

Wiley Loose-Leaf Print Edition

ACCOUNTING

TOOLS FOR BUSINESS DECISION MAKING

8TH EDITION



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Paul Kimmel's

Accounting Course Design with WileyPLUS

Paul Kimmel, author of several Wiley courses, teaches at The University of Wisconsin—Madison and uses WileyPLUS in a flipped classroom format.



Ignite student potential with WileyPLUS

See how Paul uses four key elements to focus his course on developing his students' success.



Guided Learning

EXAMPLE:

Paul sets up his learning path to highlight and structure pre-assignments, post-assignments and discussions, adaptive assignments, exam practice, and quizzing.

A **guided learning path** enables you to control what your students see, when they see it, and in what order. This makes it very clear for students to understand what they're supposed to complete. This is especially vital for online classes. **Having a clear path to learning reduces the risk of "losing" students, keeping them engaged and on track in your course.**



Information Retention

EXAMPLE:

Paul assigns Interactive Tutorial Assignments ahead of pre-lecture activities so students come to class ready to actively participate.

Interactive Tutorial Assignments provide students with self-paced lecture walkthroughs of each chapter. Broken into smaller chunks with Knowledge Check questions and Do It!s, students must watch the videos and respond to associated questions correctly or exhaust attempts before moving on, enhancing the retention of information. **Trying to solve a problem before being taught the solution is frustrating but improves retention.**



Personalized Practice

EXAMPLE:

Paul uses Adaptive Assignments as a capstone activity at the end of each week to improve retention.

Adaptive Assignments effectively close knowledge gaps through personalized adaptive experiences that provide just-in-time instruction, immediate feedback, and remediation to previous learning objectives. **To improve learning, employ dynamic (adaptive) testing rather than static testing. Without feedback, students often overestimate their competence and don't see a need to try to improve.**



Just-in-Time Homework Help

EXAMPLE:

Paul assigns post-assignment problems supported by Solution Walkthrough Videos.

Solution Walkthrough Videos provide students with 24/7 just-in-time homework support and enable you to assign more difficult homework questions. **Longer, multi-learning objective problems with video support help students consolidate their understanding.**

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Course Design Suggestions from *Make It Stick**

- ✓ Trying to solve a problem before being taught the solution improves retention.
- ✓ Testing (active retrieval) doesn't just measure learning, it strengthens memory.
- ✓ Spaced "testing" results in greater retention.
- ✓ Providing feedback strengthens learning more than testing alone.

**Make It Stick*; Brown, Roediger, and McDaniel, 2014.

Considerations for a Flipped Classroom

Based on Paul Kimmel's course with two in-person lectures per week.

EXAMPLE WEEKLY SCHEDULE

SUNDAY	Online	Complete first pre-assignment. Due Monday before class.
MONDAY	In Class	Students do at least two exercises in class on blank sheet (i.e., conditions faced in a test).
TUESDAY	Online	Complete second pre-assignment. Due Wednesday before class.
WEDNESDAY	In Class	Students do at least two exercises in class on blank sheet.
THURSDAY/FRIDAY	Online	Complete post-assignment. Due Friday night.
FRIDAY/SATURDAY	Online	Complete adaptive assignment. Due Saturday night.

Want to learn more about Paul Kimmel's course?



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Accounting

Tools for Business Decision Making

Eighth Edition

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Cases for Management Decision Making

From the Authors

Dear Student,

Why This Course? Remember your biology course in high school? Did you have one of those “invisible man” models (or maybe something more high-tech than that) that gave you the opportunity to look “inside” the human body? This accounting course offers something similar. To understand a business, you have to understand the financial insides of a business organization. An accounting course will help you understand the essential financial components of businesses. Whether you are looking at a large multinational company like **Apple** or **Starbucks** or a single-owner software consulting business or coffee shop, knowing the fundamentals of accounting will help you understand what is happening. As an employee, a manager, an investor, a business owner, or a director of your own personal finances—any of which roles you will have at some point in your life—you will make better decisions for having taken this course.

Why This Text? Your instructor has chosen this text for you because of its trusted reputation. We have worked hard to provide instructional material that is engaging, timely, and accurate.

How to Succeed? We’ve asked many students and many instructors whether there is a secret for success in this course. The nearly unanimous answer turns out to be not much of a secret: “Do the homework.” This is one course where doing is learning. The more time you spend on the homework assignments—using the various tools that this text provides—the more likely you are to learn the essential concepts, techniques, and methods of accounting.

Good luck in this course. We hope you enjoy the experience and that you put to good use throughout a lifetime of success the knowledge you obtain in this course. We are sure you will not be disappointed.

“Whether you are looking at a large multinational company like **Apple** or **Starbucks** or a single-owner software consulting business or coffee shop, knowing the fundamentals of accounting will help you understand what is happening.”

Paul D. Kimmel
Jerry J. Weygandt
Jill E. Mitchell

Author Commitment



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New to This Edition: Data Analytics

The authors carefully considered how to thoughtfully and meaningfully integrate data analytics into the accounting course, and are pleased to provide the following data analytics resources.

Data Analytics and Decision-Making

The text provides numerous discussions on how decision-makers are increasingly relying on data analytics to make decisions using accounting information.

Accounting software systems collect vast amounts of data about a company's economic events as well as its suppliers and customers. Business decision-makers take advantage of this wealth of data by using data analytics to gain insights and therefore make more informed business decisions.

- **Data analytics** involves analyzing data, often employing both software and statistics, to draw inferences.
- As both data access and analytical software improve, the use of data analytics to support decisions is becoming increasingly common at virtually all types of companies.

Data Analytics in the Real World

Real-world examples that illustrate engaging situations in companies are provided throughout the text.

Data Analytics Insight Netflix



Bogdan Glisik/
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Using Data Science to Create Art

Technology provides decision-makers and problem-solvers with access to a large volume of information called “big data.” And **Netflix**, the world's leading subscription streaming entertainment service, is tapping into this big data as part of its efforts to ramp up its original content production.

In a recent year, Netflix planned to spend \$8 billion on content creation. Producing content involves a blend of creativity, technology, and business decisions, all of which result in costs. And by analyzing the large amounts of data from past productions, such as filming locations and production

schedules, Netflix can more precisely estimate costs for future productions. Further, consider that the production of a TV show or film involves hundreds of tasks. Here again, Netflix uses data science, in this case to visualize where bottlenecks might occur or where opportunities might exist to increase the efficiency of the production process.

Source: Ritwik Kumar et. al., “Data Science and the Art of Producing Entertainment at Netflix,” *The Netflix Tech Blog* (March 26, 2018).

How can “big data” improve decision-making? (Answer is available at the end of the chapter.)

Data Analytics in Action

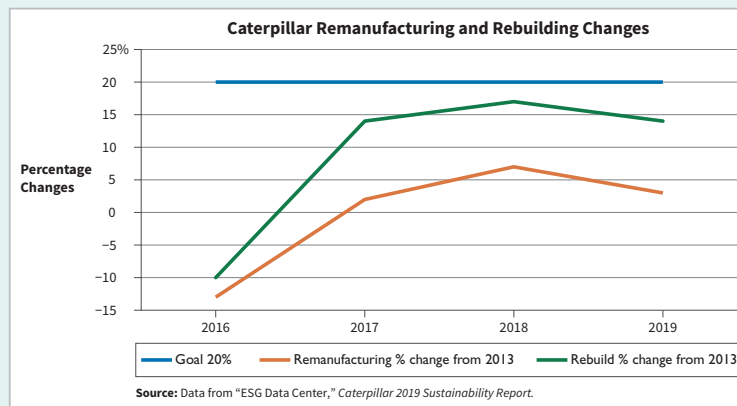
Data Analytics in Action problems provide students with the opportunity to see how to use data analytics to help solve realistic business problems. Excel templates for each *Data Analytics in Action* problem provide students a framework for solving the problem. *Data Analytics in Excel* videos provide students with step-by-step guidance to perform the Excel skills they need to solve these problems.

Using Data Visualization to Analyze Changes over Time

DA6.1 Data visualization can be used to analyze company changes over time.

Example: Recall the Feature Story “Where Is That Spare Bulldozer Blade?” presented in the chapter. **Caterpillar** continues to enhance its inventory management by improving its product sustainability in two ways. First, it is rebuilding used parts to like-new condition. Second, the company is remanufacturing usable inventory parts when customers trade-in or dispose of their used equipment. These actions not only reduce inventory costs but also enable Caterpillar to participate in the circular economy, where manufacturers take responsibility for their products at the end of the product lives. As noted in its 2019 sustainability report, Caterpillar has a goal of 20% growth in both rebuilding and remanufacturing.

Has Caterpillar reached this goal? A line chart can help you visualize the company’s progress over time. What information can you obtain by examining the following chart?



The chart indicates that while Caterpillar’s goal has remained at 20%, the remanufacturing and rebuilding businesses are growing. The biggest increase in the growth of rebuilding occurred from 2016 to 2017. There was a decline from 2018 to 2019 in these initiatives as Caterpillar may have reached a peak that is leveling off due to new production that is more sustainable.

For this case, you will look more closely at specific Caterpillar data regarding its end-of-life returned materials and the percentage usable for recycling. You will create and analyze a combination column and line chart to determine how Caterpillar can increase its gross profit as it relates to these end-of-life materials.

Go to Wiley Course Resources for complete case details and instructions.

Using Data Analytics to Compare Companies’ Inventory Turnover

DA6.2 Inventory turnover shows the number of times during the period a firm sells the entire dollar amount of its inventory. It is advantageous to turn over inventory more quickly to reduce the risk of obsolescence and spoilage. As such, companies often have a goal of increasing inventory turnover. For this case, you will use inventory turnover data for **Costco**, **Walmart**, **Target**, and **Amazon** to create and analyze scatter plots, as well as to calculate days’ sales in inventory, to determine which company is managing its inventory levels most effectively.

Go to Wiley Course Resources for complete case details and instructions.



Data Visualization Homework Assignments

PowerBI and Tableau visualizations accompanied by assignable questions are available with most chapters. PowerBI and Tableau visualizations allow students to interpret visualizations and think critically about data.

Data Analytics Module

An **accounting-specific data analytics module** with interactive lessons, case studies, and videos is part of the Wiley online course. The module has been prepared using industry-validated content to help students develop the professional competencies needed for the changing workforce.

New to This Edition: Chapter-by-Chapter Changes

Chapter 1: Introduction to Financial Statements

- NEW discussions of hybrid forms of organization and critical audit matters.
- NEW section on overview of data analytics, including Data Analytics Insight box on how **Netflix** relies on data science to streamline production costs on content creation.
- NEW DO IT!s on using financial information and components of annual reports.
- NEW chapter appendix on career opportunities in accounting.
- ADDED Questions, Do It's, Exercises, and Ethics Case to end-of-chapter (EOC) problem material.

Chapter 2: A Further Look at Financial Statements

- MOVED discussion of free cash flow/using a statement of cash flows to Chapter 12.
- NEW discussion of why receivables are considered more liquid than inventory.
- DELETED partial balance sheet illustrations showing classifications for more streamlined presentation.
- NEW Investor Insight box, on reliability of investor bulletin board postings.
- UPDATED definitions of materiality and the full disclosure principle per recent FASB actions.
- NEW illustrations on (1) world view of the standard-setting environment, (2) enhancing qualities of accounting information, and (3) summary of the conceptual framework.
- ADDED Exercises to EOC problem material.

Chapter 3: The Accounting Information System

- NEW discussion of recent technologies used, such as cloud-based storage and data automation tools.
- NEW DO IT! on accounts, debits, and credits.
- ADDED Practice Brief Exercise, DO IT!, Exercises, and Ethics Case to EOC problem material.

Chapter 4: Accrual Accounting Concepts

- NEW discussion of recent technologies used, such as the use of robotic process automation (RPA) in the closing process.
- NEW illustration of a post-closing trial balance.
- ADDED Exercises and Problem to EOC problem material.

