



FINANCIAL ACCOUNTING *for* MANAGERS

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Financial Accounting for Managers

FIRST EDITION

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University of Oklahoma

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**Mc
Graw
Hill**



Dedicated to

Wayne's wife Julee, daughter Olivia and her husband Corbin, son Jake and his wife Bekah, and other sons Eli and Luke.

Mike's wife McKenzie, children Gavin, Abbie, Quentin, Maxwell, and Hannah, and his parents, Terry and Marvia Drake.

Jake's wife Kerrie, and children Allie, Luke, Mia, and Josie.

David's wife Charlene, daughters Denise and Jessica, and three sons Mike, Michael, and David.



FINANCIAL ACCOUNTING FOR MANAGERS, FIRST EDITION

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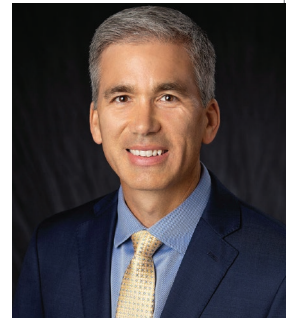
WAYNE THOMAS

Wayne Thomas is the Senior Associate Dean for Faculty and Research Innovation and the David C. Steed Chair of Accounting at the University of Oklahoma, where he teaches introductory financial accounting, intermediate accounting, and MBAs. He received his bachelor's degree in accounting from Southwestern Oklahoma State University, and his master's and PhD in accounting from Oklahoma State University.

Wayne has won teaching awards at the university, college, and departmental levels, and has received the Outstanding Educator Award from the Oklahoma Society of CPAs. In addition to *Financial Accounting for Managers*, he also co-authors McGraw Hill's best-selling *Intermediate Accounting*, with David Spiceland, Mark Nelson, and Jennifer Winchel, and *Financial Accounting* with David Spiceland and Don Herrmann.

His primary research interests include accounting information in capital markets, techniques used by managers to manipulate earnings, the importance of financial disclosures, and financial statement analysis. He previously served as an editor of *The Accounting Review* and has published articles in a variety of journals, including *The Accounting Review*, *Journal of Accounting and Economics*, *Journal of Accounting Research*, *Review of Accounting Studies*, and *Contemporary Accounting Research*. He has won several research awards, including the American Accounting Association's Competitive Manuscript Award and the University of Oklahoma's highest research award, being named a George Lynn Cross Research Professor.

Wayne is married to Julee, and they have four kids, Olivia, Jake, Eli, and Luke. He enjoys sports (basketball, tennis, golf, biking, and ping pong), crossword puzzles, the outdoors, and spending time with his family.



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MICHAEL DRAKE

Michael Drake is the K. Fred Skousen Professor of Accounting in the BYU Marriott School of Business at Brigham Young University. Before joining BYU, he was on faculty in the Fisher College of Business at The Ohio State University and a doctoral student in the Mays Business School at Texas A&M University, where he was a Deloitte Foundation Doctoral Fellow. Prior to his graduate work, he worked in public accounting at Arthur Andersen and Ernst & Young.

Michael teaches financial accounting and financial statement analysis at the undergraduate, graduate, and executive levels and has won several teaching awards, including the MBA Core Professor of the Year award in several consecutive years and the BYU Marriott School Teaching Excellence Award.

Michael's primary research interest is in capital markets with a specific focus on the intermediaries and technologies that facilitate price formation. His research has been published in top academic journals, including the *Journal of Accounting and Economics*, *Journal of Accounting Research*, *The Accounting Review*, *Contemporary Accounting Research*, *Review of Accounting Studies*, and *Management Science*. He has won several awards at the academy, university, and college level for his research, including multiple best paper awards and the BYU Young Scholar award. Michael currently serves on the editorial boards of *The Accounting Review* and *Contemporary Accounting Research*.

Michael is married to McKenzie, and they have five children, Gavin, Abbie, Quentin, Maxwell, and Hannah. He enjoys playing, coaching, and watching all sports.



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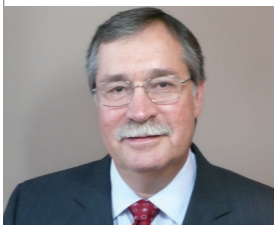
JAKE THORNOCK

Jake Thornock is a professor of accounting in the BYU Marriott School of Business at Brigham Young University and holds the John and Nancy Hardy Chaired Professorship. He joined BYU from the University of Washington, where he was a tenured associate professor of accounting and the PwC Faculty Fellow. Jake completed his doctoral studies at Kenan-Flagler Business School at the University of North Carolina, where he was awarded the William Delozier Fellowship for Outstanding Doctoral Student. He earned his undergraduate and master's degrees in accounting at BYU.

Jake has diverse research interests, including interest in taxation, tax havens, earnings information content, and information technologies. His research has been accepted for publication at the *Journal of Accounting and Economics*, *Journal of Accounting Research*, *The Accounting Review*, *Contemporary Accounting Research*, *Review of Accounting Studies*, *Journal of Finance*, *Journal of Financial Economics*, and *Management Science*. Jake's research has been cited or featured in the *Wall Street Journal*, *New York Times*, *Bloomberg Businessweek*, *Fox News*, and NPR, and has been presented at the IRS, the SEC, and a congressional subcommittee. Jake currently serves as an editor at *Contemporary Accounting Research*.

Jake has taught accounting at undergraduate and graduate levels. He has won several awards for teaching, mentoring, research, and innovation in the classroom. He also co-founded Accounting Coding Camp with Mike Drake and Josh Lee, which provides coding education to graduate students in accounting and finance.

Jake is married to Kerrie, and they have four children, Allie, Luke, Mia, and Josie. He enjoys audiobooks, enjoys college sports, and is an ardent fly fisherman.



Courtesy of David Spiceland

DAVID SPICELAND

David Spiceland is Accounting Professor Emeritus at the University of Memphis. He received his BS degree in finance from the University of Tennessee, his MBA from Southern Illinois University, and his PhD in accounting from the University of Arkansas.

Professor Spiceland's primary research interests are in earnings management and educational research. He has published articles in a variety of journals, including *The Accounting Review*, *Accounting and Business Research*, *Journal of Financial Research*, *Advances in Quantitative Analysis of Finance and Accounting*, and most accounting education journals: *Issues in Accounting Education*, *Journal of Accounting Education*, *Advances in Accounting Education*, *The Accounting Educators' Journal*, *Accounting Education*, *The Journal of Asynchronous Learning Networks*, and *Journal of Business Education*. David has received university and college awards and recognition for his teaching, research, and technological innovations in the classroom. David is a co-author on McGraw Hill's best-selling *Intermediate Accounting* text, with Mark Nelson, and Wayne Thomas.

David enjoys playing basketball, is a former all-state linebacker, and is an avid fisherman. Cooking is a passion for David, who served as sous chef for Paula Deen at a Mid-South Fair cooking demonstration.

CELEBRATING STUDENT SUCCESS

Don't you love those moments when your students see the bigger picture of financial accounting? Or when they see the important role that financial reporting plays in business decisions and our society? The authors have developed *Financial Accounting for Managers* with this purpose in mind. Students will gain knowledge of not only how to account for particular transactions, but perhaps more importantly, how those transactions affect the financial statements and how those financial statements are critical to understanding the financial performance, health, and prospects of a company. After reading this book, students will see financial accounting as an information tool that will help them make better decisions in their careers.

SPICELAND/THOMAS ACCOUNTING SERIES

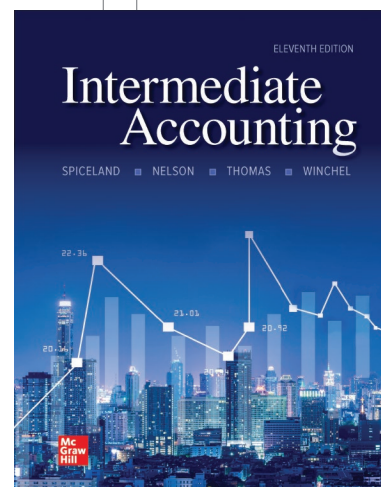
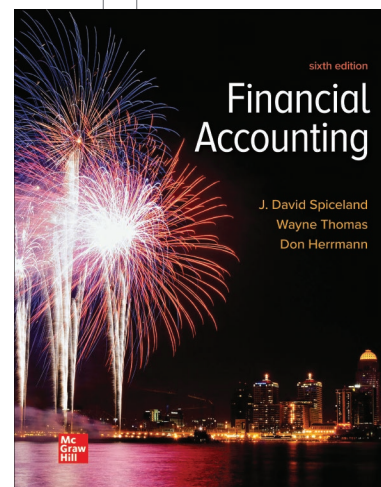
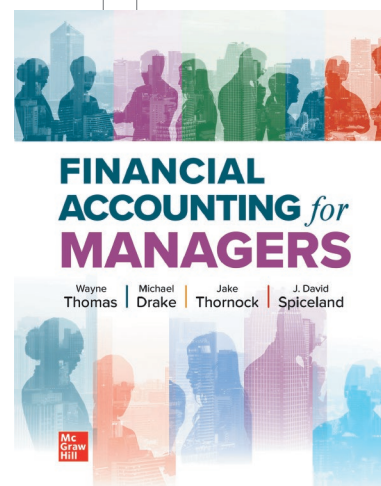
The Spiceland/Thomas Accounting series includes:

- *Financial Accounting* 6e
- *Intermediate Accounting* 11e
- *Financial Accounting for Managers* 1e

Financial Accounting and *Intermediate Accounting* have proven records of market-leading success by engaging a broad range of students, offering a wide array of resources necessary for building accounting concepts, and giving instructors the variety of tools they need to structure their unique courses.

Financial Accounting for Managers provides an exciting new book to the series with the addition of award-winning authors Michael Drake and Jake Thornock. Using the same proven Spiceland/Thomas approach, the text motivates student engagement by using modern companies, robust financial analysis sections, auto-graded real-world cases, and a focus on helping students see how financial statements are used to make business decisions. They also provide a flexible approach to accommodate various teaching styles, programs, and methods, including the extent to which debits and credits are considered.

The Spiceland/Thomas Accounting Series is fully integrated with McGraw Hill's Connect, an educational platform that seamlessly joins Spiceland/Thomas superior content with enhanced digital tools to deliver precisely what a student needs, when and how they need it.



A Flexible Approach

We recognize instructors have a wide variety of choices for topical coverage depending on their own preferences, course objectives, student mix, and length of the course. Because of this, instructors need flexibility in how much material to include in the course. *Financial Accounting for Managers* by Thomas, Drake, Thornock, and Spiceland has been designed to provide this flexibility. For example:

- Each chapter is designed to include fundamental topics in Parts A and B.
- For those instructors desiring expanded coverage of certain topics, some chapters contain Parts C and D, or Appendices.
- All end-of-chapter assignments are organized by Parts to simplify course development.
- All 12 chapters include a focus on the usefulness of financial statements to managers' decisions, and all of the topical chapters (5–11) include a specific analysis section using real-world companies. A comprehensive discussion of financial analysis is provided in Chapter 12.
- All chapters include a variety of cases and assignments to meet different course needs.

	Chapter	Fundamental Parts	Expanded Parts	Analysis Section
Introduction	1. Overview of Financial Reporting	A, B	C, App	
	2. The Financial Statements	A, B	C, D	
Accounting Cycle	3. The Accounting Cycle: During the Period	A, B	C	
	4. The Accounting Cycle: End of the Period	A, B	C	
Topical Issues	5. Revenue and Receivables	A, B	App	✓
	6. Inventory and Cost of Goods Sold	A, B	App	✓
	7. Long-Term Assets	A, B	App	✓
	8. Investments	A, B	C	✓
	9. Liabilities	A, B	App	✓
	10. Stockholders' Equity	A, B	C	✓
	11. Statement of Cash Flows	A, B	App	✓
Analysis	12. Financial Statement Analysis	A, B	C	✓

DEBITS AND CREDITS?

Instructors also differ in whether to use debits and credits in teaching the course. The entire book and its assignment material have been written to accommodate both approaches.

All transactions are presented in the book showing their financial statement effects. Then, a separate call-out box, titled "DEBITS & CREDITS," shows related journal entries and T-accounts.

Balance Sheet				Income Statement		
		Stockholders' Equity				Net
Assets	=	Liabilities	+ Common Stock + Retained Earnings	Revenues	– Expenses	Income
+75 Cash				+75 Sales Revenue	+40 Cost of Goods Sold	+35
–40 Inventory			+35			

DEBITS & CREDITS		
To record the sale of the skirt, Nordstrom would record the following journal entries:		
	Debit	Credit
Cash.....	75	
Sales Revenue		75
Cost of Goods Sold	40	
Inventory.....		40

Cash	
75	
Sales Revenue	
	75
Cost of Goods Sold	
40	
Inventory	
	40

- Instructors **not** covering debits and credits can skip these call-out boxes.
- Instructors **covering** debits and credits can utilize these call-out boxes.

Additionally, all end-of-chapter assignment materials are available for both approaches by separating versions that use journal entries from those that do not. Assignments within the Brief Exercises, Exercises, and Problems ask students to identify the financial statement effects, while corresponding Journal Entries sections ask students to record the transactions using debits and credits. These corresponding assignments are cross referenced to make them easy to find.

