

eleventh edition

Fundamental Financial Accounting Concepts

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FUNDAMENTAL FINANCIAL ACCOUNTING CONCEPTS, ELEVENTH EDITION

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This book is dedicated to our students, whose questions have so frequently caused us to reevaluate our method of presentation that they have, in fact, become major contributors to the development of this text.

NOTE FROM THE AUTHORS

Technology is having a profound effect on what we teach and how we teach it. The specific impacts on this text are discussed next.

● EXPOSURE TO DATA ANALYTICS AND VISUALIZATIONS

Just as spreadsheet software transformed accounting practice, data analytics is likely to have a similar impact. While there is general agreement that introductory accounting students need exposure to data analytics, agreement regarding the level and type of exposure is evolving. Do students need to know how to use the software or will the ability to interpret the output of the software be sufficient? We offer opportunities for you to expose your students to either or both options.

For those looking to give their students a deeper dive into data analytics, we offer an in-depth project, *Applying Tableau*, where students get hands-on operational experience with the software to answer a variety of business type questions. The answers to *Applying Tableau* are auto-gradable in *Connect*, saving you valuable time. *Applying Tableau* includes a tutorial video that walks students through the Tableau software and demonstrates the basic skills students need to get started using the software. A thorough description of this project is located in Appendix G at the end of the text.

For those who prefer to focus their students on understanding outputs rather than learning software, we have included short exercises called Tableau Dashboard Activities (TDAs). We have created TDAs for each chapter in the text that require students to interpret the data displayed in the dashboard and answer questions that relate to concepts covered in each chapter. These TDAs do not require students to learn how to use the Tableau software as discussed in the first option. Instead, the TDAs are displayed directly within *Connect* and accompanied by auto-gradable questions that students must answer based on the visualizations. The use of these TDAs creates a streamlined, integrated experience and allows students to focus on interpreting the outputs rather than creating them.

Having multiple options for teaching data analytics to your students gives you flexibility in how you want to incorporate these resources into your classroom. As data analytics trends continue to evolve, these resources should keep your curriculum current and your students up to date.

● FOCUSING ON FINANCIAL STATEMENT IMPACTS

Technology has changed accounting practice. Gone are the days where accountants used pens, paper, and calculators to maintain records and prepare statements. Indeed, most companies use computer software that simplifies data entry, recordkeeping, and statement preparation. Today's accountants spend less time preparing financial information and more time consulting and advising clients. To remain relevant, accounting education must move beyond the traditional preparer approach.

The first step in learning how to advise clients is to understand how business professionals incorporate accounting in the decision-making process. Business professionals tend to think about bottom-line consequences. If I do this or that, how will it affect my company's net income, total assets, cash flow, and so on. To promote bottom-line thinking, we take the student one step beyond the recording process. Specifically, we employ a **financial statements model** to show them how the journal entries affect financial statements. The model arranges the balance sheet, income statement, and statement of cash flows horizontally across a single line of text as shown next.

Balance Sheet					Income Statement					Statement of Cash Flows	
Assets	=	Liab.	+	Stk. Equity	Rev.	—	Exp.	=	Net Inc.		

Typically, we show the statements model immediately after each journal entry. For example, the settlement of the liability for interest would be shown as follows.

Account Title	Debit	Credit
Interest Payable	8,400	
Cash		8,400

Balance Sheet					Income Statement					Statement of Cash Flows	
Assets	=	Liab.	+	Stk. Equity	Rev.	—	Exp.	=	Net Inc.		
(8,400)		(8,400)		NA	NA		NA		NA	(8,400) OA	

This approach provides a direct visual connection between journal entries and financial statements and enables students to see how **each individual accounting event affects decision making**. It shifts the focus from memorizing procedures to developing real-world thinking patterns. In today's world, computers prepare statements, humans evaluate consequences.

Most textbooks, including this one, still provide coverage of debits and credits, journal entries, trial balances, and statement preparation. It can be insightful to know what the computer is doing behind the scenes. Even so, accounting education must go beyond the procedure. An accountant who can prepare a journal entry but has no idea how that entry affects financial statements cannot provide the insight and counsel expected of today's practicing accountant.

● USING ANALYTICS TO IMPROVE VIDEO QUALITY

YouTube has demonstrated that videos can be a more effective medium for learning than reading. When learning almost anything, most of us reach for a video instead of the owner's manual. Even so, be aware that **all videos are not created equal**. When you search YouTube for an instructional video, you usually have to flip through several videos to find a really good one. Similarly, you must be prepared to look through several textbook video offerings to identify a set of high-quality videos. For comparison

purposes, the following is a description of the key features of the lecture videos included in this text:

- **Our videos have been developed by members of the author team.** These videos have the feel of a live lecture. Delivering an effective lecture requires not only knowledge but also the proper tone, inflection, emphasis, attitude, and confidence. Scripted videos presented by a professional orator cannot compete with the spontaneous delivery of an experienced teacher.
- **We provide comprehensive instructional coverage.** We offer a lecture video for every learning objective in our text. Indeed, we refer to our set of videos as a video textbook. You can obtain the knowledge required to accomplish all learning objectives by watching the videos or by reading the text. The content is the same. It is only the method of delivery that differs.
- **We have assessment quizzes that accompany each lecture video.** After watching a video, a student is required to answer 5 to 10 multiple-choice questions. These questions are graded electronically, and students and instructors are able to obtain immediate feedback. Using this feedback, instructors can identify student weaknesses and focus class time on subjects where students are experiencing difficulty, thus more effectively helping students learn from their mistakes. The faster the feedback, the more effective the learning experience. Further, including assessment quiz scores as part of the course grade will motivate students to take video assignments seriously.
- **Our videos facilitate learning for students with disabilities.** Consistent with the Americans with Disabilities Act, all our videos are closed-captioned. This provides a learning tool for students who are visually and hearing impaired. Students with hearing impairment can see and read the video content, and those with visual impairment can listen to the lecture. Also, international students, who are less proficient in the English language, find videos with closed captions to be useful.
- **We use analytics to assess and improve the quality of our videos.** Based on this rationale, we have implemented a continuous quality improvement program for the videos that accompany our texts. Specifically, we analyze drop and finish rates to determine which videos are working and which ones are not. A typical analytical report is shown here.

4. Received \$85,000 cash from earning revenue.
 5. Paid \$50,000 cash for expenses.
 6. Paid \$4,000 of cash dividends to the owners.
 7. The market value of the land was appraised at \$525,000 on December 31, Year 1.

Event	Balance Sheet						Income Statement		Statement of Cash Flows
	Assets		=	Liab.	+	Stockholders' Equity	Exp.	= Net Inc.	
	Cash	Land	=	N. Pay.	+ Com. Stk.	+ Ret. Earn.			
Beg.	0	0	=	0	+	0		0	
1.	110,000		=		+	110,000			110,000 FA
2.	(100,000)		=	40,000					400,000 FA
3.	(500,000)	500,000	=						(500,000) IA
4.	85,000		=			85,000	85,000	= 85,000	85,000 OA
5.	(50,000)		=			(50,000)			

- This report shows that the video kept 96 percent of students tuned-in at the half-way point and 85 percent of students completed the entire video. While there is always room for improvement, this video produced a high-quality result. We completed an extensive analysis of all videos and replaced select videos that had a

finish rate of less than 80 percent. The results of this analysis led us to create new and/or improve our lecture video content.

• **Comprehensive set of technological teaching tools**

Technology has provided many teaching tools that improve the quality of education while reducing the tasks associated with course management. Some examples include algorithmic test banks and homework management systems. Video content is one component of a comprehensive set of technological teaching tools. Some of the other tools that accompany our text include:

- Connect
- SmartBook
- Test banks (via Connect or TestGen)
- Guided exercises
- Excel simulations
- Data Analytics Problems
- Active Learning Worksheets

These tools can be used independently or in conjunction with one another. A detailed description of each tool is included in the following sections of the front matter.

We appreciate your interest in our text and welcome comments, questions, and suggestions.

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ABOUT THE AUTHORS



Courtesy of Thomas Edmonds

Thomas P. Edmonds

Thomas P. Edmonds, PhD, is Professor Emeritus in the Department of Accounting at the University of Alabama at Birmingham (UAB). He has been actively involved in teaching accounting principles throughout his academic career. Dr. Edmonds has coordinated the accounting principles courses at the University of Houston and UAB. He has taught introductory accounting in mass sections and in distance learning programs. He has received five prestigious teaching awards, including the Alabama Society of CPAs Outstanding Educator Award, the UAB President's Excellence in Teaching Award, and the distinguished Ellen Gregg Ingalls Award for excellence in classroom teaching. He has written numerous articles that have appeared in many publications, including *Issues in Accounting*, the *Journal of Accounting Education*, *Advances in Accounting Education*, *Accounting Education: A Journal of Theory, Practice and Research*, the *Accounting Review*, *Advances in Accounting*, the *Journal of Accountancy*, *Management Accounting*, the *Journal of Commercial Bank Lending*, the *Banker's Magazine*, and the *Journal of Accounting, Auditing, and Finance*. Dr. Edmonds has served as a member of the editorial board for *Advances in Accounting: Teaching and Curriculum Innovations* and *Issues in Accounting Education*. He has published five textbooks, five practice problems (including two computerized problems), and a variety of supplemental materials including study guides, work papers, and solutions manuals. Dr. Edmonds's writing is influenced by a wide range of business experience. He is a successful entrepreneur. He has worked as a management accountant for Refrigerated Transport, a trucking company. Dr. Edmonds also worked in the not-for-profit sector as a commercial lending officer for the Federal Home Loan Bank. In addition, he has acted as a consultant to major corporations, including First City Bank of Houston (now Citi Bank), AmSouth Bank in Birmingham (now Regions Bank), Texaco, and Cortland Chemicals. Dr. Edmonds began his academic training at Young Harris Community College in Young Harris, Georgia. He received a BBA degree with a major in finance from Georgia State University in Atlanta, Georgia. He obtained an MBA degree with a concentration in finance from St. Mary's University in San Antonio, Texas. His PhD degree with a major in accounting was awarded by Georgia State University. Dr. Edmonds's work experience and academic training have enabled him to bring a unique user perspective to this textbook.