Chapter 5: Merchandising Operations and the Multiple-Step Income Statement

- EXPANDED discussion of FOB shipping/destination for improved student understanding.
- ADDED discussion of new technology, such as use of artificial intelligence and algorithms, to Data Analytics and Credit Sales section.
- UPDATED People, Planet, and Profit Insight box to focus on **REI**, for greater continuity throughout chapter.
- MOVED discussion of the comprehensive income statement to Chapter 13.
- ADDED Exercises, Ethics Case, and Data Analytics in Action to EOC problem material.

Chapter 6: Reporting and Analyzing Inventory

- ADDED separate DO IT's after each cost flow method discussion.
- NEW illustration on the impact on cost flow assumptions when costs change.
- NEW discussion of how companies can use data analytics when determining NRV of products.
- NEW Data Analytics Insight box on value of dashboards.
- ADDED Exercises, Critical Thinking Case, and Data Analytics in Action to EOC problem material.

Chapter 7: Fraud, Internal Control, and Cash

- UPDATED discussion and illustrations of cash receipts controls, to reflect current practices and technology.
- NEW section on electronic banking.
- NEW illustration on how to determine outstanding checks in a bank reconciliation.
- ADDED Real-World Focus Case and Data Analytics in Action to EOC problem material.

Chapter 8: Reporting and Analyzing Receivables

- NEW Data Analytics Insight box on how companies are making increasingly more sophisticated credit decisions using data analytics.
- NEW illustration on the use of Tableau dashboards to provide tracking and analysis of a company's receivables.
- ADDED Exercises Data Analytics in Action to EOC problem material.

Chapter 9: Reporting and Analyzing Long-Lived Assets

- UPDATED People, Planet, and Profit Insight box to now focus on **Nike**'s sustainability report.
- ADDED Exercises, Critical Thinking Case, and Data Analytics in Action to EOC problem material.

Chapter 10: Reporting and Analyzing Liabilities

- NEW Investor Insight box on how **Ford** issued bonds to raise cash for operations and new products.
- ADDED **Tesla** as comparative company in analyzing the liquidity and solvency of **General Motors**.
- ADDED Critical Thinking Case to EOC problem material.

Chapter 11: Reporting and Analyzing Stockholders' Equity

- UPDATED People, Planet, and Profit Insight box to highlight latest information on corporate social responsibility proposals.
- ADDED new discussion of liquidating dividends.
- NEW Investor Insight box on stock dividends.
- ADDED Exercises, Critical Thinking Case, and Data Analytics in Action to EOC problem material.

Chapter 12: Statement of Cash Flows

- ADDED Data Analytics in Action to EOC problem material.

Chapter 13: Financial Analysis: The Big Picture

- NEW presentation of discontinued operations on the income statement (previously on the statement of comprehensive income) as well as discussion and format of the statement of comprehensive income.
- ADDED Critical Thinking Case to EOC problem material.

Chapter 14: Managerial Accounting

- NEW section on the value of data analytics in helping managers understand the relationship between CVP variables and business trends.
- NEW Data Analytics Insight box on how **Disney** uses its MagicBands as a source of data to analyze the behavior of its customers.
- EXPANDED discussion within "Manufacturing Costs" section to ensure student understanding of raw materials versus direct materials as well as what is considered to be manufacturing overhead. Also updated Illustration 1.4 (assignment of costs to cost categories) to include an explanation for each cost classification, again to ensure student understanding.
- MOVED UP discussion of balance sheet (before income statement) in "Manufacturing Costs in Financial Statements" section for more logical presentation of topics.
- UPDATED each "Managerial Accounting Today" section subtopic for the latest information on service industries, lean manufacturing, balanced scorecard, ethics, and social responsibility.
- NEW Data Analytics in Action problems allow students to perform basic data analytics and data visualization.

Chapter 15: Job Order Costing

- NEW Data Analytics Insight box on how **Autodesk** uses data analytics to improve its software and profitability.

- ADDED discussion on assigning raw materials costs and assigning factory labor costs, to improve student understanding.
- UPDATED time ticket discussion for more recent process involving scanning of employee identification codes.
- NEW Data Analytics in Action problems allow students to perform basic data analytics and data visualization.

Chapter 16: Process Costing

- UPDATED production cost report so that the "Cost Reconciliation Schedule" section now includes costs to be accounted for, not just costs accounted for.
- EDITED discussion throughout to ensure complete student understanding. For example, in the "Transfer to Next Department" section, have added explanation of what department transfers entail.

Chapter 17: Activity-Based Costing

- NEW data analytics discussion added to section of identifying cost drivers.
- NEW Data Analytics Insight box on how companies such as **GE** and **UPS** use data analytics to help reduce non-value-added activities.
- NEW section ("Assigning Nonmanufacturing Overhead Costs") and income statement presentations, to help highlight differences between traditional costing and activity-based costing.

Chapter 18: Cost-Volume-Profit

- NEW discussion on CVP and the use of data analytics, using **DHL Express** as an example.
- NEW expanded highlighted equations, to show more detailed calculations for improved understanding.
- NEW expanded explanation of what CVP analysis is.
- NEW illustration and discussion on how a GAAP income statement differs from a CVP income statement.
- NEW discussion on the variable cost ratio.
- UPDATED Service Company Insight box to feature more recent information on the business of music promotion (and using Drake as an example instead of the Rolling Stones) and computing the break-even point.
- ENHANCED EOC assignments by offering students more opportunities to prepare CVP income statements, as well as a new problem on regression analysis.
- NEW Data Analytics in Action problems allow students to perform basic data analytics and data visualization.

Chapter 19: Cost-Volume-Profit Analysis: Additional Issues

- NEW Data Analytics Insight box on how **Caesars Entertainment** uses data analytics to determine how to maximize profits from its customers.
- NEW Data Analytics in Action problems allow students to perform basic data analytics and data visualization.

Chapter 20: Incremental Analysis

- HIGHLIGHTED the decision rules, as well as additional factors to consider, for incremental analysis decisions.

Chapter 21: Pricing

- NEW Data Analytics Insight box on how **Big Data Pricing** helps customers use data analytics to improve dynamic pricing practices.
- NEW Data Analytics in Action problem allows students to perform basic data analytics and data visualization.

Chapter 22: Budgetary Planning

- NEW Data Analytics Insight box on how **Dickey's Barbecue Pit** uses data analytics to improve restaurant sales performance.
- NEW Data Analytics in Action problem allows students to perform basic data analytics and data visualization.

Chapter 23: Budgetary Control and Responsibility Accounting

- NEW Data Analytics Insight boxes on rolling forecasts and zero-based budgeting.
- UPDATED section on “Judgmental Factors in ROI” with “Alternative Measures of ROI Inputs” for more precise discussion and improved student understanding.
- NEW Data Analytics in Action problems allow students to perform basic data analytics and data visualization.

Chapter 24: Standard Costs and Balanced Scorecard

- NEW Data Analytics Insight box on how manufacturing companies are using technology such as 5G cellular to improve the amount and speed of data collection to improve operations.

- NEW highlighted applications of determining standard costs in “A Case Study” section, for improved student understanding.
- NEW Data Analytics in Action problem allows students to perform basic data analytics and data visualization.

Chapter 25: Planning for Capital Investments

- NEW Data Analytics Insight box on how **Electronic Arts** uses data from its current online video games to help it develop future products.
- IMPROVED illustration showing computation of cash payback period by including detailed steps and computations.
- NEW Management Insight box on 5G and how it presents a risky investment to telecom companies.
- NEW Data Analytics in Action problems allow students to perform basic data analytics and data visualization.

Appendix F: Time Value of Money (previously Appendix G)

- NEW discussion of using Excel function to solve time value of money problems.

Appendix G: Reporting and Analyzing Investments (previously Appendix H)

- NEW DO IT!s added to appendix discussion as well as EOC problem material.
- NEW Review and Practice section includes multiple-choice questions followed by annotated solutions, practice brief exercises with solutions, practice exercises with solutions, and a practice problem with solution.

New to This Edition in Your Wiley Course**Lecture Videos**

Lecture Videos, narrated by an accounting instructor for every section in the text, talk through the PowerPoint slides, including embedded application videos where applicable, providing support for online courses, flipped classrooms, and student study and review.

Interactive Tutorial Assignments

Interactive Tutorial Assignments provide students a guided walkthrough and review of the chapter content and topics, including Chapter Overview Videos, Lecture Videos for each learning objective, and selected Real World Videos. Interactive Knowledge Check and Do It! questions in the assignments check student understanding and knowledge acquisition. In applicable questions, values change algorithmically, to support student practice and integrity. The Interactive Tutorial Assignments are available to students as practice, and may be separately customized and assigned by instructors.

Animations

Short, animated videos engage students and simplify major concepts in the text, making the concepts easier to understand. They offer an alternative approach to understanding the written material.

Brief Exercise Solution Walkthrough Videos

Additional Solution Walkthrough Videos developed for this edition, now also including selected Brief Exercises, continue to build scaffolding for student understanding and 24/7 problem-solving support.

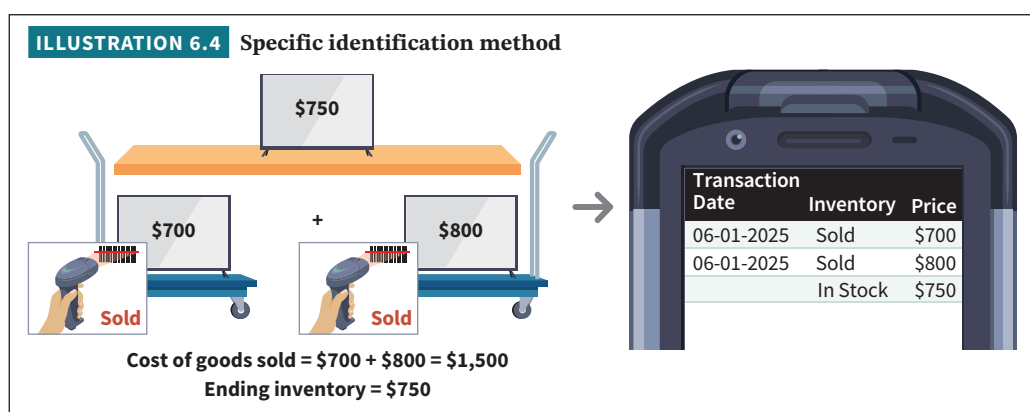
Proven Pedagogical Features

When you think of accounting, you probably don't think of athletics. So why do we have a photo of bicycles on our cover? It's because this image represents active learning that's best accomplished through full engagement, commitment, and practice.

In this new edition, all content has been carefully reviewed and revised to ensure maximum student understanding. At the same time, the time-tested features that have proven to be of most help to students have been retained, such as the following.

Infographic Learning

Over half of the text is visual, providing students alternative ways of learning about accounting.



Real-World Decision-Making

Real-world examples, which illustrate engaging situations in companies, are provided throughout the text. Answers to the critical thinking questions posed to readers within the real-world examples are now available at the end of each chapter.

People, Planet, and Profit Insight



njgphoto/Getty Images

Got Junk?

Do you have an old computer or two in your garage? How about an old TV that needs replacing? Many people do. Approximately 163,000 computers and televisions become obsolete **each day**. Yet, in a recent year, only 11% of computers were recycled.

It is estimated that 75% of all computers ever sold are sitting in storage somewhere, waiting

to be disposed of. Each of these old TVs and computers is loaded with lead, cadmium, mercury, and other toxic chemicals. If you have one of these electronic gadgets, you have a responsibility, and a probable cost, for disposing of it. Companies have the same problem, but their discarded materials may include lead paint, asbestos, and other toxic chemicals.

What accounting issue might this cause for companies?
(Answer is available at the end of the chapter.)

DO IT! Exercises

DO IT! Exercises in the body of the text prompt students to stop and review key concepts. They outline the Action Plan necessary to complete the exercise as well as show a detailed solution.

