

WARREN | REEVE | DUCHAC

Financial & Managerial Accounting



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Financial and Managerial Accounting ^{14e}

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Roadmap for Success

Warren/Reeve/Duchac *Financial and Managerial Accounting, 14e*, makes it easy for you to give students a solid foundation in business and accounting. Warren/Reeve/Duchac covers the fundamentals AND motivates students to learn by showing how accounting is important to a business.

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

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

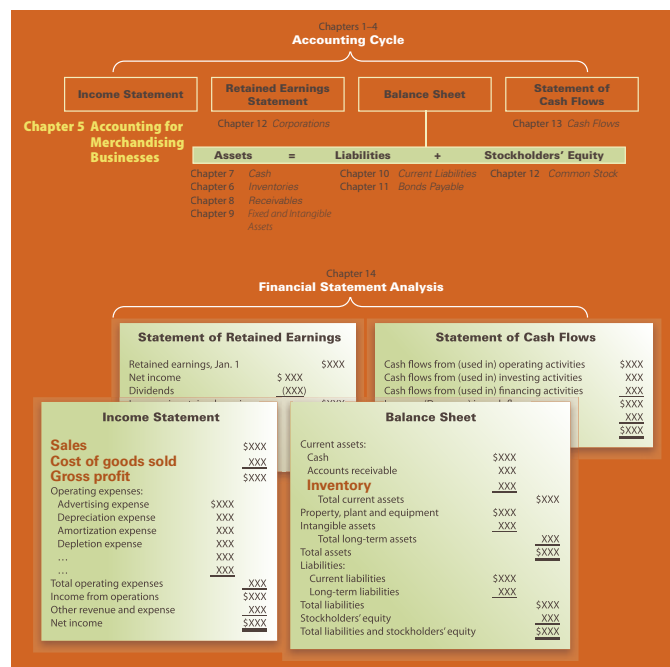
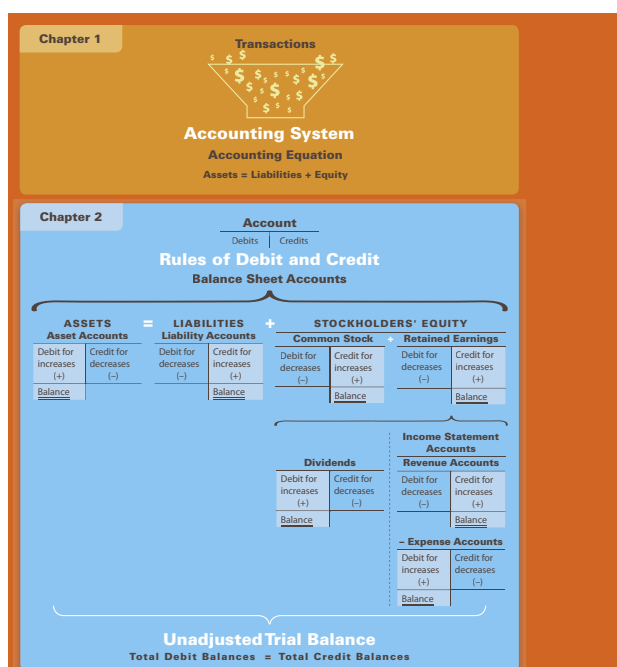
- New! Schema
- New! Links to Business
- New! Why It Matters
- New! Analysis for Decision Making and Make a Decision
- New! Accounting Equation Impacts added beside journal entries

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

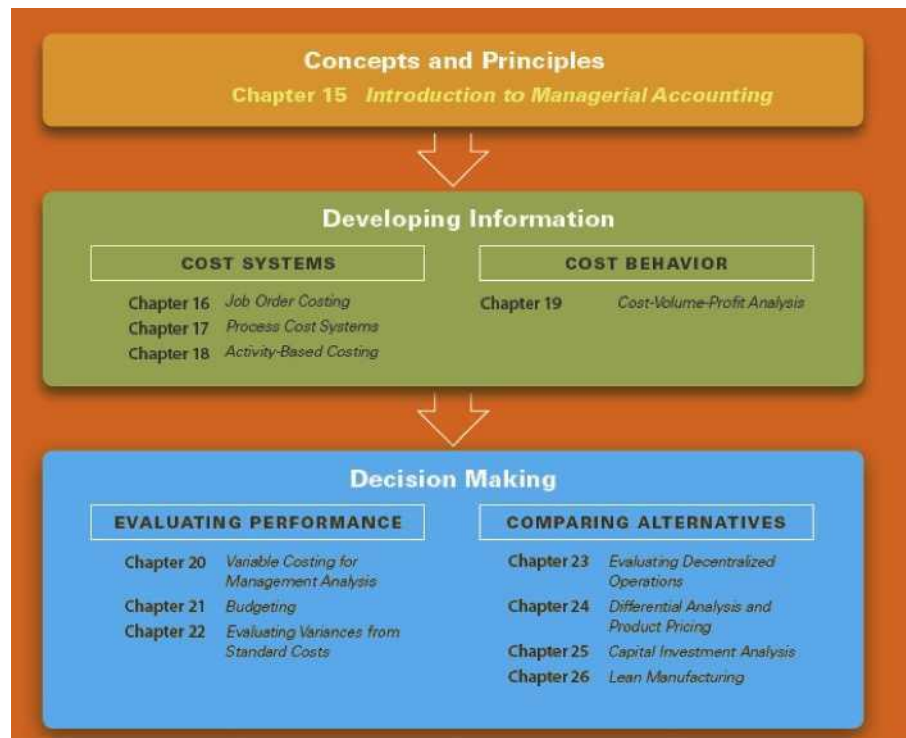
- Stepwise approach to accounting cycle
- Presentation style designed around the way students learn
- New! Check Up Corner
- New! Let's Review

Hallmarks of the revision include:

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



The schema in the managerial accounting chapters emphasizes the role of managerial accounting in developing and providing information for decision making.



"The schema shows the 'big picture.' It connects all the chapters. Students need help seeing the big picture and the connection."

— Gloria Sanchez, Mt. San Jacinto College

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



McDonald's recently reported that it is the lessee in over 14,000 locations. The leases are normally for 20 years with an option to renew.

Link to McDonald's

The accounting for leases is currently the focus of a joint project by the Financial Accounting Standards (FASB) and the International Accounting Standards Board (IASB) to merge U.S. and international standards.² Under the proposed standard lessors and lessees would be required to record assets and liabilities related to certain long-term lease contracts.

IFRS
See Appendix C for more information.

For purposes of this text, we assume that leases are short-term and not extending beyond one year. Thus, lease payments are recorded as rent by debiting Rent Expense and crediting Cash. The lease terms, such as a renewal option, may be disclosed in the notes to the financial statements. The asset rentals described in the earlier chapters of this text were accounted for in this manner.

- **NEW!** Located early in each chapter, **Why It Matters** shows students how accounting is important to businesses with which they are familiar.

Why It Matters

Fixed Assets

Fixed assets often represent a significant portion of a company's total assets. The table that follows shows the fixed assets as a percent of total assets for some select companies across a variety of industries.

As can be seen, the type of industry will impact the proportion of fixed assets to total assets. Retail has the highest percent of fixed assets to total assets, while social media and software are on the lower end of the scale. High-tech service companies often use fewer fixed assets to deliver their services than will companies that use stores, equipment, planes, cell towers, or theme parks.

Company	Industry	Percent of Fixed Assets to Total Assets
McDonald's Corporation	Food Retail	72%
Target Corporation	Merchandise Retail	63%
Alcoa Inc.	Heavy Industry	44%
Delta Air Lines, Inc.	Transportation	41%
Verizon Communications Inc.	Communications	39%
The Walt Disney Company	Entertainment	28%
Facebook, Inc.	Social Media	10%
Microsoft Corporation	Software	8%

Fixed assets have important properties that require management attention:

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

"These features show students the relevance to the business world of what they are learning and so should help motivate them to learn."

— Steven J. LaFave, Augsburg College

"It does a good job of bringing the materials into a 'real world' environment."

— Bob Urell, Irvine Valley College

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

2019			
Jan. 3	Inventory	2,510	
	Cash		2,510
	Purchased inventory from Bowen Co.		

$$\begin{array}{rcl} \mathbf{A} & = & \mathbf{L} + \mathbf{E} \\ + - & & \end{array}$$

Purchases of inventory on account are recorded as follows:

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

$$\begin{array}{rcl} \mathbf{A} & = & \mathbf{L} + \mathbf{E} \\ + & & + \end{array}$$

The terms of purchases on account are normally indicated on the **invoice** or bill that the seller sends the buyer. An example of an invoice sent to **NetSolutions** by Alpha Technologies is shown in Exhibit 2.

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

Check Up Corner 9-1 Fixed Assets

On the first day of the year, Firefall Company acquired equipment for use in operations at a cost of \$340,000. The equipment was expected to have a useful life of four years or 1,000 hours, and a residual value of \$20,000. The equipment was used for 280 hours during the first year, 260 hours during the second year, 240 hours during the third year, and 220 hours during the fourth year.