EXERCISES



E6-11 Littleton Books has the following transactions during May.

- May 2 Purchases books on account from Readers Wholesale for \$3,300, terms 1/10, n/30.
- May 3 Pays cash for freight costs of \$200 on books purchased from Readers.
- May 5 Returns books with a cost of \$400 to Readers because part of the order is incorrect.
- May 10 Pays the full amount due to Readers.
- May 30 Sells all books purchased on May 2 (less those returned on May 5) for \$4,000 on account.

Examine additional inventory transactions (**LO6-7**) See JE6-4 for journal entries.

Required:

- Determine the financial statement effects of the transactions of Littleton Books, assuming the company uses a perpetual inventory system.
- Assume payment to Readers is made on May 24 instead of May 10. Determine the financial statement effects of this payment.

JOURNAL ENTRIES



JE6-4 Littleton Books has the following transactions during May.

- May 2 Purchases books on account from Readers Wholesale for \$3,300, terms 1/10, n/30.
- May 3 Pays cash for freight costs of \$200 on books purchased from Readers.
- May 5 Returns books with a cost of \$400 to Readers because part of the order is incorrect.
- May 10 Pays the full amount due to Readers.
- May 30 Sells all books purchased on May 2 (less those returned on May 5) for \$4,000 on account.

Record additional inventory transactions (**LO6-7**) See E6-11 for financial statement effects.

Required:

- Record the transactions of Littleton Books, assuming the company uses a perpetual inventory system.
- Assume payment to Readers is made on May 24 instead of May 10. Record this payment.

CASE-BASED INSTRUCTION

Financial Accounting for Managers offers a robust array of Brief Exercises, Exercises, and Problems to cover each chapter's topics. In addition, many instructors want to add cases, offering important real-world applications, to their in-class curriculum or take-home activities. *Financial Accounting for Managers* offers over 100 cases in its "Real World Perspectives" sections and dozens of Excel and Data Analytics assignments online, with each one auto-gradable in Connect, allowing additional decision-making practice for students and ease of grading for instructors. Our goal is to provide instructors with flexibility in the coursework they choose for their classes, ranging from knowledge-building assignments to real-world perspectives cases.

REAL WORLD PERSPECTIVES



CASE TYPE	CASE DESCRIPTION
EDGAR	Analyze each chapter's topics through the lens of dozens of real-world financial statements and disclosure notes acquired from the SEC's EDGAR database.
Financial Analysis	Analyze the financial statements of Buckle and American Eagle for each chapter.
Comparative Analysis	Compare the financial statements of Buckle versus American Eagle for each chapter.
Ethics	Address ethical dilemmas facing managers in their financial reporting decisions.
Sustainability	Analyze real-world sustainability disclosures related to environmental, social, and governance issues.
Earnings Management	Demonstrate the incentives facing managers to aggressively use accounting estimates and judgments.
Great Adventures	Follow a single company through all chapters, adding topics as the story unfolds.
Excel	Learn the topical content while also learning Excel.
Data Analytics	Connect the chapter's content with technical analytics tools, including data visualization with Tableau.



CREATING FUTURE BUSINESS LEADERS

Financial Accounting for Managers combines years of author experience talking with business leaders, financial analysts, standard setters, auditors, and fellow accounting instructors across the country to ensure the book and its supplemental materials are consistent with what's being practiced in the business world and presented in such a way to help students be ready for business success. In keeping with this feedback, the authors have focused their approach on four key areas:

- Developing real-world perspectives and career-ready students
- Fostering decision-making and analysis skills
- Helping students focus on critical concepts
- Using technology to enhance learning

Developing Real-World Perspectives & Career-Ready Students

The authors know that students are most engaged when they see real-world examples that are applicable to their lives and future careers. As the chapter's topics are being presented, references to real companies in the chapter's opening **Feature Story** and other related companies help keep topics relevant. Instructors can assign **Real-World Perspective** cases related to **EDGAR Research**, **Financial Analysis**, **Comparative Analysis**, **Ethics**, **Sustainability**, **Earnings Management**, and **Great Adventures Continuing Problem**. *Financial Accounting for Managers* offers more than 100 cases, with each one auto-gradable in Connect, allowing additional decision-making practice for students and ease of grading for instructors.

Fostering Decision-Making and Analysis Skills

Companies today cite decision-making and analysis skills as top desired skills among recent graduates. Students are given opportunities to see real business decision-making practices in each chapter's **Decision Maker's Perspectives** and **Manager Analysis** boxes. Instructors can help students build their Excel, Tableau, and data visualization skills using a wide variety of **Data Analytics** and **Excel** assignments that are auto-gradable in Connect. Finally, the **Great Adventures Continuing Problem** progresses from chapter to chapter, encompassing the accounting issues of each new chapter as the story unfolds. These problems are also available in McGraw Hill Connect's General Ledger format.

Helping Students Focus on Critical Concepts

Students check their understanding along the way by using **Key Points** within each Learning Objective and in-chapter **Let's Review** problems of the chapter's primary topics. These items prepare students to successfully complete the assigned end-of-chapter materials. Many Let's Review problems are complemented by videos. The **Common Mistakes** feature is a student favorite, helping them avoid mistakes that regularly trip up both learners and professionals.

Using Technology to Enhance Learning

Today's students are comfortable online and seek out videos to aid their learning. *Financial Accounting for Managers* reinforces students' conceptual understanding with videos such as **Let's Review**, **Interactive Illustrations**, **Concept Overview**, and **Applying Excel**. Select end-of-chapter exercises are supplemented with **Hints/Guided Example videos**, and additional online resources like adaptive-learning **SmartBook**.

DEVELOPING REAL-WORLD PERSPECTIVES & CAREER-READY STUDENTS

Students retain more information when they see how concepts are applied in the real world. Each chapter begins with a **Feature Story** that highlights real companies and offers business insights related to the material in the chapter. As the chapter's topics are being presented, references to the companies in the Feature Story and other related companies help keep topics relevant. The authors understand that students are best engaged when the discussion involves companies that students find interesting and whose products or services are familiar, such as **Apple**, **American Eagle Outfitters**, **Best Buy**, **Lululemon**, **Walmart**, **Disney**, and **Zoom**. In Chapter 12, full financial statement analysis is provided for **Nike** versus **VF Corporation**. The authors carry these real-world companies into the end-of-chapter material, asking students to analyze real-world situations. Over 100 real-world companies are featured in examples and assignments materials throughout the text.

The **Real World Perspectives** section of each chapter offers cases and activities that ask students to apply the knowledge and skills they've learned to actual, real-world situations. Students are placed in the role of decision maker, presented with a set of information, and asked to draw conclusions that test their understanding of the issues discussed in the chapters. All cases and activities are auto-gradable, meaning that McGraw Hill's Connect will automatically grade each case. Chapters contain: four Edgar Research, two Continuing Financial Analysis, Comparative Financial Analysis, Ethics, Sustainability, Earnings Management, and Great Adventures Continuing General Ledger cases, as well as Excel and Data Analytics cases that are available online.

REAL WORLD PERSPECTIVES



EDGAR Case

Norfolk Southern (ticker: NSC)

RWP7-1 In EDGAR, find the annual report (10-K) for Norfolk Southern for the year ended December 31, 2019, and locate the note titled "7. Properties." Use the information in this note to answer the questions below.

Required:

1. Does the company have any assets that are *not* depreciated? If so, what are they?
2. What type of property has the highest depreciation rate?
3. Focus on Locomotives, which are one of Norfolk's major assets used in operations. Based on the stated depreciation rate, back into the implied service life of the company's locomotives.

Sustainability issues continue to have increasing importance for managers' decisions, not only related to environmental risks, but also the social and governance impact of their decisions. Chapter 1 introduces Sustainability Disclosures to set the stage, and Sustainability boxes are provided in the remaining chapters to highlight how the chapter's topics relate to environmental, social, and governance issues. A Sustainability Case using a real-world company can also be found in each chapter's Real World Perspectives assignment material.



SUSTAINABILITY

The SASB aims to enable standardized, comparable reporting of sustainability metrics for many topics, including inventory sourcing. This goal of standardization and comparability implies that similar companies report similar sustainability measures in similar ways. Comparability will allow investors and other stakeholders to credibly assess and compare the quality of a company's sustainability numbers to other similar companies.

This issue can be seen in the SASB standards for the Apparel, Accessories & Footwear industry, which ask companies to disclose accounting metrics related to product inventory. The following table presents some of the important quantitative metrics requested by the SASB for apparel companies:

Topic	Accounting Metric	Unit of Measure	SASB Code
Raw Material Sourcing & Innovation	Top five raw materials used in products	Metric tons	CN0501-03
	Percentage of raw materials third-party certified to meet sustainability standards	Percentage (%) by weight	CN0501-04
Labor Conditions in the Supply Chain	Percentage of suppliers beyond that have been audited to a labor code of conduct.	Percentage (%)	CN0501-05
	Non-conformance rate for suppliers' labor code of conduct audits	Rate	CN0501-06
Environmental Impacts in the Supply Chain	Percentage of supplier facilities with wastewater discharge meeting or exceeding legal requirements	Percentage (%)	CN0501-08
	Percentage of suppliers who have completed an independent assessment on environmental data collection	Percentage (%)	CN0501-09

By encouraging the consistent measurement and disclosure of these important metrics, the SASB is aiming to improve practices on responsible inventory sourcing.

Source: https://www.sasb.org/wp-content/uploads/2015/09/CN0501_Apparel-Accessories-Footwear_Standard.pdf

HELPING STUDENTS FOCUS ON CRITICAL CONCEPTS

Critical Concepts—It is crucial that students begin with a solid understanding of the role of financial accounting and the importance of financial statements to decision makers. For this reason, the first two chapters focus on building a framework for financial accounting (Chapter 1) and walking students through each primary financial statement (Chapter 2). Then, in Chapters 3 and 4, students work through the accounting cycle during the period and at the end of the period to understand how those financial statements are built. This sequence of coverage provides students with a solid foundation with which to tackle specific topics (Chapters 5 through 10) that are presented in general balance sheet order. The book finishes with coverage of cash flows (Chapter 11) and financial statement analysis (Chapter 12) to provide students a summary view of how the accounting information they’ve studied helps to understand a company’s financial position and valuation.

Let’s Review sections within each chapter test students’ comprehension of key concepts. These short review exercises, with solutions, are intended to reinforce understanding of specific chapter material and allow students to apply concepts and procedures learned in the chapter prior to attempting their homework assignment. **Let’s Review Videos** show students how to solve select exercises and model that approach for related homework.

The following is a list of accounts in alphabetical order and their balances for the Gav Paint Corporation at December 31, 2024:

Let’s Review

Account Title	Amount
Accounts payable	\$170,000
Accounts receivable, net	180,000
Bonds payable (due in 10 years)	500,000
Cash	80,000
Common stock	400,000
Intangible assets, net	50,000
Interest payable	10,000
Inventory	300,000
Investment in equity securities ^a	50,000
Notes payable ^b	200,000
Short-term investments	60,000

Common Mistakes made by students and professionals are highlighted throughout each of the chapters. With greater awareness of the potential pitfalls, students can avoid making the same mistakes and gain a deeper understanding of the chapter material.



COMMON MISTAKE

Some students confuse par value with market value. Par value is the legal capital per share that is set when the corporation is first established and actually is unrelated to “value.” The market value per share is equal to the current share price. In most cases, the market value per share will far exceed the par value.

Key Points provide quick synopses of the critical pieces of information presented throughout each chapter.



KEY POINT

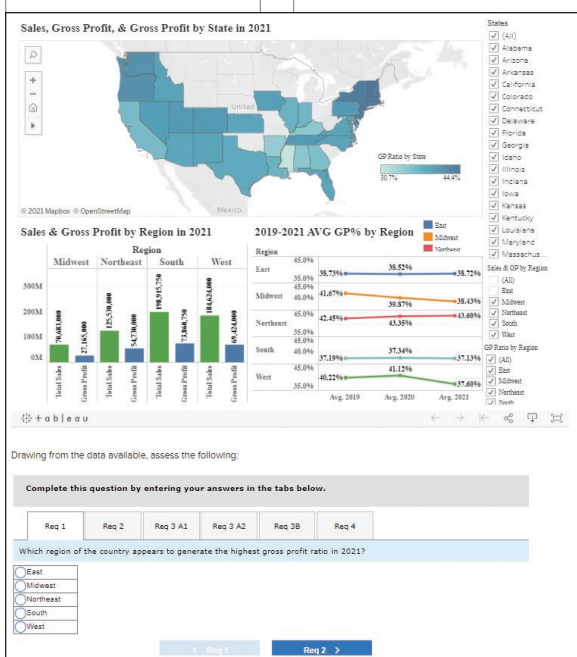
External transactions are activities conducted between the company and other entities. The effects of these transactions on the financial position of a company are recorded in accounts. Accounts provide a record of all business activities related to a particular item. The balance of the account equals all activities that increase the account minus all activities that decrease the account.