ACTION PLAN

- Understand the periodic inventory system.
- Allocate costs between goods sold and goods on hand (ending inventory) for the FIFO method.
- Compute cost of goods sold for the FIFO method.

DO IT! 2a | Cost Flow Methods—FIFO Method

The accounting records of Shumway Ag Implements show the following data.

Beginning inventory	4,000 units at \$3
Purchases	6,000 units at \$4
Sales	7,000 units at \$12

Determine the cost of goods sold during the period under a periodic inventory system using the FIFO method.

Solution

Cost of goods available for sale = $(4,000 \times \$3) + (6,000 \times \$4) = \$36,000$

Ending inventory = $10,000 - 7,000 = 3,000$ units

Cost of goods sold FIFO: $\$36,000 - (3,000 \times \$4) = \$24,000$

Related exercise material: BE6.3, BE6.4, BE6.5, BE6.6, DO IT! 6.2, E6.5, E6.6, E6.7, and E6.8.

Decision Tools

Accounting concepts that are useful for management decision-making are highlighted throughout the text. A summary of Decision Tools is included in each chapter as well as a practice exercise and solution called Using the Decision Tools.

USING THE DECISION TOOLS | Eastman Chemical

Eastman Chemical is a global specialty materials company that produces a broad range of products found in items people use every day. Eastman employs approximately 14,500 people around the world and serves customers in more than 100 countries. The company is headquartered in Kingsport, Tennessee. Here is the inventory note taken from recent financial statements.

Eastman Chemical Company Notes to the Financial Statements

Inventories: The components of inventories are summarized as follows:

(in millions)	
Inventories—gross:	
Raw materials	\$ 576
Work in process	220
Finished goods	1,114
Total inventories—at FIFO or average cost	1,910
Less: LIFO reserve	248
Inventories—net (as reported on balance sheet)	<u>\$1,662</u>

Eastman determines the cost of most raw materials, work in process, and finished goods inventories in the United States and Switzerland by the LIFO method. The cost of all other inventories is determined by the average-cost method, which approximates the FIFO method.

Additional facts (amounts in millions):

Current liabilities	\$1,789
Current assets (as reported)	3,321
Cost of goods sold	7,039
Beginning inventory	1,583

Instructions

Answer the following questions.

- Why does the company report its inventory in three components?
- Why might the company use three methods (LIFO, FIFO and average-cost) to account for its inventory?
- Perform each of the following.
 - Calculate the inventory turnover and days in inventory using the LIFO inventory.
 - Calculate the current ratio using LIFO and the current ratio using FIFO. Discuss the difference.

Solution

- Eastern Chemical is a manufacturer, so it purchases raw materials and makes them into finished products. At the end of each period, it has some goods that have been started but are not yet complete (work in process).

By reporting all three components of inventory, a company reveals important information about its inventory position. For example, if amounts of raw materials have increased significantly compared to the previous year, we might assume the company is planning to step up production. On the other hand, if levels of finished goods have increased relative to last year and raw materials have declined, we might conclude that sales are slowing down—that the company has too much inventory on hand and is cutting back production.

- Companies are free to choose different cost flow assumptions for different types of inventory. A company might choose to use FIFO for a product that is expected to decrease in price over time. One common reason for choosing a method other than LIFO is that many foreign countries do not allow LIFO; thus, the company cannot use LIFO for its foreign operations.

$$\text{c. 1. Inventory turnover} = \frac{\text{Cost of goods sold}}{\text{Average inventory}} = \frac{\$7,039}{(\$1,583 + \$1,662) \div 2} = 4.3 \text{ times}$$

$$\text{Days in inventory} = \frac{365}{\text{Inventory turnover}} = \frac{365}{4.3} = 84.9 \text{ days}$$

- Current ratio

	LIFO		FIFO
Current assets	\$3,321		\$3,321 + \$248
Current liabilities	\$1,789		\$1,789
	$= 1.86:1$		$= 1.99:1$

This represents a 7% increase in the current ratio $[(1.99 - 1.86) \div 1.86]$.

Review and Practice

Each chapter concludes with a Review and Practice section which includes a review of learning objectives, Decision Tools review, key terms glossary, practice multiple-choice questions with annotated solutions, practice brief exercises with solutions, practice exercises with solutions, and a practice problem with a solution.

Review and Practice

Practice Brief Exercises

Determine ending inventory amount.

1. (LO 1) Fylus Company took a physical inventory on December 31 and determined that goods costing \$180,000 were on hand. Not included in the physical count were \$18,000 of goods purchased from Rake Corporation, FOB destination, and \$27,000 of goods sold to Shovel Company for \$40,000, FOB destination. Both the Rake purchase and the Shovel sale were in transit year-end. What amount should Fylus report as its December 31 inventory?

Solution

1. Physical inventory	\$180,000
Add: Goods sold to Shovel	<u>27,000</u>
Fylus ending inventory	<u>\$207,000</u>

The \$18,000 of goods purchased from Rake are excluded from ending inventory because the terms are FOB destination which means Fylus takes title at the time the goods are received. Goods sold to Shovel FOB destination means that the goods are still Fylus's until delivered.

Engaging Digital Tools

Digital study tools in Wiley's online course include the following.

Lecture Videos

Lecture Videos, narrated by an accounting instructor for every section in the text, talk through the PowerPoint slides, including embedded application videos where applicable, providing support for online courses, flipped classrooms, and student study and review.

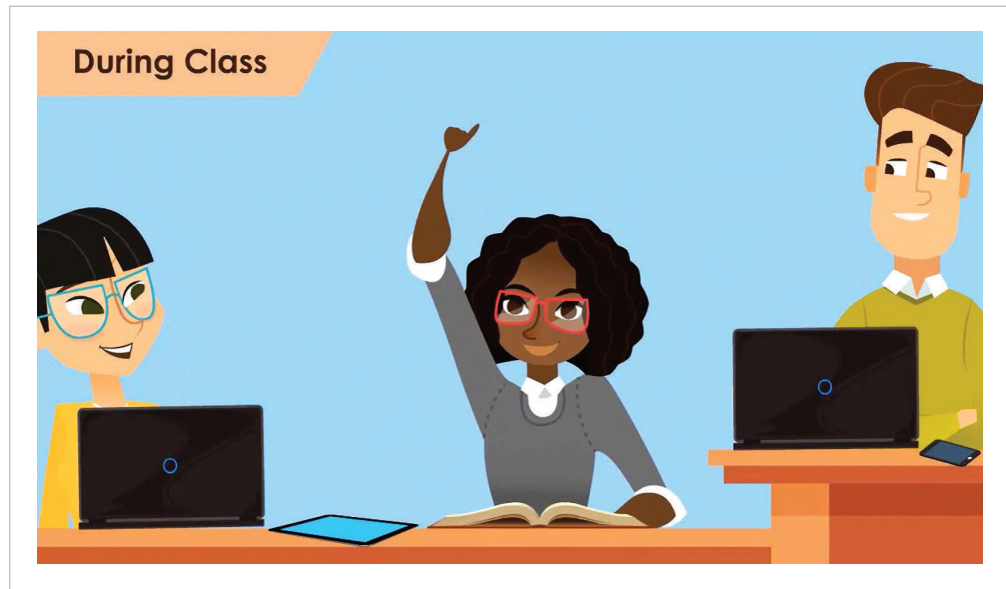
The screenshot displays a Wiley online course interface. At the top, a red banner states the **Learning Objective: 6.1** Discuss how to classify and determine inventory. Below this, a blue header reads **6.1 Classifying and Determining Inventory: Classifying Inventory – Lecture Video (2 min)**. The section is titled **Lecture Video** and includes the instruction: "Watch this video, then answer the questions that follow to check your understanding." The video player shows a slide titled **Reporting Inventory** with the text "Two steps at the end of the accounting period" and a list: "1. Classifica complete" and "2. Determin". To the right of the video player, a **Knowledge Check** section is visible, titled **6.1 Classifying and Determining Inventory: Classifying Inventory – Knowledge Check**. It asks the user to "Answer the following questions. If you would like to review the video or transcript, click [here](#)." There are three questions with input fields: "1. Work in process is a type of inventory for [] companies.", "2. Companies using a [] inventory system take a physical inventory to determine the cost of goods sold for the period.", and "3. Companies take a physical inventory at the [] of the accounting period." Below the questions, there are three columns for selecting answers: **Question 1** with options **merchandising** and **manufacturing**; **Question 2** with options **periodic** and **perpetual**; and **Question 3** with options **beginning** and **end**. At the bottom, there is a **Save for Later** button, a counter showing **Attempts: 0 of 2 used**, and a **Submit Answer** button.

Interactive Tutorial Assignments

Interactive Tutorial Assignments provide students with guided instruction of the chapter content and topics, including Chapter Overview Videos, Lecture Videos for each learning objective, and selected Real World Videos. Knowledge Check questions in the assignments check student understanding and knowledge acquisition. The Interactive Tutorial Assignments are available to students as practice, and may be separately customized and assigned by instructors.

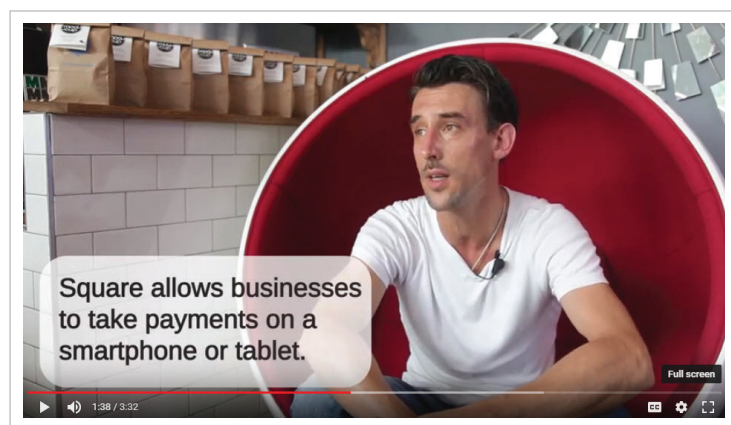
Animations

Short, animated videos engage students and simplify major concepts in the text, making the concepts easier to understand. They offer an alternative approach to understanding the written material.



Real-World Company Videos

Real-world company videos feature both small businesses and larger companies to help students apply content and see how business owners apply concepts from the text in the real world. Many of the videos have associated questions available to be assigned.



Source: YouTube.

Solution Walkthrough Videos

Solution Walkthrough Videos are available as question assistance and to help students develop problem-solving techniques. These videos walk students through solutions step-by-step and are based on the most regularly assigned exercises and problems in the text.

Nex Company uses both special journals and a general journal as described in this chapter. On June 30, after all monthly postings had been completed, the Accounts Receivable control account in the general ledger had a debit balance of \$318,190; the Accounts Payable control account had a credit balance of \$85,390.

The July transactions recorded in the special journals are summarized below. No entries affecting accounts receivable and accounts payable were recorded in the general journal for July.

Sales journal	Total sales	\$157,460
Purchases journal	Total purchases	\$55,265
Cash receipts journal	Accounts receivable column total	\$144,550
Cash payments journal	Accounts payable column total	\$49,437

What is the balance of the Accounts Receivable control account after the monthly postings on July 31?

The balance of the Accounts Receivable control account: \$

[SHOW SOLUTION](#) [SHOW ANSWER](#)

What is the balance of the Accounts Payable control account after the monthly postings on July 31?

The balance of the Accounts Payable control account: \$

[SHOW SOLUTION](#) [SHOW ANSWER](#)

1:00 / 3:00 1x

Source: YouTube.

Gradable Excel Questions

Gradable Excel questions for each chapter provide students an opportunity to practice Excel skills in the context of solving accounting problems.

