

Wiley Loose-Leaf Print Edition

FINANCIAL ACCOUNTING

TOOLS FOR BUSINESS DECISION MAKING TENTH EDITION

kimmel
weygandt
mitchell

ISBN 978-1-119-79108-9

90000



9 781119 791089

WILEY

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.**

Paul Kimmel's

Accounting Course Design with WileyPLUS



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?



Scan this QR code to sign up for a
WileyPLUS demo

WILEY

Financial Accounting

Tools for Business Decision Making

Tenth Edition

PAUL D. KIMMEL PhD, CPA

University of Wisconsin—Madison
Madison, Wisconsin

JERRY J. WEYGANDT PhD, CPA

University of Wisconsin—Madison
Madison, Wisconsin

JILL E. MITCHELL MS, MEd, CIA

Northern Virginia Community College
Annandale, Virginia

WILEY

DEDICATED TO

Our spouses, Enid, Merlynn, and Sean,
for their love, support, and encouragement.

VICE PRESIDENT, EDITORIAL PRODUCT MANAGEMENT
ASSOCIATE EDITORIAL DIRECTOR
SENIOR COURSE CONTENT DEVELOPER
INSTRUCTIONAL DESIGNER
SENIOR PRODUCT MARKETING MANAGER
EDITORIAL SUPERVISOR
PROGRAM ASSISTANT
SENIOR MANAGER, COURSE DEVELOPMENT AND PRODUCTION
EXECUTIVE MANAGING EDITOR
SENIOR PRODUCTION EDITOR
SENIOR DESIGNER
COVER IMAGE

Michael McDonald
Zoe Craig
Jenny Welter
Matt Origoni
Christina Koop Minarik
Terry Ann Tatro
Natalie Munoz
Ed Brislin
Karen Staudinger
Rachel Conrad
Jon Boylan
Paul Kimmel

This book was set in 9.5/12 STIX Two Text by Lumina Datamatics, Inc.

Founded in 1807, John Wiley & Sons, Inc. has been a valued source of knowledge and understanding for more than 200 years, helping people around the world meet their needs and fulfill their aspirations. Our company is built on a foundation of principles that include responsibility to the communities we serve and where we live and work. In 2008, we launched a Corporate Citizenship Initiative, a global effort to address the environmental, social, economic, and ethical challenges we face in our business. Among the issues we are addressing are carbon impact, paper specifications and procurement, ethical conduct within our business and among our vendors, and community and charitable support. For more information, please visit our website: www.wiley.com/go/citizenship.

Copyright © 2022 John Wiley & Sons, Inc. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning or otherwise, except as permitted under Sections 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc. 222 Rosewood Drive, Danvers, MA 01923, website www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030-5774, (201)748-6011, fax (201)748-6008, website <http://www.wiley.com/go/permissions>.

ISBN-13: 978-1-119-78309-1

The inside back cover will contain printing identification and country of origin if omitted from this page. In addition, if the ISBN on the back cover differs from the ISBN on this page, the one on the back cover is correct.

Printed in America.

10 9 8 7 6 5 4 3 2 1

Brief Contents

| | | |
|-------------------------------|---|-------------|
| 1 | Introduction to Financial Statements | 1-1 |
| 2 | A Further Look at Financial Statements | 2-1 |
| 3 | The Accounting Information System | 3-1 |
| 4 | Accrual Accounting Concepts | 4-1 |
| 5 | Merchandising Operations and the Multiple-Step Income Statement | 5-1 |
| 6 | Reporting and Analyzing Inventory | 6-1 |
| 7 | Fraud, Internal Control, and Cash | 7-1 |
| 8 | Reporting and Analyzing Receivables | 8-1 |
| 9 | Reporting and Analyzing Long-Lived Assets | 9-1 |
| 10 | Reporting and Analyzing Liabilities | 10-1 |
| 11 | Reporting and Analyzing Stockholders' Equity | 11-1 |
| 12 | Statement of Cash Flows | 12-1 |
| 13 | Financial Analysis: The Big Picture | 13-1 |
| APPENDIX A | Specimen Financial Statements: Apple Inc. | A-1 |
| APPENDIX B | Specimen Financial Statements: Columbia Sportswear Company | B-1 |
| APPENDIX C | Specimen Financial Statements: Under Armour, Inc. | C-1 |
| APPENDIX D | Specimen Financial Statements: Amazon.com, Inc. | D-1 |
| APPENDIX E | Specimen Financial Statements: Walmart Inc. | E-1 |
| APPENDIX F | Time Value of Money | F-1 |
| APPENDIX G | Reporting and Analyzing Investments | G-1 |
| COMPANY INDEX | | I-1 |
| SUBJECT INDEX | | I-5 |
| RAPID REVIEW: CHAPTER CONTENT | | |

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. A financial 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 financial 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.

“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 financial accounting will help you understand what is happening.”

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.

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

Author Commitment



PAUL D. KIMMEL, PhD, CPA, received his bachelor's degree from the University of Minnesota and his doctorate in accounting from the University of Wisconsin. He was an Associate Professor at the University of Wisconsin—Milwaukee for more than 25 years and is now a Senior Lecturer at the University of Wisconsin—Madison. He has public accounting experience with Deloitte & Touche (Minneapolis). He was the recipient of the UWM School of Business Advisory Council Teaching Award and the Reggie Taite Excellence in Teaching Award, and a three-time winner of the Outstanding Teaching Assistant Award at the University of Wisconsin. He is also a recipient of the Elijah Watts Sells Award for Honorary Distinction for his results on the CPA exam. He is a member of the American Accounting Association and the Institute of Management Accountants and has published articles in *Accounting Review*, *Accounting Horizons*, *Advances in Management Accounting*, *Managerial Finance*, *Issues in Accounting Education*, and *Journal of Accounting Education*, as well as other journals. His research interests include accounting for financial instruments and innovation in accounting education.



JERRY J. WEYGANDT, PhD, CPA, is Arthur Andersen Alumni Emeritus Professor of Accounting at the University of Wisconsin—Madison. He holds a Ph.D. in accounting from the University of Illinois. Articles by Professor Weygandt have appeared in *The Accounting Review*, *Journal of Accounting Research*, *Accounting Horizons*, *Journal of Accountancy*, and other academic and professional journals. These articles have examined such financial reporting issues as accounting for price-level adjustments, pensions, convertible securities, stock option contracts, and interim reports. Professor Weygandt is author of other accounting and financial reporting texts and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Wisconsin Society of Certified Public Accountants. He has served on numerous committees of the American Accounting Association and as a member of the editorial board of the *Accounting Review*; he also has served as President and Secretary-Treasurer of the American Accounting Association. In addition, he has been actively involved with the American Institute of Certified Public Accountants and has been a member of the Accounting Standards Executive Committee (AcSEC) of that organization. He has served on the FASB task force that examined the reporting issues related to accounting for income taxes and served as a trustee of the Financial Accounting Foundation. Professor Weygandt has received the Chancellor's Award for Excellence in Teaching and the Beta Gamma Sigma Dean's Teaching Award. He is on the board of directors of M & I Bank of Southern Wisconsin. He is the recipient of the Wisconsin Institute of CPA's Outstanding Educator's Award and the Lifetime Achievement Award. In 2001 he received the American Accounting Association's Outstanding Educator Award.



JILL E. MITCHELL, MS, Med, CIA, is a Professor of Accounting at Northern Virginia Community College (NOVA), where she has taught face-to-face, hybrid, and online courses since 2008. Since 2009, she has been an adjunct instructor at George Mason University (GMU). She is a past president of the Washington, D.C. Chapter of the Accounting and Financial Women's Alliance (AFWA), and she served on the board of directors of the Virginia Society of CPAs (VSCPA). She is a member of the American Accounting Association (AAA) and the Institute of Internal Auditors. Jill serves on the AAA Education Committee and is the co-chair for the Conference on Teaching and Learning in Accounting (CTLA). Prior to joining the faculty at NOVA, Jill was a senior auditor with Ernst & Young's Business Risk Services practice in Miami, Florida. She is a certified internal auditor and earned an MS in Accountancy from the University of Virginia and a BBA in Management Information Systems from the University of Georgia honors program. Recently, she earned an MEd in Instructional Design Technology from GMU. Jill is a recipient of the Outstanding Faculty Award, the Commonwealth's highest honor for faculty of Virginia's universities and colleges presented by the State Council of Higher Education for Virginia; the Virginia Community College System Chancellor's Award for Teaching Excellence; the AFWA's Women Who Count Award; the AAA Two-Year College Educator of the Year Award; and the AAA/J. Michael and Mary Anne Cook/Deloitte Foundation Prize, the foremost recognition of an individual who consistently demonstrates the attributes of a superior teacher in the discipline of accounting.