FOSTERING DECISION-MAKING & ANALYSIS SKILLS

Manager Analysis boxes are provided throughout each chapter and summarize why information presented in the chapter is important to managers. These boxes offer a framework of questions managers ask, the accounting information needed for reference, and possible analysis of that information.

Manager Analysis

Question	Accounting information	Analysis
How much profit is being generated from sales?	Profit margin	A higher profit margin indicates a company generates a higher net income per dollar of sales.
Is the company effectively generating sales from its assets?	Asset turnover ratio	A higher asset turnover indicates a company generates a higher sales volume per dollar of assets invested.



Data Analytics assignments are provided with each chapter. Instructors can visit Connect to find a variety of auto-graded Data Analytics questions that introduce students to seeing data presented in the types of visual formats they'll see in today's business environments. These exercises have been thoughtfully developed and scaffolded to build data analytics exposure and skills. Assignable, auto-gradable materials include:

- **Data Visualizations**—Familiarize students with data visualizations. Students interpret data in a static visual to answer accounting questions.
- **Tableau Dashboard Activities**—Easily introduce students to Tableau. Students learn to gather the information they need from a live embedded Tableau dashboard—no prior knowledge of Tableau needed.
- **Applying Tableau Cases**—Build student's data analytics skills. Students download an Excel file and build a Tableau dashboard with video tutorial guidance. Once they've completed their dashboard, they'll use it to answer auto-graded questions in Connect.

In today's environment, business graduates need to be well-equipped in analyzing data and making decisions. To address this need, each chapter includes **Decision Maker's Perspective** sections, which offer insights into how the information discussed in the chapters affects decisions made by investors, creditors, managers, and others.

The Great Adventures Continuing Problem progresses from chapter to chapter, encompassing the accounting issues of each new chapter as the story unfolds. These problems allow students to see how each chapter's topics can be integrated into the operations of a single company. Great Adventures problems are also available in McGraw Hill Connect's General Ledger format.

Excel activities and exercises foster career readiness by offering students hands-on training in multiple ways:

- **Integrated Excel** assignments pair the power of Microsoft Excel with the power of Connect. A seamless integration of Excel within Connect, Integrated Excel questions allow students to work in live, auto-graded Excel spreadsheets—no additional logins, no need to upload or download files. Instructors can choose to grade by formula or solution value, and students receive instant cell-level feedback via integrated Check My Work functionality.
- **Applying Excel** features in each chapter help build students' Excel skills, showing them how Excel can be used to make efficient calculations and analysis. Applying Excel video solutions housed in Connect complement the feature, allowing students to view the power of Excel to analyze business scenarios.

Decision Maker's Perspective

Limited Liability and Beneficial Tax Treatment

Wouldn't it be nice to get the best of both worlds—enjoy the limited liability of a corporation and the tax benefits of a sole proprietorship or partnership? An **S corporation** allows a company to enjoy limited liability as a corporation but tax treatment as a partnership. Because of these benefits, many companies that qualify choose to incorporate as S corporations. One of the major restrictions is that the corporation cannot have more than 100 stockholders, so S corporations appeal more to smaller, less widely held businesses.

Two additional business forms have evolved in response to liability issues and tax treatment—**limited liability companies (LLCs)** and **limited liability partnerships (LLPs)**. Most accounting firms in the United States adopt one of these two business forms because they offer limited liability and avoid double taxation, but with no limits on the number of owners as in an S corporation.

The screenshot shows an Excel spreadsheet for a bond pricing problem. The input data is as follows:

Input	Value
Face Value	\$25,000
Number of Years	10
Stated Interest Rate	7%
Number of Payments per Year	2

The 'Required' section contains the following questions:

- How many total payments or periods will this bond pay interest?
- Calculate the amount of interest that will be paid on March 31st.
- Calculate the selling price of this bond using the PV Function.
- Use the IF function to show the balance in the Premium or Discount account at the time the bond is issued based on the selling price you calculated in letter c.

The 'Check My Work' button is located at the bottom right of the spreadsheet. A sidebar on the right displays the 'Question Title' and 'Legend'.

USING TECHNOLOGY TO ENHANCE LEARNING



Connect and *Financial Accounting for Managers* are tightly integrated to continue honing students' conceptual understanding, problem-solving, decision-making, and analysis skills.

All end-of-chapter items in the textbook are built in the Connect platform. These items include feedback and explanations and many with **Hints/Guided Example Videos** to help students work through their homework in an effective manner.

ASSESSMENT & PRACTICE: END-OF-CHAPTER AND TEST BANK

Algorithmic Content & End-of-Chapter Assignments

A large set of algorithmic problems have been included, allowing students more opportunities for students to demonstrate their understanding.

Extensive end-of-chapter assignments are available in the text and Connect:

- Self-Study Questions
- Real World Perspectives
 - EDGAR cases
 - Financial analysis cases
 - Ethics cases
 - Sustainability cases
 - Earnings Management cases
 - Great Adventures continuing cases
- Brief Exercises
- Exercises
- Problems
- Journal Entries—Brief Exercises
- Journal Entries—Exercises
- Journal Entries—Problems
- Data Analytics & Excel cases (available online)

Using EDGAR (Electronic Data Gathering, Analysis, and Retrieval system), find the annual report (10-K) for Apple for the year ended September 28, 2019. Locate the "Consolidated Statements of Operations" (income statement) and "Consolidated Balance Sheets." You also may find the annual report at the company's website.

Required:

Determine the following from the company's financial statements:

1. What amount does the company report for accounts receivable? What does this amount represent?
2. What amount does the company report for accounts payable? What does this amount represent?
3. The company reports a single amount for "Other current liabilities" in the liability section of the balance sheet. What are some possible liabilities included in this amount?
4. What amount does the company report for common stock (including additional paid-in capital)? What does this amount represent?
5. Determine whether the company's total assets equal total liabilities plus total stockholders' (or shareholders') equity.
6. What amount does the company report for net sales? When a sale is made, does the company debit or credit the Sales Revenue account?
7. Do the company's total revenues exceed total expenses? By how much?

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

Required 1

Required 2

Required 3

Required 4

Required 5

Required 6

Required 7

Accounts receivable

The accounts receivable account represents the

< Required 1

Required 2 >

Concept Overview Videos

Concept Overview Videos provide engaging narratives of chapter learning objectives in an assignable, interactive online format. These videos follow the structure of the text and match specific learning objectives within each chapter of *Financial Accounting for Managers*. Concept Overview Videos provide additional explanation and enhancement of material from the text chapter, allowing students to learn, study, and practice at their own pace. Assignable assessment questions paired with the videos help students test their knowledge, ensuring that they are retaining concepts.

Hints/Guided Example Videos

Hint/Guided Example videos are narrated, animated, and step-by-step walkthroughs of algorithmic versions of select exercises in Connect. Presented to the student as hints, Guided Examples provide just-in-time feedback, focused on the areas where students need the most guidance.

Interactive Illustration Videos

Interactive Illustrations provide video-based explanations of key illustrations in the chapter. These videos transform a static illustration in the text into a dynamic, step-by-step walk through of the illustration, deepening students' understanding of the concepts or the calculations shown.

Let's Review Videos

Let's Review videos relate to the Let's Review sections in the text, showing students how to solve certain exercises. In walking students through a particular scenario or question, these videos model how students can approach problem solving.

1 Required Information
[The following information applies to the questions displayed below.]

If no-par value stock is issued, the corporation debits Cash and credits Common Stock. If par value or stated value stock is issued, the corporation debits Cash and credits two equity accounts—Common Stock at the par value or stated value per share and Additional Paid-in Capital for the portion above par or stated value.

Knowledge Check 01
On January 1, Year 1, Davidson Corporation issues 1,000 shares of \$1 par value common stock for \$20 per share. Complete the necessary journal entry for the issuance of common stock by indicating the relevant account names and dollar amounts below. If more than one account title is debited or credited, enter the account titles in their alphabetical order.

[View transaction list](#)

Journal entry worksheet

1
Record the issue of additional common stock.

Hint

ACTIVITY-BASED	
Depreciable cost	
Total miles expected to be driven	100,000 miles
Cost	\$10,000
Less: Residual value	\$2,000
Depreciable cost	\$8,000
Depreciation rate per mile	\$8,000 / 100,000 miles = \$0.08 per mile
Depreciation expense	Depreciation rate per mile × Actual mileage in a year
Dec. 31, Year 1	\$0.08 per mile × 5,000 miles = \$0.40
Dec. 31, Year 2	\$0.08 per mile × 15,000 miles = \$1.20

Links among Financial Statements

EAGLE GOLF ACADEMY Income Statement

Revenue	\$7,200
Expenses	(5,000)
Net income	\$2,200

EAGLE GOLF ACADEMY Statement of Stockholders' Equity

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance (Dec. 1)	\$0	\$0	\$0
Issuance	25,000	25,000	50,000
Add Net income		2,200	2,200
Less: Dividends		(2,000)	(2,000)
Ending balance (Dec. 31)	25,000	25,200	50,200

EAGLE GOLF ACADEMY Balance Sheet

Assets		Liabilities and Stockholders' Equity	
Cash	\$14,000	Accounts Payable	\$14,000
Other assets	36,200	Stockholders' equity	36,200
Total assets	\$50,200	Total liabilities and stockholders' equity	\$50,200

EAGLE GOLF ACADEMY Statement of Cash Flows

Cash flows from operating activities	\$2,200
Cash flows from investing activities	(24,000)
Cash flows from financing activities	34,000
Net increase in cash	2,200
Cash at the beginning of the year	11,800
Cash at the end of the year	14,000

Requirements:
• Indicate how each transaction affects the accounting equation.

	ASSETS	=	LIABILITIES	+	STOCKHOLDERS' EQUITY
May 1	+5,000		+5,000		Common Stock
May 6	+1,800				Retained Earnings
May 12	-1,200				+1,800
May 17	-1,000		-1,000		-1,200
May 25	+ 800				
	- 800				
	<u>+4,600</u>	=	<u>+4,000</u>	+	<u>600</u>

Test Builder in Connect

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.
- Easily pinpoint the most relevant content through robust filtering options.
- Manipulate the order of questions or scramble questions and/or answers.
- Pin questions to a specific location within a test.
- Determine your preferred treatment of algorithmic questions.
- Choose the layout and spacing.
- Add instructions and configure default settings.

Test Builder provides a secure interface for better protection of content and allows for just-in-time updates to flow directly into assessments.

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A HEARTFELT THANKS

Financial Accounting for Managers would not be the same book without the valuable suggestions, keen insights, and constructive criticisms of the list of reviewers below. Each professor listed here contributed in substantive ways to the organization of chapters, coverage of topics, and selective use of pedagogy. We are grateful to them for taking the time to read each chapter and offer their insights.

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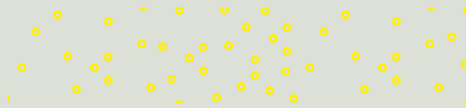
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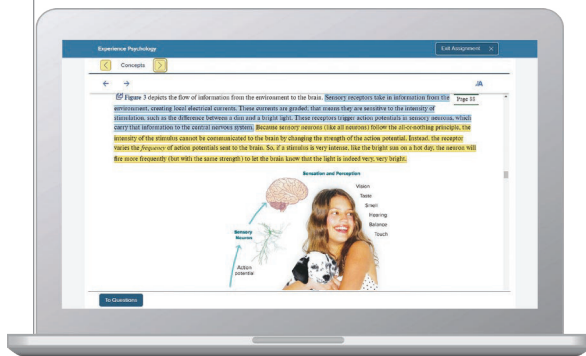


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*Available online only

Financial Accounting for Managers

CHAPTER ONE

A Framework for Financial Accounting

Learning Objectives

PART A: ACCOUNTING AS A MEASUREMENT/COMMUNICATION PROCESS

- **LO1-1** Describe the two primary functions of financial accounting.
- **LO1-2** Understand the business activities that financial accounting measures.
- **LO1-3** Determine how financial accounting information is communicated through financial statements.

PART B: THE DEMAND FOR FINANCIAL ACCOUNTING INFORMATION

- **LO1-4** Describe the role that financial accounting plays in the decision-making process.
- **LO1-5** Explain the need for accounting standards and the demand by investors and creditors for audited financial statements.

PART C: THE SUPPLY OF FINANCIAL ACCOUNTING INFORMATION

- **LO1-6** Understand the types of financial statement disclosures that companies provide in annual and quarterly reports.
- **LO1-7** Understand the types of financial statement disclosures that companies provide in current reports.
- **LO1-8** Understand the types of sustainability disclosures that companies provide.

APPENDIX

- **LO1-9** Explain the nature of the conceptual framework used to develop generally accepted accounting principles.

Self-Study Materials

- Let's Review—Measuring business activities (p. 8).
- Let's Review—Communicating through financial statements (p. 17).
- The Bottom-Line (Key Points by Learning Objective) (p. 36).
- Glossary of Key Terms (p. 37).
- Self-Study Questions with answers available (p. 38).



Feature Story

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Accounting: The Language of Business

Some of you reading this book may question if the material will be important for you in your future business careers. Perhaps you are planning a career in consulting, product management, marketing, supply chain, human resources, or finance and wondering why you have to learn accounting. You may even be thinking—*I don't want to be an accountant. I don't even plan to work closely with accountants. So why am I reading an accounting textbook?* We invite you to consider the following.