Courtesy of Christopher Edmonds

Christopher T. Edmonds

Christopher T. Edmonds, PhD, is an Associate Professor in the Department of Accounting and Finance at the UAB Collat School of Business. He is the course coordinator for the face-to-face and online principles of accounting courses. Dr. Edmonds specializes in teaching and developing engaging face-to-face and online introductory accounting courses. He is a frequent speaker at conferences and universities on best teaching practices and has delivered over 40 professional teaching workshops. His passion for helping students learn inspired him to create hundreds of short videos teaching the fundamental concepts of accounting. This work led to the publication of the first interactive video textbook for introductory accounting. Dr. Edmonds has received numerous prestigious teaching awards, including the UAB President's Award for Excellence in Teaching, UAB Faculty Student Success Award, UAB Transformative Online Course Award, UAB Loudell Ellis Robinson Classroom Teaching Award, UAB Disability Support Recognition Award, and the Virginia Tech Favorite Faculty Award. He has published four textbooks and has written numerous articles that have appeared in publications, including *The Accounting Review*, *Auditing: A Journal of Practice & Theory*, *Journal of Accounting and Public Policy*, *Issues in Accounting Education*, *Advances in Accounting Education*, *Advances in Accounting*, and *Review of Quantitative Finance and Accounting*. Dr. Edmonds started his career as a web application developer creating software solutions to put newspapers online. He began his academic training at Colorado State University. He obtained an MBA from UAB. His PhD with a major in accounting was awarded by Virginia Polytechnic Institute and State University.

Mark A. Edmonds

Mark A. Edmonds, PhD, CPA, is an Assistant Professor in the Department of Accounting and Finance at the University of Alabama at Birmingham. He has taught principles and advanced accounting classes in face-to-face, flipped, and online formats. He is the recipient of the Loudell Robinson Excellence in Teaching Award. Dr. Edmonds began his career providing assurance services for the internationally recognized accounting firm Ernst & Young. At the conclusion of his professional service, he obtained his PhD from Southern Illinois University Carbondale. He serves as the education advisor on the board of the Institute of Internal Auditors Birmingham Chapter. Dr. Edmonds's research focuses on alternative learning strategies and auditor decision making.



Courtesy of UAB

Jennifer E. Edmonds

Jennifer Echols Edmonds, PhD, is an Associate Professor at the University of Alabama at Birmingham (UAB) Collat School of Business. Her primary teaching areas are financial and managerial accounting. She has experience teaching in the undergraduate, MAC, and MBA programs and currently serves as the course coordinator for the managerial accounting sequence at UAB. She has received the UAB Loudell Ellis Robinson Classroom Teaching Award, as well as teaching grants from Deloitte, UAB, and Virginia Tech. She created teaching resources for incorporating International Financial Reporting Standards into Intermediate Accounting that were published online at the American Accounting Association. Dr. Edmonds is also active in the research community. She has published articles in prominent journals such as *Journal of Accounting and Public Policy*, *Advances in Accounting*, *Research in Accounting Regulation*, and *The CPA Journal*. Dr. Edmonds received a bachelor's degree in accounting from Birmingham-Southern College and completed her master's and PhD degrees in accounting at Virginia Polytechnic Institute and State University.



Courtesy of Jennifer Edmonds

Philip R. Olds

Professor Olds is an Associate Professor of accounting at Virginia Commonwealth University (VCU). He serves as the coordinator of the introduction to accounting courses at VCU. Professor Olds received his AS degree from Brunswick Junior College in Brunswick, Georgia (now Coastal Georgia Community College). He received a BBA in accounting from Georgia Southern College (now Georgia Southern University), and his MPA and PhD degrees are from Georgia State University. After graduating from Georgia Southern, he worked as an auditor with the U.S. Department of Labor in Atlanta, Georgia. A former CPA in Virginia, Professor Olds has published articles in various professional journals and presented papers at national and regional conferences. He also served as the faculty adviser to the VCU chapter of Beta Alpha Psi for five years. In 1989, he was recognized with an Outstanding Faculty Vice-President Award by the national Beta Alpha Psi organization. Professor Olds has received both the Distinguished Teaching Award and the Distinguished Service Award from the VCU School of Business. Most recently, he received the university's award for maintaining High Ethical and Academic Standards While Advocating for Student-Athletes and Their Quest Towards a Degree.



Courtesy of Philip Olds

WHAT WE DID TO MAKE IT BETTER

Specific chapter changes:

Chapter 1 An Introduction to Accounting

- Revised lecture videos and assessment quizzes
- Revised *The Curious Accountant* 1 & 2 content
- Revised *Reality Bytes* feature
- Revised *Focus on International Issues* text box that includes IFRS coverage
- Updated Exhibit 1.1 to make terminology more clear to students
- Updated Exhibit 1.18 with new real-world data
- Updated horizontal financial statements models to include statement titles
- New *End of Chapter Study Guide*
- New Tableau data analytics problem
- Updated exercises, problems, and ATC cases

Chapter 2 Accounting for Accruals and Deferrals

- Updated *The Curious Accountant* content
- Revised *Reality Bytes* feature
- Expanded the discussion of the adjusting process in LO 2-2
- Updated Exhibit 2.8 with new real-world data
- Updated horizontal financial statements models to include statement titles
- New *End of Chapter Study Guide*
- New Tableau data analytics problem
- Updated exercises, problems, and ATC cases

Chapter 3 The Double-Entry Accounting System

- Revised lecture videos and assessment quizzes
- Updated *The Curious Accountant* content
- Revised *Reality Bytes* feature
- Updated Exhibit 3.12 with new real-world data
- To help students better understand how to record transactions in T-accounts added a three-step process to LO 3-1
- Updated horizontal financial statements models to include statement titles
- New *End of Chapter Study Guide*
- Updated exercises, problems, and ATC cases

Chapter 4 Accounting for Merchandising Businesses

- Revised lecture videos and assessment quizzes
- Updated *The Curious Accountant* section
- Updated Exhibit 4.1 with new real-world data
- Updated Exhibit 4.10 with new real-world data
- Updated horizontal financial statements models to include statement titles
- New *End of Chapter Study Guide*
- New Tableau data analytics problem
- Updated exercises, problems, and ATC cases

Chapter 5 Accounting for Inventories

- Revised *The Curious Accountant* section
- Revised *Reality Bytes* feature
- Updated the *Focus on International Issues* feature
- Updated Exhibit 5.1 with new real-world data
- Updated Exhibit 5.6 with new real-world data
- Updated horizontal financial statements models to include statement titles
- New *End of Chapter Study Guide*
- New Tableau data analytics problem
- Updated exercises, problems, and ATC cases

Chapter 6 Internal Control and Accounting for Cash

- Updated *The Curious Accountant* content
- Updated horizontal financial statements models to include statement titles
- New *End of Chapter Study Guide*
- New Tableau data analytics problem
- Updated exercises, problems, and ATC cases

Chapter 7 Accounting for Receivables

- Revised lecture videos and assessment quizzes
- Revised *The Curious Accountant* section
- Updated *Reality Bytes* section
- Updated Exhibit 7.7 with new real-world data
- Updated Exhibit 7.8 with new real-world data
- Updated horizontal financial statements models to include statement titles
- New *End of Chapter Study Guide*
- New Tableau data analytics problem
- Updated exercises, problems, and ATC cases

Chapter 8 Accounting for Long-Term Operational Assets

- Revised lecture videos and assessment quizzes
- Updated *The Curious Accountant* section
- Updated *Reality Bytes* feature
- Modified LO 8-1 to clearly show land as a component of “Property, Plant, and Equipment”
- Modified LO 8-10 to clearly explain the acquisition of goodwill
- Updated Exhibit 8.8 with new real-world data
- Updated horizontal financial statements models to include statement titles
- New *End of Chapter Study Guide*
- New Tableau data analytics problem
- Updated exercises, problems, and ATC cases

Chapter 9 Accounting for Current Liabilities and Payroll

- Revised *The Curious Accountant* section
- Updated *Reality Bytes* section
- Updated the *Focus on International Issues* feature
- Updated social security and medicare tax rates in LO 9-5
- Modified horizontal financial statements models in LO 9-8 to show the “Carrying Value of Note Payable”
- Updated Exhibit 9.6 with new real-world data
- Updated horizontal financial statements models to include statement titles
- New *End of Chapter Study Guide*
- New Tableau data analytics problem
- Updated exercises, problems, and ATC cases

Chapter 10 Accounting for Long-Term Debt

- Revised *The Curious Accountant* section
- Updated *Reality Bytes* section
- Updated the new real world data in *The Financial Analysis*
- Updated horizontal financial statements models to include statement titles
- New *End of Chapter Study Guide*
- New Tableau data analytics problem
- Updated exercises, problems, and ATC cases

Chapter 11 Proprietorships, Partnerships, and Corporations

- Revised *The Curious Accountant* section
- Updated two *Reality Bytes* features
- Updated the new real world data in *The Financial Analysis*
- Update double taxation section in LO 11-1 with new tax rates
- Updated horizontal financial statements models to include statement titles
- New *End of Chapter Study Guide*
- New Tableau data analytics problem
- Updated exercises, problems, and ATC cases

Chapter 12 Statement of Cash Flows

- Revised *The Curious Accountant* section
- Updated *Reality Bytes* section
- Revised Exhibit 12.6 with new real-world data
- Updated horizontal financial statements models to include statement titles
- New *End of Chapter Study Guide*
- Updated exercises, problems, and ATC cases

Chapter 13 Financial Statement Analysis

- Revised *The Curious Accountant* section
- Updated all real world ratio data
- New *End of Chapter Study Guide*
- Updated exercises, problems, and ATC cases

“The beauty is in the details. The authors cover all the steps in buying goods, dealing with freight and discounts, and they cover the sales issues”

DON LUCY,
INDIAN RIVER STATE
COLLEGE CENTRAL

HOW DOES THE BOOK

The Curious Accountant

Cindy recently purchased a new Ford automobile from a dealer near her home. When she told her friend Tiffany that she was able to purchase the car for \$1,000 less than the sticker price, Tiffany told Cindy she had gotten a lousy deal. "Everybody knows there is a huge markup on cars," Tiffany said. "You could have gotten a much lower price if you'd shopped around."

Cindy responded, "If there is such a big profit margin on cars, why did so many of the car manufacturers get into financial trouble?" Tiffany told her that she was confusing the maker of the car with the dealer. Tiffany argued that although the manufacturers may not have high profit margins, the dealers do, and told her again that she had paid too much.