New to This Edition: Data Analytics

The authors carefully considered how to thoughtfully and meaningfully integrate data analytics into the financial 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/
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.)

Data Analytics in Action

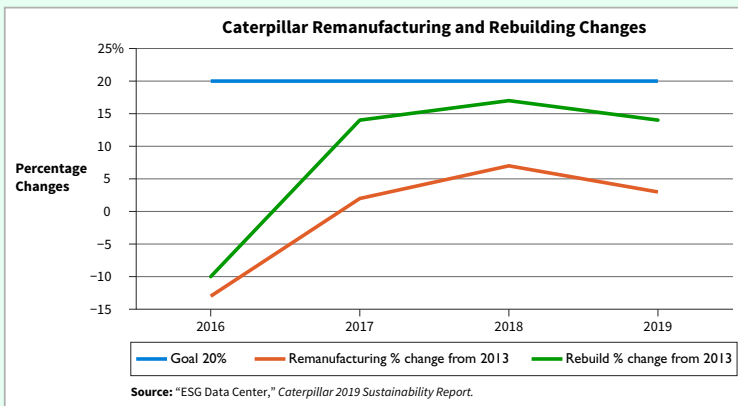
Data Analytics in Action problems provide students with the opportunity to see how to use data analytics to help solve realistic business problems. Excel templates for each *Data Analytics in Action* problem provide students a framework for solving the problem. *Data Analytics in Excel* videos provide 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.

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 end-of-chapter 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.

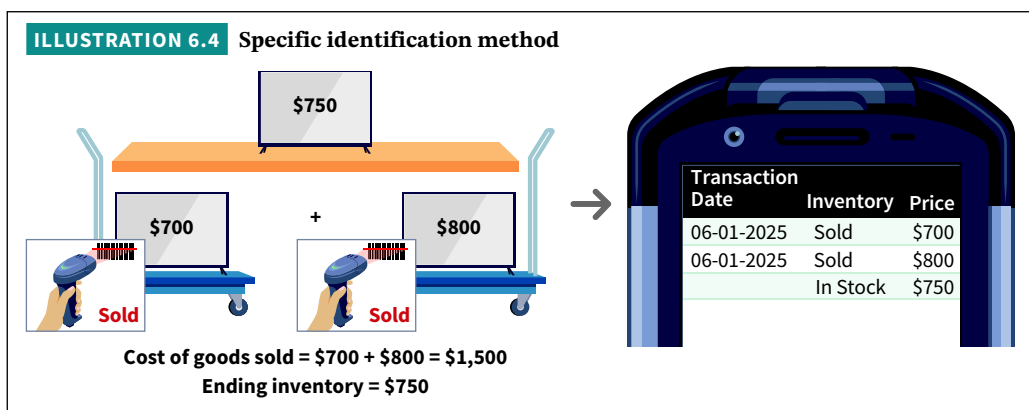
Proven Pedagogical Features

When you think of accounting, you probably don't think of athletics. So why do we have a photo of a cyclist 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, E.6.6, 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.

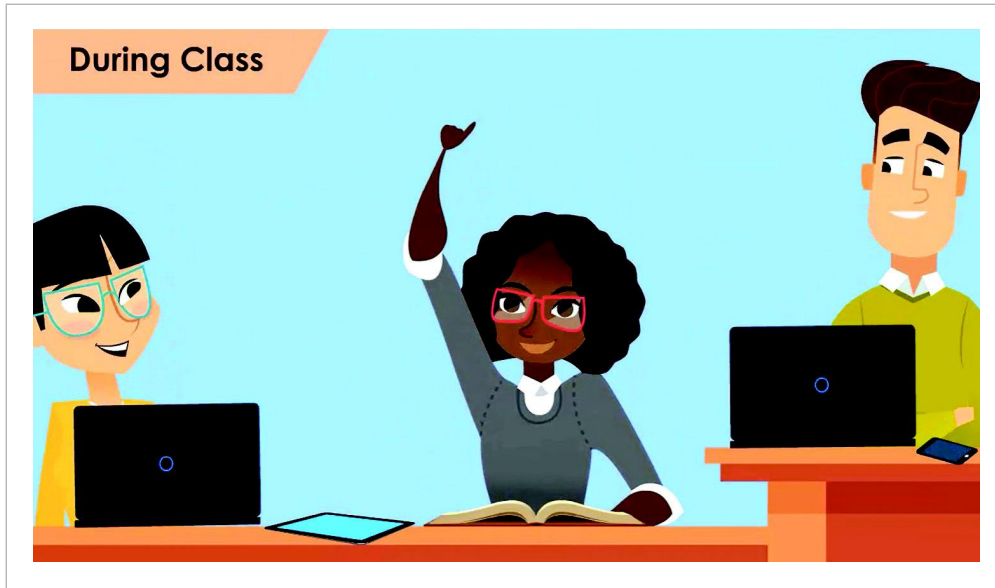
The screenshot displays a Wiley online course interface. At the top, a 'Learning Objective' states: '6.1 Discuss how to classify and determine inventory.' Below this, a section titled '6.1 Classifying and Determining Inventory: Classifying Inventory – Lecture Video (2 min)' is shown. A 'Lecture Video' section follows, with instructions to 'Watch this video, then answer the questions that follow to check your understanding.' The video title is 'Video: Classifying Inventory'. A video player is visible, showing a slide titled 'Reporting Inventory' with the text 'Two steps at the end of the accounting period' and a list: '1. Classifica complete', '2. Determin'. Below the video player, a 'Knowledge Check' section is displayed. 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: '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 answers: 'Question 1' with buttons for 'merchandising' and 'manufacturing'; 'Question 2' with buttons for 'periodic' and 'perpetual'; and 'Question 3' with buttons for 'beginning' and 'end'. At the bottom left is a 'Save for Later' button, and at the bottom right is a 'Submit Answer' button. The text 'Attempts: 0 of 2 used' is displayed above the '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.

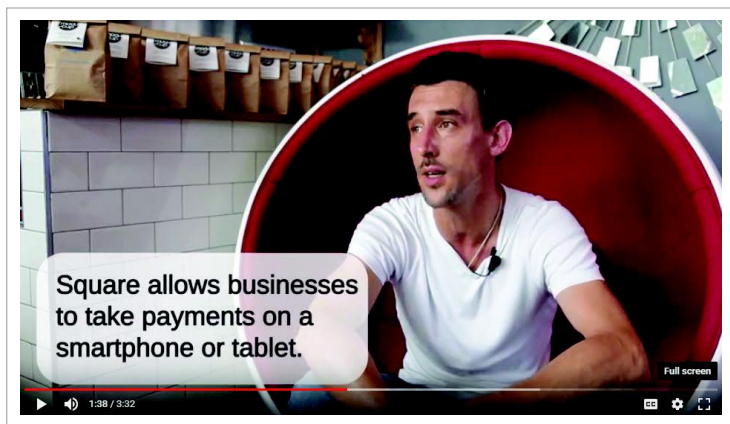
Animations

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 | \$144,530 |
| 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](#)

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 template. Use cell references to the Problem area with mathematical formulas in the input cells. In the last input field, input an IF function with cell references to your work area. | | | | |
| 5 | In October, Pine Company was determining its overhead variance. Its predetermined overhead rate is based on | | | | | | | | | |
| 6 | direct labor hours. The following | | | | | | | | | |
| 7 | | | | | | | | | | |
| 8 | | | | | | | | | | |
| 9 | Manufacturing overhead costs incurred | | \$ 118,000 | | | Actual overhead | | | | |
| 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. | | | | | | | | | |

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.

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 chapters and offers students the opportunity to see how a small business might use financial 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.