Managers, investors, lenders, suppliers, customers, and many others make important business decisions every day. These decisions relate to how a company grows, remains competitive in the marketplace, finances its operations, manages its operating costs, minimizes its risks, utilizes its resources, and generates profits for its owners, to name just a few. To make good decisions, these individuals need

timely and reliable information. This is where accounting plays a critical role for business professionals. The primary functions of accounting are to measure the activities of a company and communicate those measurements to help individuals make good decisions. The better the information, the better the decisions.

Further, understanding accounting means understanding the language of business. When you speak that language, you'll be able to better communicate with others, which will allow you to make better decisions, help others make better decisions, and play a more influential role in creating a prosperous business.

Finally, you'll soon see how accounting reports help tell a company's story. Understanding the story plays a critical role in helping to shape the company's future. Accounting reports help reveal business success, failures, opportunities, challenges, risks, and uncertainties not otherwise known to the managers. The better you understand the stories told by the accounting reports, the better decisions you'll make to improve the company's future.

PART A

LO1-1

Describe the two primary functions of financial accounting.

ACCOUNTING AS A MEASUREMENT/COMMUNICATION PROCESS

Defining Accounting

Accounting is “the language of business.” It’s the language companies use to tell their financial story. More precisely, **accounting** is a system of maintaining records of a company’s operations and communicating that information to decision makers. The earliest use of such systematic recordkeeping dates back thousands of years to when records were kept of delivered agricultural products. Using accounting to maintain a record of multiple transactions allowed for better exchange among individuals and aided in the development of more complex societies.¹ In this book, you’ll learn how to read, interpret, and communicate a company’s financial story using the language of business.

Millions of people every day must make informed decisions about companies. Illustration 1-1 identifies some of those people and examples of decisions they make about the companies.

ILLUSTRATION 1-1

Decisions People Make About Companies



1. **Investors** decide whether to invest in stock.
2. **Creditors** decide whether to lend money.
3. **Customers** decide whether to purchase products.
4. **Suppliers** decide the customer’s ability to pay for supplies.
5. **Managers** decide production and expansion.
6. **Employees** decide employment opportunities.
7. **Competitors** decide market share and profitability.
8. **Regulators** decide on social welfare.
9. **Tax authorities** decide on taxation policies.
10. **Local communities** decide on environmental issues.

To make the decisions outlined in Illustration 1-1, these people need information. This is where accounting plays a key role. As Illustration 1-2 shows, accountants **measure the activities of the company and communicate those measurements to others**.

Accounting information provided for *internal* users (managers) is referred to as **managerial accounting**; that provided to *external* users is referred to as **financial accounting**. In this book, we focus on financial accounting. Formally defined, the two functions of **financial accounting** are to measure business activities of a company and then to communicate those measurements to *external* parties for decision-making purposes.

As you study the business activities discussed in this book, it is important to keep in mind the following “framework” for financial accounting. For each activity, ask yourself

1. How is the business activity being measured?
2. How is the business activity being communicated?

These are the two functions of financial accounting. You’ll better understand *why* this process exists by thinking about *how* the measurements being communicated help people make better decisions.

¹S. Basu and G. Waymire, 2006, “Recordkeeping and Human Evolution,” *Accounting Horizons* 20 (3): 201–229.

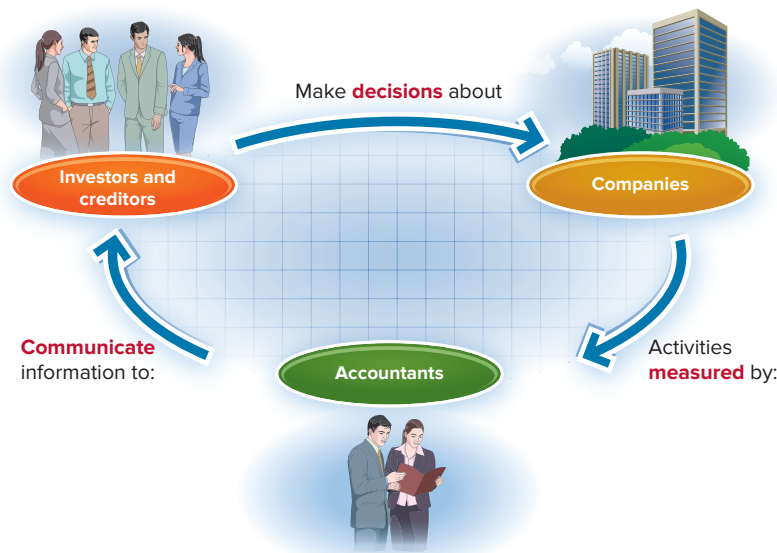


ILLUSTRATION 1-2
Framework for
Financial Accounting



For example, **investors** want to make good decisions related to buying and selling their shares of the company's stock: Will the company's stock increase or decrease in value? The value of a stock is tied directly to the company's ability to make a profit, so what activities reflect the company's profitability? How should those activities be measured, and how should they be communicated in formal accounting reports?

As another example, **creditors** make decisions related to lending money to the company: Will the company be able to repay its debt and interest when they come due? How can debt activity be measured and how can it be communicated so that creditors better understand the ability of the company to have sufficient cash to repay debt and interest in the short term and the long term?



KEY POINT

The two primary functions of financial accounting are to measure business activities of a company and to communicate information about those activities to investors and creditors and other outside users for decision-making purposes.

User's Guide

For learning objectives throughout this book, you will see boxed sections, like this one, titled *Key Point*. These boxed items will highlight the central focus of the learning objectives.

Measuring Business Activities

Let's first look at the typical activities of a start-up business. We'll do this with a simple example. Suppose you and two associates (one a mechanical engineer and another a software engineer) want to start a business that sells and customizes robots for commercial use. The company will purchase generic robots from a manufacturer and then customize the robot (including hardware and software customization) to suit the specific needs of its customers. You name the company Eagle Robotics.

Let's assume, after running some numbers, you estimate you'll need \$1,500,000 to get the business up and running. You don't have that amount of money to start the business, so you start looking for investors. With their money, investors buy ownership in the company and have the right to share in the company's profits. Each share of ownership is typically referred to as a share of common stock. You develop a business proposal, explaining your target customers, funds needed, expected profits, and benefits your company will bring to the community. You pitch your idea to a private equity firm that agrees to invest \$1,000,000 in your company in exchange for a 70 percent equity stake. The remaining 30 percent equity stake is divided equally among you and your two associates. Your company now has \$1,000,000 from issuing common stock, which sometimes is referred to as contributed capital.

To raise the remaining cash needed, you turn to **creditors**. Creditors lend money to a company, expecting to be paid back the loan amount plus interest. Impressed by your business

LO1-2

Understand the business activities that financial accounting measures.

proposal and ability to raise funding from investors, a local bank lends you \$500,000 with 12 percent annual interest, which you agree to repay within three years.

Now, with the \$1,500,000 of cash obtained from investors and creditors, your company buys equipment. This equipment costs \$240,000, leaving \$1,260,000 cash for future use. At this point, your company has the following resources that can be used for operations.

Cash	\$1,260,000	Resources
Equipment	240,000	
	<u>\$1,500,000</u>	

Who has the claims to the company's resources? Answer: The investors and creditors. Creditors have claims equal to the amount loaned to the company, \$500,000. In other words, \$500,000 of the company's resources are promised to the local bank. Investors have claims to all remaining resources, \$1,000,000.

Creditors (bank)	\$ 500,000	Claims to Resources
Investors (common stock)	1,000,000	
	<u>\$1,500,000</u>	

We can see that the company has engaged in financing and investing activities, and it will soon begin operating activities.

- **Financing activities** include transactions with investors and creditors, such as issuing stock (\$1,000,000) and borrowing money from a bank (\$500,000).
- **Investing activities** include transactions involving the purchase and sale of resources that are expected to benefit the company for several years, such as the purchase of equipment for \$240,000. With the necessary resources in place, the company is ready to begin operations.
- **Operating activities** will include transactions that relate to the primary operations of the company, such as providing products and services to customers and the associated costs of doing so, like rent, salaries, utilities, taxes, and advertising.

Types of Business Organizations. Notice that you are both the manager and a stockholder of Eagle Robotics. You manage the resources of the company on behalf of all owners (stockholders, in this case), and you are also a stockholder, which helps align your interests with that of the other stockholders in the company. This is common in many start-up businesses. Mark Cuban, the owner of the Dallas Mavericks and a tech savvy entrepreneur, refers to a manager who also owns shares in the company as having "skin in the game." Companies that issue shares of stock often form as corporations.

A **corporation** is a company that is legally separate from its owners. The advantage of being legally separate is that the stockholders have limited liability. Limited liability prevents stockholders from being held personally responsible for the financial obligations of the corporation. Stockholders of Eagle Robotics can lose their investment of \$1,000,000 if the company fails, but they cannot lose any of their personal assets (such as homes, cars, computers, and furniture).

A **sole proprietorship** is a business owned by one person; a **partnership** is a business owned by two or more persons. If you had decided to start Eagle Robotics alone, you could have formed a sole proprietorship, or you and your friends could have formed a partnership. However, because you did not have the necessary resources to start the business, being a sole proprietorship (or even one member of a partnership) was not a viable option. Thus, a disadvantage of selecting the sole proprietorship or partnership form of business is that owners must have sufficient personal funds to finance the business in addition to the ability to borrow money. Another disadvantage of being a sole proprietorship or partnership is that neither offers limited liability. Owners (and partners) are held personally responsible for the activities of the business.

A potential disadvantage of a corporation is *double taxation*: (1) the company first pays corporate income taxes on income it earns, and (2) stockholders then pay personal income

taxes on income distributed to them from the company. There are many complexities in tax laws, and these laws are subject to change. For certain types of corporations and in certain instances, corporations may pay a higher or lower overall tax rate compared to partnerships and sole proprietors.

Because most of the largest companies in the United States are corporations, in this book we will focus primarily on accounting from a corporation's perspective. Focusing on corporations also highlights the importance of financial accounting—to measure and communicate activities of a company for investors (stockholders) and creditors (lenders, such as a local bank).

ASSETS, LIABILITIES, AND STOCKHOLDERS' EQUITY

What information would Eagle's investors and creditors be interested in knowing to determine whether their investment in the company was a good decision? **Ultimately, investors and creditors want to know about the company's resources and their claims to those resources.** Accounting uses three measurement categories to describe such resources and claims.

Assets are the total resources of a company. At this point, Eagle Robotics has two assets—cash of \$1,260,000 and equipment of \$240,000—equaling total resources of \$1,500,000. Of course, there are many other possible resources that a company can have, such as supplies, inventory for sale to customers, buildings, land, and investments. You'll learn about these and many other assets throughout this book.

Liabilities are amounts owed to creditors. Eagle Robotics has a liability of \$500,000 to a bank. Other examples of liabilities would be amounts owed to suppliers, employees, utility companies, and the government (in the form of taxes). Liabilities typically include claims that must be paid by a specified date.

Stockholders' equity represents the owners' claims to resources. These claims arise from two primary sources: (1) contributions by the owners themselves and (2) net resources generated by company operations. To this point, Eagle Robotics has contributions from owners of \$1,000,000.

The **accounting equation** in Illustration 1-3 shows the relationship among the three measurement categories. The equation shows that a company's assets equal its liabilities plus stockholders' equity. Alternatively, a company's resources equal creditors' and owners' claims to those resources.

Assets	=	Liabilities	+	Stockholders' Equity
		(creditors' claims)		(owners' claims)
Resources		Claims to Resources		

The accounting equation for Eagle Robotics would be

Assets	=	Liabilities	+	Stockholders' Equity
(resources)		(creditors' claims)		(owners' claims)
\$1,500,000	=	\$500,000	+	\$1,000,000

The accounting equation illustrates a fundamental model of business valuation. The value of a company to its owners equals total resources of the company minus amounts owed to creditors. Creditors expect to receive only resources equal to the amount owed them. Stockholders, on the other hand, can claim all of the company's resources in excess of the amount owed to creditors.

ILLUSTRATION 1-3

The Accounting Equation

Common Terms
Other common names for net income include *earnings* or *profit*.

REVENUES, EXPENSES, AND DIVIDENDS

Of course, all owners hope their claims to the company’s resources increase over time. This increase occurs when the company makes a profit. Stockholders claim all resources in excess of amounts owed to creditors; thus, profits of the company are claimed solely by stockholders. We calculate a company’s profits as the difference between revenues and expenses.

Revenues are the amounts recognized when the company sells products or provides services to customers. For example, when you or one of your employees provides services to a customer, the company recognizes revenue. However, as you’ve probably heard, “It takes money to make money.” To operate the business, you’ll encounter many costs.

Expenses are the costs of providing products and services and other business activities during the current period. For example, to operate the business, you’ll have costs related to salaries, rent, supplies, and utilities. These are typical expenses of most companies.

Net income is the difference between revenues and expenses. All businesses want revenues to be greater than expenses, producing a positive net income and adding to stockholders’ equity in the business. However, if expenses exceed revenues, as happens from time to time, the difference between them is a negative amount—a **net loss**.

