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ACCOUNTING

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Throughout this text, real-world companies are used in the narrative, illustrations, and end-of-chapter assignments. These companies are identified in **boldface** type, and any data presented was adapted from or based upon annual reports, Securities and Exchange Commission filings, or other publicly available sources. Any other individuals or companies used in illustrations or homework are fictional, and any resemblance to actual persons, living or dead, businesses or companies is entirely coincidental.

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Brief Contents

Chapter 1	Introduction to Accounting and Business	2
Chapter 2	Analyzing Transactions	56
Chapter 3	The Adjusting Process	110
Chapter 4	Completing the Accounting Cycle	160
Chapter 5	Accounting Systems	228
Chapter 6	Accounting for Merchandising Businesses	278
Chapter 7	Inventories	346
Chapter 8	Internal Control and Cash	396
Chapter 9	Receivables	444
Chapter 10	Long-Term Assets: Fixed and Intangible	490
Chapter 11	Current Liabilities and Payroll	540
Chapter 12	Accounting for Partnerships and Limited Liability Companies	588
Chapter 13	Corporations: Organization, Stock Transactions, and Dividends	632
Chapter 14	Long-Term Liabilities: Bonds and Notes	679
Chapter 15	Investments	723
Chapter 16	Statement of Cash Flows	765
Chapter 17	Financial Statement Analysis	821
Chapter 18	Introduction to Managerial Accounting	881
Chapter 19	Job Order Costing	922
Chapter 20	Process Cost Systems	966
Chapter 21	Cost-Volume-Profit Analysis	1018
Chapter 22	Budgeting	1072
Chapter 23	Evaluating Variances from Standard Costs	1122
Chapter 24	Decentralized Operations	1170
Chapter 25	Differential Analysis, Product Pricing, and Activity-Based Costing	1216
Chapter 26	Capital Investment Analysis	1270
	Mornin' Joe	MJ-1
Appendix A	Interest Tables	A-2
Appendix B	Revenue Recognition	B-2
Appendix C	Selected Excerpts from Nike Inc., Form 10-K for the Fiscal Year Ended May 31, 2018	C-1
	Glossary	G-1
	Index	I-1

Preface

Roadmap for Success

Warren's *Accounting 28e* makes it easy for you to give students a solid foundation in accounting without overwhelming students. Warren covers the fundamentals AND motivates students to learn by showing how accounting is important to a business.

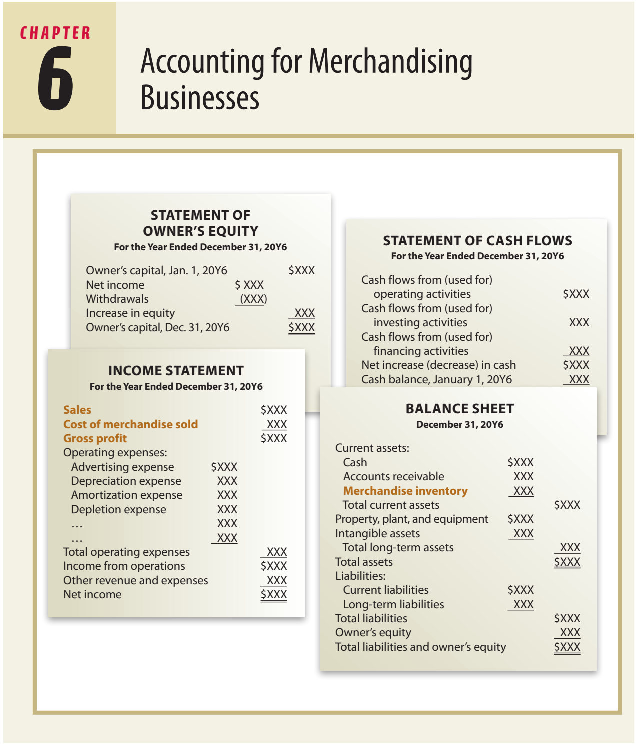
The Warren presentation style provides content in a way that this generation reads and assimilates information.