1 Introduction to Financial Statements 1-1

Knowing the Numbers: Columbia Sportswear Company 1-1

1.1 Business Organization and Accounting Information Uses 1-2

Forms of Business Organization 1-3

Users and Uses of Financial Information 1-4

Data Analytics 1-6

Ethics in Financial Reporting 1-7

1.2 The Three Types of Business Activity 1-8

Financing Activities 1-9

Investing Activities 1-9

Operating Activities 1-10

1.3 The Four Financial Statements 1-11

Income Statement 1-12

Retained Earnings Statement 1-13

Balance Sheet 1-14

Statement of Cash Flows 1-16

Interrelationships of Statements 1-17

Elements of an Annual Report 1-20

Appendix 1A: Career Opportunities in Accounting 1-23

“Show Me the Money” 1-24

2 A Further Look at Financial Statements 2-1

Just Fooling Around?: The Motley Fool 2-2

2.1 The Classified Balance Sheet 2-3

Current Assets 2-3

Long-Term Investments 2-5

Property, Plant, and Equipment 2-5

Intangible Assets 2-5

Current Liabilities 2-7

Long-Term Liabilities 2-7

Stockholders' Equity 2-7

2.2 Analyzing the Financial Statements Using Ratios 2-8

Ratio Analysis 2-8

Using the Income Statement 2-9

Using a Classified Balance Sheet 2-10

2.3 Financial Reporting Concepts 2-14

The Standard-Setting Environment 2-14

Qualities of Useful Information 2-16

Assumptions in Financial Reporting 2-17

Principles in Financial Reporting 2-18

Cost Constraint 2-18

3 The Accounting Information System 3-1

Accidents Happen: MF Global Holdings Ltd 3-1

3.1 Using the Accounting Equation to Analyze Transactions 3-3

Accounting Transactions 3-3

Analyzing Transactions 3-4

Summary of Transactions 3-10

3.2 Accounts, Debits, and Credits 3-11

Debits and Credits 3-11

Debit and Credit Procedures 3-12

Stockholders' Equity Relationships 3-15

Summary of Debit/Credit Rules 3-16

3.3 Using a Journal 3-17

The Recording Process 3-17

The Journal 3-18

3.4 The Ledger and Posting 3-20

The Ledger 3-20

Chart of Accounts 3-21

Posting 3-21

The Recording Process Illustrated 3-22

Summary Illustration of Journalizing and Posting 3-28

3.5 The Trial Balance 3-30

Limitations of a Trial Balance 3-31

4 Accrual Accounting Concepts 4-1

Keeping Track of Groupons: Groupon 4-1

4.1 Accrual-Basis Accounting and Adjusting Entries 4-2

The Revenue Recognition Principle 4-3

The Expense Recognition Principle 4-4

Accrual versus Cash Basis of Accounting 4-5

The Need for Adjusting Entries 4-5

Types of Adjusting Entries 4-6

4.2 Adjusting Entries for Deferrals 4-7

Prepaid Expenses 4-7

Unearned Revenues 4-12

4.3 Adjusting Entries for Accruals 4-15

Accrued Revenues 4-15

Accrued Expenses 4-17

Summary of Basic Relationships 4-20

4.4 The Adjusted Trial Balance and Closing Entries 4-23

Preparing the Adjusted Trial Balance 4-23

Preparing Financial Statements 4-24

Quality of Earnings 4-24

Closing the Books 4-27

Summary of the Accounting Cycle 4-30

Appendix 4A: Using a Worksheet 4-34

5 Merchandising Operations and the Multiple-Step Income Statement 5-1

Buy Now, Vote Later: REI 5-1

5.1 Merchandising Operations and Inventory Systems 5-2

Operating Cycles 5-3

Flow of Costs 5-4

5.2 Recording Purchases Under a Perpetual System 5-6

Freight Costs 5-8

Purchase Returns and Allowances 5-9

Purchase Discounts 5-10

Summary of Purchasing Transactions 5-11

5.3 Recording Sales Under a Perpetual System 5-11

Sales Returns and Allowances 5-13

Sales Discounts 5-14

Data Analytics and Credit Sales 5-15

5.4 Preparing the Multiple-Step Income Statement 5-16

Single-Step Income Statement 5-16

Multiple-Step Income Statement 5-17

5.5 Cost of Goods Sold Under a Periodic System 5-21

5.6 Gross Profit Rate and Profit Margin 5-23

Gross Profit Rate 5-23

Profit Margin 5-24

Appendix 5A: Periodic Inventory System 5-27

Recording Merchandise Transactions 5-27

Recording Purchases of Merchandise 5-28

Freight Costs 5-28

Recording Sales of Merchandise 5-28

Comparison of Entries—Perpetual vs. Periodic 5-29

Appendix 5B: Adjusting Entries for Credit Sales with Returns and Allowances 5-30

Data Analytics in Action 5-52

6 Reporting and Analyzing Inventory 6-1

“Where Is That Spare Bulldozer Blade?”: Caterpillar 6-1

6.1 Classifying and Determining Inventory 6-2

Classifying Inventory 6-2

Determining Inventory Quantities 6-4

6.2 Inventory Methods and Financial Effects 6-7

Specific Identification 6-7

Cost Flow Assumptions 6-8

Financial Statement and Tax Effects of Cost Flow Methods 6-13

Using Inventory Cost Flow Methods Consistently 6-15

6.3 Inventory Presentation and Analysis 6-17

Presentation 6-17

Lower-of-Cost-or-Net Realizable Value 6-17

Financial Analysis and Data Analytics 6-18

Adjustments for LIFO Reserve 6-21

Appendix 6A: Inventory Cost Flow Methods in Perpetual Inventory Systems 6-24

First-In, First-Out (FIFO) 6-24

Last-In, First-Out (LIFO) 6-25

Average-Cost 6-26

Appendix 6B: Effects of Inventory Errors 6-27

Income Statement Effects 6-27

Balance Sheet Effects 6-28

Data Analytics in Action 6-49

7 Fraud, Internal Control, and Cash 7-1

Minding the Money in Madison: Barriques 7-1

7.1 Fraud and Internal Control 7-3

Fraud 7-3

The Sarbanes-Oxley Act 7-3

Internal Control 7-4

Principles of Internal Control Activities 7-5

Data Analytics and Internal Controls 7-10

Limitations of Internal Control 7-11

7.2 Cash Controls 7-12

Cash Receipts Controls 7-12

Cash Disbursements Controls 7-14

Petty Cash Fund 7-16

7.3 Control Features of a Bank Account 7-17

Electronic Banking 7-18

Bank Statements 7-18

Reconciling the Bank Account 7-20

7.4 Reporting Cash 7-25

Cash Equivalents 7-26

Restricted Cash 7-26

Managing and Monitoring Cash 7-27

Cash Budgeting 7-29

Appendix 7A: Operation of a Petty Cash Fund 7-32

Establishing the Petty Cash Fund 7-33

Making Payments from the Petty Cash Fund 7-33

Replenishing the Petty Cash Fund 7-34

Data Analytics in Action 7-56

8 Reporting and Analyzing Receivables 8-1

What’s Cooking?: Nike 8-1

8.1 Recognition of Accounts Receivable 8-3

Types of Receivables 8-3

Recognizing Accounts Receivable 8-3

8.2 Valuation and Disposition of Accounts Receivable 8-5

Valuing Accounts Receivable 8-5

Disposing of Accounts Receivable 8-13

8.3 Notes Receivable 8-15

Determining the Maturity Date 8-16

Computing Interest 8-16

Recognizing Notes Receivable 8-17

Valuing Notes Receivable 8-17

Disposing of Notes Receivable 8-17

8.4 Receivables Presentation and Management 8-20

Financial Statement Presentation of Receivables 8-20

Managing Receivables 8-21

Evaluating Liquidity of Receivables 8-23

Accelerating Cash Receipts 8-24

Data Analytics and Receivables Management 8-25

Data Analytics in Action 8-46**9 Reporting and Analyzing
Long-Lived Assets 9-1***A Tale of Two Airlines: American Airlines 9-1***9.1 Plant Asset Expenditures 9-3**

Determining the Cost of Plant Assets 9-3

Expenditures During Useful Life 9-6

To Buy or Lease? 9-7

9.2 Depreciation Methods 9-8

Factors in Computing Depreciation 9-9

Depreciation Methods 9-9

Revising Periodic Depreciation 9-14

Impairments 9-15

9.3 Plant Asset Disposals 9-16

Sale of Plant Assets 9-16

Retirement of Plant Assets 9-18

9.4 Intangible Assets 9-19

Accounting for Intangible Assets 9-19

Types of Intangible Assets 9-20

Research and Development Costs 9-22

9.5 Statement Presentation and Analysis 9-23

Presentation 9-23

Analysis 9-25

Appendix 9A: Other Depreciation Methods 9-30

Declining-Balance Method 9-30

Units-of-Activity Method 9-31

Data Analytics in Action 9-55**10 Reporting and Analyzing
Liabilities 10-1***And Then There Were Two: Maxwell Car Company 10-1***10.1 Accounting for Current Liabilities 10-3**

What Is a Current Liability? 10-3

Notes Payable 10-3

Sales Taxes Payable 10-4

Unearned Revenues 10-5

Current Maturities of Long-Term Debt 10-6

Payroll and Payroll Taxes Payable 10-6

10.2 Characteristics of Bonds 10-9

Types of Bonds 10-9

Issuing Procedures 10-10

Bond Trading 10-10

Determining the Market Price of a Bond 10-11

10.3 Accounting for Bond Transactions 10-14

Issuing Bonds at Face Value 10-14

Discount or Premium on Bonds 10-14

Issuing Bonds at a Discount 10-15

Issuing Bonds at a Premium 10-17

Redeeming Bonds at Maturity 10-19

Redeeming Bonds Before Maturity 10-19

10.4 Presentation and Analysis 10-20

Presentation 10-20

Analysis 10-22

Appendix 10A: Straight-Line Amortization 10-26

Amortizing Bond Discount 10-26

Amortizing Bond Premium 10-28

Appendix 10B: Effective-Interest Amortization 10-29

Amortizing Bond Discount 10-29

Amortizing Bond Premium 10-31

Appendix 10C: Accounting for Long-Term**Notes Payable 10-32****11 Reporting and Analyzing
Stockholders' Equity 11-1***Oh Well, I Guess I'll Get Rich: Facebook 11-1***11.1 Corporate Form of Organization 11-3**