You’ll notice the use of the term *net* to describe a company’s profitability. In business, the term *net* is used often to describe the difference between two amounts. Here, we measure revenues *net* of (or minus) expenses, to calculate the net income or net loss. If we assume that by the end of the first month of operations Eagle Robotics has total revenues of \$375,000 and total expenses of \$330,000, then we would say that the company has *net income* of \$45,000 for the month.

Dividends are cash payments to stockholders. Suppose Eagle Robotics generated net income of \$45,000 for the month. From these profits, let’s suppose the company decides to make a cash payment of \$14,000 to stockholders. The remaining \$31,000 of resources are retained in the company to help grow future operations. Thus, when Eagle has net income of \$45,000, stockholders receive a total benefit of \$45,000, equal to \$14,000 of dividends received and \$31,000 retained in the company they own.

Dividends Are Not an Expense. Recall earlier we defined expenses as the costs necessary to run the business to produce revenues. Dividends, on the other hand, are not costs related to providing products and services to *customers*; dividends are distributions (most often cash) to the *owners* of the company—the stockholders. Thus, dividends are not considered an expense of the business.

Let’s Review

Match the term with the appropriate definition.

- | | |
|------------------------------|--|
| 1. ____ Assets | A. Costs of selling products or services. |
| 2. ____ Liabilities | B. Sales of products or services to customers. |
| 3. ____ Stockholders’ equity | C. Amounts owed. |
| 4. ____ Dividends | D. Distributions to stockholders. |
| 5. ____ Revenues | E. Owners’ claims to resources. |
| 6. ____ Expenses | F. Resources of a company. |

Solution:

1. F; 2. C; 3. E; 4. D; 5. B; 6. A

User’s Guide
Let’s Review exercises test your comprehension of key concepts covered in the chapter text.

In summary, the measurement role of accounting is to create a record of the activities of a company. To make this possible, a company must maintain an accurate record of its assets,

liabilities, stockholders' equity, revenues, expenses, and dividends. Be sure you understand the meaning of these items. We will refer to them throughout this book. Illustration 1-4 summarizes the business activities and the categories that measure them.

Activities Related to:	Measurement Category	Relationship
<ul style="list-style-type: none"> Resources of the company Amounts owed Stockholders' investment 	<ul style="list-style-type: none"> Assets Liabilities Stockholders' equity 	Accounting Equation $(A = L + SE)$
<ul style="list-style-type: none"> Distributions to stockholders 	<ul style="list-style-type: none"> Dividends 	
<ul style="list-style-type: none"> Sales of products or services Costs of providing sales 	<ul style="list-style-type: none"> Revenues Expenses 	Net Income $(R - E = NI)$

ILLUSTRATION 1-4

Business Activities and Their Measurement



KEY POINT

The measurement role of accounting is to create a record of the activities of a company. To make this possible, a company must maintain an accurate record of its assets, liabilities, stockholders' equity, revenues, expenses, and dividends.

Communicating through Financial Statements

We've discussed that different business activities produce assets, liabilities, stockholders' equity, dividends, revenues, and expenses, and that the first important role of financial accounting is to *measure* the relevant transactions of a company. Its second vital role is to *communicate* these business activities to those outside the company. The primary means of communicating business activities is through financial statements.

Financial statements are periodic reports published by the company for the purpose of providing information to external users. There are five primary financial statements.

1. Income statement
2. Statement of stockholders' equity
3. Balance sheet
4. Statement of cash flows
5. Statement of comprehensive income (when necessary)

These financial statements give investors and creditors the key information they need when making decisions about a company: Should I buy the company's stock? Should I lend money to the company? Is management efficiently operating the company? **Without these financial statements, it would be difficult for those outside the company to see what's going on inside the company.**

Let's go through a simple set of financial statements to see what they look like. We'll continue with our example of Eagle Robotics. Actual companies' financial statements report items you haven't yet encountered. However, because actual companies' financial information will be useful in helping you understand certain accounting topics, we'll sample them often throughout this book.

INCOME STATEMENT

The **income statement** is a financial statement that reports the company's revenues and expenses over an *interval of time* (e.g., a month, quarter, or year). It shows whether the

LO1-3

Determine how financial accounting information is communicated through financial statements.

Common Terms

Other common names for the income statement include *statement of operations*, *statement of income*, and *profit and loss statement*.

company was able to generate enough revenue during the period to cover the expenses of running the business. If revenues exceed expenses, then the company reports *net income*:

$$\text{Revenues} - \text{Expenses} = \text{Net Income}$$

If expenses exceed revenues, then the company reports a *net loss*.

On December 1, 2024, Eagle Robotics began operations. At the end of the first month of operations, Eagle Robotics reports its income statement as shown in Illustration 1–5.

ILLUSTRATION 1–5

Income Statement for Eagle Robotics

EAGLE ROBOTICS Income Statement For the month ended December 31, 2024	
Revenue	\$ 375,000
Cost of goods sold	<u>250,000</u>
Gross profit	125,000
Operating expenses	<u>60,000</u>
Operating income	65,000
Interest expense	<u>5,000</u>
Pretax income	60,000
Income tax expense	<u>15,000</u>
Net income	<u>\$ 45,000</u>




Here are some specifics about Eagle's income statement:

- **Heading**—The heading includes the company's name, the title of the financial statement, and the time period covered by the financial statement. Because Eagle began operations on December 1, this income statement shows activity occurring *from* December 1 to December 31, 2024.
- **Revenues**—Eagle billed customers \$375,000 for robot sales and customization services.
- **Gross profit**—Eagle has costs associated with the purchase of the generic robots from a supplier. The cost associated with the inventory sold to customers (or the "cost of goods sold") totaled \$250,000 in December. After taking out the direct cost of the robots sold, Eagle has \$125,000 left over. We call this amount the gross profit, which equals revenues minus cost of goods sold.
- **Operating income**—Eagle has other costs associated with operating its business including salaries, rent, supplies, etc. These operating expenses total \$60,000 for the month of December. The operating expenses are subtracted from the gross profit to determine the company's operating income for the month. Eagle reports operating income of \$65,000.
- **Pretax income**—Eagle also has expenses related to how it financed its business. Recall that Eagle borrowed \$500,000 from a bank at 12% annual interest. The \$5,000 in interest expense relates to the interest charge for the month of December and is subtracted from operating income to arrive at pretax income. Pretax income is also sometimes referred to as "income before income taxes."
- **Net income**—Finally, Eagle has to account for taxes. As discussed previously, corporations pay taxes to the government. For December, income tax expense is \$15,000 or 25% of its pretax income amount. Income tax expense is subtracted from pretax income to arrive at net income. Eagle earned net income of \$45,000 in the month of December.
- **Underlines**—In a financial statement, a single underline generally represents a subtotal, while a double underline indicates a final total.

The fact that Eagle reports a positive net income is, in some sense, a signal of the company's success. The company is able to generate more revenue from customers than the costs of running the business. Do you assume most companies sell their products and services for a profit? It's not as easy as you might think. In recent years, companies such as **Tesla**, **eBay**, **Uber**, **Boeing**, **General Electric**, **Wayfair**, **Fitbit**, and thousands of others have reported net losses.

**KEY POINT**

The income statement compares revenues and expenses for the current period to assess the company's ability to generate a profit from running its operations.

Question 	Accounting information 	Analysis 
How can I tell if a company is profitable?	Income statement	If revenues exceed expenses, then a company has net income and is profitable.

Manager Analysis**User's Guide**

Manager Analysis in chapter highlights specific decisions related to chapter topics that can be made using financial accounting information.

STATEMENT OF STOCKHOLDERS' EQUITY

The **statement of stockholders' equity** is a financial statement that summarizes the changes in stockholders' equity over an interval of time. Stockholders' equity arises from two primary sources—common stock and retained earnings.

$$\text{Stockholders' Equity} = \text{Common Stock} + \text{Retained Earnings}$$

1. **Common Stock** (*external* source of equity) represents amounts invested by stockholders (owners) when they purchase shares of stock. The change in common stock over the period is shown as:

$$\text{Beginning Common Stock} + \text{New Issuances} = \text{Ending Common Stock}$$

2. **Retained Earnings** (*internal* source of equity) represent *all net income minus all dividends over the life of the company*. The change in retained earnings over the period is shown as:

$$\text{Beginning Retained Earnings} + \text{Net Income} - \text{Dividends} = \text{Ending Retained Earnings}$$

Think of retained earnings this way. A company that has net income has generated resources for owners through its operations. Those resources can either be returned to owners for their personal use (dividend payments) or retained in the business for future company use. From the company's perspective, we need to account for the total net income retained in the business. That's the balance of retained earnings. In each period, the beginning balance of retained earnings is updated for the current period's net income minus dividends to calculate ending retained earnings. This same calculation repeats each period.

Illustration 1-6 shows the statement of stockholders' equity for Eagle Robotics.

EAGLE ROBOTICS Statement of Stockholders' Equity For the month ended December 31, 2024			
	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance (Dec. 1)*	\$ -0-	\$ -0-	\$ -0-
Issuance of common stock	1,000,000		1,000,000
Add: Net income for the period		45,000	45,000
Less: Dividends		(14,000)	(14,000)
Ending balance (Dec. 31)	\$1,000,000	\$31,000	\$1,031,000

ILLUSTRATION 1-6

Statement of Stockholders' Equity for Eagle Robotics

From the income statement

*Beginning balances are zero only because this is the first month of operations for Eagle. Normally, beginning balances for Common Stock and Retained Earnings equal ending balances from the previous period.

Accounting convention uses parentheses to signify an amount to be subtracted (such as dividends here).

User's Guide

Throughout each chapter, you will see sections titled Common Mistake. Information in these boxes will help you avoid common mistakes on exams, quizzes, and homework.

Here are some specifics about Eagle's statement of stockholders' equity:

- **Heading**—The statement of stockholders' equity reports the activity for common stock and retained earnings over an *interval of time*. Similar to the income statement, the period of time in this example is December 1 to December 31, 2024.
- **Common Stock**—When Eagle begins operations on December 1, the balance of common stock is **\$0**. This would be true of any company beginning operations. During December, Eagle issues \$1,000,000 in common stock, so the balance of common stock increases by **\$1,000,000**.
- **Retained Earnings**—Retained Earnings also begins the first month of operations with a balance of **\$0**. For the month of December, retained earnings increase by net income of **\$45,000** and decrease by \$14,000 for dividends paid to stockholders. We show the amount of net income in blue here to emphasize that it came from the income statement (Illustration 1–5). The ending balance of **\$31,000** represents all net income minus all dividends over the life of the company, which is only one month to this point in our example.
- **Total Stockholders' Equity**—The third column shows that the two components—common stock and retained earnings—add to equal total stockholders' equity of **\$1,031,000**.



COMMON MISTAKE

Dividends represent the payment of cash but are not considered an expense in running the business. Students sometimes mistakenly include the amount of dividends as an expense in the income statement, rather than as a distribution of net income in the statement of stockholders' equity.






KEY POINT

The statement of stockholders' equity reports information related to changes in common stock and retained earnings each period. The change in retained earnings equals net income less dividends for the period.

Statement of Retained Earnings. Notice the middle column of the statement of stockholders' equity in Illustration 1–6. This column sometimes is referred to as the *statement of retained earnings*. In practice, companies don't report retained earnings in a separate statement from common stock, so that's why we demonstrate the statement of stockholders' equity. Nevertheless, it's useful to see that this column highlights how net income (revenues minus expenses) from the income statement links to total stockholders' equity by adding to the balance of retained earnings.

Manager Analysis

Question 	Accounting information 	Analysis 
Was the change in stockholders' equity the result of external or internal sources?	Statement of stockholders' equity	When a company sells common stock, equity increases due to external sources. When a company has profits during the year in excess of dividends paid, equity increases due to internal sources.

BALANCE SHEET

The **balance sheet** is a financial statement that presents the financial position of the company on a particular date. The financial position of a company is summarized by the accounting equation (see Illustration 1–3):

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

As discussed earlier, this equation provides a fundamental model of business valuation. Assets are the resources of the company, and liabilities are amounts owed to creditors. Stockholders have equity in the company to the extent that assets exceed liabilities. Creditors also need to understand the balance sheet; it's the company's assets that will be used to pay liabilities as they become due. Illustration 1–7 shows the balance sheet of Eagle Robotics.

EAGLE ROBOTICS Balance Sheet December 31, 2024			
Assets		Liabilities	
Cash	\$ 458,000	Accounts payable	\$ 14,000
Accounts receivable	287,000	Salaries payable	3,000
Supplies	4,000	Income tax payable	15,000
Inventory	500,000	Interest payable	5,000
Other assets	165,000	Other liabilities	82,000
Equipment, net	236,000	Notes payable	500,000
		Total liabilities	\$ 619,000
		Stockholders' Equity	
		Common stock	1,000,000
		Retained earnings	31,000
		Total stockholders' equity	1,031,000
Total assets	\$1,650,000	Total liabilities and stockholders' equity	\$1,650,000

ILLUSTRATION 1–7**Balance Sheet for Eagle Robotics****Common Terms**

Another name for the balance sheet is the *statement of financial position*.