- A. Determine the annual depreciation expense in each year and the book value of the equipment at the end of each year under the:
1. straight-line method
 2. units-of-activity method
 3. double-declining-balance method
- B. Assuming the equipment was sold for \$95,000 on the first day of the fourth year of operations, journalize the entry to record the sale if the equipment was depreciated under the:
1. straight-line method
 2. units-of-activity method
 3. double-declining-balance method

Solution:

- A. 1. Straight-Line Method:

$$\text{Annual Depreciation Expense} = \frac{\text{Cost} - \text{Residual Value}}{\text{Useful Life}} = \frac{\$340,000 - \$20,000}{4 \text{ Years}} = \$80,000$$

The straight-line percentage is computed as follows:

$$\text{Straight-Line Percentage} = \frac{100\%}{4 \text{ Years}} = 25\%$$

Annual depreciation expense and end-of-year book value are computed as follows:

Year	Calculation of Depreciation				End of Year	
	Straight-Line Percentage	x	Depreciable Cost	=	Annual Depreciation Expense	Book Value
1	25%	x	\$320,000	=	\$80,000	\$260,000
2	25%	x	320,000	=	80,000	180,000
3	25%	x	320,000	=	80,000	100,000
4	25%	x	320,000	=	80,000	20,000

Book Value =
Asset Cost (\$340,000) –
Accumulated Depreciation
← Ending Book Value =
Residual Value

2. Units-of-Activity Method:

$$\text{Depreciation per Hour of Use} = \frac{\text{Cost} - \text{Residual Value}}{\text{Total Number of Hours}} = \frac{\$340,000 - \$20,000}{1,000 \text{ Hours}} = \$320 \text{ per Hour}$$

Annual depreciation expense and end-of-year book value are computed as follows:

Year	Calculation of Depreciation				End of Year	
	Depreciation per Hour of Use	x	Total Hours of Activity Used	=	Annual Depreciation Expense	Book Value
1	\$320	x	280	=	\$89,600	\$250,400
2	320	x	260	=	83,200	167,200
3	320	x	240	=	76,800	90,400
4	320	x	220	=	70,400	20,000

Book Value =
Asset Cost (\$340,000) –
Accumulated Depreciation
← Ending Book Value =
Residual Value

"These are good, I like the step-by-step approach. I also like it when it reinforces concepts before the solution begins."

– Pam Neely, The College at Brockport, SUNY

- In each chapter, **Analysis for Decision Making** highlights how businesses use accounting information to make decisions and evaluate the health of a business. This provides students with context of why accounting is important to a business.

Analysis for Decision Making

Nonmanufacturing Staffing Levels

The budgeting illustrated in this chapter is similar to budgeting used for nonmanufacturing businesses. However, many nonmanufacturing businesses often do not have direct materials purchases budgets, direct labor cost budgets, or factory overhead cost budgets. Thus, the budgeted income statement is simplified in many nonmanufacturing settings.

A primary budget in nonmanufacturing businesses is the labor, or staffing, budget. This budget, which is highly flexible to service demands, is used to manage staffing levels. For example, a theme park will have greater staffing in the summer vacation months than in the fall months. Likewise, a retailer will have greater staffing during the holidays than on typical weekdays.

To illustrate, Concord Hotel operates a hotel in a business district. The hotel has 150 rooms that average 120 guests per night during the weekdays and 50 guests per night during the weekend. The housekeeping staff is able to clean 10 rooms per employee. The number of housekeepers required for an average weekday and weekend is determined as follows:

	Weekday	Weekend
Number of guests per day	120	50
Rooms per housekeeper	÷ 10	÷ 10
Number of housekeepers per day	12	5

If each housekeeper is paid \$15 per hour for an eight-hour shift per day, the annual budget for the staff is as follows:

	Weekday	Weekend	Total
Number of housekeepers per day	12	5	
Hours per shift	× 8	× 8	
Days per year	× 260*	× 104**	
Number of hours per year	24,960	4,160	
Rate per hour	× \$15	× \$15	
Housekeeping staff annual budget	<u>\$374,400</u>	<u>\$62,400</u>	<u>\$436,800</u>

* 52 weeks × 5 days
** 52 weeks × 2 days

Objective

Describe and illustrate the use of staffing budgets for nonmanufacturing businesses.

- Following the Analysis for Decision Making segment, students have an opportunity to apply their knowledge in making decisions.

Make a Decision Nonmanufacturing Staffing Levels

Johnson Stores is planning its staffing for the upcoming holiday season. From past history, the store determines that it needs one additional sales clerk for each \$12,000 in daily sales. The average daily sales is anticipated to increase by \$96,000 from Black Friday until Christmas Eve, or 27 shopping days. Each additional sales clerk will work an eight-hour shift and will be paid \$14 per hour.

A. Determine the amount to budget for additional sales clerks for the holiday season.
 B. If Johnson Stores has an average 40% gross profit on sales, should it add the staff suggested by your answer in A? That is, is it profitable to staff for the increased sales in A?

Solution:

A.

Average daily revenue	\$96,000
Revenue per clerk	÷ 12,000
Number of additional sales clerks	8
Hours per day per clerk	× 8
Number of hours per day	64
Number of shopping days	× 27
Number of hours	1,728
Rate per hour	× \$14
Holiday staff budget for additional clerks	<u>\$24,192</u>

B.

Johnson Stores should add the staff because it will be profitable.

Increase in daily revenue	\$ 96,000
Gross profit percentage	× 40%
Increase in daily gross profit	\$ 38,400
Number of shopping days	× 27
Additional gross profit	\$1,036,800
Staff budget increase [from (A)]	(24,192)
Additional profit	<u>\$1,012,608</u>

Make a Decision

"I like the explanation of how to calculate the ratio and the way it's demonstrated how to calculate McDonald's – the presentation is clear and concise. Then, I really like the clear and concise answer to 'Is 1.1 efficient?' Ex 14 is great. I like the Make a Decision feature so students get to practice right away. Overall, a great section."

– Barbara Muller, Arizona State University

- At the end of each chapter, **Let's Review** is a new chapter summary and self-assessment feature that is designed to help busy students prepare for an exam. It includes a summary of each learning objective's key points, key terms, multiple-choice questions, exercises, and a sample problem that students may use to practice.

78 **Chapter 2** Analyzing Transactions

Let's Review

Chapter Summary

- The simplest form of an account, a T account, has three parts: (1) a title, which is the name of the item recorded in the account; (2) a left side, called the debit side; and (3) a right side, called the credit side. Periodically, the debits in an account are added, the credits in the account are added, and the balance of the account is determined. The system of accounts that make up a ledger is called a chart of accounts.
- Transactions are initially entered in a record called a journal. The rules of debit and credit for recording increases or decreases in accounts are shown in Exhibit 3. Each transaction is recorded so that the sum of the debits is always equal to the sum of the credits. The normal balance of an account is indicated by the side of the account (debit or credit) that receives the increases.
- Transactions are journalized and posted to the ledger using the rules of debit and credit. The debits and credits for each journal entry are posted to the accounts in the order in which they occur in the journal.
- A trial balance is prepared by listing the accounts from the ledger and their balances. The totals of the Debit column and Credit column of the trial balance must be equal. If the two totals are not equal, an error has occurred. Errors may occur even though the trial balance totals are equal. Such errors may require a correcting journal entry.

Key Terms

account (54)	double-entry accounting system (57)	retained earnings (56)
account receivable (67)	expenses (56)	revenues (56)
assets (56)	horizontal analysis (75)	rules of debit and credit (57)
balance of the account (55)	journal (59)	slide (73)
chart of accounts (55)	journal entry (60)	stockholders' equity (56)
correcting journal entry (74)	journalizing (60)	T account (55)
common stock (56)	ledger (55)	transposition (73)
credit (55)	liabilities (56)	trial balance (72)
debit (55)	normal balance of an account (58)	unadjusted trial balance (72)
dividends (56)	posting (63)	unearned revenue (65)

Practice

Multiple-Choice Questions

- A debit may signify a(n):

A. increase in an asset account.	C. increase in a liability account.
B. decrease in an asset account.	D. increase in the stockholders' equity (common stock) account.
- The type of account with a normal credit balance is:

A. an asset.	C. a revenue.
B. stockholders' equity (dividend).	D. an expense.
- A debit balance in which of the following accounts would indicate a likely error?

A. Accounts Receivable	C. Fees Earned
B. Cash	D. Miscellaneous Expense

79 **Chapter 2** Analyzing Transactions

- The receipt of cash from customers in payment of their accounts would be recorded by:

A. a debit to Cash and a credit to Accounts Receivable.	C. a debit to Cash and a credit to Accounts Payable.
B. a debit to Accounts Receivable and a credit to Cash.	D. a debit to Accounts Payable and a credit to Cash.
- The form listing the titles and balances of the accounts in the ledger on a given date is the:

A. income statement.	C. retained earnings statement.
B. balance sheet.	D. trial balance.

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

Exercises

- Rules of debit and credit and normal balances** Obj. 2
State for each account whether it is likely to have (A) debit entries only, (B) credit entries only, or (C) both debit and credit entries. Also, indicate its normal balance.

1. Accounts Receivable	4. Common Stock
2. Commissions Earned	5. Rent Revenue
3. Notes Payable	6. Wages Expense
- Journal entry for asset purchase** Obj. 2
Prepare a journal entry for the purchase of office equipment on October 27 for \$32,750, paying \$6,550 cash and the remainder on account.
- Journal entry for fees earned** Obj. 3
Prepare a journal entry on March 16 for fees earned on account, \$9,450.
- Journal entry for dividends** Obj. 3
Prepare a journal entry on December 23 for dividends paid of \$20,000.
- Missing amount from an account** Obj. 3
On July 1, the cash account balance was \$37,450. During July, cash payments totaled \$115,860 and the July 31 balance was \$29,600. Determine the cash receipts during July.
- Trial balance errors** Obj. 3
For each of the following errors, considered individually, indicate whether the error would cause the trial balance totals to be unequal. If the error would cause the trial balance totals to be unequal, indicate whether the debit or credit total is higher and by how much.

A. The payment of an insurance premium of \$5,400 for a three-year policy was debited to Prepaid Insurance for \$5,400 and credited to Cash for \$4,500.
B. A payment of \$270 on account was debited to Accounts Payable for \$720 and credited to Cash for \$720.
C. A purchase of supplies on account for \$1,600 was debited to Supplies for \$1,600 and debited to Accounts Payable for \$1,600.
- Correcting entries** Obj. 4
The following errors took place in journalizing and posting transactions:

A. Rent expense of \$4,650 paid for the current month was recorded as a debit to Miscellaneous Expense and a credit to Rent Expense.
B. The payment of \$3,700 from a customer on account was recorded as a debit to Cash and a credit to Accounts Payable.