Exhibit 4.1 presents the income statements for AutoNation, Inc. and Ford Motor Company. Based on these statements, do you think either of these women is correct? For example, if you pay \$20,000 for a vehicle from a dealership operated by AutoNation, the largest auto retailer in the United States, how much did the car cost the company? Also, how much did the car cost the company?



Answers to The Curious Accountant

As data from the income statement for AutoNation show, automobile dealers

do not have big markups on the cars they sell. The new vehicles the company sold for \$11,751.6 million in 2018 cost the company \$11,235.5 to purchase, resulting in a gross margin of \$516.1, or 4.4 percent. In other words, if you bought an "average" car from AutoNation for \$20,000, the company's gross profit on it was only \$880 (\$20,000 × .044), meaning it paid Ford \$19,120 (\$20,000 – \$880). Furthermore, the company still had other expenses to pay besides its cost of goods sold. In 2018, only 1.9 percent of each dollar of AutoNation's sales was net profit (\$396.0 ÷ \$21,412.8). Remember, the amount shown for sales on AutoNation's income statement is based on what customers actually paid for the cars the company sold, not the "sticker price."

Meanwhile, if Ford sold the car to AutoNation for \$19,120, it earned a 8.2 percent gross margin on the sale, or \$1,568 [\$12,205 ÷ \$148,294 = 8.2%; (\$148,294 – \$136,269 = \$12,025)] [\$19,120 × .082 = \$1,568]. Like AutoNation, Ford still had other expenses to pay for besides the cost of goods sold. In 2018, Ford earned 2.3 percent of net profit on each dollar of sales (\$3,677 ÷ \$160,338).

REAL-WORLD EXAMPLES

The text provides a variety of real-world examples of financial accounting as an essential part of the management process. There are descriptions of accounting practices from real organizations such as Coca-Cola, Enron, General Motors, and Amazon.com. These companies are highlighted in blue in the text.

"Excellent real-world example included."

PAUL GOODCHILD,
UNIVERSITY OF CENTRAL MISSOURI

THE CURIOUS ACCOUNTANT

Each chapter opens with a short vignette. These pose a question about a real-world accounting issue related to the topic of the chapter. The answer to the question appears in a separate sidebar a few pages further into the chapter.

FOCUS ON INTERNATIONAL ISSUES

HOW DOES IFRS DIFFER FROM U.S. GAAP?

Chapter 1 discussed the progression toward a single global GAAP in the form of International Financial Reporting Standards (IFRS). That discussion noted that the United States does not currently allow domestic companies to use IFRS; they must follow GAAP. Let's briefly consider just how U.S. GAAP differs from IFRS.

The differences can be summarized in a few broad categories. First, some differences are relatively minor. Consider the case of bank overdrafts. Under IFRS, some bank overdrafts are included as a cash inflow and reported on the statement of cash flows. U.S. GAAP does not permit this. Conversely, some differences relate to very significant issues. Both IFRS and GAAP use historical cost as their primary method for reporting information on financial statements, but both allow exceptions in some circumstances. However, IFRS permits more exceptions to historical cost than GAAP does. Some of these differences will be discussed in later chapters.

Some of the differences affect how financial statements are presented in annual reports. IFRS requires companies to report all financial statements for the current year and the prior year—two years of comparative data. Rules of the Securities and Exchange Commission require U.S. companies to report two years of balance sheets, the current and prior year, and three years of all other statements. See the financial statements of Target Corporation in Appendix B as an example. Of course, companies can show additional years if they wish.

As you would expect in the differences between IFRS and GAAP, some differences are relatively minor. Examples of such items relate to company buys and sells (and foreign currency subsidiaries that operate). Do not be overwhelmed by them. They have many more rules with a reasonable understanding of U.S. GAAP and IFRS.



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FOCUS ON INTERNATIONAL ISSUES

These boxed inserts expose students to IFRS and other international issues in accounting.

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FINANCIAL ANALYST

Corporate governance is the set of relationships between the board of directors, management, shareholders, auditors, and other stakeholders that determine how a company is operated. Clearly, financial analysts are keenly interested in these relationships. This section discusses the key components of corporate governance.

THE FINANCIAL ANALYST

Financial statement analysis is highlighted in each chapter under this heading.

CHECK YOURSELF 3.1

What are the three sources of assets? Which accounts are debited and credited when a business acquires an asset?

Answer The three sources of assets are creditors, investors, and earnings. When a company acquires an asset, the asset account is debited and the source account is credited. For example, if a company earns revenue on account, the Receivables account is debited and the Revenue account is credited.

CHECK YOURSELF

These short question/answer features occur at the end of each main topic and ask students to stop and think about the material just covered. The answer follows to provide immediate feedback before students go on to a new topic.

REALITY BYTES

Do all accounting systems require using debits and credits? The answer is a definite no. Many small businesses use a single-entry system. A checkbook constitutes a sufficient accounting system for many business owners. Deposits represent revenues, and payments constitute expenses. Many excellent automated accounting systems do not require data entry through a debit/credit recording scheme. QuickBooks is a good example of this type of system. Data are entered into the QuickBooks software program through a user-friendly computer interface that does not require knowledge of debit/credit terminology. Even so, the QuickBooks program produces traditional financial reports such as an income statement, balance sheet, and statement of cash flows. How is this possible? Before you become too ingrained in the debit/credit system, recall that throughout the first two chapters of this text, we illustrated accounting records without using debits and credits. Financial reports can be produced in many ways without using a double-entry system. Having recognized this point, we also note that the vast majority of medium- to large-sized companies use the double-entry system. Indeed, debit/credit terminology is a part of common culture. Most people have an understanding of what is happening when a business tells them that their account is being debited or credited. It is important for you to embrace the double-entry system as well as other financial reporting systems.



MAKOS Photos/Alamy

REALITY BYTES

This feature expands on the topics by showing how companies use the concepts discussed in the chapter to make real-world business decisions.

©Paul Sakuma/AP Images

Index of Pages

A financial statement analysis project for the annual report is located in Appendix D. Also, a general purpose annual report project is included for instructors to assign for any company.



END OF CHAPTER STUDY GUIDE

This chapter introduced *merchandising companies*. Merchandising companies earn profits by selling inventory at prices that are higher than the cost paid for the goods. Merchandising companies include *retail companies* (companies that sell goods to the final consumer) and *wholesale companies* (companies that sell to other merchandising companies).

To this point, the text has explained the basic accounting cycle for service and merchandising businesses. Future chapters more closely address specific accounting issues. For example, in Chapter 5 you will learn how to deal with inventory items that are purchased at differing prices. Other chapters will discuss a variety of specific practices widely used by real-world companies.

XV

HOW ARE CHAPTER CONCEPTS

Regardless of the instructional approach, there is no shortcut to learning accounting. Students must practice to master basic accounting concepts. The text includes a prodigious supply of practice materials and exercises and problems.

SELF-STUDY REVIEW PROBLEM

A step-by-step audio-narrated series of slides is available in Connect.

Academy Sales Company (ASC) started the Year 2 accounting period with the balances given in the financial statements model shown as follows. During Year 2, ASC experienced the following business events:

1. Purchased \$16,000 of merchandise inventory on account, terms 2/10, n/30.
2. The goods that were purchased in Event 1 were delivered FOB shipping point. Freight costs of \$600 were paid in cash by the responsible party.
3. Returned \$500 of goods purchased in Event 1.
- 4a. Recorded the cash discount on the goods purchased in Event 1.
- 4b. Paid the balance due on the account payable within the discount period.
- 5a. Recognized \$21,000 of cash revenue from the sale of merchandise.
- 5b. Recognized \$15,000 of cost of goods sold.
6. The merchandise in Event 5a was sold to customers FOB destination. Freight costs of \$950 were paid in cash by the responsible party.
7. Paid cash of \$4,000 for selling and administrative expenses.
8. Sold the land for \$5,600 cash.

Required

a. Record the preceding transactions in a financial statements model like the following one.

Event No.	Balance Sheet							Income Statement			Statement of Cash Flow
	Cash	Inventory	Land	=	Accts. Pay.	Com. Stk.	Ret. Earn.	Rev./Gain	Exp.	= Net Inc.	
Bal.	25,000	3,000	5,000	=	0	18,000	15,000	NA	NA	= NA	NA

SELF-STUDY REVIEW PROBLEM

These example problems include a detailed, worked-out solution and provide support for students before they work problems on their own. These review problems are included in an animated audio presentation in the *Connect* Library.

EXERCISE SERIES A & B AND PROBLEM SERIES A & B

There are two sets of problems and exercises: Series A and B. Instructors can assign one set for homework and another set for classwork.

• Check Figures

The figures provide key answers for selected problems.

• In-class Worksheets for Set B Exercises and Problems

To facilitate students that only purchase *Connect* (i.e., e-book only), in-class worksheets are available for all set B exercises and problems. These word documents include each exercise and problem followed by a worksheet to assist students in organizing the solution. The B set in-class worksheets are available in *Connect* under Instructor Resources.

• Excel

Many problems can be solved using the Excel™ templates available in the *Connect* Library. A logo appears in the margins next to these problems.

PROBLEMS—SERIES A

connect All applicable Problems in Series A are available in Connect.

LO 4-4 **Problem 4-23A** Identifying freight costs

Required

For each of the following events, determine the amount of freight paid by The Box Company. Also indicate whether the freight cost would be classified as a product or period (selling and administrative) cost.

- a. Purchased merchandise with freight costs of \$650. The merchandise was shipped FOB shipping point.
- b. Shipped merchandise to customers, freight terms FOB shipping point. The freight costs were \$310.

“The self-study problems and supplements on the web are very useful for students.”

BARRY BUCHOFF,
TOWSON UNIVERSITY

“Good/Excellent exercises and problems at the end of chapter with Excel.”

ROBERT KACHUR,
RICHARD STOCKTON COLLEGE OF
NEW JERSEY

REINFORCED?

● ANALYZE, THINK, COMMUNICATE (ATC)

Each chapter includes an innovative section entitled Analyze, Think, Communicate (ATC). This section offers Business Applications Cases, Group Assignments, Real-World Cases, Writing Assignments, Ethical Dilemma Problems, Research Assignments, and Spreadsheet Assignments.

We use icons to help students identify the type of question being asked.