From the statement of stockholders' equity

Here are some specifics about Eagle's balance sheet:

- **Heading**—The balance sheet reports assets, liabilities, and stockholders' equity at a *point in time*, in contrast to the income statement, which shows revenue and expense activities over an *interval of time*. For example, Eagle's income statement shows revenue and expense activity occurring *from* December 1 *to* December 31, 2024; its balance sheet shows assets, liabilities, and stockholders' equity of the company *on* December 31, 2024.
- **Assets**—These are the resources of a company. Eagle has total assets of **\$1,650,000**. *Cash* is a resource because it can be used to make purchases. *Accounts receivable* is a resource because they represent the right to receive cash from customers that have already been provided products or services. *Supplies* include resources used to run the business, such as paper, cleaning supplies, and basic office materials. *Inventory* and *Equipment* are resources that can be used to provide sales and services to customers.
- **Liabilities**—These are the amounts owed by a company. Eagle has total liabilities of **\$619,000**. These include amounts owed to regular vendors (accounts payable), as well as amounts owed for other items such as employee salaries, taxes to government agencies, interest, and bank borrowing (notes payable). Many liabilities are referred to as "payables" to signify amounts the company will "pay" in the future.
- **Stockholders' equity**—The difference between total assets and total liabilities of **\$1,031,000** represents stockholders' equity. Total stockholders' equity includes the amount of common stock plus the amount of retained earnings from the statement of stockholders' equity. We show the stockholders' equity items in purple here to indicate they came from the statement of stockholders' equity (Illustration 1–6).
- **Accounting Equation**—Notice that the amounts listed in the "balance sheet" show that the accounting equation "balances."

The income statement is like a video (shows events over time), whereas a balance sheet is like a photograph (shows events at a point in time).

Total assets must equal total liabilities and stockholders' equity.




Assets (resources)	=	Liabilities (creditors' claims)	+	Stockholders' Equity (owners' claims)
\$1,650,000	=	\$619,000	+	\$1,031,000



KEY POINT

The balance sheet demonstrates that the company's resources (assets) equal creditors' claims (liabilities) plus owners' claims (stockholders' equity) to those resources on a particular date.

Manager Analysis

Question 	Accounting information 	Analysis 
What are creditors' claims and owners' claims to the company's resources?	Balance sheet	The amount of total liabilities equals creditors' claims to the company's resources. The extent to which total assets exceed total liabilities represents owners' claims.

STATEMENT OF CASH FLOWS

The **statement of cash flows** is a financial statement that measures activities involving cash receipts and cash payments over an interval of time. We classify all cash transactions into three categories that correspond to the three fundamental business activities—operating, investing, and financing.

- **Operating cash flows** include cash receipts and cash payments for transactions involving revenue and expense activities that arise during normal business operations during the period. In other words, operating activities include the cash effects of the same activities that are reported in the income statement to calculate net income. For this reason, the statement of cash flows presents a reconciliation of net income to operating cash flows.
- **Investing cash flows** generally include cash transactions for the purchase and sale of investments and long-term assets. Long-term assets are resources owned by a company that are thought to provide benefits for more than one year.
- **Financing cash flows** include cash transactions with lenders, such as borrowing money and repaying debt, and with stockholders, such as issuing stock and paying dividends.

Illustration 1–8 provides the statement of cash flows for Eagle Robotics. The statement shows the cash flows for each type of activity, with net cash inflows shown as positive amounts and net cash outflows shown in parentheses to denote negative amounts. Cash flows from operating activities are most often computed as net income adjusted for certain reconciling items that we'll cover later. Cash flows from investing and financing activities are computed as all cash inflows minus all cash outflows associated with those activities.

The total of the net cash flows from operating, investing, and financing activities equals the *net change in cash* during the period.

$$\text{Change in cash} = \text{Operating cash flows} + \text{Investing cash flows} + \text{Financing cash flows}$$

For Eagle, the net change in cash for December was an increase of **\$458,000**. That amount equals the sum of its operating cash flows of $-\$788,000$, investing cash flows of $-\$240,000$,

EAGLE ROBOTICS
Statement of Cash Flows
For the month ended December 31, 2024

Net Income	\$ 45,000	
Reconciling items	<u>(833,000)</u>	
Cash flows from operating activities		\$ (788,000)
Cash flows from investing activities		\$ (240,000)
Cash flows from financing activities		<u>\$1,486,000</u>
Net increase in cash		\$ 458,000
Cash at the beginning of the period		<u>0</u>
Cash at the end of the period		<u>\$ 458,000</u>

ILLUSTRATION 1-8
Statement of Cash
Flows for Eagle
Robotics

Remember, amounts in parentheses indicate outflows of cash.

← Included in the balance sheet

and financing cash flows of \$1,486,000. The pattern of negative operating cash flows, negative investing cash flows, and positive financing cash flows is very common for start-ups. New companies generally have to make significant cash outlays to build-up inventory and to purchase equipment. We next add the beginning balance of cash. Because this is the first month of operations for Eagle, cash at the beginning of the period is zero. The ending balance of cash is the same as that reported in the balance sheet in Illustration 1-7. This reconciliation of the beginning and ending cash balances emphasizes that the statement of cash flows explains *why* the cash reported in the balance sheet changed from one period to the next.



KEY POINT

The statement of cash flows reports cash transactions from operating, investing, and financing activities for the period.

Decision Maker's Perspective

The statement of cash flows can be an important source of information to investors and creditors. For example, investors use the relationship between net income (revenues minus expenses) and operating cash flows (cash flows from revenue and expense activities) to forecast a company's future profitability. Creditors compare operating cash flows and investing cash flows to assess a company's ability to repay debt. Financing activities provide information to investors and creditors about the mix of external financing of the company.

User's Guide

Decision Maker's Perspective sections discuss the usefulness of accounting information to decision makers such as investors, creditors, and company managers.

STATEMENT OF COMPREHENSIVE INCOME

The **statement of comprehensive income** measures changes in equity that arise from non-owner sources. Items that can potentially impact comprehensive income include gains and losses associated with investments in certain types of debt securities, certain types derivatives, pensions, and foreign currency translations. If a company, like Eagle Robotics, does not have any changes in equity from nonowner sources, then they are not required to prepare a statement of comprehensive income. We will discuss this statement in more detail in Chapter 2.

THE LINKS AMONG FINANCIAL STATEMENTS

The financial statements are linked, because events that are reported in one financial statement often affect amounts reported in another. Many times, a single business transaction, such as receiving cash from a customer when providing services, will affect more than one of the financial statements. Providing services to a customer, for example, results in revenues recorded in the income statement, which are used to calculate net income. Net income, in turn, is reported in the calculation of retained earnings in the statement of stockholders'



Photodisc/Getty Images

equity. Then, the ending balance of retained earnings is reported in the balance sheet. **Thus, any transaction that affects the income statement ultimately affects the balance sheet through the balance of retained earnings.** The cash received from customers will be reported as part of the ending cash balance in the balance sheet and as part of operating cash flows in the statement of cash flows.

Illustration 1-9 shows the links among the financial statements of Eagle Robotics in Illustrations 1-5, 1-6, 1-7, and 1-8.

- Link [1] shows that net income from the income statement is reported in the statement of stockholders' equity as part of the calculation of retained earnings.
- Link [2] shows that after calculating the balance of retained earnings, the amount of total stockholders' equity can be reported in the balance sheet. Finally,
- Link [3] demonstrates that the balance of cash in the balance sheet equals the amount of cash reported in the statement of cash flows.

ILLUSTRATION 1-9**Links among Financial Statements**

[1] Notice that the amount of net income in the income statement reappears in the statement of stockholders' equity.

[2] Notice that the ending balance in the statement of stockholders' equity reappears in the balance sheet.

[3] Notice that the amount of cash in the balance sheet reappears as the ending cash balance in the statement of cash flows.

EAGLE ROBOTICS Income Statement			
Revenues	\$375,000		
Expenses	330,000		
Net income	<u>\$ 45,000</u>		

EAGLE ROBOTICS Statement of Stockholders' Equity			
	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance (Dec. 1)	\$ -0-	\$ -0-	\$ -0-
Issuance of common stock	1,000,000		1,000,000
Add: Net income for the period		45,000	45,000
Less: Dividends		(14,000)	(14,000)
Ending balance (Dec. 31)	<u>\$1,000,000</u>	<u>\$31,000</u>	<u>\$1,031,000</u>

EAGLE ROBOTICS Balance Sheet			
Cash	<u>\$ 458,000</u>	Liabilities	\$ 619,000
Other assets	<u>1,192,000</u>	Stockholders' equity	<u>1,031,000</u>
		Total liabilities and stockholders' equity	<u>\$1,650,000</u>
Total assets	<u>\$1,650,000</u>		

EAGLE ROBOTICS Statement of Cash Flows		
Net Income	\$ 45,000	
Reconciling items	<u>(833,000)</u>	
Cash flows from operating activities		\$ (788,000)
Cash flows from investing activities		(240,000)
Cash flows from financing activities		<u>1,486,000</u>
Net increase in cash		458,000
Cash at the beginning of the period		<u>-0-</u>
Cash at the end of the period		<u>\$ 458,000</u>

Test your understanding of what you've read so far. The Computer Shop repairs laptops, desktops, and mainframe computers. On December 31, 2024, the company reports the following year-end amounts:

Assets:	Cash	\$10,000	Revenues:	Service	\$65,000
	Supplies	8,000			
	Equipment, net	26,000			
Liabilities:	Accounts payable	4,000	Expenses:	Rent	6,000
	Notes payable	10,000		Supplies	14,000
				Salaries	40,000

Additional information:

- The balance of retained earnings at the beginning of the year is \$7,000.
- The company pays dividends of \$1,000 on December 31, 2024.
- Common stock is \$15,000 at the beginning of the year, and additional shares are issued for \$4,000 during 2024.

Required:

Prepare the (1) income statement, (2) statement of stockholders' equity, and (3) balance sheet.

Solution:

1. Income statement:

THE COMPUTER SHOP Income Statement Year ended Dec. 31, 2024	
Revenues:	
Service revenue	\$65,000
Expenses:	
Rent expense	6,000
Supplies expense	14,000
Salaries expense	40,000
Net income	\$ 5,000

2. Statement of stockholders' equity:

THE COMPUTER SHOP Statement of Stockholders' Equity Year ended Dec. 31, 2024			
	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance (Jan. 1)	\$15,000	\$ 7,000	\$22,000
Issuance of common stock	4,000		4,000
Add: Net income		5,000	5,000
Less: Dividends		(1,000)	(1,000)
Ending balance (Dec. 31)	<u>\$19,000</u>	<u>\$11,000</u>	<u>\$30,000</u>

3. Balance sheet:

THE COMPUTER SHOP Balance Sheet December 31, 2024			
<u>Assets</u>		<u>Liabilities</u>	
Cash	\$10,000	Accounts payable	\$ 4,000
Supplies	8,000	Notes payable	10,000
Equipment	26,000	Stockholders' Equity	
		Common stock	19,000
		Retained earnings	11,000
Total assets	<u>\$44,000</u>	Total liabilities and stockholders' equity	<u>\$44,000</u>

Let's Review



**KEY POINT**

All transactions that affect revenues or expenses reported in the income statement ultimately affect the balance sheet through the balance in retained earnings.

PART B**LO1-4**

Describe the role that financial accounting plays in the decision-making process.

THE DEMAND FOR FINANCIAL ACCOUNTING INFORMATION

As discussed in Part A, accounting plays a critical role in communicating the financial story of a company. To this point, we've presented a simple look at how the financial story of a start-up company is measured and communicated to external users. Subsequent chapters will provide a more detailed view of this measurement and communication process. Before proceeding, it's important to understand a little more about the *demand* for accounting information by external users and the role of accounting in helping users to make decisions.

Making Decisions with Accounting Information

In a free-enterprise economy, the majority of productive resources are privately owned rather than government owned. For the economy to operate efficiently, these resources should be allocated to enterprises that will use them best to provide the goods and services desired by society and not to enterprises that will waste them. The mechanisms that foster this efficient allocation of resources are the **capital markets**. We can think of the capital markets simply as a composite of all investors and creditors who provide funds to businesses who need them. Businesses go to the capital markets to obtain the cash necessary for the business to function and grow.