 Journalize the entries to correct the errors. Omit explanations.

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

- Sample multiple-choice questions allow students to practice with the type of assessments they are likely to see on an exam.
- Short exercises and a longer problem allow students to apply their knowledge.
- **Answers** provided at the end of the Let's Review section let students check their knowledge immediately.
- Algorithmic practice activities in the accompanying CengageNOWv2 allow students to regenerate a practice activity at will.

"I like the idea that they're within the chapter and immediately after the specific chapter topic. Also, they're easy and promote a sense of accomplishment and understanding in the student."

— John Seilo, Irvine Valley College

- **Take It Further** in the end-of-chapter activities allows instructors to assign other special activities related to ethics, communication, and teamwork.

Take It Further



TIF 11-1 Ethics in Action

CEG Capital Inc. is a large holding company that uses long-term debt extensively to fund its operations. At December 31, the company reported total assets of \$100 million, total debt of \$55 million, and total equity of \$45 million. In January, the company issued \$11 billion in long-term bonds to investors at par value. This was the largest debt issuance in the company's history, and it significantly increased the company's ratio of total debt to total equity. Five days after the debt issuance, CEG filed legal documents to prepare for an additional \$50 billion long-term bond issue. As a result of this filing, the price of the \$11 billion in bonds that the company issued earlier in the week dropped to 94 because of the increased risk associated with the company's debt. The investors in the original \$11 billion bond issuance were not informed of the company's plans to issue additional debt so quickly after the initial bond issue.

➡ Did CEG Capital act unethically by not disclosing to initial bond investors its immediate plans to issue an additional \$50 billion debt offering?



TIF 11-2 Team Activity

In teams, select a public company that interests you. Obtain the company's most recent annual report on Form 10-K. The Form 10-K is a company's annually required filing with the Securities and Exchange Commission (SEC). It includes the company's financial statements and accompanying notes. The Form 10-K can be obtained either (A) from the investor relations section of the company's Web site or (B) by using the company search feature of the SEC's EDGAR database service found at www.sec.gov/edgar/searchedgar/companysearch.html.

- Based on the information in the company's most recent annual report, answer the following questions:
 - How much long-term debt does the company report at the end of the most recent year presented?
 - Does the company have any bonds outstanding at the end of the most recent year? If so, read the supporting notes to the financial statements and determine:
 - The contract rate of interest on the bond issue(s).
 - The discount or premium on the bond issue(s).
 - The due date of the bond issue(s).
 - The total amount of any bonds that will mature within one year of the balance sheet date.
- ➡ Based on your answers to the questions in requirement 1, evaluate the company's debt position.

Other Icons

- IFRS icon directs students to content specific to the International Financial Reporting Standards. More information about IFRS can be found in Appendix C.
- Mornin' Joe is a fictitious coffeehouse chain whose financial statements are provided to illustrate the complete financial statements of a corporation. Excerpts of the Mornin' Joe financial statements are used to illustrate topics discussed in Chapters 6–13.

IFRS



Mornin' Joe

CengageNOWv2

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



Closing the Gap between Homework and Exam Performance

Many students perform well on homework but struggle when it comes to exams. Now, with the new Blank Sheet of Paper Experience, students must problem-solve on their own, just as they would if taking a test on a blank sheet of paper.

Blank Sheet of Paper Experience

A less-leading Blank Sheet of Paper Experience discourages overreliance on the system.

- Instructors may choose between Learning Problems that guide student learning via drop-down menus, or they may use Blank Sheet of Paper problems.
- In Blank Sheet of Paper items, students must refer to the Chart of Accounts and decide for themselves which account is impacted.
- The number of accounts in each transaction is not given away.
- Whether the account should be debited or credited is not given away.

- Transactions may be entered in any order (as long as the entries are correct).
- Check My Work feedback only reports on what students have actually attempted, which prevents students from “guessing” their way through the assignment.

Instructions

The estimated amount of depreciation on equipment for the current year is \$7,700.

Journalize the December 31 [adjusting entry](#) to record the depreciation. Refer to the Chart of Accounts for exact wording of account titles.

Journal

Journalize the December 31 [adjusting entry](#) to record the depreciation. Refer to the Chart of Accounts for exact wording of account titles.

JOURNAL				
DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT
1	Adjusting Entries			
2				
3				

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

Journal

A. Journalize and insert the posting references for the October 3, 2018, transaction on page 91 of Regal Company's two-column [Journal](#).

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

“As they are creating their journal entry, this will allow them to see when they debit or credit an account the effect it has on the accounting equation. If they are not sure of the debit or credit, this might help them to figure it out.”

— Cecile Roberti, Community College of Rhode Island

“With the Accounting Equation impact automatically recorded, the student sees the impact, which I think is a better learning tool than having an additional step to completing the journal entry. The student sees the cause and effect, which for a beginning accounting student would help to increase understanding.”

— Sally Whitney, Colorado State University

Multi-Panel View

The new Multi-Panel View in CengageNOWv2 enables students to see all the elements of a problem on one screen.

- Students make connections and see the tasks as connected components in the accounting process.
- Dramatically reduced scrolling eliminates student frustration.

With the ability to move and resize journals, ledgers, forms, and financial statements, it is easier to navigate the problem and understand the accounting system.

Adaptive Feedback

Adaptive Feedback in CengageNOWv2 responds to students based upon their unique answers and alerts them to the type of error they have made without giving away the answer.

The screenshot displays a 'LEDGER' window for 'Account: Cash' with 'Score: 20/376' and 'Account No. 11'. The ledger table has columns: DATE, ITEM, POST. REF., DEBIT, CREDIT, and BALANCE (with sub-columns DEBIT and CREDIT). The first entry is dated 'Nov. 1' with a debit of '3600' and a balance debit of '36,000.00'. An error message box is overlaid on the table, stating: 'The transaction amount for this account is incorrect.' Below this, a 'Line' section lists three feedback points:

- The transaction amount for this account is incorrect, although you've entered the amount in the correct column. [-2]
- The value of the balance debit amount you've entered is not consistent with the transaction amount. [-2]
- The account balance needs to be recalculated.

In addition to groundbreaking, adaptive feedback, CengageNOWv2 continues to provide multiple layers of guidance to keep students on track and progressing.

- **Check My Work Feedback** provides general guidance and hints as students work through homework assignments.
- **Check My Work Feedback** in CengageNOWv2 now only reports on what students have actually attempted, which prevents them from “guessing” their way through assignments.
- **Explanations** are available after the assignment has been submitted and provide a detailed description of how the student should have arrived at the solution.

Motivation: Set Expectations and Prepare Students for the Course

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

CengageNOWv2 Start-Up Center

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

- **What Is Accounting?** Module ensures students understand course expectations and how to be successful in the introductory accounting course. This module consists of two assignable videos: *Introduction to Accounting* and *Success Strategies*. The Student Advice Videos offer advice from real students about what it takes to do well in the course.
- **Math Review Module**, designed to help students get up to speed with necessary math skills, includes math review assignments and Show Me How math review videos to ensure that students have an understanding of basic math skills, including:
 - Whole number operations
 - Decimal operations and rounding
 - Percentage operations and conversion

- Fraction operations
 - Converting numbers expressed in one form to a different form
 - Positive and negative numbers
 - Ratios and averages
- How to Use CengageNOWv2 Module focuses on learning accounting, not on a particular software system. Quickly familiarize your students with CengageNOWv2 and direct them to all of its built-in student resources.

Motivation: Prepare Them for Class

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

- **Video: Tell Me More.** Short Tell Me More lecture activities explain the core concepts of the chapter through an engaging auditory and visual presentation. Available either on a stand-alone basis or as an assignment, they are ideal for all class formats—flipped model, online, hybrid, or face-to-face.
- **NEW Adaptive Study Plan** in CengageNOWv2 is an assignable/gradable study center that adapts to each student's unique needs and provides a remediation pathway to keep students progressing. With the NEW Adaptive Study Plan, they can focus on learning new topics and fully understanding difficult concepts.

How Does It Work?

Step 1: Students take a chapter-level quiz consisting of random questions that cover both conceptual and procedural aspects of the chapter.

Step 2: Feedback is provided for each answer option explaining why the answer is right or wrong.

Step 3: Based on the quiz results, students are provided a remediation path that includes media assets and algorithmic practice problems to help them improve their understanding of the course material.

Instructors may use prerequisites that require students to achieve mastery in the Adaptive Study Plan before moving on to new material.

Using the Adaptive Study Plan, students may also review and check their knowledge with the new Practice! Activities. These items (generally one per learning objective) build application skills by allowing students to complete practice problems and “Try Another Version.”

CENGAGENOWv2 Home Courses Users Assignments Gradenbook Study Tools

Textbook: Warren/Reeve/Duchac: Corporate Financial Accounting, 13th Edition Go Back To TOC

Chapter 3 - The Adjusting Process Study Quiz View Progress

Progress: Done

Activity Take: Practice! Effect of Omitting Adjustments

Question 1 ✔ 1 pt

Effect of Omitting Adjustments

For the year ending April 30, 2016, Beckinworth Medical Services Co. mistakenly omitted adjusting entries for (1) \$6,700 of supplies that were used, (2) unearned revenue of \$11,500 that was earned, and (3) insurance of \$2,400 that expired. Indicate the combined effect of the errors on (a) revenues, (b) expenses, and (c) net income for the year ended April 30, 2016.

(a) Revenues	understated ✔	\$ 6,700 ✘
(b) Expenses	understated ✔	\$ 11,100 ✘
(c) Net income	understated ✔	\$ 4,400 ✘

Partially Correct

Consider, in each situation, if the adjustment involves an expense or a revenue. A quick calculation for this would be to add the revenues not recorded and subtract the expenses not recorded. The difference would be the effect on net income.