	• Target Corp.		• Excel
	• Group Work		• Ethics
	• Real World Company		• Writing

● COMPREHENSIVE PROBLEM

Beginning in Chapter 1, a comprehensive problem builds in each successive chapter, with the ending account balances in one chapter becoming the beginning account balances in the next chapter.

● MASTERING EXCEL AND USING EXCEL

The Excel applications are used to make students comfortable with this analytical tool and to show its use in accounting.

"I love the spreadsheet assignments and the comprehensive problems at the end of each chapter. I love the check figures that are available on some of the problems."

JANE GARVIN,
IVY TECH COMMUNITY COLLEGE

ANALYZE, THINK, COMMUNICATE

ATC 4-1 Business Applications Case Understanding real-world annual reports

Required

Obtain **Target Corporation's** annual report for its 2019 fiscal year (year ended February 1, 2020) at <http://investors.target.com> using the instructions in Appendix B, and use it to answer the following questions:

- What was Target's gross margin percentage for the fiscal year ended February 2, 2020 (2019) and 2018?
- What was Target's return on sales percentage for 2019 and 2018?
- Target's return on sales percentage for 2019 was higher than it was in 2018. Ignoring taxes, how much lower would Target's 2019 net income have been if its return on sales percentage in 2019 had been the same as for 2018?



ATC 4-2 Group Exercise Multistep income statement

The following quarterly information is given for Rossie for Year 1 (amounts shown are in millions).

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net Sales	\$736.0	\$717.4	\$815.2	\$620.1
Gross Margin	461.9	440.3	525.3	252.3
Net Income	37.1	24.6	38.6	31.4

COMPREHENSIVE PROBLEM

The trial balance of Pacilio Security Services, Inc. as of January 1, Year 4, had the following normal balances.

Cash	\$12,500
Accounts Receivable	3,500
Supplies	120
Prepaid Rent	1,000
Land	4,000
Unearned Revenue	900
Salaries Payable	1,000
Common Stock	8,000
Retained Earnings	11,220

In Year 4, Pacilio Security Services decided to expand its business to sell security systems and offer 24-hour alarm monitoring services. It plans to phase out its current service of providing security personnel at various events. The following summary transactions occurred during Year 4:

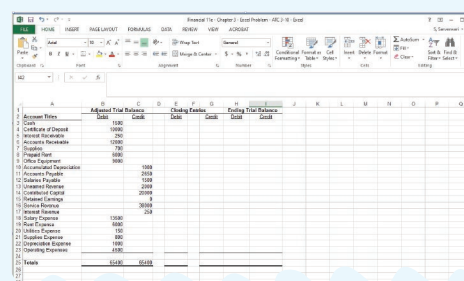
- Paid the salaries payable from Year 3.
- Acquired an additional \$42,000 cash from the issue of common stock.
- Rented a larger building on May 1; paid \$6,000 for 12 months' rent in advance.
- Paid \$800 cash for supplies to be used over the next several months by the business.
- Purchased alarm systems for resale at a cost of \$12,000. The alarm systems were purchased on account with the terms 2/10, n/30.
- Returned alarm systems that had a cost of \$240.
- Installed alarm systems during the year for a total sales amount of \$20,000. The cost of these systems amounted to \$9,440. Sales of \$15,000 were on account, while \$5,000 were cash sales.
- Paid the installers and other employees a total of \$9,500 in salaries.

Spreadsheet Tips

- Rows and columns can be inserted by positioning the mouse on the immediate row or column after the desired position. Click on the *right* mouse button. With the *left* mouse button, choose Insert and then either Entire Column or Entire Row. Use the same method to delete columns or rows.
- Enter the sequential numbering of the adjusting entries as labels rather than values by positioning an apostrophe in front of each entry. The first adjusting entry should be labeled '(1)'.

ATC 3-10 Spreadsheet Assignment Mastery of Excel

At the end of the accounting period, Adams Company's general ledger contained the following adjusted balances.

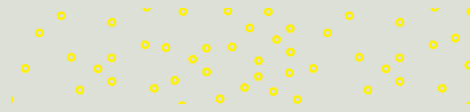


Account Titles	Adjusted Trial Balance	Debit	Credit	Debit	Credit
1 Cash	10,000				
2 Accounts Receivable	1,000				
3 Inventory	500				
4 Prepaid Insurance	1,000				
5 Land	10,000				
6 Accounts Payable			1,000		
7 Unearned Revenue			1,000		
8 Common Stock			10,000		
9 Retained Earnings			1,500		
10 Sales Revenue			20,000		
11 Cost of Sales	10,000				
12 Salaries Expense	9,500				
13 Insurance Expense	1,000				
14 Depreciation Expense	500				
15 Advertising Expense	1,000				
16 Totals	23,000	23,000		23,000	23,000

Source: Microsoft Office Excel



connect[®]



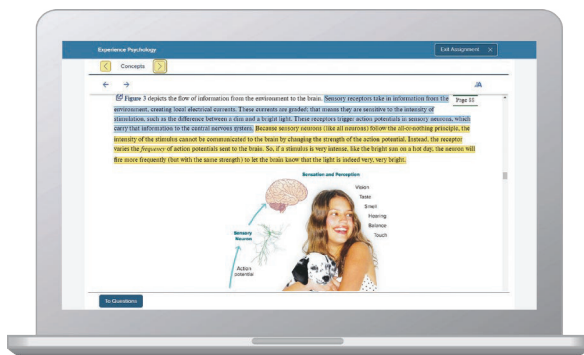
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"I really liked this app—it made it easy to study when you don't have your textbook in front of you."

— Jordan Cunningham,
Eastern Washington University



Calendar: owattaphotos/Getty Images

Everything you need in one place

Your Connect course has everything you need—whether reading on your digital eBook or completing assignments for class, Connect makes it easy to get your work done.

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HOW CAN TECHNOLOGY HELP

• Online assignments

Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. *Connect* grades homework automatically and gives immediate feedback on any questions students may have missed. Our assignable, gradable end-of-chapter content includes a general journal application that looks and feels like what you would find in a general ledger software package. Also, select questions have been redesigned to test students' knowledge more fully. They now include tables for students to work through rather than requiring that all calculations be done offline.

End-of-chapter content in *Connect* includes:

- Exercises
- Problems
- Analyze, Think, Communicate
- Comprehensive Problems

Exercise 3-4A Applying debit/credit terminology to accounting events LO 3-1

Required

a. In parallel columns, list the accounts that would be debited and credited for each of the following unrelated transactions:

- (1) Acquired cash from the issue of common stock.
- (2) Provided services for cash.
- (3) Paid cash for salaries expense.
- (4) Purchased supplies for cash.
- (5) Paid in advance for two-year lease on office space.
- (6) Provided services on account.
- (7) Recognized expense for prepaid rent that had been used up by the end of the accounting period.
- (8) Recorded accrued salaries at the end of the accounting period.

b. Use a horizontal statements model to show how each event affects the balance sheet, income statement, and statement of cash flows. Indicate whether the event increases (+), decreases (-), or does not affect (NA) each element of the financial statements. Also, in the Cash Flow column, use the letters OA to designate operating activity, IA for investing activity, and FA for financing activity. The first event is shown as an example.

Complete this question by entering your answers in the tabs below.

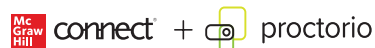
Required A

Required B

In parallel columns, list the accounts that would be debited and credited for each of the following unrelated transactions.

	Event	Account Debited	Account Credited
(1)	Acquired cash from the issue of common stock.	Cash	Common stock
(2)	Provided services for cash.	Cash	Service revenue
(3)	Paid cash for salaries expense.	Salaries expense	Cash
(4)	Purchased supplies for cash.		
(5)	Paid in advance for two-year lease on office space.		Cash
(6)	Provided services on account.		

• Remote Proctoring and Browser-Locking Capabilities



New remote proctoring and browser-locking capabilities, hosted by Proctorio within Connect, provide control of the assessment environment by enabling security options and verifying the identity of the student.

IMPROVE STUDENT SUCCESS?

Seamlessly integrated within Connect, these services allow instructors to control students' assessment experience by restricting browser activity, recording students' activity, and verifying students are doing their own work.

Instant and detailed reporting gives instructors an at-a-glance view of potential academic integrity concerns, thereby avoiding personal bias and supporting evidence-based claims.

NEW! Tableau Dashboard Activities

Tableau Dashboard Activities allow students to explore live Tableau dashboards directly integrated into Connect, and include auto-graded questions focused on both calculations and analysis. Students can check their understanding and apply what they are learning within the framework of analytics and critical thinking.

• Lecture videos

Lecture videos are available for every learning objective introduced throughout the text. The videos have been developed by a member of the author team and have the touch and feel of a live lecture. The videos are accompanied by a set of self-assessment quizzes. Students can watch the videos and then test themselves to determine if they understand the material presented in the video. Students can repeat the process, switching back and forth between the video and self-assessment quizzes, until they are satisfied that they understand the material.

"This is the best part of the entire Connect material. I think access to these Lecture Videos would be positive, especially for online students."

CHERYL CORKE, GENESEE COMMUNITY COLLEGE

Business Events for Year 1:

1. Rustic Campsites (RCS) was formed at the beginning of Year 1 when it acquired \$120,000 cash from issuing common stock to its owners.
2. RCS borrowed \$400,000 cash from a creditor.
3. RCS paid \$500,000 cash to purchase land.
4. RCS obtained \$85,000 cash from leasing camp sites to customers.
5. RCS paid \$50,000 cash for expenses.
6. RCS paid dividends of \$4,000 cash to its owners.
7. The land that RCS paid \$500,000 to purchase had an appraised market value of \$525,000 at the end of Year 1.

Accounting Equation						Other Account Titles
Assets		=	Liab.	+	Equity	
	Cash	Land		Note Payable	Com. Stk.	Ret. Earn
Beg. Bal.	0	0		0	0	0
1.	120,000				120,000	
2.	400,000			400,000		
3.	(500,000)	500,000				
4.	85,000					85,000
5.	(50,000)					(50,000)
6.						

Revenue 85,000
- Expenses 50,000
= Net Income 35,000

↓
Retained Earnings
 ↓
Dividend

1. Compute a predetermined overhead rate.
2. Prepare schedules of cost of goods manufactured and cost of goods sold.
3. Compute underapplied or overapplied overhead cost to close the balance in Manufacturing Overhead to the appropriate accounts.