But how do investors and creditors identify the successful companies from the unsuccessful companies? How do they get the information necessary to make good investment decisions that help develop a prosperous society? Here's where financial accounting enters the picture. **Investors and creditors rely heavily on financial accounting information in making investment and lending decisions.**

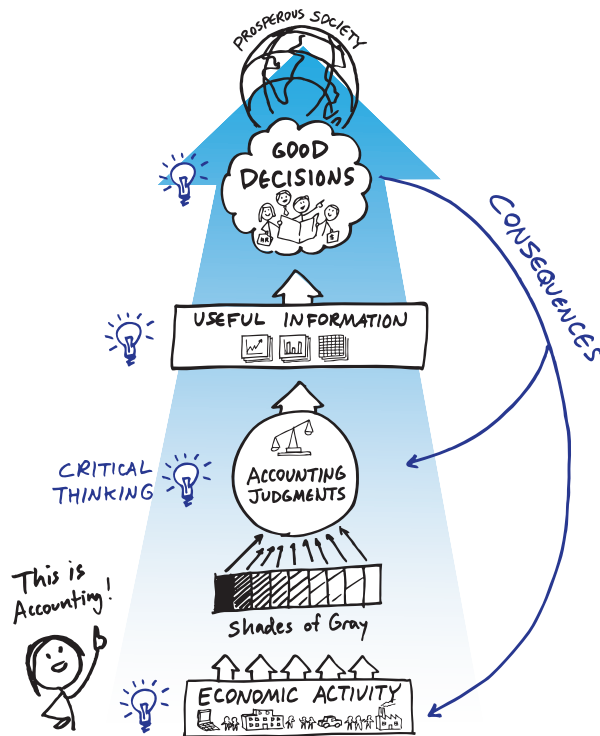
Think of financial accounting as a special "language" that companies use to communicate financial information to capital market participants. The Pathways Commission of the American Accounting Association developed an illustration to help visualize this important role of accounting. As shown in Illustration 1-10, accounting provides useful information about economic activity to help produce good decisions and foster a prosperous society. Economic activity is complex, and decisions have real consequences, so critical thinking and many judgments are needed to produce the most useful accounting information possible.

USEFULNESS OF FINANCIAL STATEMENTS

A recent survey of professional financial statement users (investors, creditors, analysts) examined the usefulness of the financial statements for six different decisions, including

1. Assessing the prospect of future cash flows.
2. Estimating firm value.
3. Identifying red flags.
4. Evaluating risks and uncertainties.
5. Assessing credit risk.
6. Evaluating management.

You can imagine that these decisions require reliable information, which you can get from the financial statements. The survey asked participants to assess the usefulness for these decisions of the five financial statements—balance sheet, income statement, statement



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ILLUSTRATION 1-10

Pathways Commission Visualization: "THIS is Accounting!"

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of cash flows, statement of stockholders' equity, and statement of comprehensive income.² The survey participants assessed each statement on a scale of 1 (not important) to 5 (very important).

We present the survey results in Illustration 1-11.

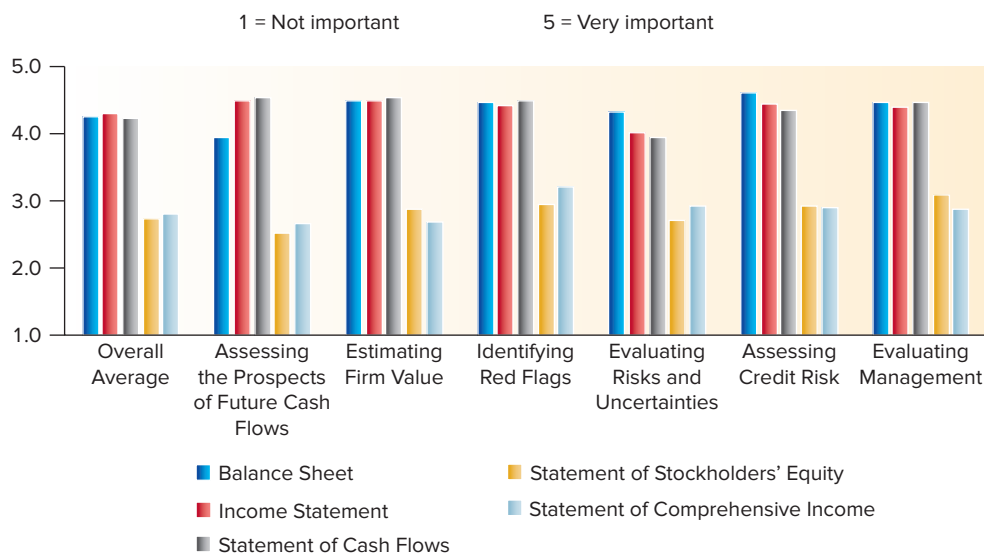


ILLUSTRATION 1-11

Professional User Perceptions of Financial Statement Usefulness

²Drake, M. S., Hales, J., & Rees, L. (2017). Disclosure Overload? A Professional-User Perspective on the Usefulness of General Purpose Financial Statements. *Contemporary Accounting Research* Vol. 36 (4).

The survey results reveal that the balance sheet, income statement, and statement of cash flows are all deemed to be important or very important to financial statement users for all tasks. The statement of stockholders' equity and the statement of comprehensive income are deemed to be less important than the other three statements. In Chapter 2, we discuss each of these statements in much more detail to learn more about the information investors and creditors can learn from each. Overall, the results of this survey indicate that financial accounting information is highly useful in making important information-based decisions.

**KEY POINT**

Financial accounting serves an important role by providing information useful in investment and lending decisions.

LINK BETWEEN ACCOUNTING AND COMPANY VALUE

To demonstrate the importance of financial accounting information to investment decisions, we can look at the relationship between changes in stock prices and changes in net income over the past 10 years. As an investor, you will make money from an increase in the stock price of a company in which you invest (you can sell the stock for more than you bought it). So as an investor, you are looking for companies whose stock price is likely to increase. Is there a way to find such companies? Interestingly, there is: **No other single piece of company information better explains companies' stock price performance than does financial accounting net income**, the bottom line in the income statement.

What if you could accurately predict which companies would have the largest increases in net income over the next year—that is, suppose you could predict the companies that will be above the 75th percentile in terms of their net income changes—and then you invested \$1,000 in these companies? In contrast, what if instead you invested \$1,000 in companies with the largest decreases in net income—that is, companies in the bottom 25th percentile in terms of their net income changes. Illustration 1-12 shows what would happen to your \$1,000 investment over 10 years for each scenario.

You can see that if you had invested \$1,000 in companies with the largest increases in net income, your investment would have increased to about \$3,500 over the 10-year period. That's a 250% increase! If instead you had invested \$1,000 in companies with the largest decreases in net income, your \$1,000 investment would have shrunk to about \$400 over this same period. This dramatic difference in the value of the investment demonstrates the importance of financial accounting information to investors. This book will provide you with a thorough understanding of how net income is calculated and presented in financial statements. As you can see from the illustration, if you are able to predict the change in financial accounting's measure of profitability—net income—then you can predict the change in stock prices as well.

Investors and creditors also use information reported in the balance sheet. For example, the liabilities section of the balance sheet reports *total debt*. Expanding debt levels limit management's ability to respond quickly and effectively to business situations. The "overhanging" debt, which involves legal obligation of repayment, restricts management's ability to engage in new profit-generating activities. Increased debt levels also increase interest payment burdens on the company. Failure to pay interest or to repay debt can result in creditors forcing the company to declare bankruptcy and go out of business. Understandably, then, investors and creditors keep a close eye on the company's debt level and its ability to repay.

**KEY POINT**

No single piece of company information better explains companies' stock price performance than does financial accounting net income. A company's debt level is an important indicator of management's ability to respond to business situations and the possibility of bankruptcy.



*Amounts in this chart represent the investment growth based on the median stock return of each group each year. Companies in the top (bottom) group include the 25 percent of all U.S. listed companies with the largest increase (decrease) in net income. Each group has an average of about 1,700 companies per year.

ILLUSTRATION 1-12

Relationship between Changes in Stock Prices and Changes in Net Income over a 10-Year Period

The Demand for Comparable Accounting Information

Because financial accounting information is so vital to investors and creditors, formal standards have been established. The rules of financial accounting are called **generally accepted accounting principles**, often abbreviated as **GAAP** (pronounced *gap*). The fact that all companies use these same rules is critical to financial statement users. It helps investors to accurately *compare* financial information among companies when they are making decisions about where to invest or lend their resources.

STANDARD SETTING AND THE OBJECTIVES OF FINANCIAL REPORTING

The 1933 Securities Act and the Securities Exchange Act of 1934 were enacted after the stock market crash and ensuing Great Depression of the 1930s to restore investor confidence in financial accounting. The 1933 act sets forth accounting and disclosure requirements for initial offerings of securities (stocks and bonds). The 1934 act created a government agency, the **Securities and Exchange Commission (SEC)**. The 1934 act gives the SEC the power to require companies that publicly trade their stock to prepare periodic financial statements for distribution to investors and creditors.

While Congress has given the SEC both the power and the responsibility for setting accounting and reporting standards for publicly traded companies, the SEC has delegated the primary responsibility for setting accounting standards to the private sector, currently the **Financial Accounting Standards Board (FASB)** (pronounced either by the letters themselves or as *faz-be*). The FASB is an independent, private-sector body with full-time voting members and a very large support staff. Members include representatives from the accounting profession, large corporations, financial analysts, accounting educators, and government agencies. Note that the SEC delegated only the responsibility, not the authority, to set these standards. The power still lies with the SEC. If the SEC does not agree with a particular standard issued by the FASB, it can force a change in the standard. In fact, it has done so in the past.

LO1-5

Explain the need for accounting standards and the demand by investors and creditors for audited financial statements.

For information about the activities of the Financial Accounting Standards Board, see its website, www.fasb.org.

**KEY POINT**

The rules of financial accounting are called generally accepted accounting principles (GAAP). The Financial Accounting Standards Board (FASB) is an independent, private body that has primary responsibility for the establishment of GAAP in the United States.

The FASB has explicitly stated the specific objectives of financial accounting. These objectives are presented in Illustration 1–13.

ILLUSTRATION 1–13**Objectives of Financial Accounting****Financial accounting should provide information that:**

1. Is useful to investors and creditors in making decisions.
2. Helps to predict cash flows.
3. Tells about economic resources, claims to resources, and changes in resources and claims.

Not all countries follow the same accounting and reporting standards. Many countries around the world follow broad standards set by the **International Accounting Standards Board (IASB)** and then often customized those standards to their particular country. The standards being developed and promoted by the IASB are called **International Financial Reporting Standards (IFRS)**. The FASB and IASB have made several efforts to converge U.S. GAAP and IFRS, although some differences remain.

THE DEMAND FOR CREDIBLE ACCOUNTING INFORMATION

For many businesses, there is a natural separation between those who run the business (managers) and those who own the business or finance operations (investors and creditors). This separation creates the need to ensure honest financial reporting. Managers may purposely provide misleading financial accounting information, called “cooking the books” for several reasons, such as to hide the poor operating performance of the company or to increase their personal wealth at stockholders’ expense.

To help ensure that management has in fact appropriately applied GAAP, the SEC requires independent outside verification of the financial statements of publicly traded companies. Such independent examination is done by **auditors**, who are *not* employees of the company, but who are hired by the company as an independent party to express a professional opinion of the extent to which financial statements are prepared in compliance with GAAP and are free of material misstatement. If auditors find material mistakes or fraudulent reporting behavior, then they require the company to correct all significant information before issuing financial statements. **Auditors play a major role in investors’ and creditors’ decisions by adding credibility to a company’s financial statements.**

Auditors formally state their professional opinion about the financial statements in a report called the “Report of Independent Auditors.” There are four basic types of auditor reports:

1. *Unqualified.* An auditor issues an unqualified or “clean” opinion when it is their opinion that the financial statements are presented in conformity with GAAP and free of material misstatement.
2. *Unqualified with an explanatory or emphasis paragraph.* An auditor believes the financial statements are in conformity with GAAP (unqualified), but the auditor feels that other important information needs to be emphasized to financial statement users.
3. *Qualified.* An auditor issues a qualified opinion when either the audit process has been limited (scope limitation), or there has been a departure from GAAP, but neither is of sufficient seriousness to invalidate the financial statements as a whole.

Common Terms

The auditor’s report is also commonly referred to as the *auditor’s opinion*.

4. *Adverse.* An auditor issues an adverse opinion when the auditor has specific knowledge that financial statements or disclosures are seriously misstated or misleading. Adverse opinions are rare because auditors usually are able to persuade management to rectify problems to avoid this undesirable report.

Illustration 1–14 presents an excerpt from the auditor’s report for **Tesla**. The auditor’s report indicates that the financial statements for the period mentioned have been prepared in conformity with GAAP.

Tesla
Report of Independent Auditors (excerpt)

To the Board of Directors and Stockholders of Tesla, Inc.

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of Tesla, Inc. and its subsidiaries (the “Company”) as of December 31, 2020 and 2019 and the related consolidated statements of operations, of comprehensive loss, of redeemable noncontrolling interests and equity, and of cash flows for each of the three years in the period ended December 31, 2020, including the related notes (collectively referred to as the “consolidated financial statements”).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2020 and 2019, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2020 in conformity with accounting principles generally accepted in the United States of America.

/s/PricewaterhouseCoopers LLP

San Jose, California

February 8, 2021

We have served as the Company’s auditor since 2005.

ILLUSTRATION 1–14

Excerpt from the
Independent Auditor’s
Report of Tesla

To further enhance the credibility of financial reporting, Congress established in 2002 the **Public Company Accounting Oversight Board (PCAOB)**. The role of the PCAOB is to ensure that auditors follow a strict set of guidelines when conducting their audits of public companies’ financial statements. The PCAOB is a government entity that, simply stated, “audits the auditors.”



KEY POINT

Auditors play a major role in investors’ and creditors’ decisions by adding credibility to a company’s financial statements.