[Learning Objective 3](#)

Progress: 1/1 item

Submit Answer Try Another Version

Previous Next

Provide Help Right When Students Need It

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

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



Help Students Go Beyond Memorization to True Understanding

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

- **Mastery Problems.** New Mastery Problems enable you to assign problems and activities designed to test students' comprehension and mastery of difficult concepts.
- **Dynamic Exhibits.** To overcome this gap, the authors have created a series of interactive Dynamic Exhibits that allow students to change the variables in a scenario and see how a change ripples through the accounting system. Dynamic Exhibits allow students to see connections and relationships like never before.



Other features of Gradebook Analytics include:

- Ability to drill into both aggregate class performance and individual student performance.
- Preview items and view score distribution on that item.
- View at a glance summary information for a particular class, assignment, or item.

MindTap eReader

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

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

Cengage Learning General Ledger Software (CLGL)

CLGL exposes students to computerized accounting software without teaching the specifics of a certain software system—preparing students for *any* software program they might encounter in the real world.

- Available in CengageNOWv2, CLGL allows students to work through end-of-chapter assignments and practice sets in a format that emulates commercial general ledger software, but in a manner that is more forgiving of errors.
- Assignments are automatically graded online.
- Selected problems that can be solved using CLGL are designated by an icon in the textbook and are listed in the assignment preparation grid in the Instructor's Manual.



New to This Edition

In this edition, we have reorganized the sequence of the financial chapters so that they follow the order of the balance sheet. Installment Notes (Chapter 10) and Bonds Payable (Chapter 11) now precede Corporations (Chapters 12). We have also reorganized the sequence of the managerial chapters. Additionally, in all chapters, the following improvements have been made:

- Added schema at beginning of each chapter linking material to the accounting cycle or the financial statements
- Updated dates and real company information for currency
- Added “Link to” for the opening company to interweave real-world references throughout each chapter
- Added margin accounting equation impact for journal entries
- Refreshed end-of-chapter assignments with different numerical values and updated information
- Replaced the following:
 - “Financial Analysis and Interpretation” with “Analysis for Decision Making” followed by an exercise “Make a Decision”
 - “Business Connection” articles with “Why It Matters”
 - “Integrity, Objectivity, and Ethics in Business” articles with “Ethics: (Don’t) Do It!”
 - “Example Exercises” with “Check Up Corner” boxes throughout chapter
 - “At a Glance” summaries with “Let’s Review” while retaining key points
 - “Illustrative Problems” with “Practice” which includes multiple-choice questions, exercises, problems, and related answers
 - “Practice Exercises” with “Basic Exercises”
 - “Cases & Projects” with “Take It Further”

Chapter 1

- Added Characteristics of Financial Information section
- Updated sections on Assumptions and Principles
- Added “Why It Matters” article on Round-Tripping, which describes commercial substance
- Added “Check Up Corner” boxes on:
 - Business Transactions and the Accounting Equation
 - Financial Statements
- Introduced the “report” form of balance sheet so that one form is used throughout the text

Chapter 2

- Refreshed exhibit Rules of Debit and Credit, Normal Balances of Accounts
- Added “Why It Matters” on Debits and Credits at the Bank and refreshed the Why It Matters on Computerized Accounting Systems
- Added “Check Up Corner” boxes on:
 - Balance Sheet Accounts
 - Preparing Journal Entries
 - Trial Balance

- When appropriate, account numbers are included in the trial balance

Chapter 3

- Added Revenue and Expense Recognition section
- Added new Exhibits 1 and 2 that illustrate why adjustments are required for accruals and deferrals
- Reorganized/streamlined Accruals and Deferrals
- Added “Check Up Corner” boxes on:
 - Adjusting Entries for Accruals
 - Adjusting Entries for Deferrals
 - Depreciation
- Added “Why It Matters” on Sports Signing Bonus
- When given in end-of-chapter items, account numbers are included in the trial balance

Chapter 4

- Added “Check Up Corner” boxes on:
 - Prepare Financial Statements from Adjusted Trial Balance
 - Closing Entries
- Added a “Why It Matters” on Temporary Accounts on Your Pay Stub
- Modified exhibit on Accounting Cycle so that it is consistent with the schema presented at the beginning of Chapters 1–4
- When appropriate, account numbers are included in the trial balance
- Added Appendix 2 Reversing Entries with exhibits on Accrued Wages, Wages Expense and Wages Payable after adjustment, and Wages Expense and Wages Payable after reversing entry

Chapter 5

- Added “Why It Matters” on:
 - Comcast Versus Lowe’s
 - Apple’s Credit Terms
 - E-commerce Shopping Carts
- Changed account titles of “Cost of Merchandise Sold” to “Cost of Goods Sold” and “Merchandise Inventory” to “Inventory”
- Added “Check Up Corner” boxes on:
 - Purchases Transactions
 - Sales Transactions
 - Multiple-Step Income Statement
- Revised the illustration for NetSolutions, including the chart of accounts, to include customer returns and allowances
- Revised the discussion of customer returns and allowances so that the adjusting entries for returns and allowances are presented with the adjusting entry for inventory shrinkage near the end of the chapter
- Expanded and refreshed exhibits on Illustration of Inventory Transactions for Seller and Buyer, Multiple-Step Income Statement, Single-Step Income Statement, Retained Earnings Statement for Merchandising Business, and Balance Sheet for Merchandising Business

- Revised Appendix on the Periodic Inventory System to include customer returns and allowances

Chapter 6

- Added “Why It Matters” on:
 - Pawn Stars and Specific Identification
 - Good Samaritan
- Added “Check Up Corner” boxes on:
 - Perpetual Inventory Costing
 - Periodic Inventory
 - Lower of Cost or Market
 - Effects of Inventory Errors

Chapter 7

- Revised chapter title
- Added new exhibit on eBay’s Report of Compliance with Sarbanes-Oxley
- Added “Why It Matters” on:
 - Mobile Payments
 - Bank Error in Your Favor (or Maybe Not)
 - Apple’s Hedge Fund
- Updated “Why It Matters” on Employee Fraud
- Added “Check Up Corner” boxes on:
 - Internal Controls
 - Bank Reconciliation
- Revised the form of the bank reconciliation to be consistent with CengageNOWv2
- Added calculation of Days’ Cash on Hand in Analysis for Decision Making

Chapter 8

- New chapter opener on Keurig Green Mountain, Inc.
- Added “Why It Matters” on:
 - Warning Signs
 - Failure to Collect
- Refreshed “Why It Matters” on Allowance Percentages Across Companies
- Added “Ethics: Don’t Do It!” on extending credit to financially distressed companies
- Added “Check Up Corner” boxes on:
 - Percent of Sales Method
 - Analysis of Receivables Method
 - Notes Receivable

Chapter 9

- Revised chapter title
- Changed “units-of-output method” to “units-of-activity method”
- Added new sections on Partial-Year Depreciation and Repair and Improvements
- Modified existing exhibits and added several new exhibits
- Added “Why It Matters” on:
 - Selling a Fixed Asset
 - Depreciation under IRS MACRS
 - Percent of Fixed Assets to Total Assets
 - Market Value versus Book Value
- Added “Check Up Corner” boxes on:
 - Fixed Assets

- Natural Resources
- Intangible Assets

Chapter 10

- Revised chapter title
- Revamped and simplified discussion of Payroll and added new topic on Installment Notes (from Chapter 12 in previous edition)
- Added “Check Up Corner” boxes on:
 - Short-Term Note Payable
 - Payroll Entries
 - Installment Note
 - Contingent Liabilities
- Added “Why It Matters” on:
 - State Pension Obligations
 - Installment Credit
- Added new exhibits on Note Transactions: Borrower and Creditor and on Allocation of Periodic Payments

Chapter 11

- Chapter 12 in the previous edition
- Moved topic of Installment Notes to Chapter 10
- New chapter opener on PepsiCo, Inc.
- Added a “Why It Matters” on Investor Bond Price Risk
- Added “Check Up Corner” boxes on:
 - Nature of Bonds Payable
 - Bond Issued at a Discount
 - Bond Issued at a Premium
- Updated “Ethics: Don’t Do It!” article on The Ratings Game

Chapter 12

- Chapter 11 in the previous edition
- Added “Why It Matters” on:
 - Red Tape and Starting a Business
 - You Have No Vote
 - Treasury Stock vs. Dividends
- Added “Check Up Corner” boxes on:
 - Classes of Stock
 - Dividends
 - Treasury Stock Transactions
- Refreshed exhibits on Stockholders’ Equity Section of a Balance Sheet and on Retained Earnings Statement

Chapter 13

- Chapter 14 in the previous edition
- Added “Check Up Corner” boxes on:
 - Cash Flows from Operating Activities
 - Cash Flows from Investing Activities
 - Classify Cash Flows
- Added “Why It Matters” on:
 - Growing Pains
 - Twenty Years After
- Refreshed exhibits on Statement of Cash Flows—Indirect Method and Statement of Cash Flows—Direct Method
- Moved the discussion of the direct method to Appendix 2

Chapter 14

- Chapter 15 in the previous edition
- Revamped sections on Analyzing Liquidity and Analyzing Solvency
- Name changes to several ratios:
 - “Number of Times Interest Charges Are Earned” to “Times Interest Earned”
 - “Ratio of Sales to Assets” to “Asset Turnover”
 - “Rate Earned on Total Assets” to “Return on Total Assets”
 - “Rate Earned on Stockholders’ Equity” to “Return on Stockholders’ Equity”
 - “Rate Earned on Common Stockholders’ Equity” to “Return on Common Stockholders’ Equity”
- Refreshed exhibit on Summary of Analytical Measures
- Added Appendix 2 on Fair Value and Comprehensive Income (from Chapter 13 in previous edition)
- Added “Check Up Corner” boxes on:
 - Horizontal and Vertical Analysis
 - Liquidity Analysis
 - Solvency Analysis
 - Profitability Analysis
- Added “Why It Matters” on:
 - Flying Off the Shelves
 - Economic Success
 - Investing for Yield