	Beginning	Ending
Inventories:		
Raw materials (all direct)	\$ 15,000	\$ 11,375
Work in process	\$ 27,875	\$ 22,350
Finished goods	\$ 34,600	\$ 26,450

	Debit	Credit
1. Compute applied overhead and determine the amount of underapplied or overapplied overhead:		
Actual manufacturing overhead cost		\$11.00
Predetermined overhead rate		
Actual direct labor hours		
Manufacturing overhead applied		

• Excel Simulations

Simulated Excel questions, assignable within *Connect*, allow students to practice their Excel skills—such as basic formulas and formatting—within the content of financial accounting. These questions feature animated, narrated Help and Show Me tutorials (when enabled), as well as automatic feedback and grading for both students and professors.

• Guided Examples

The **Guided Examples** in *Connect* provide a video-based, step-by-step walk-through of select exercises similar to those assigned. These short videos can be made available to students as hints by instructors and provide reinforcement when students need it most.

• General Ledger Problems

General Ledger Problems provide a much-improved student experience when working with accounting cycle questions, offering improved navigation and less scrolling. Students can audit their mistakes by easily linking back to their original entries and can see how the numbers flow through the various financial statements. Many General Ledger Problems include an analysis tab that allows students to demonstrate their critical thinking skills and a deeper understanding of accounting concepts.

Prepare the journal entries to record transactions (1) through (13). Then prepare the necessary adjusting entries (14) through (17) to correctly report net income for the period. Then record the closing entries (18) through (20) as of December 31, 2013. (If no entry is required for a transaction, select "No journal entry required" in the first account field.)

View transaction list

Journal entry worksheet

< 1 2 3 4 5 6 7 8 20 >

Paid the salaries payable from 2012.

Note: Enter debits before credits.

Date	General Journal	Debit	Credit
Dec 31, 2013	Salaries payable	1,200	
	Cash		
	101: Cash		

Record entry

Clear entry

View general journal

• Instructor Library

The *Connect Instructor Library* is your repository for additional resources to improve student engagement in and out of class. You can select and use any asset that enhances your lecture. The *Connect Instructor Library* includes access to:

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SUPPLEMENTS FOR INSTRUCTORS

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Many educational institutions today are focused on the notion of *assurance of learning*, an important element of many accreditation standards. *Fundamental Financial Accounting Concepts 11e* is designed specifically to support your assurance of learning initiatives with a simple, yet powerful, solution.

Each chapter in the book begins with a list of numbered learning objectives, which appear throughout the chapter, as well as in the end-of-chapter assignments. Every Test Bank question for *Fundamental Financial Accounting Concepts* maps to a specific chapter learning objective in the textbook. Each Test Bank question also identifies topic area, level of difficulty, Bloom's Taxonomy level, and AICPA and AACSB skill area. You can use our Test Bank software, *EZ Test Online*, or *Connect Plus Accounting* to easily search for learning objectives that directly relate to the learning objectives for your course. You can then use the reporting features of *EZ Test* to aggregate student results in a similar fashion, making the collection and presentation of Assurance of Learning data simple and easy.

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McGraw-Hill Education is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *Fundamental Financial Accounting Concepts 11e* recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the text and the Test Bank to the general knowledge and skill guidelines in the revised AACSB standards.

The statements contained in *Fundamental Financial Accounting Concepts 11e* are provided only as a guide for the users of this textbook. The AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the

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Available within *Connect*, Test Builder is a cloud-based tool that enables instructors to format tests that can be printed or administered within a LMS. Test Builder offers a modern, streamlined interface for easy content configuration that matches course needs, without requiring a download.

Test Builder allows you to:

- access all test bank content from a particular title.
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Test Builder provides a secure interface for better protection of content and allows for just-in-time updates to flow directly into assessments.

ACKNOWLEDGMENTS

Our grateful appreciation is extended to those who reviewed previous editions:

Special thanks to the talented people who prepared the supplements. These take a great deal of time and effort to write and we appreciate our contributors' efforts. LuAnn Bean, Ph.D., of Nathan M. Bisk College of Business—Florida Institute of Technology prepared the Instructor's Manual and PowerPoints; Helen Roybark, Ph.D., of Radford University and Beth Kobylarz provided text accuracy checking; Jack Terry developed the Excel templates; and Barbara Muller of Arizona State University reviewed the Test Bank.

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- Thomas P. Edmonds • Christopher T. Edmonds • Mark A. Edmonds
- Jennifer E. Edmonds • Philip R. Olds

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wolandmaster/123RF

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Fundamental Financial Accounting Concepts



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CHAPTER 1

An Introduction to Accounting

LEARNING OBJECTIVES

After you have mastered the material in this chapter, you will be able to:

SECTION 1: COLLECTING AND ORGANIZING INFORMATION

- LO 1-1** Identify the ways accounting benefits society.
- LO 1-2** Identify reporting entities.
- LO 1-3** Identify the components of the accounting equation.
- LO 1-4** Show how business events affect the accounting equation.
- LO 1-5** Interpret information shown in an accounting equation.
- LO 1-6** Classify business events as asset source, use, or exchange transactions.

SECTION 2: REPORTING INFORMATION

- LO 1-7** Prepare an income statement, a statement of changes in stockholders' equity, and a balance sheet.
- LO 1-8** Prepare a statement of cash flows.
- LO 1-9** Close revenue, expense, and dividend accounts.
- LO 1-10** Record business events using a horizontal financial statements model.



Video lectures and accompanying self-assessment quizzes are available in Connect for all learning objectives.

The Curious Accountant

Who owns **Apple**? Who owns the **American Red Cross** (ARC)? Many people and organizations other than owners are interested in the operations of Apple and the ARC. These parties are called **stakeholders**. Among others, they include lenders, employees, suppliers, customers, benefactors, research institutions, local governments, flood victims, lawyers, bankers, financial analysts, and government agencies such as the Internal Revenue Service and the Securities and Exchange Commission. Organizations communicate information to stakeholders through **financial reports**.

How do you think the financial reports of Apple, Inc. differ from those of the ARC? (Answers.)



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SECTION 1:

COLLECTING AND ORGANIZING INFORMATION

Why should you study accounting? Because it can help you succeed in business. Businesses use accounting to keep score. Imagine trying to play football without knowing how many points a touchdown is worth. Like sports, business is competitive. If you do not know how to keep score, you will not likely succeed.

Accounting is an information system that reports on the economic activities and financial condition of a business or other organization. The importance of accounting information is paramount. It helps predict business success, and could make you a wealthy Wall Street investor. Indeed, it is so important that accounting is frequently called the *language of business*.

LO 1-1



Identify the ways accounting benefits society.

THE ROLE OF ACCOUNTING IN SOCIETY

How should society allocate its resources? Should we spend more to harvest food or cure disease? Should we build computers or cars? Should we invest money in IBM or General Motors? Accounting provides information that helps answer such questions.

Using Free Markets to Set Resource Priorities

Suppose you want to start a business. You may have heard “you have to have money to make money.” In fact, you will need more than just money to start and operate a business. You will likely need such resources as equipment, land, materials, and employees. If you do not have these resources, how can you get them? In the United States, you compete for resources in open markets.

A **market** is a group of people or entities organized to exchange items of value. The market for business resources involves three distinct participants: consumers, businesses, and resource owners. *Consumers* use resources. Resources are frequently not in a form consumers want. For example, nature provides trees but consumers want houses. Businesses transform resources such as trees into desirable products such as houses. *Resource owners* control the distribution of resources to businesses. Thus, resource owners provide resources (inputs) to businesses that provide goods and services (outputs) to consumers.

For example, a home builder (a business) transforms labor and materials (inputs) into houses (output) that consumers use. The transformation adds value to the inputs, creating outputs worth more than the sum of the inputs. Suppose a house that required \$220,000 of materials and labor to build could have a market value of \$250,000.



David Buffington/Photodisc/Getty Images

Common terms for the added value created in the transformation process include **profit**, **income**, or **earnings**. Accountants measure the added value as the difference between the cost of a product or service and the selling price of that product or service. The profit on the house described earlier is \$30,000, the difference between its \$220,000 cost and \$250,000 market value.

Businesses that successfully and efficiently (at low cost) satisfy consumer preferences are rewarded with high earnings. These earnings are shared with resource owners, so businesses that exhibit high earnings potential are more likely to compete successfully for resources.

Return to the original question. How can you get the resources you need to start a business? You must go to open markets and convince resource owners that you can produce profits. Exhibit 1.1 illustrates the market trilogy involved in resource allocation.

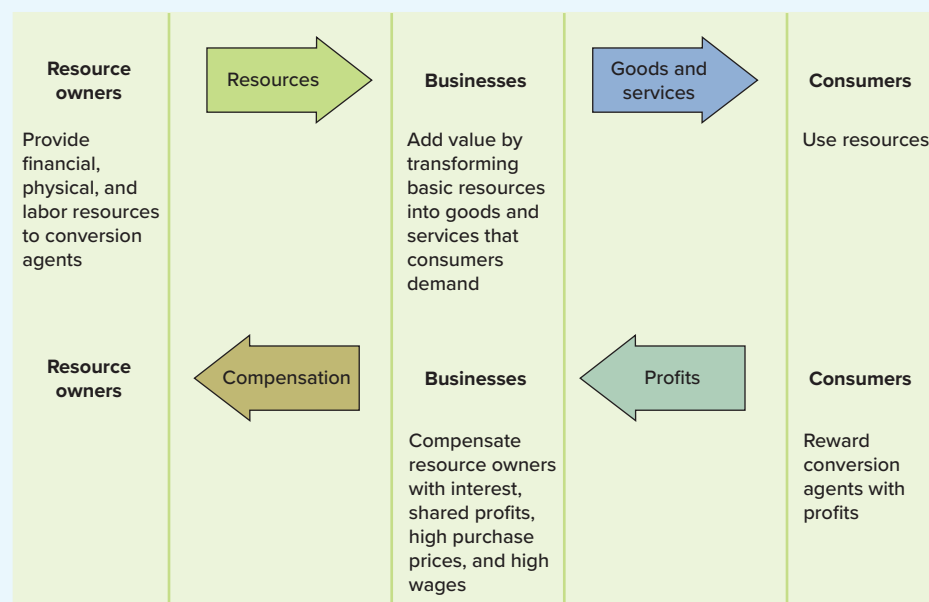
The specific resources businesses commonly use to satisfy consumer demand are financial resources, physical resources, and labor resources.