	A	B	C	D	E	F	G	H	I	J	
1	Function: IF; Formula: Subtract, Multiply; Cell Referencing										
2											
3	Brief Exercise - Using Excel to Determine Variances					Student Work Area					
4	PROBLEM					Required: Provide input into cells shaded in yellow in this					
5	In October, Pine Company was determining its overhead					template. Use cell references to the Problem area with					
6	variance. Its predetermined overhead rate is based on					mathematical formulas in the input cells. In the last input					
7	direct labor hours. The following					field, input an IF function with cell references to your work area.					
8											
9	Manufacturing overhead costs incurred		\$ 118,000		Actual overhead					Answer Field 15.4% of your score. Formula: Multiply; Cell reference. Use a mathematical formula and cell referencing to the Problem area to determine the overhead applied.	
10	Actual direct labor hours		21,000		Overhead applied						
11	Standard hours allowed for work done		20,600		Total overhead variance						
12	Predetermined overhead rate		\$ 6.00								
13						Nature of variance					
14	Compute the amount of the total overhead variance and										
15	designate if the variance is favorable or unfavorable using										
16	Excel's IF function.										

Data Visualization Homework Assignments

PowerBI and Tableau visualizations accompanied by questions are available with most chapters. PowerBI and Tableau visualizations allow students to interpret visualizations and think critically about data.

Other Learning Opportunities

Other learning opportunities in Wiley's online course include the following.

- **Accounting-Specific Data Analytics Module** offers interactive lessons, case studies, and videos. The module has been prepared using industry-validated content to help students develop the professional competencies needed for the changing workforce.
- **Cookie Creations** is a continuing case that spans across the financial accounting chapters and offers students the opportunity to see how a small business might use financial accounting to operate effectively.
- **Waterways Corporation** is a continuing case that spans across the managerial accounting chapters and offers students the opportunity to see how a small business might use managerial accounting to operate effectively.
- **Wiley Accounting Updates** (wileyaccountingupdates.com) provide faculty and students with weekly curated news articles and suggested discussion questions.
- **Flashcards and Crossword Puzzles** help students study and master basic vocabulary and concepts.
- **Student Practice** quickly and effectively assesses student understanding of the material they have just covered.
- **Adaptive Assignments** encourage students to persist so that they can succeed in this course and beyond. By continuously adapting to each student's needs and providing achievable goals with just-in-time instruction, Adaptive Assignments close knowledge gaps to accelerate learning.

CHAPTER 1



My Good Images/Shutterstock.com.

Introduction to Financial Statements

Chapter Preview

If you own a business, how do you determine whether it is making or losing money? How should you finance expansion—should you borrow, should you issue stock, should you use your own funds? How do you convince banks to lend you money or investors to buy your stock? Success in business requires making countless decisions, and decisions require financial information.

The purpose of this chapter is to show you what role accounting plays in providing financial information.

The **Chapter Preview** describes the purpose of the chapter and highlights major topics.

The **Feature Story** helps you picture how the chapter topic relates to the real world of accounting and business.

Feature Story

Knowing the Numbers

Many students who take this course do not plan to be accountants. If you are in that group, you might be thinking, “If I’m not going to be an accountant, why do I need to

know accounting?” Well, consider this quote from Harold Geneen, the former chairman of **IT&T**: “To be good at your business, you have to know the numbers—cold.” In business, accounting financial statements are the means for communicating the numbers. If you don’t know how to read financial statements, you can’t really know your business.

Knowing the numbers is sometimes even a matter of corporate survival. Consider the story of **Columbia Sportswear Company**, headquartered in Portland, Oregon. Gert Boyle’s family fled Nazi Germany when she was 13 years old and then purchased a small hat company in Oregon, Columbia Hat Company. In 1971, Gert’s husband, who was then running the company, died suddenly. Gert took over the small, struggling company with help from her son Tim, who was then a senior at the University of Oregon. Somehow, they kept the

company afloat. Today, Columbia has more than 4,000 employees and annual sales in excess of \$1 billion. Its brands include Columbia, Mountain Hardwear, Sorel, and Montrail.

Employers such as Columbia Sportswear generally assume that managers in all areas of the company are “financially literate.” To help prepare you for that, in this text you will learn how to read and prepare financial statements, and how to use key tools to evaluate financial results using basic data analytics.

Chapter Outline

The **Chapter Outline** presents the chapter’s topics and subtopics, as well as practice opportunities.

LEARNING OBJECTIVES	REVIEW	PRACTICE
LO 1 Identify the forms of business organization and the uses of accounting information.	<ul style="list-style-type: none">• Forms of business organization• Users and uses of financial information• Data analytics• Ethics in financial reporting	DO IT! 1a Business Organization Forms 1b Using Financial Information
LO 2 Explain the three principal types of business activity.	<ul style="list-style-type: none">• Financing activities• Investing activities• Operating activities	DO IT! 2 Business Activities
LO 3 Describe the four financial statements and how they are prepared.	<ul style="list-style-type: none">• Income statement• Retained earnings statement• Balance sheet• Statement of cash flows• Interrelationships of statements• Elements of an annual report	DO IT! 3a Financial Statements: Parts 1–4 3b Components of Annual Reports
Go to the Review and Practice section at the end of the chapter for a targeted summary and practice applications with solutions.		
Visit Wiley Course Resources for additional tutorials and practice opportunities.		

1.1

Business Organization and Accounting Information Uses

LEARNING OBJECTIVE 1
Identify the forms of business organization and the uses of accounting information.

Suppose you graduate with a business degree and decide you want to start your own business. But what kind of business? You enjoy working with people, especially teaching them new skills. You spend most of your free time outdoors, kayaking, backpacking, skiing, rock climbing, and mountain biking. You think you might successfully combine your teaching skills and outdoor interest by starting an outdoor guide service.

Forms of Business Organization

What organizational form should you choose for your business? You have three choices—sole proprietorship, partnership, or corporation.

Sole Proprietorship

You might choose the sole proprietorship form for your outdoor guide service.

- A business owned by one person is a **sole proprietorship**.
- It is **simple to set up** and **gives you control** over the business.

Small owner-operated businesses such as barber shops, law offices, and auto repair shops are often sole proprietorships, as are farms and small retail stores.

Partnership

Another possibility is for you to join forces with other individuals to form a partnership.

- A business owned by two or more persons associated as partners is a **partnership**.
- Partnerships often are formed because one individual does not have **enough economic resources** or other **unique skills or resources** to initiate or expand the business.

You and your partners should formalize your duties and contributions in a written partnership agreement. Retail and service-type businesses, including professional practices (lawyers, doctors, architects, and certified public accountants), often organize as partnerships.

Corporation

As a third alternative, you might organize as a corporation.

- A business organized as a separate legal entity owned by stockholders is a **corporation**.
- Investors in a corporation receive shares of stock to indicate their ownership claim.

Buying stock in a corporation is often more attractive than investing in a partnership because shares of stock are **easy to sell** (transfer ownership). Selling a proprietorship or partnership interest is much more involved. Also, individuals can become **stockholders** by investing relatively small amounts of money (see **Alternative Terminology**).

Therefore, it is **easier for corporations to raise funds** compared to sole proprietorships or partnerships. Successful corporations often have thousands of stockholders, and their stock is traded on organized stock exchanges like the **New York Stock Exchange**. Many businesses start as sole proprietorships or partnerships and eventually incorporate.

Other factors to consider in deciding which organizational form to choose are **taxes and legal liability**. Sole proprietorships or partnerships, generally receive more favorable tax treatment than corporations. However, proprietors and partners are personally liable for all debts and legal obligations of the business; corporate stockholders are not. In other words, corporate stockholders generally pay higher taxes but have no personal legal liability. We will discuss these issues in more depth in a later chapter.

Hybrid Forms of Organization

Finally, while sole proprietorships, partnerships, and corporations represent the main types of business organizations, hybrid forms are now allowed in all states.

- Hybrid business forms combine the tax advantages of partnerships with the limited liability of corporations.
- Probably the most common among these hybrid types are limited liability companies (LLCs) and subchapter S corporations (these forms are discussed extensively in business law classes).

The combined number of proprietorships and partnerships in the United States far exceeds the number of corporations. However, the revenue produced by corporations is many times greater. Most of the largest businesses in the United States—for example, **Apple**, **Google**, **Verizon**, **Visa**, and **Microsoft**—are corporations. Because the majority of U.S. business is done by corporations, the emphasis in this text is on the corporate form of organization.

Sole Proprietorship



- Simple to establish
- Owner-controlled
- Tax advantages

Partnership



- Simple to establish
- Shared control
- Broader skills and resources
- Tax advantages

Corporation



- Easier to transfer ownership
- Easier to raise funds
- No personal liability

ALTERNATIVE TERMINOLOGY

Stockholders are sometimes called *shareholders*.

Alternative Terminology notes present synonymous terms that you may come across in practice.

DO IT! exercises prompt you to stop and review the key points you have just studied. The **Action Plan** offers you tips about how to approach the problem.

ACTION PLAN

- Know which organizational form best matches the business type, size, and preferences of the owner(s).

DO IT! 1a | Business Organization Forms

In choosing the organizational form for your outdoor guide service, you should consider the pros and cons of each. Identify each of the following organizational characteristics with the organizational form or forms with which it is associated (sole proprietorship, partnership, or corporation).

1. Easier to raise funds.
2. Simple to establish.
3. No personal legal liability.
4. Tax advantages.
5. Easier to transfer ownership.

Solution

1. Easier to raise funds: Corporation.
2. Simple to establish: Sole proprietorship and partnership.
3. No personal legal liability: Corporation.
4. Tax advantages: Sole proprietorship and partnership.
5. Easier to transfer ownership: Corporation.

Related exercise material: BE1.1, DO IT! 1.1a, and E1.2.

Users and Uses of Financial Information

The purpose of financial information is to provide inputs for decision-making.

- **Accounting** is the information system that identifies, records, and communicates the economic events of an organization to interested users.
- **Users** of accounting information can be divided broadly into two groups: internal users and external users.

Internal Users

Internal users of accounting information are managers who plan, organize, and run a business. These include **marketing managers, production supervisors, finance directors, and company officers**. In running a business, managers must answer many important questions, as shown in **Illustration 1.1**.

ILLUSTRATION 1.1 Questions that internal users ask



To answer these and other questions, you need detailed information on a timely basis. For internal users, accounting provides internal reports, such as financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year. In addition, companies present summarized financial information in the form of financial statements.

Accounting Across the Organization boxes show applications of accounting information in various business functions.

Accounting Across the Organization Clif Bar & Company



carterdayne/Getty Images

Owning a Piece of the Bar

The original Clif Bar® energy bar was created in 1990 after six months of experimentation by Gary Erickson and his mother in her kitchen. Today, the company has approximately 1,000 employees and was named one of Lander's Breakaway Brands®. One of **Clif Bar & Company's** proudest moments was the creation of an employee stock ownership plan (ESOP). This plan

gives its employees 20% ownership of the company. The ESOP also resulted in Clif Bar enacting an open-book management program, including the commitment to educate all employee-owners about its finances. Armed with basic accounting knowledge, employees are more aware of the financial impact of their actions, which leads to better decisions.

What are the benefits to the company and to the employees of making the financial statements available to all employees? (Answer is available at the end of the chapter.)

External Users

There are several types of **external users** of accounting information. **Investors** (owners) use accounting information to make decisions to buy, hold, or sell stock. **Creditors**, such as suppliers and bankers, use accounting information to evaluate the risks of selling on credit or lending money. Some questions that investors and creditors may ask about a company are shown in **Illustration 1.2**.