Chapter 15

- Chapter 16 in the previous edition
- Revised chapter title
- New chapter opener on Gibson Guitars
- Added Links to Gibson Guitars throughout chapter
- Added new Learning Objective on Sustainability and Accounting Information
- Added “Why It Matters” on:
 - Line and Staff for Service Companies
 - Not According to Plan: Contract Clauses
 - Overhead Costs
 - Service Companies and Product Costs
- Added “Check Up Corner” boxes on:
 - Management Process
 - Manufacturing Operations
 - Manufacturing Financial Statements
- Added Analysis for Decision Making section on measuring utilization for a service company with related end-of-chapter assignments
- Added Take It Further section with assignments involving ethics, teams, and communication

Chapter 16

- Chapter 17 in the previous edition
- New chapter opener on Gibson Guitars
- Added Links to Gibson Guitars throughout chapter
- Added in the margin the impact of each journal entry on the accounting equation
- Added “Why It Matters” on:
 - 3D Printing

- Advanced Robotics
- Job Order Costing in Hollywood
- Added “Check Up Corner” boxes on:
 - Direct Materials, Direct Labor, and Factory Overhead Costs
 - Applying Overhead and Determining Job Cost
 - Job Order Costing for a Service Business
- Added Analysis for Decision Making section on using job order costs in a service company with related end-of-chapter assignments
- Added Take It Further section with assignments involving ethics, teams, and communication

Chapter 17

- Chapter 18 in the previous edition
- Added Links to Dreyer’s Ice Cream throughout chapter
- Added “Why It Matters” on:
 - Sustainable Papermaking
 - Cost of Gasoline
- Added “Check Up Corner” boxes on:
 - Equivalent Units
 - Cost per Equivalent Unit
 - Process Costing Journal Entries
- Added Analysis for Decision Making section on using cost of production reports with related end-of-chapter assignments
- Added Take It Further section with assignments involving ethics, teams, and communication

Chapter 18

- Chapter 26 in the previous edition
- Revised chapter title
- Added Links to Cold Stone Creamery throughout chapter
- Added “Why It Matters” on:
 - Activity-Based Costing in the Public Sector
 - \$600 Hammer (Cost Allocation Distortion)
- Added “Check Up Corner” boxes on:
 - Single Plantwide Factory Overhead Rate
 - Multiple Production Department Factory Overhead Rates
 - Activity-Based Costing: Factory Overhead Costs
 - Activity-Based Costing for a Service Business
- Added Analysis for Decision Making section on using ABC to reduce costs with related end-of-chapter assignments
- Added Take It Further section with assignments involving ethics, teams, and communication

Chapter 19

- Revised chapter title
- Added Links to Ford Motor Company throughout chapter
- Added “Why It Matters” on:
 - Variable Cost for Home and Business
 - Booking Fees
- Added “Check Up Corner” boxes on:
 - Cost Behavior
 - Contribution Margin

- Break-Even Sales and Target Profit
- Special Cost-Volume-Profit Relationships
- Added Analysis for Decision Making section on using cost-volume-profit for service companies with related end-of-chapter assignments
- Removed the Variable Costing Appendix
- Added Take It Further section with assignments involving ethics, teams, and communication

Chapter 20

- Added Links to Adobe Systems, Incorporated throughout chapter
- Added “Why It Matters” on:
 - Business Segments
 - Eastman Revenue Price and Volume Effects
- Added “Check Up Corner” boxes on:
 - Absorption and Variable Costing Income Statements: Production Greater than Sales
 - Absorption and Variable Costing Income Statements: Different Levels of Production
 - Contribution Margin by Segment
 - Contribution Margin Analysis
- Added Analysis for Decision Making section on using segment analysis and EBITDA with related end-of-chapter assignments
- Added Take It Further section with assignments involving ethics, teams, and communication

Chapter 21

- Added Links to Hendrick Motorsports throughout chapter
- Added “Why It Matters” on Advertising Budget
- Added “Check Up Corner” boxes on:
 - Flexible Budget
 - Direct Materials, Direct Labor, and Cost of Goods Sold Budget
 - Cash Budget
- Added Analysis for Decision Making section on using staffing budgets for nonmanufacturing businesses with related end-of-chapter assignments
- Added Take It Further section with assignments involving ethics, teams, and communication

Chapter 22

- Revised chapter title
- Added Links to BMW Group throughout chapter
- Added “Why It Matters” on The Lesson of Moneyball
- Added “Check Up Corner” boxes on:
 - Direct Materials and Direct Labor Cost Variances
 - Factory Overhead Cost Variances
 - Income Statement with Variances
- Added Analysis for Decision Making section on using direct labor time variance in evaluating staff in a service business with related end-of-chapter assignments
- Added Take It Further section with assignments involving ethics, teams, and communication

Chapter 23

- Revised chapter title
- Added Links to Caterpillar Inc. throughout chapter
- Added “Why It Matters” on:
 - Dover Corporation: Many Pieces, One Picture
 - Coca-Cola Company Expansion
- Added “Check Up Corner” boxes on:
 - Cost Center Responsibility Measures
 - Profit Center Responsibility Reporting
 - Investment Center Performance Measures
 - Transfer Pricing
- Added Analysis for Decision Making section on whether a company should franchise its operations with related end-of-chapter assignments
- Added Take It Further section with assignments involving ethics, teams, and communication

Chapter 24

- Added Links to Facebook Inc. throughout chapter
- Added a “Why It Matters” on Dynamic Pricing
- Added “Check Up Corner” boxes on:
 - Differential Analysis
 - Setting Product Selling Prices
- Added Analysis for Decision Making section on the use of yield pricing in service businesses with related end-of-chapter assignments
- Added Take It Further section with assignments involving ethics, teams, and communication

Chapter 25

- Added Links to Vail Resorts Inc. throughout chapter
- Added “Check Up Corner” boxes on:
 - Capital Investment Analysis Not Using Present Value
 - Net Present Value and Internal Rate of Return Analyses
 - Net Present Value—Unequal Lives
- Added Analysis for Decision Making section on using capital investment analysis in evaluating sustainability with related end-of-chapter assignments
- Added Take It Further section with assignments involving ethics, teams, and communication

Chapter 26

- Chapter 27 in previous edition
- Revised chapter title
- Added Links to Precor Incorporated throughout chapter
- Added a “Why It Matters” on External Failure Costs: Lululemon Stretched Thin
- Added “Check Up Corner” boxes on:
 - Lean Principles
 - Lean Accounting
 - Cost of Quality Report
- Added Analysis for Decision Making section on using lean principles in service or administrative settings with related end-of-chapter assignments
- Added Take It Further section with assignments involving ethics, teams, and communication

Instructor Resources

Solutions Manual

Author-written and carefully verified multiple times to ensure accuracy and consistency with the text, the Solutions Manual contains answers to the Discussion Questions, Basic Exercises, Exercises, Problems (Series A and Series B), Continuing Problems, Comprehensive Problems, Analysis for Decision Making, and Take It Further activities that appear in the text. These solutions help you easily plan, assign, and efficiently grade assignments.

Test Bank

Test Bank content is delivered via Cengage Learning Testing, powered by Cognero® a flexible, online system that allows you to:

- Author, edit, and manage test bank content from multiple Cengage Learning solutions
- Create multiple test versions in an instant
- Deliver tests from your LMS, your classroom, or through CengageNOWv2

Companion Web Site

This robust companion web site provides immediate access to a rich array of teaching and learning resources—including the Instructor's Manual, PowerPoint slides, and Excel Template Solutions. Easily download the instructor resources you need from the password-protected, instructor-only section of the site.

Instructor's Manual Discover new ways to engage your students by utilizing the Instructor's Manual ideas for class discussion, group learning activities, writing exercises, and Internet activities. Moreover, simplify class preparation by reviewing a brief summary of each chapter, a detailed chapter synopsis, teaching tips regarding a suggested approach to the material, questions students frequently ask in the classroom, lecture aids, and demonstration problems in the Instructor's Manual. Transparency Masters and Handouts (with solutions) are also included.

Quickly identify the assignments that best align with your course with the assignment preparation grid that includes information about learning objective coverage, difficulty level and Bloom's taxonomy categorization, time estimates, and accrediting standard alignment for business programs, AICPA, ACBSP, and IMA.

PowerPoint Slides Bring your lectures to life with slides designed to clarify difficult concepts for your students. The lecture PowerPoints include key terms and definitions, equations, examples, and exhibits from the textbook. Descriptions for all graphics in the PowerPoints are included to enhance PowerPoint usability for students with disabilities.

A separate PowerPoint deck that includes just the Exhibits from the textbook is ideal for instructors who create their own PowerPoint decks and just want to refresh them.

Excel Template Solutions Excel Templates are provided for selected long or complicated end-of-chapter exercises and problems to assist students as they set up and work the problems. Certain cells are coded to display a red asterisk when an incorrect answer is entered, which helps students stay on track. Selected problems that can be solved using these templates are designated by an icon in the textbook and are listed in the assignment preparation grid in the Instructor's Manual. The Excel Template Solutions provide answers to these templates.



EXCEL TEMPLATE

Practice Set Solutions Establish a fundamental understanding of the accounting cycle for your students with Practice Sets, which require students to complete one month of transactions for a fictional company. Brief descriptions of each Practice Set are provided in the Table of Contents. The Practice Set Solutions provide answers to these practice sets.

Student Resources

Study Guide

Now available free in CengageNOWv2, the Study Guide allows students to easily assess what they know with a “Do You Know” checklist covering the key points in each chapter. To further test their comprehension, students can work through Practice Exercises, which include a “strategy” hint and solution so they can continue to practice applying key accounting concepts.