Financial Resources

Businesses need **financial resources** (money) to get started and to operate. *Investors* and *creditors* provide financial resources.

- **Investors** provide financial resources in exchange for ownership interests in businesses. Owners expect businesses to return to them a share of the business, including a portion of earned income.
- **Creditors** lend financial resources to businesses. Instead of a share of the business, creditors expect the businesses to repay borrowed resources plus a specified fee called **interest**.

Investors and creditors prefer to provide financial resources to businesses with high earnings potential because such companies are better able to share profits and make interest payments. Profitable businesses are also less likely to experience bankruptcy.

EXHIBIT 1.1**Market Trilogy in Resource Allocation****Physical Resources**

In their most primitive form, **physical resources** are natural resources. Physical resources often move through numerous stages of transformation. For example, standing timber may be successively transformed into harvested logs, raw lumber, and finished houses. Owners of physical resources seek to sell those resources to businesses with high earnings potential because profitable businesses are able to pay higher prices and make repeat purchases.

Labor Resources

Labor resources include both intellectual and physical labor. Like other resource providers, workers prefer businesses that have high income potential because these businesses are able to pay higher wages and offer continued employment.

Accounting Provides Information

How do providers of financial, physical, and labor resources identify businesses with high profit potential? Investors, creditors, and workers rely heavily on accounting information to evaluate which businesses are worthy of receiving resources. In addition, other people and organizations have an interest in accounting information about businesses. The many **users** of accounting information are commonly called **stakeholders**. Stakeholders include resource providers, financial analysts, brokers, attorneys, government regulators, and news reporters.

The link between businesses and those stakeholders who provide resources is direct: businesses pay resource providers. Resource providers use accounting information to identify companies with high earnings potential because those companies are more likely to return higher profits, make interest payments, repay debt, pay higher prices, and provide stable, high-paying employment.

The link between businesses and other stakeholders is indirect. Financial analysts, brokers, and attorneys may use accounting information when advising their clients. Government agencies may use accounting information to assess companies' compliance with income tax laws and other regulations. Reporters may use accounting information in news reports.

Types of Accounting Information

Stakeholders such as investors, creditors, lawyers, and financial analysts exist outside of and separate from the businesses in which they are interested. The accounting information these *external users* need is provided by **financial accounting**. In contrast, the accounting information needed by *internal users*, stakeholders such as managers and employees who work within a business, is provided by **managerial accounting**.

The information needs of external and internal users frequently overlap. For example, external and internal users are both interested in the amount of income a business earns. Managerial accounting information, however, is usually more detailed than financial accounting reports. For example, investors are concerned about the overall profitability of **Wendy's** versus **Burger King**; whereas a Wendy's regional manager is interested in the profits of individual Wendy's restaurants. In fact, a regional manager is also interested in nonfinancial measures, such as the number of employees needed to operate a restaurant, the times at which customer demand is high versus low, and measures of cleanliness and customer satisfaction.

Nonbusiness Resource Usage

The U.S. economy is not purely market-based. Factors other than profitability often influence resource allocation priorities. For example, governments allocate resources for national defense, to redistribute wealth, or to protect the environment. Foundations, religious groups, the Peace Corps, and other benevolent organizations prioritize resource usage based on humanitarian concerns.

Organizations that are not motivated by profit are called **not-for-profit entities** (also called *nonprofit* or *nonbusiness organizations*). Stakeholders interested in nonprofit organizations also need accounting information. Accounting systems measure the cost of the goods and services not-for-profit organizations provide, the efficiency and effectiveness of the organizations' operations, and the ability of the organizations to continue to provide goods and services. This information serves a host of stakeholders, including taxpayers, contributors, lenders, suppliers, employees, managers, financial analysts, attorneys, and beneficiaries.

The focus of accounting, therefore, is to provide information that is useful to a variety of business and nonbusiness user groups for decision making. The different types of accounting information and the stakeholders that commonly use the information are summarized in Exhibit 1.2.

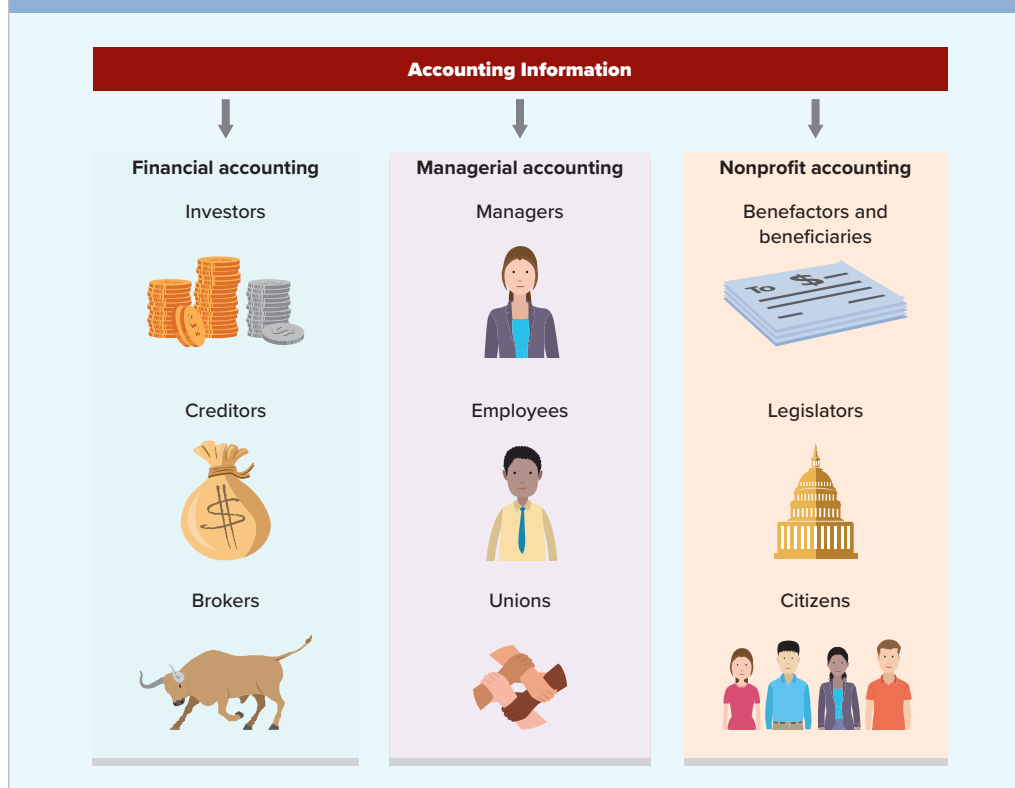
Careers in Accounting

What do accountants do? Accountants identify, record, analyze, and communicate information about the economic events that affect organizations. They may work in either public accounting or private accounting.

Public Accounting

You are probably familiar with the acronym CPA. CPA stands for *certified public accountant*. Public accountants provide services to various clients. They are usually paid a fee that varies depending on the service provided. Services typically offered by public accountants include (1) audit services, (2) tax services, and (3) consulting services.

- *Audit services* involve examining a company's accounting records in order to issue an opinion about whether the company's financial statements conform to generally accepted accounting principles. The auditor's opinion adds credibility to the statements, which are prepared by the company's management.
- *Tax services* include both determining the amount of tax due and tax planning to help companies minimize tax expense.
- *Consulting services* cover a wide range of activities that include everything from installing sophisticated accounting systems to providing personal financial advice.

EXHIBIT 1.2**Accounting as Information Provider**

All public accountants are not certified. Each state government, as well as Washington, DC, and four U.S. territories, establish certification requirements applicable in that jurisdiction. Although the requirements vary from jurisdiction to jurisdiction, CPA candidates normally must have a college education, pass a demanding technical examination, and obtain work experience relevant to practicing public accounting.

Private Accounting

Accountants employed in the private sector usually work for a specific company or nonprofit organization. Private sector accountants perform a wide variety of functions for their employers. Their duties include classifying and recording transactions, billing customers and collecting amounts due, ordering merchandise, paying suppliers, preparing and analyzing financial statements, developing budgets, measuring costs, assessing performance, and making decisions.

Private accountants may earn any of several professional certifications. For example, the Institute of Management Accountants issues the *Certified Management Accounting (CMA)* designation. The Institute of Internal Auditors issues the *Certified Internal Auditor (CIA)* designation. These designations are widely recognized indicators of technical competence and integrity on the part of individuals who hold them. All professional accounting certifications call for meeting education requirements, passing a technical examination, and obtaining relevant work experience.

Measurement Rules

Suppose a store sells a cell phone in December to a customer who agrees to pay for it in January. Should the business *recognize* (report) the sale as a December transaction or as a January transaction? It really does not matter as long as the store owner discloses the rule the decision is based on and applies it consistently to other transactions. Because businesses



Pascal Preti/Getty Images

may use different reporting rules, however, clear communication also requires full and fair disclosure of the accounting rules chosen.

Communicating business results would be simpler if each type of business activity were reported using only one measurement method. World economies and financial reporting practices, however, have not evolved uniformly. Even in highly sophisticated countries such as the United States, companies exhibit significant diversity in reporting methods. Providers of financial reports assume that users are educated about accounting practices.

The **Financial Accounting Standards Board (FASB)**¹ is a privately funded organization with the primary authority for establishing accounting standards in the United States. The measurement rules established by the FASB are called **generally accepted accounting principles (GAAP)**. Financial reports issued to the public must follow GAAP. This textbook introduces these principles so you will be able to understand business activity reported by companies in the United States.

Companies are not required to follow GAAP when preparing *management accounting* reports. Although there is considerable overlap between financial and managerial accounting, managers are free to construct internal reports in whatever fashion best suits the effective operation of their companies.

REPORTING ENTITIES

LO 1-2



Identify reporting entities.

Think of accountants in the same way you would think of news reporters. A news reporter gathers and discloses information about some person, place, or thing. Likewise, an accountant gathers and discloses financial information about specific people or businesses. The people or businesses accountants report on are called **reporting entities**. When studying accounting, you should think of yourself as the accountant. Your first step is to identify the person or business on which you are reporting. This is not always as easy as it may seem. To illustrate, consider the following scenario.