Questions Asked by External Users

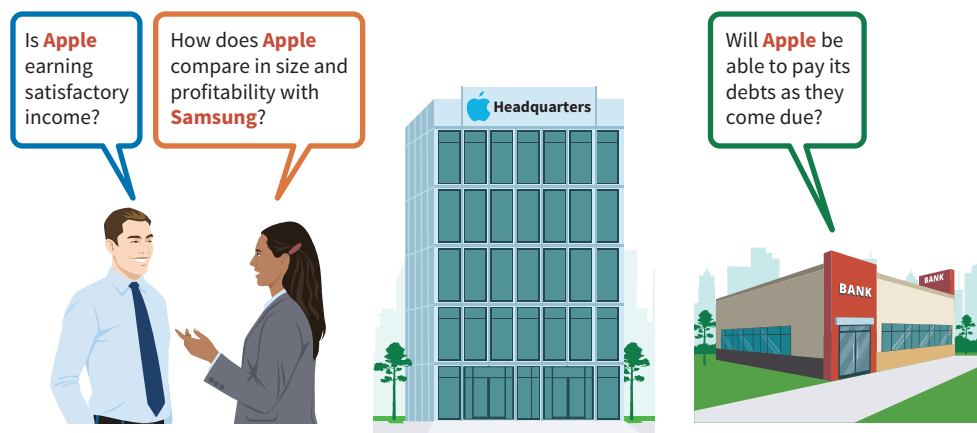


ILLUSTRATION 1.2 Questions that external users ask

The information needs and questions of other external users vary considerably.

- **Taxing authorities**, such as the Internal Revenue Service, want to know whether the company complies with the tax laws.
- **Customers** are interested in whether a company like **Tesla** will be able to honor product warranties and otherwise support its product lines.
- **Labor unions**, such as the Major League Baseball Players Association, want to know whether the owners have the ability to pay increased wages and benefits.
- **Regulatory agencies**, such as the Securities and Exchange Commission or the Federal Trade Commission, want to know whether the company is operating within prescribed rules.

For example, **Enron**, **Dynegy**, **Duke Energy**, and other big energy-trading companies reported record profits at the same time as California was paying extremely high prices for energy and suffering from blackouts. This disparity caused regulators to investigate the energy traders to make sure that the profits were earned by legitimate and fair practices.

Data Analytics

Accounting software systems collect vast amounts of data about a company's economic events as well as its suppliers and customers. Business decision-makers take advantage of this wealth of data by using data analytics to gain insights and therefore make more informed business decisions.

Helpful Hints further clarify concepts being discussed.

HELPFUL HINT

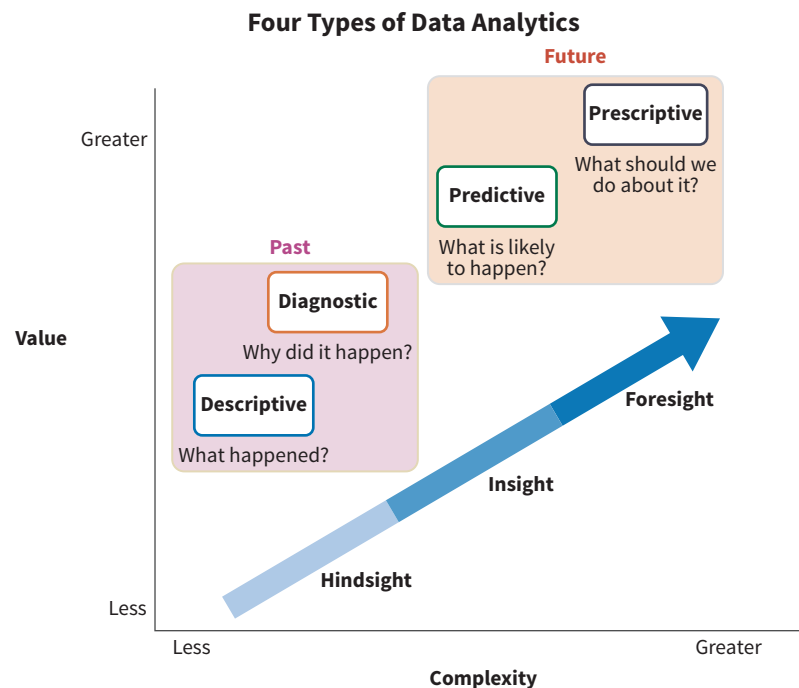
Throughout this text, we will highlight examples where accounting information is used to support business decisions using data analytics.

- **Data analytics** involves analyzing data, often employing both software and statistics, to draw inferences.
- As both data access and analytical software improve, the use of data analytics to support decisions is becoming increasingly common at virtually all types of companies (see **Helpful Hint**).

Illustration 1.3 shows the four most common types of data analytics that help answer questions ranging from what happened and why did it happen, to what is likely to happen and what should we do about it? Analytics range from simple analysis that can be performed using spreadsheets with tools like pivot tables and graphs, to complex statistical software and even artificial intelligence. More complex analysis provides greater value to the business.

ILLUSTRATION 1.3

Four types of data analytics



Insight boxes provide examples of business situations from various perspectives—ethics, investor, international, corporate social responsibility, and data analytics.

Data Analytics Insight Netflix



Bogdan Glisik/
Shutterstock.com

Using Data Science to Create Art

Technology provides decision-makers and problem-solvers with access to a large volume of information called “big data.” And **Netflix**, the world's leading subscription streaming entertainment service, is tapping

into this big data as part of its efforts to ramp up its original content production.

In a recent year, Netflix planned to spend \$8 billion on content creation. Producing content involves a blend of creativity, technology, and business decisions, all of which result in costs. And by analyzing the large amounts of data from past productions, such as filming locations and production schedules,

Netflix can more precisely estimate costs for future productions. Further, consider that the production of a TV show or film involves hundreds of tasks. Here again, Netflix uses data science, in this case to visualize where bottlenecks might occur or where opportunities might exist to increase the efficiency of the production process.

Source: Based on Ritwik Kumar et. al., “Data Science and the Art of Producing Entertainment at Netflix,” *The Netflix Tech Blog* (March 26, 2018).

How can “big data” improve decision-making? (Answer is available at the end of the chapter.)

Ethics in Financial Reporting

People won’t gamble in a casino if they think it is “rigged.” Similarly, people won’t “play” the stock market if they think stock prices are rigged. At one time, major financial scandals at **Enron**, **WorldCom**, **HealthSouth**, and **AIG** led to a mistrust of financial reporting in general.

A *Wall Street Journal* article noted that “repeated disclosures about questionable accounting practices have bruised investors’ faith in the reliability of earnings reports, which in turn has sent stock prices tumbling.” Imagine trying to carry on a business or invest money if you could not depend on the financial statements to be honestly prepared. Information would have no credibility. A well-functioning economy depends on accurate and reliable financial reporting.

U.S. regulators and lawmakers were very concerned that the economy would suffer if investors lost confidence in corporate accounting because of unethical financial reporting.

- Congress passed the **Sarbanes-Oxley Act (SOX)** to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals (see **Ethics Note**).
- As a result of SOX, top management must now certify the fairness of financial information.
- In addition, penalties for fraudulent financial activity are much more severe.
- Also, SOX increased both the independence of the outside auditors who review the accuracy of corporate financial statements and the oversight role of boards of directors.

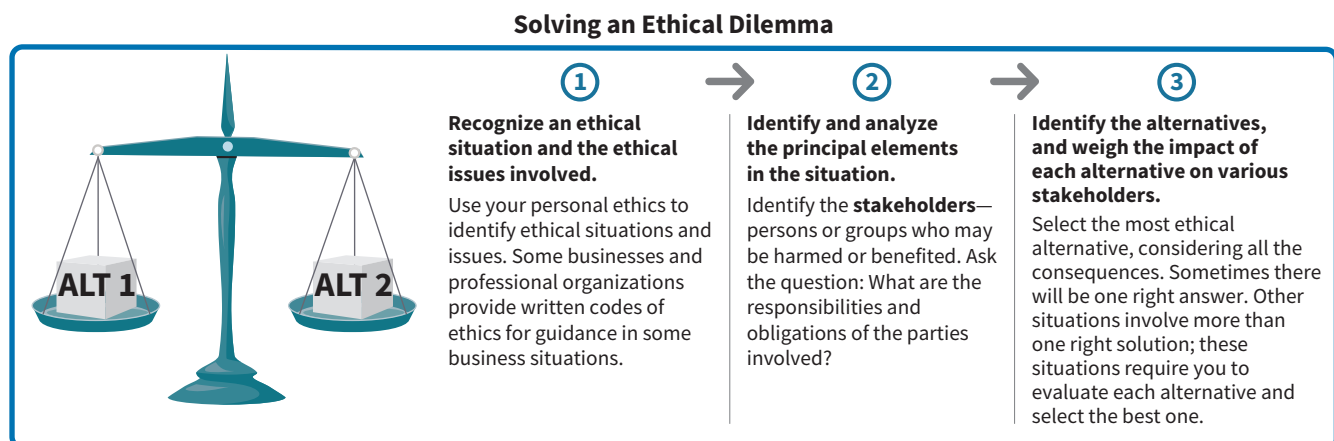
Effective financial reporting depends on sound ethical behavior. When analyzing ethics cases and your own ethical experiences, you should apply the three steps outlined in **Illustration 1.4**.

ETHICS NOTE

Circus-founder P.T. Barnum is alleged to have said, “Trust everyone, but cut the deck.” What Sarbanes-Oxley does is to provide measures that (like cutting the deck of playing cards) help ensure that fraud will not occur.

Ethics Notes help sensitize you to some of the ethical issues in accounting.

ILLUSTRATION 1.4 Steps in analyzing ethics cases



Ethics Insight Dewey & LeBoeuf LLP



Alliance Images/
Shutterstock.com

I Felt the Pressure—Would You?

“I felt the pressure.” That’s what some of the employees of the now-defunct law firm of **Dewey & LeBoeuf LLP** indicated when they helped to overstate revenue and use accounting tricks to hide losses and cover up cash shortages. These employees worked for the former finance director and former chief financial officer (CFO) of the firm. Here are some of their comments:

- “I was instructed by the CFO to create invoices, knowing they would not be sent to clients. When I created these invoices, I knew that it was inappropriate.”
- “I intentionally gave the auditors incorrect information in the course of the audit.”

What happened here is that a small group of lower-level employees over a period of years carried out the instructions of their bosses. Their bosses, however, seemed to have no concern about unethical practices as evidenced by various e-mails with one another in which they referred to their financial manipulations as accounting tricks, cooking the books, and fake income.

Sources: Ashby Jones, “Guilty Pleas of Dewey Staff Detail the Alleged Fraud,” *Wall Street Journal* (March 28, 2014); and Sara Randazzo, “Dewey CFO Escapes Jail Time in Fraud Case Sentencing,” *Wall Street Journal* (October 10, 2017).

Why did these employees lie, and what do you believe should be their penalty for these lies? (Answer is available at the end of the chapter.)

ACTION PLAN

- Review forms of business organization, users of financial information, approach to ethical dilemmas, and definition of data analytics.

DO IT! 1b | Using Financial Information

There are a variety of users and uses of financial information. Match each of the following terms with its definition, classification type, or associated phrase.

- | | |
|--|--|
| a. ____ Data analytics. | 1. Marketing managers, finance directors. |
| b. ____ Internal users of financial information. | 2. Management must certify the fairness of financial information. |
| c. ____ Element of Sarbanes-Oxley Act. | 3. Often employs both software and statistics to draw inferences. |
| d. ____ External users of financial information. | 4. Identify the alternatives and weigh the impact of each alternative on various stakeholders. |
| e. ____ Steps in solving an ethical dilemma. | 5. Investors, labor unions. |

Solution

a. 3 b. 1 c. 2 d. 5 e. 4

Related exercise material: BE1.2, DO IT! 1.1b, and E1.3.

1.2

The Three Types of Business Activity

LEARNING OBJECTIVE 2

Explain the three principal types of business activity.

Businesses engage in three types of activity—financing, investing, and operating. For example, consider Gert Boyle’s parents, the founders of **Columbia Sportswear**.

1. The Boyles obtained cash through **financing** (from personal savings and outside sources like banks) to start and grow their business.