Characteristics of a Corporation 11-3

Forming a Corporation 11-6

Stockholder Rights 11-7

Stock Issue Considerations 11-8

Corporate Capital 11-10

11.2 Accounting for Common, Preferred, and**Treasury Stock 11-12**

Accounting for Common Stock 11-12

Accounting for Preferred Stock 11-13

Accounting for Treasury Stock 11-14

11.3 Accounting for Dividends and Stock Splits 11-16

Cash Dividends 11-16

Dividend Preferences 11-19

Stock Dividends 11-21

Stock Splits 11-22

11.4 Presentation and Analysis 11-24

Retained Earnings 11-24

Retained Earnings Restrictions 11-25

Balance Sheet Presentation of Stockholders' Equity 11-26

Analysis of Stockholders' Equity 11-28

Debt versus Equity Decision 11-29

Appendix 11A: Entries for Stock Dividends 11-32**Data Analytics in Action 11-55**

12 Statement of Cash Flows 12-1

Got Cash?: Microsoft 12-2

12.1 Usefulness and Format of the Statement of Cash Flows 12-3

Usefulness of the Statement of Cash Flows 12-3

Classification of Cash Flows 12-3

Significant Noncash Activities 12-4

Format of the Statement of Cash Flows 12-5

12.2 Preparing the Statement of Cash Flows—Indirect Method 12-6

Indirect and Direct Methods 12-7

Indirect Method—Computer Services Company 12-7

Step 1: Operating Activities 12-9

Summary of Conversion to Net Cash Provided by Operating Activities—Indirect Method 12-12

Step 2: Investing and Financing Activities 12-13

Step 3: Net Change in Cash 12-15

12.3 Analyzing the Statement of Cash Flows 12-17

The Corporate Life Cycle 12-17

Free Cash Flow 12-19

Appendix 12A: Statement of Cash Flows—Direct Method 12-22

Step 1: Operating Activities 12-24

Step 2: Investing and Financing Activities 12-28

Step 3: Net Change in Cash 12-30

Appendix 12B: Worksheet for the Indirect Method 12-30

Preparing the Worksheet 12-31

Appendix 12C: Statement of Cash Flows—T-Account Approach 12-35

Data Analytics in Action 12-61

13 Financial Analysis: The Big Picture 13-1

It Pays to Be Patient: Warren Buffett 13-2

13.1 Sustainable Income and Quality of Earnings 13-3

Sustainable Income 13-3

Quality of Earnings 13-7

13.2 Horizontal Analysis and Vertical Analysis 13-9

Horizontal Analysis 13-10

Vertical Analysis 13-12

13.3 Ratio Analysis 13-15

Liquidity Ratios 13-16

Solvency Ratios 13-17

Profitability Ratios 13-17

Financial Analysis and Data Analytics 13-18

Comprehensive Example of Ratio Analysis 13-18

APPENDIX A Specimen Financial Statements:
Apple Inc. A-1

APPENDIX B Specimen Financial Statements:
Columbia Sportswear Company B-1

APPENDIX C Specimen Financial Statements:
Under Armour, Inc. C-1

APPENDIX D Specimen Financial Statements:
Amazon.com, Inc. D-1

APPENDIX E Specimen Financial Statements:
Walmart Inc. E-1

APPENDIX F Time Value of Money F-1

F.1 Interest and Future Values F-2

Nature of Interest F-2

Future Value of a Single Amount F-3

Future Value of an Annuity F-5

F.2 Present Values F-8

Present Value Variables F-8

Present Value of a Single Amount F-9

Present Value of an Annuity F-11

Time Periods and Discounting F-13

Present Value of a Long-Term Note or Bond F-13

F.3 Capital Budgeting Situations F-16

F.4 Using Technological Tools F-18

Present Value of a Single Sum F-19

Present Value of an Annuity F-20

Future Value of a Single Sum F-21

Future Value of an Annuity F-22

Internal Rate of Return F-22

Useful Applications F-23

APPENDIX G Reporting and Analyzing Investments G-1

G.1 Accounting for Debt Investments G-2

Why Corporations Invest G-2

Accounting for Debt Investments G-2

G.2 Accounting for Stock Investments G-4

Holdings of Less Than 20% G-5

Holdings Between 20% and 50% G-6

Holdings of More Than 50% G-7

G.3 Reporting Investments in Financial Statements G-9

Debt Securities G-9

Equity Securities G-12

Balance Sheet Presentation G-13

Presentation of Realized and Unrealized Gain
or Loss G-14

Company Index I-1

Subject Index I-5

Rapid Review: Chapter Content

Acknowledgments

Financial Accounting has benefitted greatly from the input of focus group participants, manuscript reviewers, those who have sent comments by letter or e-mail, ancillary authors, and proofers. We greatly appreciate the constructive suggestions and innovative ideas of reviewers and the creativity and accuracy of the ancillary authors and checkers.

Dennis Avola
Northeastern University
Ellen Bartley
Farmingdale State College
Thomas Bednarcik
Robert Morris University Illinois
Linda Bell
Park University
Martin Blaine
Columbus State Community College
Bradley Blaylock
Oklahoma State University
Isaac Bonaparte
Towson University
Gary Bower
Community College of Rhode Island
Robert Braun
Southeastern Louisiana University
Lou Bravo
North Lake College
Myra Bruegger
Southeastern Community College
Barry Buchoff
Towson University
Brian Bunce
Bellevue University
Jacqueline Burke
Hofstra University
Matthew Calderisi
Fairleigh Dickinson University
Julia Camp
Providence College
Marian Canada
Ivy Tech Community College at Franklin
James Chiafery
University of Massachusetts—Boston
Bea Chiang
The College of New Jersey
Carolyn Christesen
Westchester Community College
Colleen Chung
Miami Dade College
Shifei Chung
Rowan University
Tony Cioffi
Lorain County Community College
Leslie Cohen
University of Arizona
Jim Coughlin
Robert Morris University
Patricia Crenny
Villanova University
Dori Danko
Grand Valley State University

Mingcherng Deng
Baruch College
Kathy Dunne
Rider University
Barbara Durham
University of Central Florida
Jeanne Eibes
Creighton University
David Emerson
Salisbury University
Caroline Falconetti
Nassau Community College
Nancy Fan
*California State Polytechnic University,
Pomona*
Magdy Farag
*California State Polytechnic University,
Pomona*
Linda Flaming
Monmouth University
Joseph Fournier
University of Rhode Island
Chad Frawley
Viterbo University
Amy Geile
University of Arizona
Alan Glaser
Franklin & Marshall College
J. D. Golub
Northeastern University
Liz Grant
Northern Illinois University
Rita Grant
Grand Valley State University
Steve Groves
Ivy Tech Community College
Konrad Gunderson
Missouri Western State University
Marcye Hampton
University of Central Florida
Deborah Hanks
Cardinal Stritch University
Qian Hao
Wilkes University
Jacory Hickerson
University of Phoenix
Huong Higgins
Worcester Polytechnic Institute
Yongtao Hong
North Dakota State University
Jana Hosmer
Blue Ridge Community College
Robert Hurst
Franklin University

Wayne Ingalls
University of Maine
K. Harold Jackson
Tarrant County College
Jennifer Joe
University of Delaware
James B. Johnson
Community College of Philadelphia
Patricia Johnson
Canisius College
Jordan Kanter
University of Rhode Island
Ann Galligan Kelley
Providence College
Robert Kenny
The College of New Jersey
Emil Koren
Saint Leo University
Leah Kratz
Eastern Mennonite University
Faith Lamprey
Providence College
Claudia Larocque
Manchester Community College
Gary Laycock
Ivy Tech Community College
Charles Leflar
University of Arkansas
Jennifer LeSure
Ivy Tech Community College
Claudia Lubaski
Lorain County Community College
Susan Lynn
University of Baltimore
Yuanyuan Ma
University of Minnesota
Don McFall
Hiram College
Allison McLeod
University of North Texas
Don Minyard
University of Alabama—Tuscaloosa
Maha Mitrelis
Providence College
Louella Moore
Washburn University
Sia Nassiripour
William Paterson University
Joseph Nesi
Monmouth University
Judith Pagnette
Bellevue College
Glenn Pate
Palm Beach State College