Working Papers

Students will find the tools they need to help work through end-of-chapter assignments with the Working Papers. The preformatted templates provide a starting point by giving students a basic structure for problems and journal entries. Working Papers are available in a printed format as a bundle option.

Practice Sets

For more in-depth application of accounting practices, instructors may choose from among six different Practice Sets for long-term assignments. Each Practice Set requires students to complete one month of transactions for a fictional company. Practice Sets can be solved manually or with the Cengage Learning General Ledger software.



Web Site

Designed specifically for your students' accounting needs, this web site features student PowerPoint slides, Excel Templates, learning games, and flashcards.

- **PowerPoint Slides:** Students can easily take notes or review difficult concepts with the student version of this edition's PowerPoint slides.
- **Excel Templates:** These Excel Templates help students stay on track. If students enter an incorrect answer in certain cells, a red asterisk will appear to let them know something is wrong. Problems that can be solved using these templates are designated by an icon.
- **Crossword Puzzles:** Students can focus on learning the key terms and definitions for each chapter in a different way by completing these crossword puzzles.
- **Flashcards:** Students can prepare with these flashcards, which cover the key terms and definitions they need to know for each chapter.



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The many enhancements to this edition of *Financial and Managerial Accounting* are the direct result of one-on-one interviews, surveys, and focus groups with over 250 instructors at institutions across the country over the past year. We would like to take this opportunity to thank those who helped us better understand the challenges of the financial accounting course and provided valuable feedback on our content and digital assets.

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This set is a merchandising business operated as a proprietorship. It includes business documents, and it can be solved manually or with the General Ledger software.

Practice Set: Chic Events by Jada

This set is a merchandising business operated as a proprietorship. It includes business documents, and it can be solved manually or with the General Ledger software.

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Practice Set: My Place, House of Décor

This set is a service and merchandising business operated as a corporation. It includes narrative for six months of transactions, which are to be recorded in a general journal. The set can be solved manually or with the General Ledger software.

Practice Set: JP's Tech Solutions

This set is a departmentalized merchandising business operated as a corporation. It includes a narrative of transactions, which are to be recorded in special journals. The set can be solved manually or with the General Ledger software.

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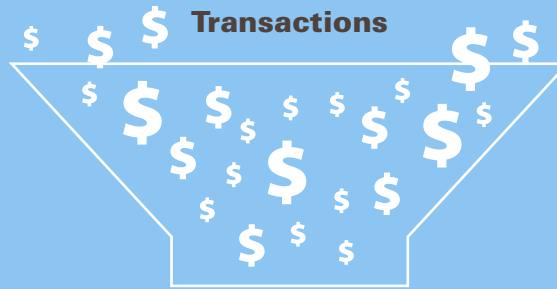
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Chapter 1

Introduction to Accounting and Business

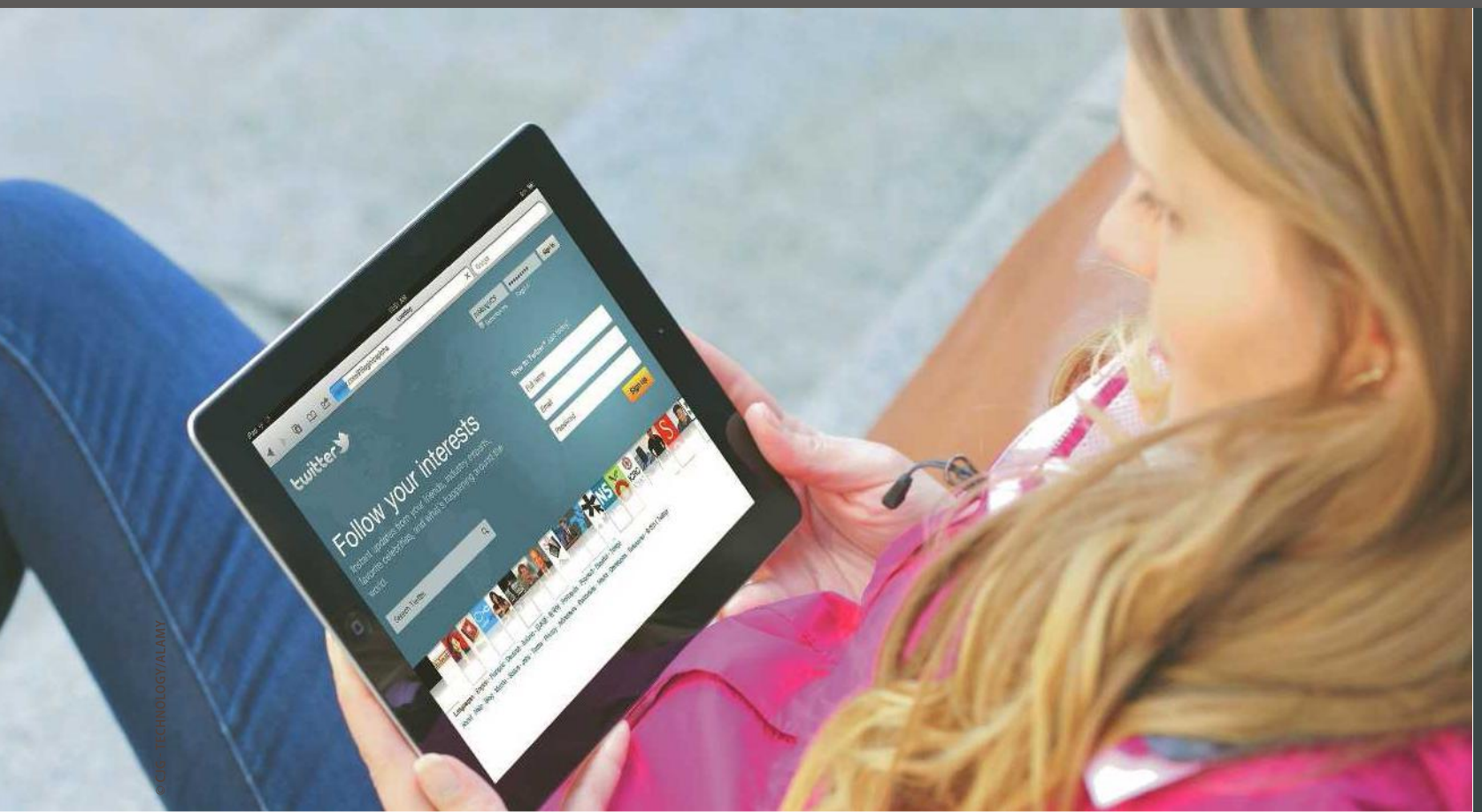
Chapter 1



Accounting System

Accounting Equation

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



Twitter

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

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

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

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

What's Covered

Introduction to Accounting and Business

Nature of Business

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

Nature of Accounting

- Types (Obj. 1)
- Opportunities (Obj. 1)
- Generally Accepted Accounting Principles (Obj. 2)

Analyzing Business Transactions

- Accounting Equation (Obj. 3)
- Transactions (Obj. 4)

Financial Statements

- Income Statement (Obj. 5)
- Retained Earnings Statement (Obj. 5)
- Balance Sheet (Obj. 5)
- Statement of Cash Flows (Obj. 5)

Learning Objectives

- Obj. 1** Describe the nature of business and the role of accounting and ethics in business.
- Obj. 2** Describe generally accepted accounting principles, including the underlying assumptions and principles.
- Obj. 3** State the accounting equation and define each element of the equation.
- Obj. 4** Describe and illustrate how business transactions can be recorded in terms of the resulting change in the elements of the accounting equation.
- Obj. 5** Describe the financial statements of a corporation and explain how they interrelate.

Analysis for Decision Making

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

Objective 1

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

Nature of Business and Accounting

A **business**¹ is an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers. Businesses come in all sizes, from a local coffee house to **Starbucks**, which sells over \$10 billion of coffee and related products each year.

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

Types of Businesses

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

- **Service businesses** provide services rather than products to customers.
 - Delta Airlines** (transportation services)
 - Walt Disney Company** (entertainment services)
- **Merchandising businesses** sell products they purchase from other businesses to customers.
 - Walmart** (general merchandise)
 - Amazon.com** (Internet books, music, videos, ...)
- **Manufacturing businesses** change basic inputs into products that are sold to customers.
 - Ford Motor Company** (cars, trucks, vans)
 - Dell Inc.** (personal computers)

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

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

Role of Accounting in Business

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

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

note:

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

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

Link to Twitter

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

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

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

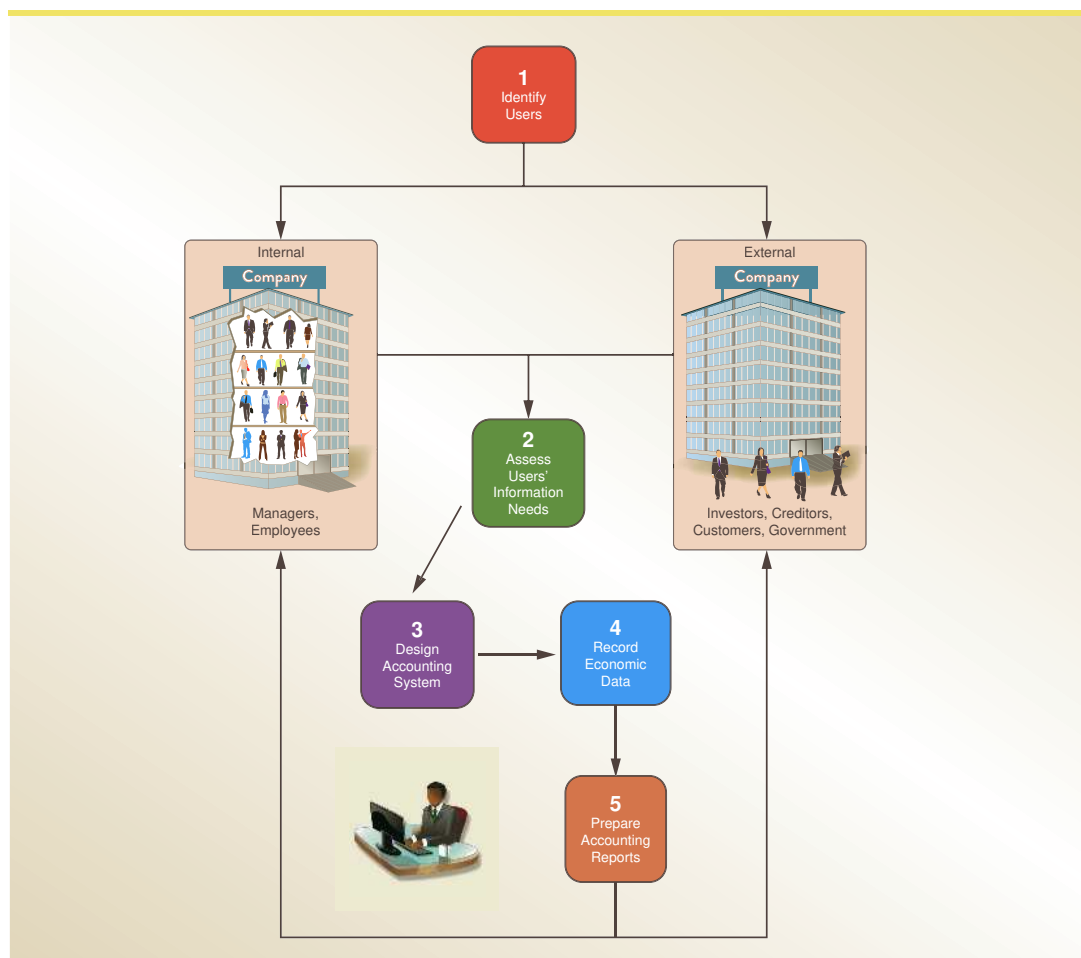


Exhibit 1

Accounting as an Information System

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

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

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

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

Link to Twitter

Twitter publishes general-purpose financial statements in its annual report to investors.



Role of Ethics in Accounting and Business

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

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

Exhibit 2 Accounting and Business Frauds

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

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

- **Failure of Individual Character:** Ethical managers and accountants are honest and fair. However, managers and accountants often face pressures from supervisors to meet company

and investor expectations. In many of the cases in Exhibit 2, managers and accountants justified small ethical violations to avoid such pressures. However, these small violations became big violations as the company's financial problems became worse.

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

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

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

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

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

Link to Twitter

Opportunities for Accountants

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

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



Bernie Madoff

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

In a Ponzi scheme, the investment manager uses funds received from new investors to pay a return to existing

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

Source: Bernie Madoff

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

Exhibit 3 Accounting Career Paths and Salaries

Accounting Career Track	Description	Career Options	Annual Starting Salaries*	Certification
Private Accounting	Accountants employed by companies, government, and not-for-profit entities.	Bookkeeper	\$45,000	Certified Payroll Professional (CPP)
		Payroll clerk	\$41,000	
		General accountant	\$49,000	
		Budget analyst	\$52,000	Certified Management Accountant (CMA) Certified Internal Auditor (CIA) Certified Information Systems Auditor (CISA)
		Cost accountant	\$53,000	
		Internal auditor	\$60,000	
		Information technology auditor	\$68,000	
Public Accounting	Accountants employed individually or within a public accounting firm in audit, tax, or management advisory services.	Large firms (over \$250 million in revenue)	\$65,000	Certified Public Accountant (CPA)
		Mid-size firms (\$25–\$250 million in revenue)	\$58,000	Certified Public Accountant (CPA)
		Small firms (less than \$25 million in revenue)	\$54,000	Certified Public Accountant (CPA)

*Average salaries rounded to the nearest thousand. Salaries may vary by size of company and region.

Source: Robert Half 2016 U.S. Salary Guide (Finance and Accounting), Robert Half International, Inc. (www.roberthalf.com/workplace-research/salary-guides)

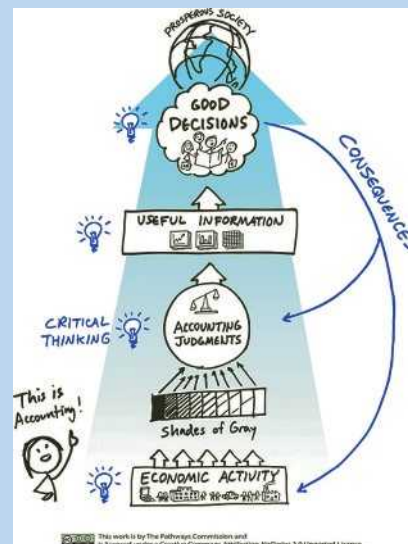
Accountants and their staff who provide services on a fee basis are said to be employed in **public accounting**. In public accounting, an accountant may practice as an individual or as a member of a public accounting firm. Public accountants who have met a state's education, experience, and examination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

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

Why It Matters

Pathways Commission

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



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

Generally Accepted Accounting Principles (GAAP)

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

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

Within the United States, the **Financial Accounting Standards Board (FASB)** has the primary responsibility for developing accounting standards. The FASB publishes *Statements of Financial Accounting Standards*, *Statements of Financial Accounting Concepts*, and *Interpretations*, which make up GAAP. The **Securities and Exchange Commission (SEC)**, an agency of the U.S. government, has authority over the accounting and financial disclosures for companies whose shares of ownership (stock) are traded and sold to the public. The SEC normally accepts the accounting standards set forth by the FASB. However, the SEC may issue *Staff Accounting Bulletins* on accounting matters that may not have been addressed by the FASB.

Outside the United States, most countries use accounting standards and principles adopted by the **International Accounting Standards Board (IASB)**. The IASB issues *International Financial Reporting Standards (IFRS)*. Differences currently exist between FASB and IASB accounting principles.

Objective 2

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

Characteristics of Financial Information

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

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

In addition to the preceding characteristics, GAAP has evolved based upon assumptions and principles.

Assumptions

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

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

International Connection

IFRS International Financial Reporting Standards (IFRS)

IFRS are considered to be more "principles-based" than U.S. GAAP, which is considered to be more "rules-based." For

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

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

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

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




Link to Twitter

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

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

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

Exhibit 4 Forms of Business Entities

Form of Business Entity	Characteristics	Examples
 Proprietorship is owned by one individual.	<ul style="list-style-type: none"> • 70% of business entities in the United States. • Easy and inexpensive to organize. • Resources are limited to those of the owner. • Used by small businesses. 	<ul style="list-style-type: none"> • A & B Painting
 Partnership is owned by two or more individuals.	<ul style="list-style-type: none"> • 10% of business organizations in the United States (combined with limited liability companies). • Combines the skills and resources of more than one person. 	<ul style="list-style-type: none"> • Jones & Smith, Architects
 Corporation is organized under state or federal statutes as a separate legal taxable entity.	<ul style="list-style-type: none"> • Generates 90% of business revenues. • 20% of the business organizations in the United States. • Ownership is divided into shares called stock. • Can obtain large amounts of resources by issuing stock. • Used by large businesses. 	<ul style="list-style-type: none"> • Apple • Google • Ford Motor Company
 Limited liability company (LLC) combines the attributes of a partnership and a corporation.	<ul style="list-style-type: none"> • 10% of business organizations in the United States (combined with partnerships). • Often used as an alternative to a partnership. • Has tax and legal liability advantages for owners. 	<ul style="list-style-type: none"> • Boston Basketball Partners, LLC

Link to Twitter

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

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

Because of the large amount of resources required to operate a manufacturing business, most manufacturers such as **Ford Motor Company** are corporations. Most large retailers such as **Walmart** and **The Home Depot** are also corporations. Companies organized as

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

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

Principles

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

- Measurement
- Historical cost
- Revenue recognition
- Expense recognition

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

To illustrate, assume that Aaron Publishers purchased the following building from Schenk Enterprises on February 20, 2018, for \$150,000:

Price listed by Schenk Enterprises on January 1, 2018	\$160,000
Aaron Publishers' initial offer to buy on January 31, 2018	140,000
Aaron Publishers' purchase price on February 20, 2018	150,000
Estimated selling price on December 31, 2020	220,000
Assessed value for property taxes, December 31, 2020	190,000

Aaron Publishers would record the building at the February 20, 2018, purchase price of \$150,000. This amount is both objective and verifiable, as it was the result of a transaction between two independent parties. Recording an item at its initial transaction price is called the **historical cost principle** or **cost principle**. Under the historical cost principle, amounts do not normally change until another transaction occurs.

To illustrate, the fact that the preceding building has an estimated selling price of \$220,000 on December 31, 2020, indicates that the building's value has increased. However, the \$220,000 is not recorded in the accounting records because Aaron Publishers has not sold the building. If, however, Aaron sells the building on January 9, 2021, for \$240,000, a profit of \$90,000 (\$240,000 – \$150,000) would be recorded by Aaron Publishers.

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

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

The Accounting Equation

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

Objective 3

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

Why It Matters

The Accounting Equation

The accounting equation serves as the basic foundation for the accounting systems of all companies. The accounting equation is

used by the smallest business, such as the local convenience store, to the largest business, such as **The Coca-Cola Company**. Some examples taken from recent financial reports of well-known companies follow:

Company	Assets*	=	Liabilities	+	Stockholders' Equity
The Coca-Cola Company	\$92,023	=	\$61,462	+	\$30,561
DuPont	\$49,876	=	\$36,498	+	\$13,378
Bay	\$45,132	=	\$25,226	+	\$19,906
Google	\$110,920	=	\$23,611	+	\$87,309
McDonald's	\$34,281	=	\$21,428	+	\$12,853
Microsoft Corporation	\$172,384	=	\$82,600	+	\$89,784
Southwest Airlines	\$20,200	=	\$13,425	+	\$6,775
Walmart	\$203,706	=	\$117,769	+	\$85,937

*Amounts are shown in millions of dollars.

