 31, 20Y3	$ 2,065

Interrelationships Among Financial Statements

Financial statements are prepared in the order of the income statement, statement of stockholders' equity, balance sheet, and statement of cash flows. This order is important because the financial statements are interrelated. These interrelationships for **NetSolutions** are shown in Exhibit 8 and are described in Exhibit 9.[6]

Exhibit 9 Financial Statement Interrelationships

Financial Statements	Interrelationship	NetSolutions Example (Exhibit 8)
Income Statement *and* Statement of Stockholders' Equity	Net income or net loss reported on the income statement is also reported on the statement of stockholders' equity as either an addition (net income) to or deduction (net loss) from the beginning retained earnings.	NetSolutions' net income of $3,050 for November is added to the beginning retained earnings on November 1, 20Y3, of $0 on the statement of stockholders' equity.
Statement of Stockholders' Equity *and* Balance Sheet	Common stock, retained earnings, and total stockholders' equity at the end of the period are reported on the statement of stockholders' equity and balance sheet.	NetSolutions' common stock of $25,000, retained earnings of $1,050, and total stockholders' equity of $26,050 as of November 30, 20Y3, are also reported on the balance sheet.
Balance Sheet *and* Statement of Cash Flows	The cash reported on the balance sheet is also reported as the end-of-period cash on the statement of cash flows.	Cash of $5,900 reported on the balance sheet as of November 30, 20Y3, is also reported on the November statement of cash flows as the end-of-period cash.

The preceding interrelationships are important in analyzing financial statements and the impact of transactions on a business. In addition, these interrelationships serve as a check on whether the financial statements are prepared correctly. For example, if the ending cash on the statement of cash flows does not agree with the balance sheet cash, then an error has occurred.

[6] Depending on the method of preparing the cash flows from operating activities section of the statement of cash flows, net income (or net loss) may also appear on the statement of cash flows. This interrelationship or method of preparing the statement of cash flows, called the "indirect method," is described and illustrated in Chapter 13.

Check Up Corner 1-2 Financial Statements

Levart Travel Service's assets and liabilities at December 31, 20Y6, and its revenue and expenses for the year follow.

Accounts payable	$ 12,200	Land	$ 90,000
Accounts receivable	31,350	Miscellaneous expense	12,950
Cash	53,050	Office expense	63,000
Common stock	100,000	Supplies	3,350
Fees earned	263,200	Wages expense	131,700

The retained earnings were $30,000 on January 1, 20Y6, the beginning of the year. During the year, no common stock was issued and dividends of $20,000 were paid.

a. Prepare an income statement for the year ended December 31, 20Y6.

b. Prepare a statement of stockholders' equity for the year ended December 31, 20Y6.

c. Prepare a balance sheet as of December 31, 20Y6.

d. Indicate the interrelationships of these three financial statements.

Solution:

The income statement reports revenues and expenses **for the period**.

The statement of stockholders' equity **connects** the income statement to the balance sheet.

Levart Travel Service
Income Statement
For the Year Ended December 31, 20Y6

Fees earned		$ 263,200
Expenses:		
Wages expense	$131,700	
Office expense	63,000	
Miscellaneous expense	12,950	
Total expenses		(207,650)
Net income		$ 55,550

The income statement is prepared first. Net income is added to beginning retained earnings in the statement of stockholders' equity.

Levart Travel Service
Statement of Stockholders' Equity
For the Year Ended December 31, 20Y6

	Common Stock	Retained Earnings	Total
Balances, January 1, 20Y6	$100,000	$ 30,000	$130,000
Net income		55,550	55,550
Dividends		(20,000)	(20,000)
Balances, December 31, 20Y6	$100,000	$ 65,550	$165,550

Dividends, which are distributions of earnings to stockholders, reduce the amount of retained earnings.

Levart Travel Service
Balance Sheet
December 31, 20Y6

The balance sheet reports the assets, liabilities, and equity **at a point in time.**

Assets		
Cash		$ 53,050
Accounts receivable		31,350
Supplies		3,350
Land		90,000
Total assets		$ 177,750
Liabilities		
Accounts payable		$ 12,200
Stockholders' Equity		
Common stock	$100,000	
Retained earnings	65,550	
Total stockholders' equity		165,550
Total liabilities and stockholders' equity		$ 177,750

The ending common stock and retained earnings is included on the balance sheet as part of total stockholders' equity.

Total assets must always equal the sum of total liabilities plus total stockholders' equity.

Check Up Corner

Analysis for Decision Making

Objective 6

Describe and illustrate the use of the ratio of liabilities to stockholders' equity in evaluating a company's financial condition.

Ratio of Liabilities to Stockholders' Equity

The basic financial statements illustrated in this chapter are useful to bankers, creditors, stockholders, and others in analyzing and interpreting the financial performance and condition of a company. Various tools and techniques that are often used to analyze and interpret a company's financial performance and condition are described and illustrated in the Analysis for Decision Making section. We begin with a method for analyzing the ability of a company to pay its creditors.