Suzy Pearse
Clemson University

Rachel Pernia
Essex County College

Bob Picard
Idaho State University

George Psaras
Aurora University

Smrity Randhawa
University of Southern California

Patrick Reihing
Nassau Community College

John Ribezzo
Community College of Rhode Island

Barbara Rice
Gateway Community and Technical College

Vernon Richardson
University of Arkansas

Patrick Rogan
Consumnes River College

Juan Roman
Saint Leo University

John Rude
Bloomsburg University

Martin Rudnick
William Paterson University

August Saibeni
Consumnes River College

Barbara Sandler
Queens College

Barbara Scofield
Washburn University

Chris Severson
Franklin University

Suzanne Seymoure
Saint Leo University

Abdus Shahid
The College of New Jersey

Mike Shapeero
Bloomsburg University

Todd Shawver
Bloomsburg University

Eileen Shifflett
James Madison University

Kathy Simmons
Bryant University

Ladd Simms
Mississippi Valley State University

Doug Stives
Monmouth University

Diane Tanner
University of North Florida

Karen Tower
Ivy Tech Community College

Daniel Tschopp
Saint Leo University

Mark Ulrich
CUNY Queensborough Community College

Ski Vanderlean
Delta College

Andrea Weickgenannt
Xavier University

Nancy Wilburn
Northern Arizona University

Wayne W. Williams
Community College of Philadelphia

Leon Wlazlo
SUNY Broome Community College

Hannah Wong
William Paterson University

Kenneth Zheng
University at Buffalo

Ancillary Authors, Contributors, Proofs, and Accuracy Checkers

Ellen Bartley
St. Joseph's College

LuAnn Bean
Florida Institute of Technology

Jack Borke
University of Wisconsin—Platteville

Ann K. Brooks
University of New Mexico

Melodi Bunting
Edgewood College

Machiavelli Chao
University of California, Irvine

Bea Chiang
The College of New Jersey

Lawrence Chui
University of St. Thomas (Minnesota)

Laura De Luca
Fanshawe College

Judy Dewitt
Central Michigan University

Dina El Mahdy
Morgan State University

James Emig
Villanova University

Larry Falcetto
Emporia State University

Michael P. Griffin
University of Massachusetts Dartmouth

Heidi Hansel
Kirkwood Community College

Coby Harmon
University of California—Santa Barbara

Lisa Hewes
Northern Arizona University

Kimberly J. Hurt
Central Community College

Derek Jackson
St. Mary's University of Minnesota

Craig Krenek
Elmhurst College

Cynthia Lovick
Austin Community College

Lisa L. Ludlum
Western Illinois University

Kirk Lynch
Sandhills Community College

Susanna Matson
Southern New Hampshire University

Jill Misuraca
University of Tampa

Barbara Muller
Arizona State University

Linda Mullins
Georgia State University—Perimeter College

Yvonne Phang
Borough of Manhattan Community College

David Polster
Oakton Community College

Laura Prosser
Black Hills State University

Alice Sineath
Forsyth Technical Community College

Teresa Speck
St. Mary's University of Minnesota

Lynn Stallworth
Appalachian State University

Diane Tanner
University of North Florida

Mark Ulrich
CUNY Queensborough Community College

Sheila Viel
University of Wisconsin—Milwaukee

Dick Wasson
Southwestern College

Catherine Wyatt
Lumina Datamatics

Lori Grady Zaher
Bucks County Community College

Aleksandra Zimmerman
Florida State University

We appreciate the exemplary support and commitment given to us by associate director Zoe Craig, marketing manager Carolyn Wells, course content developer Jenny Welter, editorial supervisor Terry Ann Tatro, designer Wendy Lai, senior production editor Rachel Conrad, and Julie Perry at Lumina. All of these professionals provided innumerable services that helped the text take shape.

We also thank Margaret Shackell of Forsyth Technical Community College and Diane Tanner of University of North

Florida for their creativity and efforts in the development of the *Data Analytics in Action* problems.

Finally, we appreciate suggestions and comments from users—instructors and students alike. We welcome your thoughts and ideas about the text.

Paul D. Kimmel
Cedarburg, Wisconsin

Jerry J. Weygandt
Madison, Wisconsin

Jill E. Mitchell
Annandale, Virginia



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

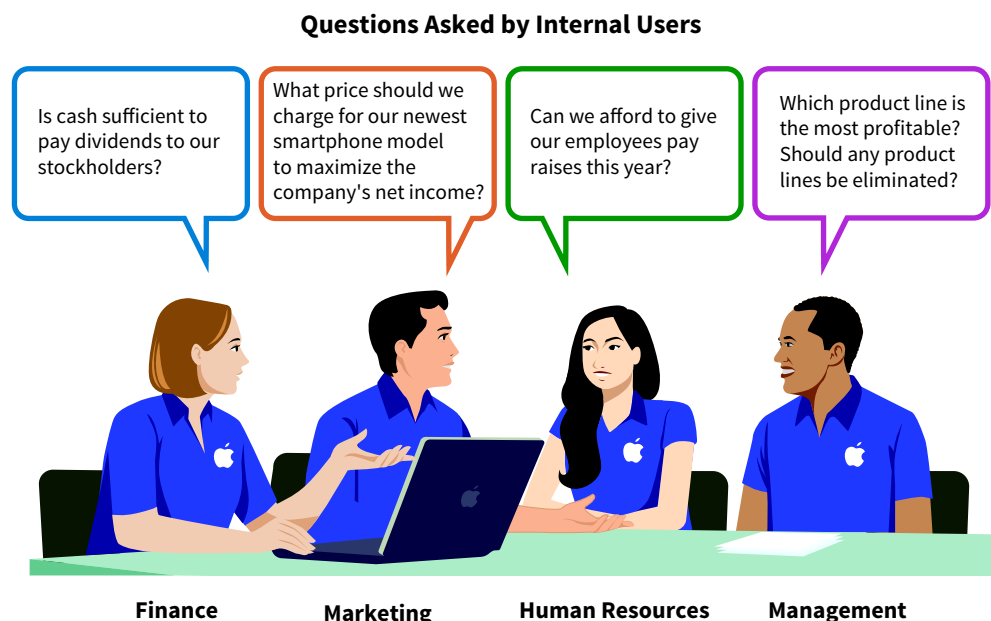
The purpose of financial information is to provide inputs for decision-making.

- **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 Landor'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

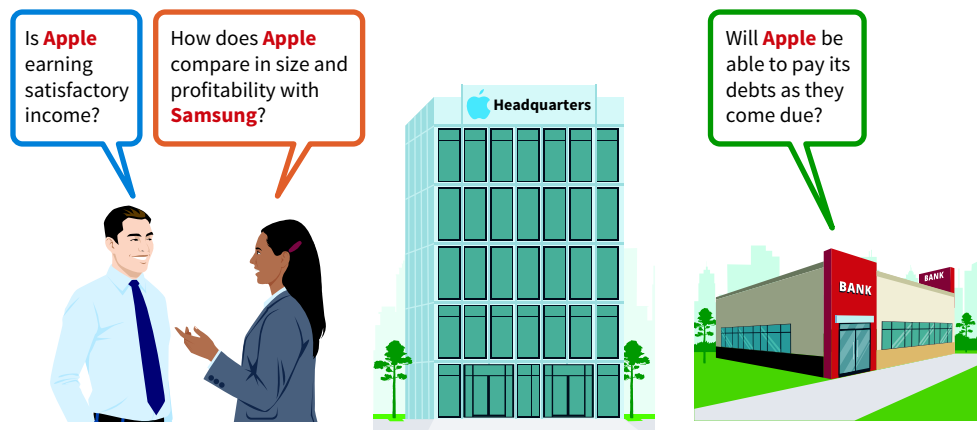


ILLUSTRATION 1.2 Questions that external users ask

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

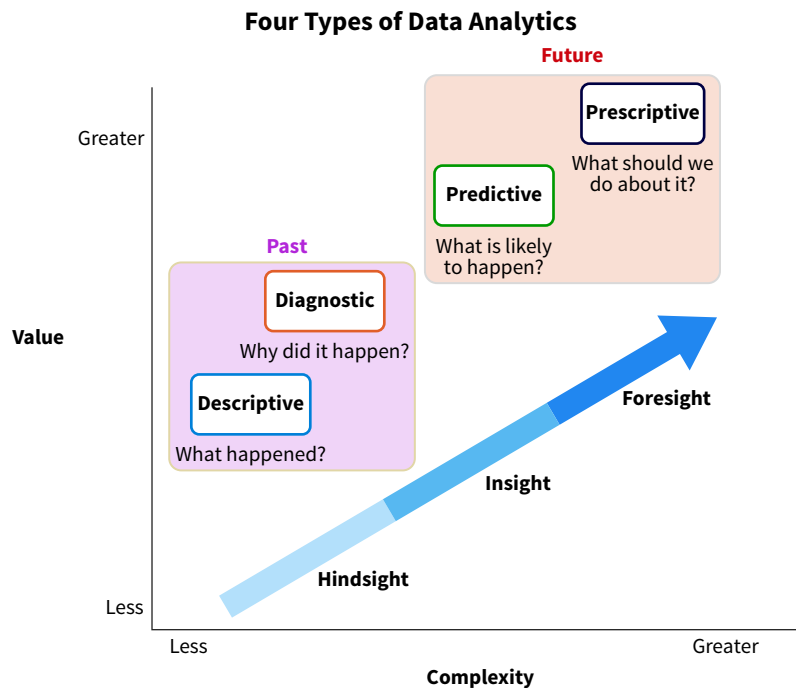
Throughout this text, we will highlight examples where accounting information is used to support business decisions using data analytics.