Jason Winston recently started a business. During the first few days of operation, Mr. Winston transferred cash from his personal account into a business account for a company he named Winston Enterprises. Mr. Winston's brother, George, invested cash in Winston Enterprises, for which he received an ownership interest in the company. Winston Enterprises borrowed cash from First Federal Bank. Winston Enterprises paid cash to purchase a building from Commercial Properties, Inc. Winston Enterprises earned cash revenues from its customers and paid its employees cash for salaries expense.

How many reporting entities are described in this scenario? Assuming all of the customers are counted as a single entity and all of the employees are counted as a single entity, there are a total of seven entities named in the scenario. These entities include: (1) Jason Winston, (2) Winston Enterprises, (3) George Winston, (4) First Federal Bank, (5) Commercial Properties, Inc., (6) the customers, and (7) the employees. A separate set of accounting records would be maintained for each entity.

¹The FASB consists of seven full-time members appointed by the supporting organization, the Financial Accounting Foundation (FAF). The FAF membership is intended to represent the broad spectrum of individuals and institutions that have an interest in accounting and financial reporting. FAF members include representatives of the accounting profession, industry, financial institutions, the government, and the investing public.

FOCUS ON INTERNATIONAL ISSUES

IS THERE A GLOBAL GAAP?

As explained in this chapter, accounting is a measurement and communication discipline based on rules referred to as *generally accepted accounting principles (GAAP)*. The rules described in this text are based on GAAP used in the United States, but what rules do the rest of the world use? Is there a global GAAP, or does each country establish its own unique GAAP?

Until recently, each country developed its own unique GAAP. Global companies were required to prepare multiple sets of financial statements to satisfy each country's GAAP. The use of multiple accounting standards across the globe made comparing company performance difficult and expensive. To address the need for a common set of financial standards, the International Accounting Standards Committee was formed in 1973. The committee was reorganized as the **International Accounting Standards Board (IASB)** in 2001. The IASB issues **International Financial Reporting Standards (IFRS)**, which are rapidly gaining support worldwide. In 2005, companies in the countries who were members of the European Union were required to use the IFRS as established by the IASB, which is headquartered in London. Today, over 120 countries require or permit companies to prepare their financial statements using IFRS.

As of 2020, most of the major economic countries have switched from their local GAAP to IFRS. One notable exception is the United States, but even here, there is an active process in place to reduce the differences between IFRS and U.S. GAAP.

There are many similarities between the IASB and the FASB. Both the FASB and the IASB are required to include members with a variety of backgrounds, including auditors, users of financial information, academics, and so forth. Also, both groups primarily require that their members work full-time for their respective boards; they cannot serve on the board while being compensated by another organization. The IASB does allow up to three of its members to be part-time. Members of each board serve five-year terms and can be reappointed once. The funds to support both boards, and the large organizations that support them, are obtained from a variety of sources, including selling publications and private contributions. To help maintain independence of the board's members, fund-raising is performed by separate sets of trustees.

Despite their similarities, there are significant differences between the IASB and the FASB. One of these relates to size and geographic diversity. The FASB has only seven members, all from the United States. The IASB has 16 members, and these must include at least 4 from Asia, 4 from Europe, 4 from North America, 1 from Africa, and 1 from South America.

Not only is the structure of the standards-setting boards different, but the standards and principles they establish may also differ significantly. In this chapter, you will learn that GAAP employs the *historical cost concept*. This means that the assets of most U.S. companies are shown on the balance sheet at the amount for which they were purchased. For example, land that has a market value of millions of dollars may be shown on Ford's financial statements with a value of only a few hundred thousand dollars. This occurs because GAAP requires Ford to show the land at its cost rather than its market value. In contrast, IFRS permits companies to show market values on their financial statements. This means that the exact same assets may show radically different values if the statements are prepared under IFRS rather than GAAP.

Throughout this text, where appropriate, we will note the differences between U.S. GAAP and IFRS. However, by the time you graduate, it is likely that among the major industrialized nations, there will be a global GAAP.



Mark Wilson/Getty Images

Your ability to learn accounting will be greatly influenced by how you approach the entity concept. Based on your everyday experiences, you likely think from the perspective of a customer. In contrast, this text is written from the perspective of a business entity. These opposing perspectives dramatically affect how you view business events. For example, as a customer, you consider a sales discount a great bargain. The view is different from the perspective of the business granting the discount. A sales discount means an item did not sell at the expected price. To move the item, the business had to accept less money than it originally planned to receive. From this perspective, a sales discount is not a good thing. To understand accounting, train yourself to interpret transactions from the perspective of a business rather than a consumer. Each time you encounter an accounting event, ask yourself, "How does this affect the business?"

LO 1-3



Identify the components of the accounting equation.

CHECK YOURSELF 1.1

In a recent business transaction, land was exchanged for cash. Did the amount of cash increase or decrease?

Answer The answer depends on the reporting entity to which the question pertains. One entity sold land. The other entity bought land. For the entity that sold land, cash increased. For the entity that bought land, cash decreased.

ELEMENTS OF FINANCIAL STATEMENTS

The individuals and organizations that need information about a business are called *stakeholders*. Stakeholders include owners, lenders, government agencies, employees, news reporters, and others. Businesses communicate information to stakeholders through four financial statements²: (1) an income statement, (2) a statement of changes in stockholders' equity, (3) a balance sheet, and (4) a statement of cash flows.

The information reported in **financial statements** is organized into 10 categories known as **elements**. Eight financial statement elements are discussed in this chapter: assets, liabilities, stockholders' equity, contributed capital, revenue, expenses, distributions, and net income. The other two elements, gains and losses, are discussed in a later chapter. In practice, the business world uses various titles to identify several of the financial statement elements. For example, businesspeople use net *income*, net *earnings*, and net *profit* interchangeably to describe the same element. Contributed capital may be called *common stock*, and equity may be called *stockholders' equity*, *owner's capital*, and *partners' equity*. Furthermore, the transfer of assets from a business to its owners may be called *distributions*, *withdrawals*, or *dividends*. Think of accounting as a language. Different terms can describe the same business event. Detailed definitions of the elements and their placement on financial statements will be discussed in the following sections of the chapter.

Using Accounts to Gather Information

Detailed information about the elements is maintained in records commonly called **accounts**. For example, information regarding the element *assets* may be organized in separate accounts for cash, equipment, buildings, land, and so forth. The types and number of accounts used by a business depends on the information needs of its stakeholders. Some businesses provide very detailed information; others report highly summarized information. The more detail desired, the greater the number of accounts needed. Think of accounts like the notebooks students keep for their classes. Some students keep detailed notes about every class they take in a separate notebook. Other students keep only the key points for all of their classes in a single notebook. Similarly, some businesses use more accounts than other businesses.

Diversity also exists regarding the names used for various accounts. For example, employee pay may be called salaries, wages, commissions, and so forth. Do not become frustrated with the diversity of terms used in accounting. Remember, accounting is a language. The same word can have different meanings. Similarly, different words can be used to describe the same phenomenon. The more you study and use accounting, the more familiar it will become to you.

²In practice these statements have alternate names. For example, the income statement may be called *results of operations* or *statement of earnings*. The balance sheet is sometimes called the *statement of financial position*. The statement of changes in equity might be called *statement of capital* or *statement of stockholders' equity*. Since the Financial Accounting Standards Board (FASB) called for the title *statement of cash flows*, companies do not use alternate names for that statement.

Answers to The Curious Accountant

Anyone who owns stock in **Apple, Inc.** owns a part of the company. Apple has

many owners. In contrast, nobody actually owns the **American Red Cross** (ARC). The ARC has a board of directors that is responsible for overseeing its operations, but the board is not its owner.

Ultimately, the purpose of a business entity is to increase the wealth of its owners. To this end, it “spends money to make money.” The expense that Apple incurs for advertising is a cost incurred in the hope that it will generate more revenues from selling iPhones. The financial statements of a business show, among other things, whether and how the company made a profit during the current year. For example, Apple’s income statements show that in 2019 it spent \$16.2 billion on research and development, and generated \$260.2 billion in revenues.

The ARC is a not-for-profit entity. It operates to provide services to society at large, not to make a profit. It cannot increase the wealth of its owners, because it has no owners. When the ARC spends money to assist flood victims, it does not spend this money in the expectation that it will generate revenues. The revenues of the ARC come from contributors who wish to support efforts related to assisting persons who have suffered from natural disasters. Because the ARC does not spend money to make money, it has no reason to prepare an *income statement* like that of Apple. The ARC’s statement of activities shows how much revenue was received from contributions versus from “investment income.”

Not-for-profit entities do prepare financial statements that are similar in appearance to those of commercial enterprises. The financial statements of not-for-profit entities are called the *statement of financial position*, the *statement of activities*, and the *cash flow statement*.

Creating an Accounting Equation

Businesses use resources to conduct their operations. For example, **Carmike Cinemas, Inc.** uses buildings, seating, screens, projection equipment, vending machines, cash registers, and so on in order to make money from ticket sales. The resources a business uses to make money are called **assets**. So, where do businesses get assets? There are three distinct sources.

1. *A business can borrow assets from creditors.* Usually a business acquires cash from creditors and then uses the cash to purchase the assets it needs to conduct its operations. When a business receives cash from creditors it accepts an obligation to return the cash to the creditors at some future date. In accounting terms, the obligations a business has to its creditors are called **liabilities**.
2. *A business can acquire assets from investors.* When a business acquires assets from investors, it commits to keep the assets safe and to use the assets in a manner that benefits the investors. The business also grants the investor an ownership interest in the business, thereby allowing the investor (owner) to share in the profits generated by the business. The specific commitments made to the investors are described in certificates called **common stock**. In accounting terms investors are called **stockholders**. Further, the business’s commitment to the stockholders is called **stockholders’ equity**.
3. *A business can acquire assets from operations.* Businesses use assets in order to produce higher amounts of other assets. For example, **Best Buy** may sell a TV that cost the company \$500 for \$600. The \$100 difference between the sales price and the cost of the TV results in an increase in Best Buy’s total assets. This explains how operations can be a source of assets. Of course operations may also result in a decrease in assets. If Best Buy has to discount the sales price of the TV to \$450 in order to sell it, the company’s total assets decrease by \$50.

Net increases in assets generated from operations are commonly called *earnings* or *income*. Net decreases in assets caused by operations are called *losses*. As a result of their ownership status, the stockholders reap the benefits and suffer the sacrifices that a business experiences from its operations. A business may distribute all or part of the assets generated through operations to the shareholders. The distribution of assets generated through earnings is called a *dividend*.