The relationship between liabilities and stockholders' equity can be expressed as a **ratio of liabilities to stockholders' equity**, as follows:

$$\text{Ratio of Liabilities to Stockholders' Equity} = \frac{\text{Total Liabilities}}{\text{Total Stockholders' Equity}}$$

To illustrate, the following data (in millions) from recent balance sheets of **Twitter (TWTR)** and **Alphabet (GOOG)** are used.

	Twitter	Alphabet
End of Year 1		
Total liabilities	$2,074	$ 25,327
Total stockholders' equity	4,368	103,860
End of Year 2		
Total liabilities	$2,265	$ 27,130
Total stockholders' equity	4,605	120,331

The ratios of liabilities to stockholders' equity for Twitter and Alphabet are computed as follows:

$$\text{Ratio of Liabilities to Stockholders' Equity} = \frac{\text{Total Liabilities}}{\text{Total Stockholders' Equity}}$$

Twitter:

End of Year 1: $\frac{\$2,074}{\$4,368} = 0.47$

End of Year 2: $\frac{\$2,265}{\$4,605} = 0.49$

Alphabet:

End of Year 1: $\frac{\$25,327}{\$103,860} = 0.24$

End of Year 2: $\frac{\$27,130}{\$120,331} = 0.23$

The rights of creditors to a business's assets come before the rights of stockholders. Thus, the lower the ratio of liabilities to stockholders' equity, the better able the company is to withstand poor business conditions and to pay its obligations to creditors.

Alphabet is a very profitable company that requires very little debt. Alphabet's ratio of liabilities to stockholders' equity was 0.24 at the end of Year 1, while decreasing slightly to 0.23 at the end of Year 2. Ratios less than 1.0 are protective to creditors. Thus, Alphabet's ratios indicate little creditor risk. In contrast, Twitter's ratio of liabilities to stockholders' equity at the end of Year 2 is over twice that of Alphabet's, indicating more risk to Twitter's creditors. Creditors normally would not be concerned with a liabilities to stockholders' equity ratio of 0.49. In addition, the increase to 0.49 in Year 2 from 0.47 in Year 1 indicates only a minor decrease in protection for creditors.

Make a Decision Ratio of Liabilities to Stockholders' Equity

Compare Amazon.com to Best Buy (MAD 1-1) (Continuing company analysis)

Analyze Home Depot for Three Years (MAD 1-2)

Analyze Lowe's for Three Years (MAD 1-3)

Compare Home Depot and Lowe's (MAD 1-4)

Compare Papa John's and Yum! Brands (MAD 1-5)

Make a Decision

Let's Review

Chapter Summary

1. A business provides goods or services (outputs) to customers with the objective of earning a profit. Three types of businesses include service, retail, and manufacturing businesses. Accounting is an information system that provides reports to users about the economic activities and condition of a business. Ethics are moral principles that guide the conduct of individuals. Good ethical conduct depends on individual character and company culture. Accountants are engaged in private accounting or public accounting.
2. Generally accepted accounting principles (GAAP) are used in preparing financial statements. To be useful, financial reports should provide information that is relevant and a faithful representation of the economic activity or condition, which are enhanced by comparability, verifiability, timeliness, and understandability. GAAP is based upon the assumptions of monetary unit, time period, business entity, and going concern. The principles of measurement, historical cost, revenue recognition, and expense recognition are an integral part of GAAP. The Financial Standards Board (FASB), Securities and Exchange Commission (SEC), and International Accounting Standards Board (IASB) develop standards that are incorporated into GAAP.
3. The resources owned by a business and the rights or claims to these resources may be stated in the form of an equation, as follows: Assets = Liabilities + Equity
4. All business transactions can be stated in terms of the change in one or more of the three elements of the accounting equation.
5. The primary financial statements of a corporation are the income statement, the statement of stockholders' equity, the balance sheet, and the statement of cash flows. The income statement reports a period's net income or net loss, which is also reported on the statement of stockholders' equity. The ending common stock and retained earnings reported on the statement of stockholders' equity are also reported on the balance sheet. The ending cash balance is reported on the balance sheet and the statement of cash flows.
6. The relationship between liabilities and stockholders' equity can be expressed as a ratio of liabilities to stockholders' equity, which is computed as total liabilities ÷ total stockholders' equity. Since the rights of creditors to a business's assets come before the rights of stockholders, the lower the ratio the better able the company is to withstand poor business conditions and to pay its obligations to creditors.

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Practice

Multiple-Choice Questions

1. A profit-making business operating as a separate legal entity and in which ownership is divided into shares of stock is known as a:
   a. proprietorship.
   b. service business.
   c. partnership.
   d. corporation.

2. The resources owned by a business are called:
   a. assets.
   b. liabilities.
   c. retained earnings.
   d. common stock.

3. A listing of a business entity's assets, liabilities, and stockholders' equity as of a specific date is a(n):
   a. balance sheet.
   b. income statement.
   c. statement of stockholders' equity.
   d. statement of cash flows.

4. If total assets increased $20,000 during a period and total liabilities increased $12,000 during the same period, the amount and direction (increase or decrease) of the change in stockholders' equity for that period is a(n):
   a. $32,000 increase.
   b. $32,000 decrease.
   c. $8,000 increase.
   d. $8,000 decrease.