- **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**.

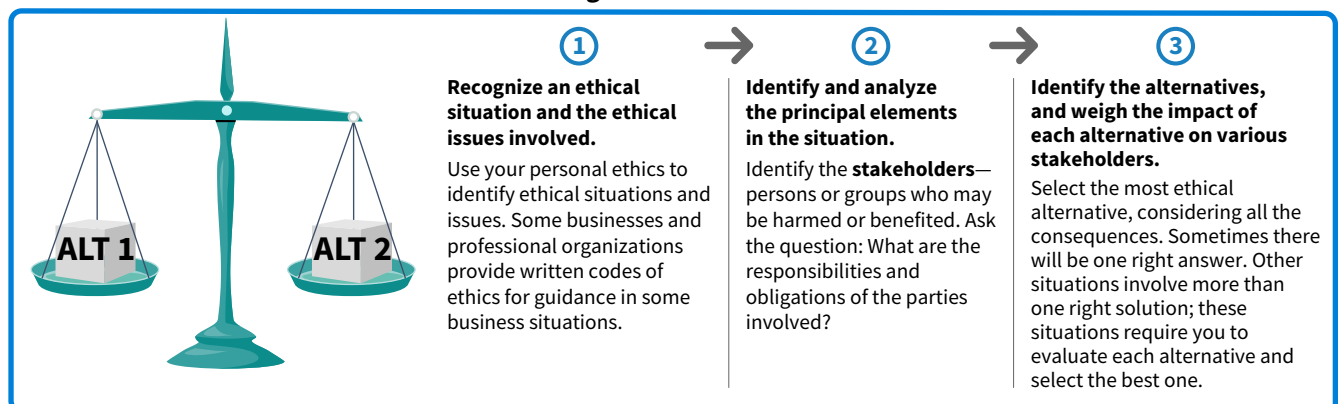
ETHICS NOTE

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

Solving an Ethical Dilemma



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).

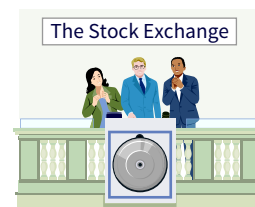
Columbia Sportswear may borrow money in a variety of ways. For example, it can take out a loan at a bank or borrow directly from investors by issuing debt securities called bonds. Persons or entities to whom Columbia owes money are its **creditors**.

- 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 Activities



Operating

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> | |
| | | <u>2,860</u> |
| 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 | 6,800 |
| | 6,800 |
| Less: Dividends | 600 |
| 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*.

Assets = Liabilities + 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.

ILLUSTRATION 1.8

Sierra Corporation's balance sheet

| 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> |

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.

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.

ILLUSTRATION 1.9

Sierra Corporation's statement of cash flows

| 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.

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 | | <u>7,740</u> |
| 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 | | \$15,200 |
| 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.

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> |

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.

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 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.

USING THE DECISION TOOLS | Under Armour, Inc.

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?

- c. Do you care if the financial statements have been audited? Explain.
- d. Appendix B contains financial statements for Columbia, and Appendix C contains those for Under Armour. You can make many comparisons between Columbia and Under Armour in terms of their respective results from operations and financial position. Compare their respective total assets, total revenues, and net cash provided by operating activities for 2020.

Solution

- a. Before you invest, you should evaluate the income statement, retained earnings statement, balance sheet, and statement of cash flows.
- b. You would probably be most interested in the income statement because it summarizes past performance and thus gives an indication of future performance. The retained earnings statement provides a record of the company's dividend history. The balance sheet reveals the relationship between assets and liabilities. The statement of cash flows reveals where the company is getting and spending its cash. This is especially important for a company that wants to grow.
- c. You would want audited financial statements. These statements indicate that a CPA (certified public accountant) has examined and expressed an opinion whether the statements present fairly the financial position and results of operations of the company. Investors and creditors should not make decisions without studying audited financial statements.
- d. Many interesting comparisons can be made between the two companies (all numbers are in thousands). Columbia is smaller, with total assets of \$2,836,571 versus \$5,030,628 for Under Armour, and it has lower revenue—\$2,501,554 versus \$4,474,667 for Under Armour. However, Columbia's net cash provided by operating activities of \$276,077 is greater than Under Armour's \$212,864. However, while useful, these basic measures are not enough to determine whether one company is a better investment than the other. In later chapters, you will learn tools that will allow you to compare the relative profitability and financial health of these and other companies.

Appendix 1A

Career Opportunities in Accounting

LEARNING OBJECTIVE *4

Explain the career opportunities in accounting.

Why is accounting such a popular major and career choice?

1. **There are a lot of jobs.** In many cities in recent years, the demand for accountants exceeded the supply. Not only are there a lot of jobs, but there are a wide array of opportunities. As one accounting organization observed, “accounting is one degree with 360 degrees of opportunity.”
2. **Accounting matters.** Interest in accounting has increased, ironically, because of the attention caused by the accounting failures of companies such as **Enron** and **WorldCom**. These widely publicized scandals revealed the important role that accounting plays in society. Most people want to make a difference, and an accounting career provides many opportunities to contribute to society.
3. **The Sarbanes-Oxley Act (SOX) significantly increased the accounting and internal control requirements for corporations.** This dramatically increased demand for professionals with accounting training.
4. **Emerging technologies such as automation, blockchain, and data analytics are changing the way accountants work.** With those skills, accountants add value to business decision-making.

Accountants are in such demand that it is not uncommon for accounting students to have accepted a job offer a year before graduation. As **Illustration 1A.1** reveals, the job options of people with accounting degrees are virtually unlimited.

ILLUSTRATION 1A.1 Career options in accounting

| Areas of Accounting Careers | Type of Work | Examples of Employers | Certification Opportunities |
|-----------------------------|---|--|--|
| Public accounting | <ul style="list-style-type: none">In auditing, accountants examine (audit) the financial statements and issue opinions on the fairness of the financial presentation.In taxation, CPAs offer tax advice and planning.In management consulting, accountants design and install accounting software and enterprise resource planning systems and support mergers and acquisitions. | Deloitte, EY, KPMG, PwC, Grant Thornton, BDO, Baker Tilly | Certified public accountants (CPAs), enrolled agent (EA), certified information systems auditor (CISA) |
| Private accounting | <ul style="list-style-type: none">Financial accountants manage the accounting information system and prepare financial statements.Managerial accountants manage costs and budgets.Internal auditors ensure compliance with policies and regulations. | For-profit: Starbucks, Google, Under Armour Non-profit: Salvation Army, Red Cross | Certified management accountant (CMA), certified internal auditor (CIA) |
| Governmental accounting | <ul style="list-style-type: none">There are opportunities in government at the local, state, and federal levels. | Internal Revenue Service (IRS), Federal Bureau of Investigation (FBI) | Certified government financial manager (CGFM) |
| Forensic accounting | <ul style="list-style-type: none">In forensic accounting, accountants conduct investigations into theft and fraud. | Insurance companies, law firms, FBI | Certified fraud examiner (CFE) |

“Show Me the Money”

How much can a new accountant make? Take a look at the average salaries for college graduates in public and private accounting shown in **Illustration 1A.2**.¹ Keep in mind if you also have a CPA license, you’ll make 10–15% more when you start out.