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

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

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

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

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

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

Link to Twitter

Twitter's accounting equation for a recent year is: Assets (\$3,366 million) = Liabilities (\$416 million) + Stockholders' Equity (\$2,950 million).

Objective 4

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

Business Transactions and the Accounting Equation

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

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

Assume that on November 1, 2017, Chris Clark organizes a corporation that will be known as **NetSolutions**. The first phase of Chris's business plan is to operate NetSolutions as a service business assisting individuals and small businesses in developing Web pages and installing computer software. Chris expects this initial phase of the business to last one to two years. During this period, Chris plans on gathering information on the software and hardware needs of customers. During the second phase of the business plan, Chris plans to expand NetSolutions into a personalized retailer of software and hardware for individuals and small businesses.

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

note:

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

Nov. 1, 2017 Chris Clark deposited \$25,000 in a bank account in the name of NetSolutions in exchange for shares of common stock in the corporation.

Transaction A

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

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

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

<u>Assets</u>		=	<u>Stockholders' Equity</u>
Cash			Common Stock
A. 25,000		=	25,000

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

Nov. 5, 2017 NetSolutions paid \$20,000 for the purchase of land as a future building site.

Transaction B

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

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

<u>Assets</u>		=	<u>Stockholders' Equity</u>
Cash	+ Land		Common Stock
Bal. 25,000		=	25,000
B. -20,000	+20,000		
Bal. 5,000	20,000		25,000
25,000		=	25,000

Nov. 10, 2017 NetSolutions purchased supplies for \$1,350 and agreed to pay the supplier in the near future.

Transaction C

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

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

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

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

Assets			=	Liabilities + Stockholders' Equity	
Cash	+ Supplies	+ Land		Accounts Payable	+ Common Stock
Bal. 5,000		20,000	=		25,000
C. <u>5,000</u>	<u>+1,350</u>			<u>+1,350</u>	
Bal. 5,000	1,350	20,000		1,350	25,000
<u>26,350</u>			=	<u>26,350</u>	

Transaction D Nov. 18, 2017 NetSolutions received cash of \$7,500 for providing services to customers.

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

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

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

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

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

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

Why It Matters

Round-Tripping

Accounting principles require that a transaction have *commercial substance*. Commercial substance means that the transaction has an economic impact on the entity. An example of a transaction lacking commercial substance is round-tripping. Round-tripping

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

Nov. 30, 2017 *NetSolutions paid the following expenses during the month: wages, \$2,125; rent, \$800; utilities, \$450; and miscellaneous, \$275.*

Transaction E

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

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

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

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

Nov. 30, 2017 *NetSolutions paid creditors on account, \$950.*

Transaction F

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

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

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

Nov. 30, 2017 *Chris Clark determined that the cost of supplies on hand at the end of the month was \$550.*

Transaction G

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

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

Transaction H Nov. 30, 2017 Paid dividends, \$2,000.

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

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

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



**DYNAMIC
EXHIBIT**

Summary

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

Exhibit 5 Summary of Transactions for NetSolutions

Assets			=	Liabilities +		Stockholders' Equity							
Cash	+ Supp.	+ Land		Accounts Payable	+ Common Stock	- Dividends	+ Fees Earned	- Wages Exp.	- Rent Exp.	- Supplies Exp.	- Utilities Exp.	- Misc. Exp.	
A. +25,000					+25,000								
B. -20,000		+20,000											
Bal. 5,000		20,000			25,000								
C. +1,350				+1,350									
Bal. 5,000	+1,350	20,000		+1,350	25,000								
D. +7,500							+7,500						
Bal. 12,500	1,350	20,000		1,350	25,000		7,500						
E. -3,650								-2,125	-800		-450	-275	
Bal. 8,850	1,350	20,000		1,350	25,000		7,500	-2,125	-800		-450	-275	
F. -950				-950									
Bal. 7,900	1,350	20,000		400	25,000		7,500	-2,125	-800		-450	-275	
G. -800										-800			
Bal. 7,900	550	20,000		400	25,000		7,500	-2,125	-800	-800	-450	-275	
H. -2,000						-2,000							
Bal. 5,900	550	20,000		400	25,000	-2,000	7,500	-2,125	-800	-800	-450	-275	
26,450			=	26,450									

You should note the following:

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

Prepare a table to indicate the effect that each of these transactions has on the following asset, liability, and stockholders' equity accounts: Cash, Accounts Receivable, Accounts Payable, Common Stock, Dividends, Fees Earned, Wages Expense, Utilities Expense.

Solution:

The change in an asset account is accompanied by a change in another asset, liability, or stockholders' equity account.

	Assets		=	Liabilities	+	Stockholders' Equity			
	Cash	+ Accounts Receivable	=	Accounts Payable	+ Common Stock	- Dividends	+ Fees Earned	- Wages Expense	- Utilities Expense
Bal.	32,500	5,000		2,500	32,500		5,000	-2,500	
A.	20,000				20,000				
B.	-2,000			-2,000					
C.	5,000	-5,000							
D.		18,000					18,000		
E.	-10,000							-10,000	
F.	-3,000								-3,000
G.	-4,500					-4,500			
Bal.	<u>38,000</u>	<u>18,000</u>	=	<u>500</u>	<u>52,500</u>	<u>-4,500</u>	<u>23,000</u>	<u>-12,500</u>	<u>-3,000</u>
	56,000		=	56,000					

Check Up Corner

Objective 5

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

Financial Statements

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

Exhibit 7

Financial Statements

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

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

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

Exhibit 8Financial
Statements for
NetSolutions**DYNAMIC
EXHIBIT**

**NetSolutions
Income Statement
For the Month Ended November 30, 2017**

Fees earned		\$7,500
Expenses:		
Wages expense	\$2,125	
Rent expense	800	
Supplies expense	800	
Utilities expense	450	
Miscellaneous expense	<u>275</u>	
Total expenses		4,450
Net income		<u><u>\$3,050</u></u>

**NetSolutions
Retained Earnings Statement
For the Month Ended November 30, 2017**

Retained earnings, November 1, 2017		\$ 0
Net income	<u>\$ 3,050</u>	
Dividends	<u>(2,000)</u>	
Change in retained earnings		1,050
Retained earnings, November 30, 2017		<u><u>\$1,050</u></u>

**NetSolutions
Balance Sheet
November 30, 2017**

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

**NetSolutions
Statement of Cash Flows
For the Month Ended November 30, 2017**

Cash flows from operating activities:		
Cash received from customers	\$ 7,500	
Cash payments for expenses and payments to creditors	<u>(4,600)</u>	
Net cash flow from operating activities		\$ 2,900
Cash flows used for investing activities:		
Cash payments for purchase of land		(20,000)
Cash flows from financing activities:		
Cash received from issuing common stock	\$25,000	
Cash dividends	<u>(2,000)</u>	
Net cash flows from financing activities		23,000
Net increase in cash and November 30, 2017, cash balance		<u><u>\$ 5,900</u></u>

note:

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

When expenses exceed revenues, it is referred to as **net loss**.

Income Statement

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

Link to Twitter

For a recent year, **Twitter** reported a net loss of \$645 million.

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

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

Retained Earnings Statement

The retained earnings statement reports the changes in the retained earnings for a period of time. It is prepared *after* the income statement because the net income or net loss for the period must be reported in this statement. Similarly, it is prepared *before* the balance sheet, since the amount of retained earnings at the end of the period must be reported on the balance sheet. Because of this, the retained earnings statement is often viewed as the connecting link between the income statement and balance sheet.

The following two types of transactions affected NetSolutions' retained earnings during November:

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

These transactions are summarized in the retained earnings statement for **NetSolutions** shown in Exhibit 8.

Since NetSolutions has been in operation for only one month, it has no retained earnings at the beginning of November. For December, however, there is a beginning balance—the balance at the end of November. This balance of \$1,050 is reported on the retained earnings statement.

To illustrate, assume that NetSolutions earned net income of \$4,155 and paid dividends of \$2,000 during December. The retained earnings statement for NetSolutions for December follows:

NetSolutions Retained Earnings Statement For the Month Ended December 31, 2017		
Retained earnings, December 1, 2017		\$1,050
Net income.....	\$ 4,155	
Dividends	(2,000)	
Change in retained earnings.....		<u>2,155</u>
Retained earnings, December 31, 2017		<u>\$3,205</u>

Balance Sheet

The balance sheet in Exhibit 8 reports the amounts of **NetSolutions'** assets, liabilities, and stockholders' equity as of November 30, 2017, in a vertical format. This form of balance sheet is commonly used and is called the **report form**.⁴

The asset and liability amounts are taken from the last line of the summary of transactions in Exhibit 5. Retained earnings as of November 30, 2017, is taken from the retained earnings statement.

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

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

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

Liabilities		
Accounts payable	\$12,900	
Wages payable	<u>2,570</u>	
Total liabilities		\$15,470

Statement of Cash Flows

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

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

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

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

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

For a recent year, **Twitter** reported \$1.4 million of cash inflows from operating activities, \$1,306.1 million of cash used for investing activities, \$1,942.2 million of cash from financing activities, and net increase in cash of \$637.5 million.

Link to Twitter

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

Transaction	Amount	Cash Flow Activity
A.	\$25,000	Financing (Issued common stock)
B.	−20,000	Investing (Purchase of land)
D.	7,500	Operating (Fees earned)
E.	−3,650	Operating (Payment of expenses)
F.	−950	Operating (Payment of account payable)
H.	−2,000	Financing (Paid dividends)

Transactions (C) and (G) are not listed since they did not involve a cash receipt or payment. In addition, the payment of accounts payable in transaction (F) is classified as an operating activity because the account payable arose from the purchase of supplies, which are used in