2. The family then **invested** the cash in equipment to run the business, such as sewing equipment and delivery vehicles.
3. Once this equipment was in place, they began the **operating** activities of making and selling clothing.

The **accounting information system** keeps track of the results of each of the various business activities—financing, investing, and operating. Let’s look at each type of business activity in more detail.

Financing Activities

It takes money to make money. **Financing activities involve raising money from outside sources.** The two primary sources of outside funds for corporations are borrowing money (debt financing) and issuing (selling) shares of stock in exchange for cash (equity financing).

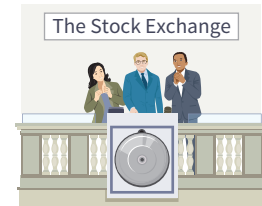
Columbia Sportswear may borrow money in a variety of ways. For example, it can take out a loan at a bank or borrow directly from investors by issuing debt securities called bonds. Persons or entities to whom Columbia owes money are its **creditors**.

- Amounts owed to creditors—in the form of debt and other obligations—are called **liabilities**.
- Specific names are given to different types of liabilities, depending on their source. Columbia may have a **note payable** to a bank for the money borrowed to purchase delivery trucks.
- Debt securities sold to investors that must be repaid at a particular date some years in the future are **bonds payable**.

Corporations also obtain funds by selling shares of stock to investors. **Common stock** is the term used to describe the total amount paid in by stockholders for the shares they purchase.

The claims of creditors differ from those of stockholders. If you loan money to a company, you are one of its creditors. In lending money, you specify a payment schedule (e.g., payment at the end of three months). As a creditor, you have a legal right to be paid at the agreed time. In the event of nonpayment, you may legally force the company to sell property to pay its debts. In the case of financial difficulty, creditor claims must be paid before stockholders’ claims.

Stockholders, on the other hand, have no claim to corporate cash until the claims of creditors are satisfied. Suppose you buy a company’s stock instead of loaning it money. You have no legal right to expect any payments from your stock ownership until all of the company’s creditors are paid amounts currently due. However, many corporations make payments to stockholders on a regular basis as long as there is sufficient cash to cover required payments to creditors. These cash payments to stockholders are called **dividends**.



Equity Financing



Debt Financing

Investing Activities

Once the company has raised cash through financing activities, it uses that cash in investing activities. **Investing activities involve the purchase of the resources a company needs in order to operate.** Resources owned by a business are called **assets**. A growing company purchases many assets, such as computers, delivery trucks, furniture, and buildings.

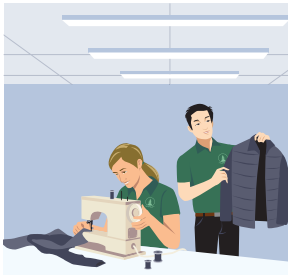
- Different types of assets are given different names; Columbia Sportswear’s sewing equipment is a type of asset referred to as **property, plant, and equipment** (see **Alternative Terminology**).
- **Cash** is one of the more important assets owned by Columbia or any other business.
- If a company has excess cash that it does not need for a while, it might choose to invest in securities (stocks or bonds) of other corporations, a type of asset referred to as **investments**.



Investing

ALTERNATIVE TERMINOLOGY

Property, plant, and equipment is sometimes called **fixed assets**.



Operating

Operating Activities

Once a business has the assets it needs to get started, it begins operating activities. **Operating activities are the day-to-day actions taken by a company to produce and sell a product, or provide a service.** Columbia Sportswear is in the business of selling outdoor clothing and footwear. It sells TurboDown jackets, Millennium snowboard pants, Sorel® snow boots, Bugaboos™, rainwear, and anything else you might need to protect you from the elements. We call amounts earned from the sale of these products **revenues**.

- **Revenue** is the increase in assets or decrease in liabilities resulting from the sale of goods or the performance of services in the normal course of business; Columbia records revenue when it sells a footwear product.
- Revenues arise from different sources and are identified by various names depending on the nature of the business; Columbia's primary source of revenue is the sale of sportswear (but it also generates interest revenue on debt securities held as investments).
- Sources of revenue common to many businesses are **sales revenue**, **service revenue**, and **interest revenue**.

The company purchases its longer-lived assets through investing activities as described earlier. Other assets with shorter lives, however, result from operating activities.

- **Supplies** are assets used in day-to-day operations (rather than sold to customers).
- Goods available for future sales to customers are assets called **inventory**.
- The right to receive money in the future is called an **account receivable**. If Columbia sells goods to a customer and does not receive cash immediately, then the company has a right to expect payment from that customer in the near future.

Before Columbia can sell a single Sorel® boot, it must purchase wool, rubber, leather, metal lace loops, laces, and other materials. It then must process, wrap, and ship the finished product. It also incurs costs like salaries, rents, and utilities. All of these costs, referred to as **expenses**, are necessary to produce and sell the product.

- In accounting language, **expenses** are the cost of assets consumed or services used in the process of generating revenues.
- Expenses take many forms and are identified by various names depending on the type of asset consumed or service used.

For example, Columbia keeps track of these types of expenses: **cost of goods sold** (such as the cost of materials), **selling expenses** (such as the cost of salespersons' salaries), **marketing expenses** (such as the cost of advertising), **administrative expenses** (such as the salaries of administrative staff, and telephone and heating costs incurred at the corporate office), **interest expense** (amounts of interest paid on various debts), and **income tax expense** (corporate taxes paid to the government).

Columbia may also have liabilities arising from these expenses.

- For example, Columbia may purchase goods on credit from suppliers. The obligations to pay for these goods are called **accounts payable**.
- Additionally, Columbia may have **interest payable** on the outstanding amounts owed to the bank.
- It may also have **wages payable** to its employees and **sales taxes payable**, **property taxes payable**, and **income taxes payable** to the government.

Columbia compares the revenues of a period with the expenses of that period to determine whether it earned a profit. When revenues exceed expenses, **net income** results. When expenses exceed revenues, a **net loss** results.

DO IT! 2 | Business Activities

Classify each item as an asset, liability, common stock, revenue, or expense.

- | | |
|------------------------------|--|
| 1. Cost of renting property. | 4. Issuance of ownership shares. |
| 2. Truck purchased. | 5. Amount recorded from performing services. |
| 3. Notes payable. | 6. Amounts owed to suppliers. |

ACTION PLAN

- Classify each item based on its economic characteristics. Proper classification of items is critical if accounting is to provide useful information.

Solution

1. Cost of renting property: Expense.
2. Truck purchased: Asset.
3. Notes payable: Liability.
4. Issuance of ownership shares: Common stock.
5. Amount recorded from performing services: Revenue.
6. Amounts owed to suppliers: Liability.

Related exercise material: BE1.3, DO IT! 1.2, and E1.7.

1.3 The Four Financial Statements

LEARNING OBJECTIVE 3

Describe the four financial statements and how they are prepared.

Assets, liabilities, expenses, and revenues are of interest to users of accounting information. This information is arranged in the format of four different **financial statements**, which form the backbone of financial accounting:

1. **Income statement.** Shows how successfully your business performed during a period of time, by subtracting expenses from revenues.
2. **Retained earnings statement.** Indicates how much of previous income was distributed to owners of your business in the form of dividends, and how much was retained in the business to allow for future growth.
3. **Balance sheet.** Presents a picture at a point in time of what your business owns (its assets) and what it owes (its liabilities).
4. **Statement of cash flows.** Shows where your business obtained cash during a period of time and how that cash was used.

To introduce you to these statements, we have prepared the financial statements for your outdoor guide service, Sierra Corporation, after your first month of operations (see **International Note**).

To summarize, you officially started your business in Truckee, California, on October 1, 2025. Sierra provides guide services in the Lake Tahoe area of the Sierra Nevada mountains. Its promotional materials describe outdoor day trips, such as rafting, snowshoeing, and hiking, as well as multi-day backcountry experiences. To minimize your initial investment, your customers either bring their own equipment or rent equipment through local outfitters. The financial statements for Sierra's first month of business are provided in the following pages.

International Note

The primary types of financial statements required by International Financial Reporting Standards (IFRS) and U.S. generally accepted accounting principles (GAAP) are the same. However, in practice, some format differences do exist in presentations commonly employed by IFRS companies as compared to GAAP companies.

International Notes highlight differences between U.S. and international accounting standards.

Income Statement

HELPFUL HINT
The financial statement heading identifies the company, the type of statement, and the time period covered.

ILLUSTRATION 1.5
Sierra Corporation's income statement

Decision Tools
The income statement helps users determine if the company's operations are profitable.

Decision Tools that are useful for business decision-making are highlighted throughout the text. A summary of the Decision Tools is also provided in each chapter.

ETHICS NOTE
When companies find errors in previously released income statements, they restate those numbers. Perhaps because of the increased scrutiny shortly after Sarbanes-Oxley was implemented, companies filed a record 1,195 restatements.

The **income statement** reports a company's revenues and expenses and resulting net income or loss for a period of time (see **Decision Tools**). To indicate that its income statement reports the results of operations for a **specific period of time**, Sierra Corporation dates the income statement "For the Month Ended October 31, 2025." The income statement lists the company's revenues followed by its expenses. Finally, Sierra determines the net income (or net loss) by deducting expenses from revenues. Sierra's income statement is shown in **Illustration 1.5** (see **Helpful Hint**). Congratulations, you are already showing a profit!

Sierra Corporation			
Income Statement			
For the Month Ended October 31, 2025			
Revenues			
Service revenue			\$10,600
Expenses			
Salaries and wages expense	\$5,200		
Supplies expense	1,500		
Rent expense	900		
Interest expense	50		
Insurance expense	50		
Depreciation expense	40		
Total expenses		7,740	
Net income			\$ 2,860

Why are financial statement users interested in net income?

- **Investors are interested in a company's past net income because it provides useful information for predicting future net income.** Investors buy and sell stock based on their beliefs about a company's future performance. If investors believe that Sierra will be successful in the future and that this will result in a higher stock price, they will buy its stock.
- **Creditors use the income statement to predict future earnings.** When a bank loans money to a company, it believes that it will be repaid in the future. If it didn't think it would be repaid, it wouldn't loan the money. Therefore, prior to making the loan the bank loan officer uses the income statement as a source of information to predict whether the company will be profitable enough to repay its loan.

Thus, reporting a strong profit will make it easier for Sierra to raise additional cash either by issuing shares of stock or borrowing.

Amounts received from issuing stock are not revenues, and amounts paid out as dividends are not expenses. As a result, they are not reported on the income statement. For example, Sierra Corporation does not treat as revenue the \$10,000 of cash received from issuing new stock (see Illustration 1.8), nor does it regard as a business expense the \$500 of dividends paid (see Illustration 1.6) (see **Ethics Note**).

- ACTION PLAN**
- Report the revenues and expenses for a period of time in an income statement.

DO IT! 3a Part 1 | Financial Statements—The Income Statement

Part 1: CSU Corporation began operations on January 1, 2025. The following information is available for CSU on December 31, 2025.

Accounts receivable	\$ 1,800	Retained earnings	\$ 0	Supplies expense	\$ 200
Accounts payable	2,000	Equipment	16,000	Cash	1,400
Rent expense	9,000	Insurance expense	1,000	Dividends	600
Notes payable	5,000	Service revenue	17,000		
Common stock	10,000	Supplies	4,000		

Prepare an income statement.

Solution

CSU Corporation		
Income Statement		
For the Year Ended December 31, 2025		
Revenues		
Service revenue		\$17,000
Expenses		
Rent expense	\$9,000	
Insurance expense	1,000	
Supplies expense	<u>200</u>	
Total expenses		<u>10,200</u>
Net income		<u>\$ 6,800</u>

Related exercise material: BE1.6, BE1.7, BE1.8, DO IT! 1.3a, E1.9, E1.10, E1.14, E1.15, E1.16, E1.18, and E1.19.