ILLUSTRATION 1A.2

Salary estimates for jobs in public and corporate accounting

| Employer | Jr. Level (0–3 yrs.) | Sr. Level (4–6 yrs.) |
|--------------------------------------|----------------------|----------------------|
| Public accounting (large firm) | \$63,250–\$83,250 | \$78,500–\$106,500 |
| Public accounting (medium firm) | \$56,500–\$67,750 | \$70,500–\$96,000 |
| Public accounting (small company) | \$51,500–\$60,500 | \$63,750–\$81,500 |
| Corporate accounting (large company) | \$53,750–\$69,500 | \$68,750–\$87,750 |

Illustration 1A.3 lists some examples of upper-level salaries for managers in corporate accounting. Note that geographic region, experience, education, CPA certification, and company size each play a role in determining salary.

ILLUSTRATION 1A.3

Upper-level management salaries in corporate accounting

| Position | Large Company | Small to Medium Company |
|-------------------------|---------------------|-------------------------|
| Chief financial officer | \$207,000–\$465,750 | \$105,250–\$208,750 |
| Corporate controller | \$140,000–\$224,750 | \$92,000–\$161,250 |
| Tax manager | \$112,000–\$158,250 | \$88,000–\$124,750 |

¹See startheregoplaces.com/students/why-accounting/salary-and-demand/ for information regarding the salaries listed in Illustrations 1A.2 and 1A.3.

The **Review and Practice** section provides opportunities for students to review key concepts and terms as well as complete multiple-choice questions, brief exercises, exercises, and a comprehensive problem. Detailed solutions are also included.

Review and Practice

Learning Objectives Review

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

A sole proprietorship is a business owned by one person. A partnership is a business owned by two or more people associated as partners. A corporation is a separate legal entity for which evidence of ownership is provided by shares of stock.

Internal users are managers who need accounting information to plan, organize, and run business operations. The primary external users are investors and creditors. Investors (stockholders) use accounting information to decide whether to buy, hold, or sell shares of a company's stock. Creditors (suppliers and bankers) use accounting information to assess the risk of granting credit or loaning money to a business. Other groups who have an indirect interest in a business are taxing authorities, customers, labor unions, and regulatory agencies.

2 Explain the three principal types of business activity.

Financing activities involve collecting the necessary funds to support the business. Investing activities involve acquiring the resources necessary to run the business. Operating activities involve putting the resources of the business into action to generate a profit.

3 Describe the four financial statements and how they are prepared.

An income statement presents the revenues and expenses of a company for a specific period of time. A retained earnings statement

summarizes the changes in retained earnings that have occurred for a specific period of time. A balance sheet reports the assets, liabilities, and stockholders' equity of a business at a specific date. A statement of cash flows summarizes information concerning the cash inflows (receipts) and outflows (payments) for a specific period of time.

Assets are resources owned by a business. Liabilities are the debts and obligations of the business. Liabilities represent claims of creditors on the assets of the business. Stockholders' equity represents the claims of owners on the assets of the business. Stockholders' equity is subdivided into two parts: common stock and retained earnings. The basic accounting equation is $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$.

Within the annual report, the management discussion and analysis provides management's interpretation of the company's results and financial position as well as a discussion of plans for the future. Notes to the financial statements provide additional explanation or detail to make the financial statements more informative. The auditor's report expresses an opinion as to whether the financial statements present fairly the company's results of operations and financial position.

*4 Explain the career opportunities in accounting.

Accounting offers many different jobs in fields such as public and private accounting, governmental, and forensic accounting. Accounting is a popular major because there are many different types of jobs, with unlimited potential for career advancement.

Decision Tools Review

| Decision Checkpoints | Info Needed for Decision | Tool to Use for Decision | How to Evaluate Results |
|---|-----------------------------|---|---|
| Are the company's operations profitable? | Income statement | The income statement reports a company's revenues and expenses and resulting net income or loss for a period of time. | If the company's revenues exceed its expenses, it will report net income; otherwise, it will report a net loss. |
| What is the company's policy toward dividends and growth? | Retained earnings statement | The retained earnings statement reports how much of this year's income the company paid out in dividends to shareholders. | A company striving for rapid growth will pay a low (or no) dividend. |

(continues)

(continued)

| Decision Checkpoints | Info Needed for Decision | Tool to Use for Decision | How to Evaluate Results |
|---|--------------------------|---|---|
| Does the company rely primarily on debt or stockholders' equity to finance its assets? | Balance sheet | The balance sheet reports the company's resources and claims to those resources; there are two types of claims: liabilities and stockholders' equity. | Compare the amount of debt versus the amount of stockholders' equity to determine whether the company relies more on creditors or owners for its financing. |
| Does the company generate sufficient cash from operations to fund its investing activities? | Statement of cash flows | The statement of cash flows shows the amount of net cash provided or used by operating activities, investing activities, and financing activities. | Compare the amount of net cash provided by operating activities with the amount of net cash used by investing activities. Any deficiency in cash from operating activities must be made up with cash from financing activities. |

Glossary Review

Accounting The information system that identifies, records, and communicates the economic events of an organization to interested users. (p. 1-4).

Annual report A report prepared by corporate management that presents financial information including financial statements, a management discussion and analysis section, notes, and an independent auditor's report. (p. 1-20).

Assets Resources owned by a business. (p. 1-9).

***Auditing** The examination of financial statements by a certified public accountant in order to express an opinion as to the fairness of presentation. (p. 1-24).

Auditor's report A report prepared by an independent outside auditor stating 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. (p. 1-21).

Balance sheet A financial statement that reports the assets and claims to those assets at a specific point in time. (p. 1-14).

Basic accounting equation $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$. (p. 1-14).

Certified public accountant (CPA) An individual who has met certain criteria and is thus allowed to perform audits of corporations. (p. 1-21).

Common stock Term used to describe the total amount paid in by stockholders for the shares they purchase. (p. 1-9).

Corporation A business organized as a separate legal entity owned by stockholders. (p. 1-3).

Data analytics The evaluation of data, often employing both software and statistics, to draw inferences. (p. 1-6).

Dividends Payments of cash from a corporation to its stockholders. (p. 1-9).

Expenses The cost of assets consumed or services used in the process of generating revenues. (p. 1-10).

***Forensic accounting** An area of accounting that uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. (p. 1-24).

Income statement A financial statement that reports a company's revenues and expenses and resulting net income or net loss for a specific period of time. (p. 1-12).

Liabilities Amounts owed to creditors in the form of debts and other obligations. (p. 1-9).

***Management consulting** An area of public accounting ranging from development of accounting and computer systems to support services for marketing projects and merger and acquisition activities. (p. 1-24).

Management discussion and analysis (MD&A) A section of the annual report that presents management's views on the company's ability to pay near-term obligations, its ability to fund operations and expansion, and its results of operations. (p. 1-20).

Net income The amount by which revenues exceed expenses. (p. 1-10).

Net loss The amount by which expenses exceed revenues. (p. 1-10).

Notes to the financial statements Notes that clarify information presented in the financial statements and provide additional detail. (p. 1-20).

Partnership A business owned by two or more persons associated as partners. (p. 1-3).

Retained earnings The amount of net income retained in the corporation. (p. 1-13).

Retained earnings statement A financial statement that summarizes the amounts and causes of changes in retained earnings for a specific time period. (p. 1-13).

Revenue 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. (p. 1-10).

Sarbanes-Oxley Act (SOX) Regulations passed by Congress to reduce unethical corporate behavior. (p. 1-7).

Sole proprietorship A business owned by one person. (p. 1-3).

Statement of cash flows A financial statement that provides financial information about the cash receipts and cash payments of a business for a specific period of time. (p. 1-16).

Stockholders' equity The owners' claim to assets. (p. 1-14).

***Taxation** An area of public accounting involving tax advice, tax planning, preparing tax returns, and representing clients before governmental agencies. (p. 1-24).

Practice Multiple-Choice Questions

1. (LO 1) Which is **not** one of the three forms of business organization?

- a. Sole proprietorship.
- b. Creditorship.
- c. Partnership.
- d. Corporation.

2. (LO 1) Which is an advantage of corporations relative to partnerships and sole proprietorships?

- a. Lower taxes.
- b. Harder to transfer ownership.
- c. Reduced legal liability for investors.
- d. Most common form of organization.

3. (LO 1) Which statement about users of accounting information is **incorrect**?

- a. Management is considered an internal user.
- b. Taxing authorities are considered external users.
- c. Present creditors are considered external users.
- d. Regulatory authorities are considered internal users.

4. (LO 1) Which of the following did **not** result from the Sarbanes-Oxley Act?

- a. Top management must now certify the accuracy of financial information.
- b. Penalties for fraudulent activity increased.
- c. Independence of auditors increased.
- d. Tax rates on corporations increased.

5. (LO 2) Which is **not** one of the three primary business activities?

- a. Financing.
- b. Operating.
- c. Advertising.
- d. Investing.

6. (LO 2) Which of the following is an example of a financing activity?

- a. Issuing shares of common stock.
- b. Selling goods on account.
- c. Buying delivery equipment.
- d. Buying inventory.