5. If revenue was $45,000, expenses were $37,500, and dividends were $10,000, the amount of net income or net loss would be:
   a. $45,000 net income.
   b. $7,500 net income.
   c. $37,500 net loss.
   d. $2,500 net loss.

Answers provided after Problem. Need more practice? Find additional multiple-choice questions, exercises, and problems in CengageNOWv2.

Exercises

SHOW ME HOW

1. Cost principle — Obj. 2

On February 22, Kountry Repair Service extended an offer of $200,000 for land that had been priced for sale at $250,000. On April 3, Kountry Repair accepted the seller's counteroffer of $230,000 and bought the land for this amount. On September 15, the land was assessed at a value of $185,000 for property tax purposes. On January 9 of the next year, Kountry Repair was offered $300,000 for the land by a national retail chain. At what value should the land be recorded in Kountry Repair Service's records?

SHOW ME HOW

2. Accounting equation — Obj. 3

Dream-It LLC is a motivational consulting business. At the end of its accounting period, December 31, 20Y2, Dream-It has assets of $780,000 and liabilities of $150,000. Using the accounting equation, determine the following amounts:

a. Stockholders' equity as of December 31, 20Y2.

b. Stockholders' equity as of December 31, 20Y3, assuming that assets increased by $90,000 and liabilities increased by $25,000 during 20Y3.

SHOW ME HOW

3. Transactions — Obj. 4

Arrowhead Delivery Service is owned and operated by Gates Deeter. The following selected transactions were completed by Arrowhead Delivery during August:

1. Received cash in exchange for common stock, $25,000.
2. Paid creditors on account, $3,750.
3. Billed customers for delivery services on account, $22,400.
4. Received cash from customers on account, $11,300.
5. Paid dividends, $6,000.

Indicate the effect of each transaction on the following accounting equation elements: Assets, Liabilities, Common Stock, Dividends, Revenue, and Expense. To illustrate, the answer to (1) follows:

(1) Asset (Cash) increases by $25,000;
Common Stock increases by $25,000.

SHOW ME HOW

4. Income statement — Obj. 5

The revenues and expenses of Ousel Travel Service for the year ended November 30, 20Y8, follow:

Fees earned	$1,475,000
Office expense	320,000
Miscellaneous expense	28,000
Wages expense	885,000

Prepare an income statement for the year ended November 30, 20Y8.

SHOW ME HOW

5. Statement of stockholders' equity **Obj. 5**

Using the income statement for Ousel Travel Service from Exercise 4, prepare a statement of stockholders' equity for the year ended November 30, 20Y8. Shane Ousel invested an additional $50,000 in the business in exchange for common stock during the year and cash dividends of $30,000 were paid. As of December 1, 20Y7, common stock had a balance of $100,000 and retained earnings had a balance of $566,000.

SHOW ME HOW

6. Balance sheet **Obj. 5**

Using the following data for Ousel Travel Service as well as the statement of stockholders' equity from Exercise 5, prepare a balance sheet as of November 30, 20Y8:

Accounts payable	$ 62,500
Accounts receivable	186,000
Cash	308,000
Common stock	150,000
Land	480,000
Supplies	16,500

SHOW ME HOW

7. Statement of cash flows **Obj. 5**

A summary of cash flows for Ousel Travel Service for the year ended November 30, 20Y8, follows:

Cash receipts:	
Cash received from customers	$1,465,000
Cash received from issuing common stock	50,000
Cash payments:	
Cash paid for operating expenses	1,230,000
Cash paid for land	150,000
Cash paid for dividends	30,000

The cash balance as of December 1, 20Y7, was $203,000.

Prepare a statement of cash flows for Ousel Travel Service for the year ended November 30, 20Y8.

SHOW ME HOW

8. Ratio of liabilities to stockholders' equity **Obj. 6**

The following data were taken from Mesa Company's balance sheet:

	Dec. 31, 20Y6	Dec. 31, 20Y5
Total liabilities	$547,800	$518,000
Total stockholders' equity	415,000	370,000

a. Compute the ratio of liabilities to stockholders' equity.

b. Has the creditor's risk increased or decreased from December 31, 20Y5, to December 31, 20Y6?

Answers provided after Problem. Need more practice? Find additional multiple-choice questions, exercises, and problems in CengageNOWv2.

Problem

Cecil Jameson, Attorney-at-Law, is organized as a corporation and operated by Cecil Jameson. On July 1, 20Y4, the company has the following assets, liabilities, and common stock: cash, $1,000; accounts receivable, $3,200; supplies, $850; land, $10,000; accounts payable, $1,530; common stock, $10,000. Office space and office equipment are currently being rented, pending the construction of an office complex on land purchased last year. Business transactions during July are summarized as follows:

a. Received cash from clients for services, $3,928.

b. Paid creditors on account, $1,055.

c. Received cash from Cecil Jameson as an additional investment in exchange for common stock, $3,700.

d. Paid office rent for the month, $1,200.

e. Charged clients for legal services on account, $2,025.