Notice that paying dividends is an option—not a legal requirement. Instead of paying dividends, a business may retain the assets it generates through operations. If a business retains the assets, it commits to use those assets for the benefit of the stockholders. This increase in the business' commitments to its stockholders is normally called **retained earnings**. Also, note that earnings that have been retained in the past can be used to pay dividends in the future. However, a company that does not have current or prior retained earnings cannot pay dividends.

As a result of providing assets to a business, the creditors and investors are entitled to make potential **claims**³ on the assets owned by the business. The relationship between a business' assets and the claims on its assets is frequently expressed in an equality called the **accounting equation**. Based on the relationships described, the accounting equation can be developed as follows:

$$\text{Assets} = \text{Claims}$$

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

$$\text{Assets} = \text{Liabilities} + \text{Common stock} + \text{Retained earnings}$$

CHECK YOURSELF 1.2

Gupta Company has \$250,000 of assets, \$60,000 of liabilities, and \$90,000 of common stock. What percentage of the assets was provided by retained earnings?

Answer First, using algebra, determine the dollar amount of retained earnings:

$$\text{Assets} = \text{Liabilities} + \text{Common stock} + \text{Retained earnings}$$

$$\text{Retained earnings} = \text{Assets} - \text{Liabilities} - \text{Common stock}$$

$$\text{Retained earnings} = \$250,000 - \$60,000 - \$90,000$$

$$\text{Retained earnings} = \$100,000$$

Second, determine the percentage:

$$\text{Percentage of assets provided by retained earnings} = \text{Retained earnings} / \text{Total assets}$$

$$\text{Percentage of assets provided by retained earnings} = \$100,000 / \$250,000 = 40\%$$

RECORDING BUSINESS EVENTS UNDER THE ACCOUNTING EQUATION

An **accounting event** is an economic occurrence that changes an enterprise's assets, liabilities, or stockholders' equity. A **transaction** is a particular kind of event that involves transferring something of value between two entities. Examples of transactions include acquiring assets from owners, borrowing money from creditors, and purchasing or selling goods and services. The following section of the text explains how several different types of accounting events affect a company's accounting equation.

LO 1-4



Show how business events affect the accounting equation.

³A claim is a legal action to obtain money, property, or the enforcement of a right against another party.

Asset Source Transactions

As previously mentioned, businesses obtain assets (resources) from three sources. They acquire assets from owners (stockholders); they borrow assets from creditors; and they earn assets through profitable operations. Asset source transactions increase total assets and total claims. A more detailed discussion of the effects of asset source transactions is provided as follows.

EVENT 1 Rustic Camp Sites (RCS) was formed on January 1, Year 1, when it acquired \$120,000 cash from issuing common stock.

When RCS issued stock, it received cash and gave each investor (owner) a stock certificate as a receipt. Because this transaction provided \$120,000 of assets (cash) to the business, it is an **asset source transaction**. It increases the business' assets (cash) and its stockholders' equity (common stock).

Event No. 1	Accounting Equation					
	Assets		=	Liab.	+	Stockholders' Equity
	Cash	+ Land	=	N. Pay.	+ Com. Stk.	+ Ret. Earn.
Acquired cash through stock issue	120,000	+ NA	=	NA	+ 120,000	+ NA

Notice the elements have been divided into accounts. For example, the element *assets* is divided into a Cash account and a Land account. Do not be concerned if some of these account titles are unfamiliar. They will be explained as new transactions are presented. Recall that the number of accounts a company uses depends on the nature of its business and the level of detail management needs to operate the business. For example, **Kroger** would have an account called Cost of Goods Sold, but **GEICO Insurance** would not. Why? Because Kroger sells goods (merchandise) but GEICO does not.

Also, notice that a stock issue transaction affects the accounting equation in two places, both under an asset (cash) and also under the source of that asset (common stock). All transactions affect the accounting equation in at least two places. It is from this practice that the **double-entry accounting** system derives its name.

EVENT 2 RCS acquired an additional \$400,000 of cash by borrowing from a creditor.

This transaction is also an *asset source transaction*. It increases assets (cash) and liabilities (notes payable). The account title Notes Payable is used because the borrower (RCS) is required to issue a promissory note to the creditor (a bank). A promissory note describes, among other things, the amount of interest RCS will pay and for how long it will borrow the money.⁴ The effect of the borrowing transaction on the accounting equation is indicated as follows.

Event No. 2	Accounting Equation					
	Assets		=	Liab.	+	Stockholders' Equity
	Cash	+ Land	=	N. Pay.	+ Com. Stk.	+ Ret. Earn.
Acquired cash by issuing note	400,000	+ NA	=	400,000	+ NA	+ NA

Asset Exchange Transactions

Businesses frequently trade one asset for another asset. In such cases, the amount of one asset decreases and the amount of the other asset increases. Total assets are unaffected by asset exchange transactions. Event 3 is an asset exchange transaction.

⁴For simplicity, the computation of interest is ignored in this chapter. Interest computation is discussed in the appendix to Chapter 2 and in subsequent chapters.

EVENT 3 RCS paid \$500,000 cash to purchase land.

This asset exchange transaction reduces the asset account Cash and increases the asset account Land. The amount of total assets is not affected. An **asset exchange transaction** simply reflects changes in the composition of assets. In this case, the company traded cash for land. The amount of cash decreased by \$500,000 and the amount of land increased by the same amount.

Event No. 3	Accounting Equation					
	Assets		=	Liab.	+	Stockholders' Equity
	Cash	+ Land	=	N. Pay.	+ Com. Stk.	+ Ret. Earn.
Paid cash to buy land	(500,000)	+ 500,000	=	NA	+ NA	+ NA

Another Asset Source Transaction**EVENT 4 RCS obtained \$85,000 cash by leasing camp sites to customers.**

The *economic benefit* a company derives from providing goods and services to its customers is called **revenue**. In this example the economic benefit is an increase in the asset cash. Businesses may receive other benefits that will be discussed later. However, at this point we will limit our definition of revenue to being *an increase in assets* that results from providing goods and services to customers. For this event, the increase in the asset account Cash is balanced by an increase in the stockholders' equity account Revenue. The effects on the accounting equation are as follows.

Event No. 4	Accounting Equation						
	Assets		=	Liab.	+	Stockholders' Equity	
	Cash	+ Land	=	N. Pay.	+ Com. Stk.	+ Ret. Earn.	Acct. Title
Acquired cash by earning revenue	85,000	+ NA	=	NA	+ NA	+ 85,000	Revenue

Note carefully that the \$85,000 shown in the retained earnings column is *not* in the Retained Earnings account. It is in the Revenue account. It will be transferred to the Retained Earnings account at the end of the accounting period. Transferring the Revenue account balance to the Retained Earnings account is part of a process called *closing the accounts*. The closing process is explained in learning objective 9.

Asset Use Transactions

Businesses use assets for a variety of purposes. For example, assets may be used to pay off liabilities or they may be transferred to owners. Assets may also be used in the process of generating earnings. All **asset use transactions** decrease the total amount of assets and the total amount of claims on assets (liabilities or stockholders' equity).

EVENT 5 RCS paid \$50,000 cash for operating expenses such as salaries, rent, and interest. RCS could establish a separate account for each type of expense. However, the management team does not currently desire this level of detail. Remember, the number of accounts a business uses depends on the level of information managers need to make decisions.

An economic sacrifice a business incurs in the process of generating revenue is called an **expense**. In this example, the economic sacrifice is a decrease in the asset Cash. While

expenses may result in other types of sacrifice, at this point we will limit our definition of expense to being a *use of assets* that is necessary to generate revenue. For this event, the decrease in the asset account is balanced by a decrease in the amount of stockholders' equity (retained earnings). The effects on the accounting equation are as follows.

Event No. 5	Accounting Equation						
	Assets		=	Liab.	+	Stockholders' Equity	
	Cash	+ Land	=	N. Pay.	+ Com. Stk.	+ Ret. Earn.	Acct. Title
Used cash to pay expenses	(50,000)	+ NA	=	NA	+ NA	+ (50,000)	Expense

Like revenues, expenses are not recorded directly into the Retained Earnings account. The \$50,000 of expense is recorded in the Expense account. It will be transferred to the Retained Earnings account at the end of the accounting period as part of the closing process. The current balance in the Retained Earnings account is zero.

EVENT 6 RCS paid \$4,000 in cash dividends to its owners.

To this point, operating RCS has caused the amount of total assets to increase by \$35,000 (\$85,000 of revenue – \$50,000 of operating expenses). Because the owners bear the risk and reap the rewards of operating the business, the \$35,000 increase in assets benefits them. RCS can use the additional assets to grow the business, or the company can transfer the earned assets to the owners. If a business transfers some or all of its earned assets to owners, the transfer is called a **dividend**. The \$4,000 dividend paid by RCS reduces the asset account Cash and the amount of stockholders' equity (retained earnings). The effects on the accounting equation are as follows.

Event No. 6	Accounting Equation						
	Assets		=	Liab.	+	Stockholders' Equity	
	Cash	+ Land	=	N. Pay.	+ Com. Stk.	+ Ret. Earn.	Acct. Title
Used cash to pay dividends	(4,000)	+ NA	=	NA	+ NA	+ (4,000)	Dividends

Like revenues and expenses, dividends are not recorded directly into the Retained Earnings account. The \$4,000 dividend is recorded in the Dividends account. It will be transferred to retained earnings at the end of the accounting period as part of the closing process. The current balance in the Retained Earnings account is zero.

EVENT 7 The land that RCS paid \$500,000 to purchase had an appraised market value of \$525,000 on December 31, Year 1.

Although the appraised value of the land is higher than the original cost, RCS will not increase the amount recorded in its accounting records above the land's \$500,000 historical cost. In general, accountants do not recognize changes in market value. The **historical cost concept** requires that most assets be reported at the amount paid for them (their historical cost) regardless of increases in market value.

Surely, investors would rather know what an asset is worth instead of how much it originally cost. So why do accountants maintain records and report financial information based on historical cost? Accountants rely heavily on verification. Information is considered to be more useful if it can be independently verified. For example, two people looking at the legal documents associated with RCS's land purchase will both conclude that RCS paid \$500,000 for the land. That historical cost is a verifiable fact. The appraised value, in contrast, is an opinion. Even two persons who are experienced appraisers are not likely to come up with the