AN ETHICAL FOUNDATION

Investors, creditors, government, and the general public rely on general ethical behavior among those who record and report the financial activities of businesses. A lack of public trust in financial reporting can undermine business and the economy.

The **Sarbanes-Oxley Act (SOX)**, named for the two congressmen who sponsored the bill, provides for the regulation of auditors and the types of services they furnish to clients, increases accountability of corporate executives, addresses conflicts of interest for securities analysts, and provides for stiff criminal penalties for violators. These increased requirements have dramatically increased the need for good accounting and, at the same time, highlighted the value of accounting information to investors and creditors.

Important as such legislation is in supporting the ethical foundation of accounting, it is equally important that accountants themselves have their own personal standards for

ethical conduct. Managers need to *develop* their ability to identify ethical situations and know the difference between right and wrong in the context of the accounting topics you will learn in this course. One of the keys to ethical decision making is having an appreciation for how your actions affect others.

When you face ethical dilemmas in your professional life (and indeed in your personal life), you can apply the following simple four-step framework as you think through what to do:

1. Understand the ethical decision you face.
2. Specify the options for alternative courses of action.
3. Identify the impact of each option on the stakeholders.
4. Make a decision.

For accountants, ethical decisions most often involve understanding how their actions affect amounts reported in the financial statements. An “Ethics Case” is included at the end of each chapter to give you an opportunity to practice this four-step process in the context of financial reporting.



KEY POINT

The primary objective of financial accounting is to provide useful information to investors and creditors in making decisions.

PART C

THE SUPPLY OF FINANCIAL ACCOUNTING INFORMATION

In Part B, we discussed why investors and creditors demand financial accounting information. We now discuss in more detail the many different types of financial accounting information that companies provide to capital markets—in other words, the *supply* of financial accounting information. While some investors and creditors may only be interested in the primary financial statements that we discussed in Part A, others demand more detail about the financial performance of the company, its financial position, and its prospects for the future. Companies supply additional financial accounting disclosures in annual and quarterly reports.

Annual Reports

At the end of each fiscal year, companies with public securities are required to provide stockholders with an annual report in a Form 10-K. Private companies are also often required to provide annual reports to lenders. The annual report includes the five primary financial statements: balance sheet, income statement, statement of cash flow, statement of stockholders’ equity, and the statement of comprehensive income. Financial statements, though, are only part of the information provided in the annual report. Critical to understanding the financial statements and to evaluating a company’s performance and financial health are additional disclosures included as part of the financial statements and also as part of the annual reporting requirements to the SEC.

The amount of information provided by annual report disclosures can be significant. For example, **Tesla**’s most recent annual report filed with the SEC included five pages of financial statements followed by 61 pages of related disclosure notes. There were another 107 pages of disclosures related to business conditions, risk factors, legal proceedings, the company’s stock performance, management’s discussion and analysis, and internal control procedures. We discuss some of the annual report disclosures in the next section.

DISCLOSURE NOTES

Some financial statement items include supporting discussion, calculations, and schedules in the notes following the financial statements. These disclosure notes are the most

LO1-6

Understand the types of financial statement disclosures that companies provide in annual and quarterly reports.

common means of providing disaggregated information or other additional information. For example, Tesla's balance sheet reports inventory of approximately \$4.1 billion. Illustration 1–15 provides an excerpt of Tesla's inventory note that provides the disaggregation of inventory into its various categories: raw materials, work in process, finished goods, and service parts.

Tesla
Notes to the Financial Statements (excerpt)

(\$ in millions)	December 31, 2020
Raw materials	\$1,508
Work in process	493
Finished goods	1,666
Service parts	434
Total	<u>\$4,101</u>

ILLUSTRATION 1–15

Excerpt from Tesla's
Annual Report

Most annual reports include a dozen or so additional notes on topics including investments, inventory, property and equipment, intangible assets, debt, leases, taxes, and employee compensation. We discuss and illustrate these in later chapters in the context of the related financial statement items.

The disclosure notes must include certain specific notes such as a summary of significant accounting policies, descriptions of subsequent events, and related third-party transactions, but many notes are fashioned to suit the disclosure needs of the particular reporting enterprise. Actually, any explanation that contributes to investors' and creditors' understanding of the results of operations, financial position, and cash flows of the company should be included. Let's take a look at just a few of these disclosure notes.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Typically, the first disclosure note consists of a summary of significant accounting policies that discloses some of the financial accounting choices the company makes. There are many areas where management chooses from among equally acceptable alternative accounting methods. For example, management chooses between different methods of accounting for inventory and for depreciation. The company also discusses its policies regarding the timing of recognizing revenues. Illustration 1–16 shows a portion of a typical summary note from a recent annual report of the Tesla.

Studying the summary of accounting policies note is an essential step in analyzing financial statements. Obviously, knowing which methods were used to derive certain accounting numbers is critical to assessing the adequacy of those amounts.

MANAGEMENT'S DISCUSSION AND ANALYSIS

In addition to the financial statements and accompanying disclosure notes, each annual report requires a fairly lengthy discussion and analysis provided by the company's management. In this section, which precedes the financial statements and the auditor's report, management provides its views on significant events, trends, and uncertainties pertaining to the company's (a) operations, (b) liquidity, (c) capital resources, (d) off-balance sheet arrangements, and (e) critical accounting estimates. Although the management's discussion and analysis (MD&A) section may embody management's biased perspective, it can offer an informed insight that might not be available elsewhere. Illustration 1–17 contains a small portion of Tesla's MD&A in its annual report.

ILLUSTRATION 1–16

Excerpt from Tesla's
Summary of Accounting
Policies

Tesla
Summary of Accounting Policies (excerpt)

Revenue Recognition

We recognize revenue on automotive sales upon delivery to the customer, which is when the control of a vehicle transfers.

Cash and Cash Equivalents

All highly liquid investments with an original maturity of three months or less at the date of purchase are considered cash equivalents. Our cash equivalents are primarily comprised of money market funds.

Property, Plant and Equipment

Property, plant and equipment, including leasehold improvements, are recognized at cost less accumulated depreciation. Depreciation is generally computed using the straight-line method over the estimated useful lives of the respective assets.

Research and Development Costs

Research and development costs are expensed as incurred.

Warranties

We provide a manufacturer's warranty on all new and used vehicles, production powertrain components and systems and energy storage products we sell. In addition, we also provide a warranty on the installation and components of the solar energy systems we sell for periods typically between 10 to 25 years. We accrue a warranty reserve for the products sold by us, which includes our best estimate of the projected costs to repair or replace items under warranties and recalls when identified.

ILLUSTRATION 1–17

Excerpt from Tesla's
Management
Discussion and
Analysis

Tesla
Management Discussion and Analysis (excerpt)

Overview and 2020 Highlights

Our mission is to accelerate the world's transition to sustainable energy. We design, develop, manufacture, lease and sell high-performance fully electric vehicles, solar energy generation systems and energy storage products. We also offer maintenance, installation, operation and other services related to our products.

Automotive

We recently announced updated versions of Model S and Model X featuring a redesigned powertrain and other improvements. In 2021, we are focused on ramping these models on new manufacturing equipment, as well as production rates of Model 3 and Model Y, to at least the capacity that we have installed. The next phase of production growth will depend on the construction of Gigafactory Berlin and Gigafactory Texas, each of which is progressing as planned for deliveries beginning in 2021.

Liquidity and Capital Resources

As of December 31, 2020, we had \$19.38 billion of cash and cash equivalents. Balances held in foreign currencies had a U.S. dollar equivalent of \$6.76 billion and consisted primarily of euros, Chinese yuan and Canadian dollars. Our sources of cash are predominantly from our deliveries of vehicles, sales and installations of our energy storage products and solar energy systems, proceeds from debt facilities, proceeds from financing funds and proceeds from equity offerings.

2020 Compared to 2019

Automotive sales revenue increased \$6.23 billion, or 31%, in the year ended December 31, 2020 as compared to the year ended December 31, 2019, primarily due to an increase of 129,268 Model 3 and Model Y cash deliveries despite production limitations as a result of temporary suspension of production at the Fremont Factory and Gigafactory Nevada during the first half of 2020. We were able to increase deliveries year over year from production ramping at both Gigafactory Shanghai and the Fremont Factory.

COMPENSATION OF DIRECTORS AND TOP EXECUTIVES

The compensation large U.S. corporations pay its top executives is an issue of considerable public debate and controversy. Stockholders, employees, politicians, and the public in general sometimes question the huge pay packages received by company officials at the same time that more and more rank-and-file employees are being laid off as a result of company cutbacks. Contributing to the debate is the realization that the compensation gap between executives and lower-level employees is much wider in the United States than in most other industrialized countries.

A substantial portion of executive pay often is in the form of stock options or restricted stock awards. Executive stock options give an individual the right to buy the company's stock at a set price, regardless of how high the stock price rises. Restricted stock is a unit of stock given to an employee, but that unit of stock is not fully transferable until certain conditions are met (such as length of employment or attainment of performance goals). In recent years, restricted stock as a form of compensation has become more popular than stock options.

To help stockholders and others sort out the content of executive pay packages and better understand the commitments of the company in this regard, the SEC requires disclosures on compensation to directors and executives. A proxy statement is provided each year and includes compensation information for directors and top executives. The statement also invites stockholders to the annual meeting to elect board members and to vote on issues before the stockholders or to vote by proxy. Illustration 1-18 provides the compensation table for Tesla.

**Tesla
Compensation Table**

Name and Principal Position	Salary	Option Awards	Total
Elon Musk, Chief Executive Officer	\$ 56,380	\$2,283,988,504	\$2,284,044,884
Jeffrey B. Straubel, Chief Technology Officer	250,560	11,416,860	11,667,420
Jerome Guillen, President Automotive	301,154	17,450,897	17,752,051
Deepak Ahuja, Former Chief Financial Officer	501,923	5,708,430	6,210,353

This note reveals that Elon Musk, the CEO of Tesla, earned a salary of \$56 thousand and was awarded stock options with a value of \$2.3 billion! However, it is important to recognize that these option awards are performance-based and that Elon Musk is not able to convert these options into cash because they have not yet "vested." The disclosure further reveals that a portion of these option awards become vested as the market value of Tesla hits certain milestones, such as doubling from its current market value of \$50 billion to \$100 billion. More options become vested as the market value grows in \$50 billion increments thereafter (e.g., at \$150 billion, \$200 billion, etc.). All stock option awards become vested only when the market value of Tesla reaches \$650 billion.

AUDITOR'S REPORT

As discussed in Part B, independent auditors examine the financial statements and notes and then express an opinion as to whether the information is presented in accordance with GAAP and free of material misstatements. Illustration 1-14 provides an example of this report from Tesla. The auditor's report is included as part of the annual report.

ILLUSTRATION 1-18

Excerpt from Tesla's
Proxy Statement

Quarterly Reports

Public companies are required to file quarterly financial statements with the SEC on Form 10-Q. These quarterly reports are similar to the annual reports in that they include a full set of financial statements and the management discussion and analysis (MD&A) section. However, the quarterly reports provide limited additional financial notes. The most recent quarterly report for Tesla includes 26 pages of additional notes compared to 61 pages of notes in the annual report. Quarterly reports are not audited by the independent auditors. Tesla makes this clear to financial statement users by stating that the statement is “unaudited” at the top of each of the financial statements.



KEY POINT

In addition to providing the primary financial statements, companies must also provide additional financial disclosures that provide disaggregated information and other additional information that supports the amounts reported in the financial statements. These additional disclosures also include a summary of significant accounting policies, descriptions of subsequent events, discussion of any related third-party transactions, management discussion and analysis, and information about executive compensation. For public companies, this information is provided annually to the SEC in a Form 10-K, and a subset of this information is provided each quarter to the SEC in a Form 10-Q.

Current Reports

In addition to filing annual reports on Form 10-K and quarterly reports on Form 10-Q, public companies must report certain major events on a more timely basis. These reports are called “current reports” and are filed with the SEC on Form 8-K. Companies generally have no more than four business days to file a current report once an event has taken place. Here are some examples of the types of events that should be reported in a current report.

The company has

- Publicly announced the results of quarterly and annual operations.
- Filed its quarterly or annual financial statements with the SEC.
- Entered into an agreement to acquire another company.
- Completed the acquisition or divestiture of another company.
- Delisted a security from a public exchange.
- Restated previously filed financial statements.
- A director or key officer that is departing.
- Declared bankruptcy.

Illustrations 1–19 and 1–20 provide examples of two current reports for Tesla. In the first example, Tesla is announcing that its financial results of the quarter ended September 30, 2020, have been released on its website. In the second example, Tesla discloses that it completed the sale of a new stock offering.

LO1–7

Understand the types of financial statement disclosures that companies provide in current reports.

ILLUSTRATION 1–19

Excerpt from a Current Report of Tesla

Tesla Current Report (excerpt)

Results of Operations and Financial Condition

On October 21, 2020, Tesla, Inc. released its financial results for the quarter ended September 30, 2020, by posting its Third Quarter 2020, Update on its website. The full text of the update is attached hereto as Exhibit 99.1 and is incorporated herein by reference.