Retained Earnings Statement

If Sierra Corporation is profitable, at the end of each period it must decide what portion of profits to pay to shareholders in dividends. In theory, it could pay all of its current-period profits, but few companies do this. Why? Because they want to retain part of the profits to allow for further expansion. High-growth companies, such as **Google** and **Facebook**, often pay no dividends. **Retained earnings** is the net income retained in the corporation.

The **retained earnings statement** shows the amounts and causes of changes in retained earnings for a specific time period (see **Decision Tools**). The time period is the same as that covered by the income statement. The beginning retained earnings amount appears on the first line of the statement. Then, the company adds net income and deducts dividends to determine the retained earnings at the end of the period. If a company has a net loss, it deducts (rather than adds) that amount in the retained earnings statement. **Illustration 1.6** presents Sierra's retained earnings statement (see **Helpful Hint**).

Decision Tools

The retained earnings statement helps users determine the company's policy toward dividends and growth.

HELPFUL HINT

The heading of this statement identifies the company, the type of statement, and the time period covered by the statement.

Sierra Corporation		
Retained Earnings Statement		
For the Month Ended October 31, 2025		
Retained earnings, October 1	\$ 0	
Add: Net income	<u>2,860</u>	
	2,860	
Less: Dividends	<u>500</u>	
Retained earnings, October 31	<u>\$2,360</u>	

ILLUSTRATION 1.6

Sierra Corporation's retained earnings statement

By monitoring the retained earnings statement, financial statement users can evaluate dividend payment practices.

- Some investors seek companies, such as **Dow Chemical**, that have a history of paying high dividends.
- Other investors seek companies, such as **Amazon.com**, that reinvest earnings to increase the company's growth instead of paying dividends.
- Lenders monitor their corporate customers' dividend payments because any money paid in dividends reduces a company's ability to repay its debts.

ACTION PLAN

- Show the amounts and causes (net income and dividends) of changes in retained earnings during the period in the retained earnings statement.

DO IT! 3a Part 2 | Financial Statements—The Retained Earnings Statement

Part 2: CSU Corporation began operations on January 1, 2025. The following information is available for CSU on December 31, 2025.

Accounts receivable	\$ 1,800	Retained earnings	\$ 0	Supplies expense	\$ 200
Accounts payable	2,000	Equipment	16,000	Cash	1,400
Rent expense	9,000	Insurance expense	1,000	Dividends	600
Notes payable	5,000	Service revenue	17,000		
Common stock	10,000	Supplies	4,000		

Prepare a retained earnings statement. Refer to **DO IT! 3a Part 1** for net income.

Solution

CSU Corporation	
Retained Earnings Statement	
For the Year Ended December 31, 2025	
Retained earnings, January 1	\$ 0
Add: Net income	<u>6,800</u>
	6,800
Less: Dividends	<u>600</u>
Retained earnings, December 31	<u>\$6,200</u>

Related exercise material: BE1.7, BE1.10, DO IT! 1.3a, E1.9, E1.10, E1.13, E1.16, E1.17, and E1.18.

Decision Tools

The balance sheet helps users determine whether the company relies on debt or stockholders' equity to finance its assets.

Balance Sheet

The **balance sheet** reports assets and claims to assets at a specific **point** in time (see **Decision Tools**). Claims to assets are subdivided into two categories: claims of creditors and claims of owners. As noted earlier, claims of creditors are called **liabilities**. The owners' claim to assets is called **stockholders' equity**.

Illustration 1.7 shows the relationship among the categories on the balance sheet in equation form.

- This equation is referred to as the **basic accounting equation**.
- This relationship is where the name "balance sheet" comes from. Assets must balance with the claims to assets.

ILLUSTRATION 1.7

Basic accounting equation

HELPFUL HINT

The heading of a balance sheet must identify the company, the statement, and the date.

ALTERNATIVE TERMINOLOGY

Liabilities are also referred to as **debt**.

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

As you can see from looking at Sierra Corporation's balance sheet in **Illustration 1.8**, the balance sheet presents the company's financial position as of a specific date—in this case, October 31, 2025 (see **Helpful Hint**). It lists assets first. Assets are listed in the order of their liquidity, that is, how quickly they could be converted to cash.

Assets are followed by liabilities and stockholders' equity (see **Alternative Terminology**). Stockholders' equity is comprised of two parts: (1) common stock and (2) retained earnings. As noted earlier, common stock results when the company sells new shares of stock;

retained earnings is the net income retained in the corporation. Sierra has common stock of \$10,000 and retained earnings of \$2,360, for total stockholders' equity of \$12,360.

Sierra Corporation		
Balance Sheet		
October 31, 2025		
<u>Assets</u>		
Cash		\$15,200
Accounts receivable		200
Supplies		1,000
Prepaid insurance		550
Equipment, net		<u>4,960</u>
Total assets		<u>\$21,910</u>
<u>Liabilities and Stockholders' Equity</u>		
Liabilities		
Notes payable	\$ 5,000	
Accounts payable	2,500	
Unearned service revenue	800	
Salaries and wages payable	1,200	
Interest payable	<u>50</u>	
Total liabilities		\$ 9,550
Stockholders' equity		
Common stock	10,000	
Retained earnings	<u>2,360</u>	
Total stockholders' equity		<u>12,360</u>
Total liabilities and stockholders' equity		<u>\$21,910</u>

ILLUSTRATION 1.8

Sierra Corporation's balance sheet

Creditors analyze a company's balance sheet to determine the likelihood that they will be repaid.

- Creditors carefully evaluate the nature of the company's assets and liabilities.
- In operating Sierra's guide service, the balance sheet will be used to determine whether cash on hand is sufficient for immediate cash needs.
- The balance sheet will also be used to evaluate the relationship between debt and stockholders' equity to determine whether the company has a satisfactory proportion of debt and common stock financing.

DO IT! 3a Part 3 | Financial Statements—The Balance Sheet

Part 3: CSU Corporation began operations on January 1, 2025. The following information is available for CSU on December 31, 2025.

Accounts receivable	\$ 1,800	Retained earnings	\$ 0	Supplies expense	\$ 200
Accounts payable	2,000	Equipment	16,000	Cash	1,400
Rent expense	9,000	Insurance expense	1,000	Dividends	600
Notes payable	5,000	Service revenue	17,000		
Common stock	10,000	Supplies	4,000		

Prepare a balance sheet. Refer to **DO IT! 3a Part 2** for the ending balance in Retained Earnings.

ACTION PLAN

- Present the assets and claims to those assets (liabilities and equity) at a specific point in time in the balance sheet.

Solution

CSU Corporation		
Balance Sheet		
December 31, 2025		
<u>Assets</u>		
Cash		\$ 1,400
Accounts receivable		1,800
Supplies		4,000
Equipment		<u>16,000</u>
Total assets		<u>\$23,200</u>
<u>Liabilities and Stockholders' Equity</u>		
Liabilities		
Notes payable	\$ 5,000	
Accounts payable	<u>2,000</u>	
Total liabilities		\$ 7,000
Stockholders' equity		
Common stock	10,000	
Retained earnings	<u>6,200</u>	
Total stockholders' equity		<u>16,200</u>
Total liabilities and stockholders' equity		<u>\$23,200</u>

Related exercise material: BE1.5, BE1.6, BE1.7, BE1.8, BE1.9, BE1.10, DO IT! 1.3a, E1.12, E1.16, E1.17, and E1.22.

Decision Tools

The statement of cash flows helps users determine if the company generates enough cash from operations to fund its investing activities.

HELPFUL HINT

The heading of this statement identifies the company, the type of statement, and the time period covered by the statement. Negative numbers are shown in parentheses.

ILLUSTRATION 1.9

Sierra Corporation's statement of cash flows

Statement of Cash Flows

The primary purpose of a **statement of cash flows** is to provide financial information about the cash receipts and cash payments of a business for a specific period of time (see **Decision Tools**). To help investors, creditors, and others in their analysis of a company's cash position, the statement of cash flows reports the cash effects of a company's **operating**, **investing**, and **financing** activities. In addition, the statement shows the net increase or decrease in cash during the period, and the amount of cash at the end of the period.

Users are interested in the statement of cash flows because they want to know what is happening to a company's most important resource. The statement of cash flows provides answers to these simple but important questions:

- Where did cash come from during the period?
- How was cash used during the period?
- What was the change in the cash balance during the period?

The statement of cash flows for Sierra Corporation, in **Illustration 1.9**, shows that cash increased \$15,200 during the month (see **Helpful Hint**). This increase resulted because operating activities (services to clients) increased cash \$5,700, and financing activities increased cash \$14,500. Investing activities used \$5,000 of cash for the purchase of equipment.

Sierra Corporation		
Statement of Cash Flows		
For the Month Ended October 31, 2025		
Cash flows from operating activities		
Cash receipts from operating activities	\$11,200	
Cash payments for operating activities	<u>(5,500)</u>	
Net cash provided by operating activities		\$ 5,700

Cash flows from investing activities		
Purchased office equipment	(5,000)	
Net cash used by investing activities		(5,000)
Cash flows from financing activities		
Issuance of common stock	10,000	
Issuance of note payable	5,000	
Payment of dividend	(500)	
Net cash provided by financing activities		14,500
Net increase in cash		15,200
Cash at beginning of period		0
Cash at end of period		<u>\$15,200</u>

ILLUSTRATION 1.9
(continued)

People, Planet, and Profit Insight



marekuliasz/Getty Images

Beyond Financial Statements

Columbia Sportswear doesn't just focus on financial success. Several of its factories continue to participate in a project to increase health awareness of female factory workers in developing countries. Columbia is also a founding member of the Sustainable Apparel Coalition, which strives to reduce the environmental and social impact of the apparel industry. In addition, the company monitors all of the independent factories that produce its products to ensure that they comply with the company's Standards of Manufacturing Practices. These standards address such issues as forced labor, child labor, harassment, wages and benefits, health and safety, and the environment.

With that in mind, should we expand our financial statements to take into account ecological and social performance, in addition to financial results, in evaluating a company? The idea is that a company's responsibility lies with anyone who is influenced by its actions. In other words, a company should be interested in benefiting many different parties, instead of only maximizing stockholders' interests.

A socially responsible business does not exploit or endanger any group of individuals. It follows fair trade practices, provides safe environments for workers, and bears responsibility for environmental damage. Measurement of these factors is difficult, but many interesting and useful efforts are underway.

Why might a company's stockholders be interested in its environmental and social performance? (Answer is available at the end of the chapter.)

Interrelationships of Statements

Illustration 1.10 shows the financial statements of Sierra Corporation (see **Helpful Hints**). Because the results on some financial statements become inputs to other statements, the statements are interrelated. These interrelationships can be seen in Sierra's financial statements, as follows.

- 1. **The retained earnings statement uses the results of the income statement.** Sierra reported net income of \$2,860 for the period. Net income is added to the beginning amount of retained earnings to determine ending retained earnings.
- 2. **The balance sheet and retained earnings statement are also interrelated.** Sierra reports the ending amount of \$2,360 on the retained earnings statement as the retained earnings amount on the balance sheet.
- 3. **The statement of cash flows relates to information on the balance sheet.** The statement of cash flows shows how the Cash account changed during the period. It shows the amount of cash at the beginning of the period, the sources and uses of cash during the period, and the \$15,200 of cash at the end of the period. The ending amount of cash shown on the statement of cash flows must agree with the amount of cash on the balance sheet.

Study these interrelationships carefully. **To prepare financial statements, you must understand the sequence in which these amounts are determined and how each statement impacts the next.**

ILLUSTRATION 1.10**Sierra Corporation's financial statements****HELPFUL HINT**

Note that final sums are double-underlined.

HELPFUL HINT

The arrows in this illustration show the interrelationships of the four financial statements.

HELPFUL HINT

Negative amounts are presented in parentheses.