7. (LO 2) Net income will result during a time period when:

- a. assets exceed liabilities.
- b. assets exceed revenues.
- c. expenses exceed revenues.
- d. revenues exceed expenses.

8. (LO 3) The financial statements for Macias Corporation contained the following information.

| | |
|----------------------------|----------|
| Accounts receivable | \$ 5,000 |
| Sales revenue | 75,000 |
| Cash | 15,000 |
| Salaries and wages expense | 20,000 |
| Rent expense | 10,000 |

What was Macias Corporation's net income?

- a. \$60,000.
- b. \$15,000.
- c. \$65,000.
- d. \$45,000.

9. (LO 3) What section of a statement of cash flows indicates the cash spent on new equipment during the past accounting period?

- a. The investing activities section.
- b. The operating activities section.
- c. The financing activities section.
- d. The statement of cash flows does not give this information.

10. (LO 3) Which statement presents information as of a specific point in time?

- a. Income statement.
- b. Balance sheet.
- c. Statement of cash flows.
- d. Retained earnings statement.

11. (LO 3) Which financial statement reports assets, liabilities, and stockholders' equity?

- a. Income statement.
- b. Retained earnings statement.
- c. Balance sheet.
- d. Statement of cash flows.

12. (LO 3) Stockholders' equity represents:

- a. claims of creditors.
- b. claims of employees.
- c. the difference between revenues and expenses.
- d. claims of owners.

13. (LO 3) As of December 31, 2025, Rockford Corporation has assets of \$3,500 and stockholders' equity of \$1,500. What are the liabilities for Rockford as of December 31, 2025?

- a. \$1,500.
- b. \$1,000.
- c. \$2,500.
- d. \$2,000.

14. (LO 3) The element of a corporation's annual report that describes the corporation's accounting methods is/are the:

- a. notes to the financial statements.
- b. management discussion and analysis.
- c. auditor's report.
- d. income statement.

15. (LO 3) The element of the annual report that presents an opinion regarding the fairness of the presentation of the financial position and results of operations is/are the:

- a. income statement.
- b. auditor's opinion.
- c. balance sheet.
- d. comparative statements.

Solutions

1. **b.** Creditorship is not a form of business organization. The other choices are incorrect because (a) sole proprietorship, (c) partnership, and (d) corporation are all forms of business organization.
2. **c.** An advantage of corporations is that investors are not personally liable for debts of the business. The other choices are incorrect because (a) lower taxes, (b) harder to transfer ownership, and (d) most common form of organization are not true of corporations.
3. **d.** Regulatory authorities are considered external, not internal, users. The other choices are true statements.
4. **d.** The Sarbanes-Oxley Act (SOX) was created to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals, not to address tax rates. The other choices are incorrect because (a) top management must now certify the accuracy of financial information, (b) penalties for fraudulent activity increased, and (c) increased independence of auditors all resulted from SOX.
5. **c.** Advertising is a type of operating activity. The other choices are incorrect because (a) financing, (b) operating, and (d) investing are the three primary business activities.
6. **a.** Issuing shares of common stock is a financing activity. The other choices are incorrect because (b) selling goods on account is an operating activity, (c) buying delivery equipment is an investing activity, and (d) buying inventory is an operating activity.
7. **d.** When a company earns more revenues than expenses, it will report net income during a time period. The other choices are incorrect because (a) assets and liabilities are on the balance sheet, not the income statement; (b) assets are on the balance sheet, not the income statement; and (c) net income results when revenues exceed expenses, not when expenses exceed revenues.

8. **d.** Net income = Sales revenue (\$75,000) – Salaries and wages expense (\$20,000) – Rent expense (\$10,000) = \$45,000. The other choices are therefore incorrect.

9. **a.** The investing activities section of the statement of cash flows provides information about property, plant, and equipment accounts, not (b) the operating activities section or (c) the financing activities section. Choice (d) is incorrect as the statement of cash flows does provide this information.

10. **b.** The balance sheet presents information as of a specific point in time. The other choices are incorrect because the (a) income statement, (c) statement of cash flows, and (d) retained earnings statement all cover a period of time.

11. **c.** The balance sheet is a formal presentation of the accounting equation, such that Assets = Liabilities + Stockholders' Equity, not the (a) income statement, (b) retained earnings statement, or (d) statement of cash flows.

12. **d.** Stockholders' equity represents claims of owners. The other choices are incorrect because (a) claims of creditors and (b) claims of employees are liabilities. Choice (c) is incorrect because the difference between revenues and expenses is net income.

13. **d.** Using the accounting equation, liabilities can be computed by subtracting stockholders' equity from assets, or \$3,500 – \$1,500 = \$2,000, not (a) \$1,500, (b) \$1,000, or (c) \$2,500.

14. **a.** The corporation's accounting methods are described in the notes to the financial statements, not in the (b) management discussion and analysis, (c) auditor's report, or (d) income statement.

15. **b.** The element of the annual report that presents an opinion regarding the fairness of the presentation of the financial position and results of operations is the auditor's opinion, not the (a) income statement, (c) balance sheet, or (d) comparative statements.

Practice Brief Exercises

Use basic accounting equation.

1. **(LO 3)** At the beginning of the year, Ortiz Company had total assets of \$900,000 and total liabilities of \$440,000. Answer the following questions.
 - a. If total assets decreased \$100,000 during the year and total liabilities increased \$80,000 during the year, what is the amount of stockholders' equity at the end of the year?
 - b. During the year, total liabilities decreased \$100,000 during the year and stockholders' equity increased \$200,000. What is the amount of total assets at the end of the year?
 - c. If total assets increased \$50,000 during the year and stockholders' equity increased \$60,000 during the year, what is the amount of total liabilities at the end of the year?

Solution

| | | | | | |
|--------------|-------------------------|---|-------------------------------------|---|----------------------|
| 1. a. | Assets | – | Liabilities | = | Stockholders' Equity |
| | (\$900,000 – \$100,000) | – | (\$440,000 + \$80,000) | = | \$280,000 |
| b. | Liabilities | + | Stockholders' Equity | = | Assets |
| | (\$440,000 – \$100,000) | + | (\$900,000 – \$440,000 + \$200,000) | = | \$1,000,000 |
| c. | Assets | – | Stockholders' Equity | = | Liabilities |
| | (\$900,000 + \$50,000) | – | (\$900,000 – \$440,000 + \$60,000) | = | \$430,000 |

Determine where items appear on financial statements.

2. **(LO 3)** Indicate whether the following items would appear on the income statement (IS), balance sheet (BS), or retained earnings statement (RES).
 - a. _____ Common stock.
 - b. _____ Cash.
 - c. _____ Salaries and wages expense.
 - d. _____ Service revenue.
 - e. _____ Accounts payable.

Solution

2. a. BS Common stock. d. IS Service revenue.
 b. BS Cash. e. BS Accounts payable.
 c. IS Salaries and wages expense.

3. (LO 3) Presented below in alphabetical order are balance sheet items for Feagler Company at December 31, 2025. Prepare a balance sheet following the format of Illustration 1.8. *Prepare a balance sheet.*

| | |
|---------------------|----------|
| Accounts receivable | \$12,500 |
| Cash | 38,000 |
| Common stock | 5,000 |
| Notes payable | 40,000 |
| Retained earnings | 5,500 |

Solution

3.

| Feagler Company Balance Sheet December 31, 2025 | | |
|---|--------------|-----------------|
| <u>Assets</u> | | |
| Cash | | \$38,000 |
| Accounts receivable | | <u>12,500</u> |
| Total assets | | <u>\$50,500</u> |
| <u>Liabilities and Stockholders' Equity</u> | | |
| Liabilities | | |
| Notes payable | \$40,000 | |
| Total liabilities | | \$40,000 |
| Stockholders' equity | | |
| Common stock | 5,000 | |
| Retained earnings | <u>5,500</u> | |
| Total stockholders' equity | | <u>10,500</u> |
| Total liabilities and stockholders' equity | | <u>\$50,500</u> |

4. (LO 3) Identify whether the following items would appear on the balance sheet (BS) or income statement (IS) of a corporation. *Determine where items appear on financial statements.*

- a. _____ Income taxes payable. f. _____ Service revenue.
 b. _____ Cost of goods sold. g. _____ Depreciation expense.
 c. _____ Supplies. h. _____ Prepaid insurance.
 d. _____ Notes payable. i. _____ Interest payable.
 e. _____ Salaries and wages expense.

Solution

4. a. BS Income taxes payable. f. IS Service revenue.
 b. IS Cost of goods sold. g. IS Depreciation expense.
 c. BS Supplies. h. BS Prepaid insurance.
 d. BS Notes payable. i. BS Interest payable.
 e. IS Salaries and wages expense.