Sierra Corporation			
Income Statement			
For the Month Ended October 31, 2025			
Revenues			
Service revenue			\$10,600
Expenses			
Salaries and wages expense	\$5,200		
Supplies expense	1,500		
Rent expense	900		
Interest expense	50		
Insurance expense	50		
Depreciation expense	40		
Total expenses		7,740	
Net income			<u><u>\$ 2,860</u></u>

Sierra Corporation			
Retained Earnings Statement			
For the Month Ended October 31, 2025			
Retained earnings, October 1		\$ 0	
Add: Net income		<u>2,860</u>	
		2,860	
Less: Dividends		<u>500</u>	
Retained earnings, October 31		<u><u>\$2,360</u></u>	

Sierra Corporation			
Balance Sheet			
October 31, 2025			
<u>Assets</u>			
Cash			<u>\$15,200</u>
Accounts receivable		200	
Supplies		1,000	
Prepaid insurance		550	
Equipment, net		<u>4,960</u>	
Total assets			<u><u>\$21,910</u></u>
<u>Liabilities and Stockholders' Equity</u>			
Liabilities			
Notes payable	\$ 5,000		
Accounts payable	2,500		
Unearned service revenue	800		
Salaries and wages payable	1,200		
Interest payable	<u>50</u>		
Total liabilities		\$ 9,550	
Stockholders' equity			
Common stock	10,000		
Retained earnings	<u>2,360</u>		
Total stockholders' equity		<u>12,360</u>	
Total liabilities and stockholders' equity			<u><u>\$21,910</u></u>

Sierra Corporation			
Statement of Cash Flows			
For the Month Ended October 31, 2025			
Cash flows from operating activities			
Cash receipts from operating activities	\$11,200		
Cash payments for operating activities	<u>(5,500)</u>		
Net cash provided by operating activities		\$ 5,700	
Cash flows from investing activities			
Purchased office equipment	<u>(5,000)</u>		
Net cash used by investing activities		(5,000)	
Cash flows from financing activities			
Issuance of common stock	10,000		
Issuance of note payable	5,000		
Payment of dividend	<u>(500)</u>		
Net cash provided by financing activities		<u>14,500</u>	
Net increase in cash		15,200	
Cash at beginning of period		<u>0</u>	
Cash at end of period		<u><u>\$15,200</u></u>	

DO IT! 3a Part 4 | Financial Statements

Part 4: BRB Corporation began operations on January 1, 2025. The following information is available for BRB on December 31, 2025.

Accounts receivable	\$ 1,600	Retained earnings	\$ 0	Supplies expense	\$ 300
Accounts payable	3,000	Equipment	21,000	Cash	2,400
Rent expense	7,000	Insurance expense	2,000	Dividends	700
Notes payable	4,000	Service revenue	21,000		
Common stock	12,000	Supplies	5,000		

Prepare an income statement, a retained earnings statement, and a balance sheet.

ACTION PLAN

- Report the revenues and expenses for a period of time in an income statement.
- Show the amounts and causes (net income and dividends) of changes in retained earnings during the period in the retained earnings statement.
- Present the assets and claims to those assets (liabilities and equity) at a specific point in time in the balance sheet.

Solution

BRB Corporation
Income Statement
For the Year Ended December 31, 2025

Revenues		
Service revenue		\$21,000
Expenses		
Rent expense	\$7,000	
Insurance expense	2,000	
Supplies expense	<u>300</u>	
Total expenses		<u>9,300</u>
Net income		<u>\$11,700</u>

BRB Corporation
Retained Earnings Statement
For the Year Ended December 31, 2025

Retained earnings, January 1	\$ 0
Add: Net income	<u>11,700</u>
	11,700
Less: Dividends	<u>700</u>
Retained earnings, December 31	<u>\$11,000</u>

BRB Corporation
Balance Sheet
December 31, 2025

<u>Assets</u>		
Cash		\$ 2,400
Accounts receivable		1,600
Supplies		5,000
Equipment		<u>21,000</u>
Total assets		<u>\$30,000</u>
<u>Liabilities and Stockholders' Equity</u>		
Liabilities		
Notes payable	\$ 4,000	
Accounts payable	<u>3,000</u>	
Total liabilities		\$ 7,000
Stockholders' equity		
Common stock	12,000	
Retained earnings	<u>11,000</u>	
Total stockholders' equity		<u>23,000</u>
Total liabilities and stockholders' equity		<u>\$30,000</u>

Related exercise material: BE1.5, BE1.6, BE1.7, BE1.8, BE1.9, BE1.10, DO IT! 1.3a, E1.9, E1.10, E1.11, E1.12, E1.13, E1.14, E1.15, E1.16, E1.17, E1.18, E1.19, and E1.22.

Elements of an Annual Report

Publicly traded U.S. companies must provide shareholders with an **annual report**. The annual report always includes the financial statements introduced in this chapter. The annual report also includes other important information such as a management discussion and analysis section, notes to the financial statements, and an independent auditor's report. No analysis of a company's financial situation and performance is complete without a review of these items.

Management Discussion and Analysis

The **management discussion and analysis (MD&A)** section presents management's views on the company's:

- Ability to pay near-term obligations.
- Ability to fund operations and expansion.
- Results of operations.

Management must highlight favorable or unfavorable trends and identify significant events and uncertainties that affect these three factors. This discussion obviously involves a number of subjective estimates and opinions. A brief excerpt from the MD&A section of a recent **Columbia Sportswear** annual report, which addresses its liquidity requirements, is presented in **Illustration 1.11**.

ILLUSTRATION 1.11

Columbia Sportswear's management discussion and analysis

Real World

Columbia Sportswear Company

Management's Discussion and Analysis of Seasonality and Variability of Business

Our business is affected by the general seasonal trends common to the industry, including discretionary consumer shopping and spending patterns, as well as seasonal weather. Our products are marketed on a seasonal basis, and our sales are weighted substantially toward the third and fourth quarters, while our operating costs are more equally distributed throughout the year.

Notes to the Financial Statements

Explanatory notes and supporting schedules accompany every set of financial statements and are an integral part of the statements. The **notes to the financial statements** clarify the financial statements and provide additional detail. Information in the notes does not have to be quantifiable (numeric). Examples of notes are:

- Descriptions of the significant accounting policies and methods used in preparing the statements.
- Explanations of uncertainties and contingencies.
- Various statistics and details too voluminous to be included in the statements.

The notes are essential to understanding a company's operating performance and financial position.

Illustration 1.12 is an excerpt from the notes to recent **Columbia Sportswear** financial statements. It describes the methods that the company uses to account for revenues.

Columbia Sportswear Company

Notes to Financial Statements Revenue Recognition

Revenues are recognized when our performance obligations are satisfied as evidenced by transfer of control of promised goods to our customers, in an amount that reflects the consideration we expect to be entitled to receive in exchanges for those goods or services. Within our wholesale channel, control generally transfers to the customer upon shipment to, or upon receipt by, the customer depending on the terms of sale with the customer. Within our DTC channel, control generally transfers to the customer at the time of sale within our retail stores and concession-based arrangements and upon shipment to the customer with respect to e-commerce transactions.

ILLUSTRATION 1.12

Notes to Columbia
Sportswear's financial
statements

Real World

Auditor's Report

An **auditor's report** is prepared by an independent outside auditor. It states the auditor's opinion as to the fairness of the presentation of the financial position and results of operations and their conformance with generally accepted accounting principles.

An **auditor** is an accounting professional who conducts an independent examination of a company's financial statements. Only accountants who meet certain criteria and thereby attain the designation **certified public accountant (CPA)** may certify audits.

- If the auditor is satisfied that the financial statements provide a fair representation of the company's financial position and results of operations in accordance with generally accepted accounting principles, then the auditor expresses an **unqualified opinion**.
- If the auditor expresses anything other than an unqualified opinion, then readers should only use the financial statements with caution.
- That is, without an unqualified opinion, we cannot have complete confidence that the financial statements give a fair picture of the company's financial health.
- A new auditing standard requires the auditor to report any **critical audit matters**. These are items that are material in size that involve challenging, subjective, or complex auditor judgment.

For example, **Blockbuster** once dominated movie rentals in the United States with over 9,000 stores. But it faltered when the upstart **Netflix** rapidly took over the movie-rental business. Blockbuster's auditor then stated that its financial situation raised "substantial doubt about the Company's ability to continue as a going concern." Shortly after that, the company filed for bankruptcy.

Illustration 1.13 is an excerpt from the auditor's report from Columbia Sportswear's 2019 annual report. Columbia received an unqualified opinion from its auditor, **Deloitte & Touche**.

Columbia Sportswear Company

Excerpt from Auditor's Report

We have audited the accompanying consolidated balance sheets of Columbia Sportswear Company and subsidiaries (the "Company") as of December 31, 2019 and 2018, the related consolidated statements of operations, comprehensive income, equity, and cash flows for each of the three years in the period ended December 31, 2019, and the related notes and schedule listed in the Index at Item 15 (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2019 and 2018, and the results of its operations and its cash flows for each of the three years ended December 31, 2019, in conformity with accounting principles generally accepted in the United States of America.

ILLUSTRATION 1.13

Excerpt from auditor's report
on Columbia Sportswear's
financial statements

Real World

Accounting Across the Organization



Prostock-studio/Shutterstock.com

Spinning the Career Wheel

How will the study of accounting help you? A working knowledge of accounting is desirable for virtually every field of business. Some examples of how accounting is used in business careers include the following.

General management: Managers of **Harley-Davidson**, a **Qdoba** franchise, and a **Trek** bike shop all need to understand accounting data in order to make wise business decisions.

Marketing: Marketing specialists at **Hulu** must be sensitive to costs and benefits to ensure that marketing efforts increase company profits.

Finance: Do you want to work for **Robinhood**, **E-Trade**, or **Goldman Sachs**? Financial fields rely heavily on accounting knowledge to analyze financial statements. In fact, it is difficult to

get a good job in a finance function without two or three courses in accounting.

Real estate: Because a third party—the bank—is almost always involved in financing a real estate transaction, brokers at **Prudential Real Estate** must understand the numbers involved.

Accounting: Certified public accountants (CPAs) examine (audit) the financial statements and issue opinions on the accuracy of the financial presentation. Some CPAs offer tax advice and planning. Others work for for-profit companies such as **Starbucks** or **Google**, or for non-profit entities such as the **Red Cross**, where they manage the accounting information systems and prepare financial statements. Opportunities also exist in government, including the **Federal Bureau of Investigation (FBI)**. Finally, forensic accountants conduct investigations into theft and fraud.

How might accounting help you? (Answer is available at the end of the chapter.)

ACTION PLAN

- Realize that financial statements provide information about a company's performance and financial position.
- Be familiar with the other elements of the annual report in order to gain a fuller understanding of a company.

DO IT! 3b | Components of Annual Reports

State whether each of the following items is most closely associated with the management discussion and analysis (MD&A), the notes to the financial statements, or the auditor's report.

1. Descriptions of significant accounting policies.
2. Unqualified opinion.
3. Explanations of uncertainties and contingencies.
4. Description of ability to fund operations and expansion.
5. Description of results of operations.
6. Certified public accountant (CPA).

Solution

1. Descriptions of significant accounting policies: Notes.
2. Unqualified opinion: Auditor's report.
3. Explanations of uncertainties and contingencies: Notes.
4. Description of ability to fund operations and expansion: MD&A.
5. Description of results of operations: MD&A.
6. Certified public accountant (CPA): Auditor's report.

Related exercise material: BE1.11, DO IT! 1.3b, and E1.25.

USING THE DECISION TOOLS | Under Armour, Inc.

Using the Decision Tools comprehensive exercises ask you to apply business information and the decision tools presented in the chapter. Most of these exercises are based on the companies highlighted in the Feature Story.

There is a good chance that you are wearing one of **Under Armour, Inc.**'s products right now. Under Armour is a competitor to **Columbia Sportswear**. Suppose that you are considering investing in shares of Under Armour's common stock.

Instructions

Answer these questions related to your decision whether to invest.

- a. What financial statements should you evaluate?
- b. What should these financial statements tell you?