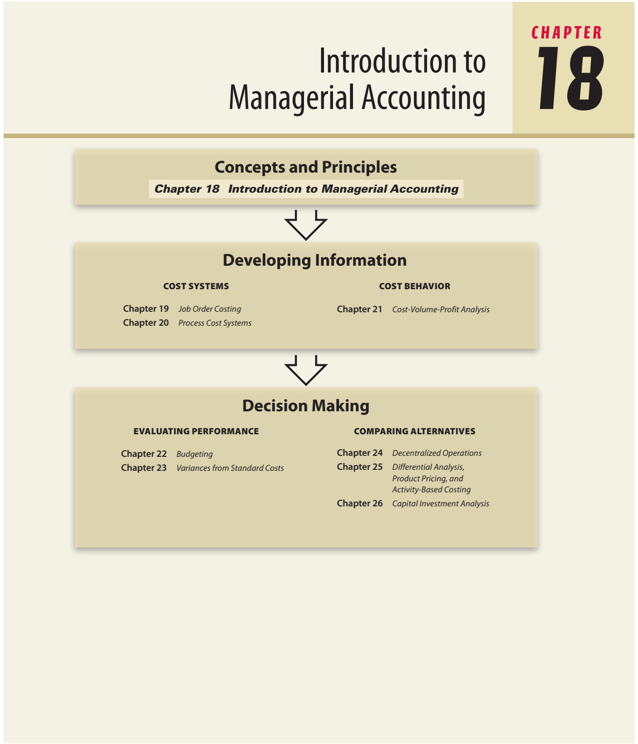
- Short, concise paragraphs and bullets
- Stepwise progression
- Meaningful illustrations and graphs

Hallmarks

Schemas provide a roadmap of accounting that emphasizes the big picture. Each chapter begins with a graphic Schema, or Roadmap of Accounting, that shows readers how the chapter material fits within the larger context of the overall book. With this approach, students view chapter concepts as part of a larger whole rather than as mere independent pieces of knowledge, for a truly functional understanding of accounting.

Financial and managerial sections use separate schemas. A four-part schema (Chs. 1–4) demonstrates how chapter content integrates within the accounting cycle. The financial accounting chapters' schema (Chs. 5–17) highlights chapter content within a set of integrated financial statements. A separate managerial accounting schema (Chs. 18–26) shows how chapter content integrates within the managerial accounting functions.





Revised and refreshed real company chapter openers engage readers from the start. Chapter openers introduce and briefly describe a real company and how its challenges relate to the chapter content. Links to this opening company appear throughout the chapter to reinforce the importance of what readers are learning.


CHAPTER 7

DUSAN PETKOVIC/SHUTTERSTOCK.COM

Best Buy

Assume that in September, you purchased a Sony HDTV from **Best Buy**. At the same time, you purchased a Denon surround sound system for $599.99. You liked your surround sound so well that in November, you purchased an identical Denon system on sale for $549.99 for your bedroom TV. Over the holidays, you moved to a new apartment and in the process of unpacking discovered that one of the Denon surround sound systems was missing. Luckily, your renters or homeowners insurance policy will cover the theft, but the insurance company needs to know the cost of the system that was stolen.

The Denon systems were identical. However, to respond to the insurance company, you will need to identify which system was stolen. Was it the first system, which cost $599.99, or was it the second system, which cost $549.99? Whichever system you choose will determine the amount that you receive from the insurance company.

Merchandising businesses such as Best Buy make similar assumptions when identical merchandise is purchased at different costs. For example, Best Buy may have purchased thousands of Denon surround sound systems over the past year at different costs. At the end of a period, some of the Denon systems will still be in inventory, and some will have been sold. But which costs relate to the sold systems, and which costs relate to the systems still in inventory? Best Buy's assumption about inventory costs can involve large dollar amounts and, thus, can have a significant impact on the financial statements. For example, Best Buy reported $5,409 million of inventory and net income of $1,464 million for a recent year.

This chapter discusses such issues as how to determine the cost of merchandise in inventory and the cost of merchandise sold. However, it begins by discussing the importance of control over inventory.

Link to Best Buy .... Pages 349, 350, 362, 364

Link to Best Buy

Best Buy values its inventory at lower of cost or market based upon cost and the amount it expects to realize from the sale.

Revised end-of-chapter assignments (homework) provide important hands-on practice. Refined, meaningful review and applications at the end of each chapter include Discussion Questions, Practice Exercises (A and B versions), Exercises, Problems (Series A and B), and Cases & Projects that emphasize ethics, teamwork, and communication skills.

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These new algorithmic activities offer pre-populated data directly in Microsoft Excel Online. Each student receives his or her own version of the problem to perform the necessary data calculations in Excel Online. Their work is constantly saved in Cengage cloud storage as a part of homework assignments in CengageNOWv2. It's easily retrievable so students can review their answers without cumbersome file management and numerous downloads/uploads.

MindTap eReader

The MindTap eReader for Warren's *Accounting* is the most robust digital reading experience available. Hallmark features include:

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New to This Edition

- Updated dates and real company information for currency.
- Refreshed end-of-chapter assignments with different numerical values and updated information.
- A new "Time Period Concept" discussion has been added to the "Generally Accepted Accounting Principles" section of Chapter 1. This discussion defines and illustrates the natural business year and fiscal year accounting periods.
- The fiscal year discussion was moved from the prior edition's Chapter 4. In addition, the notation of 20Y1, 20Y2, … is introduced for indicating years throughout the text.
- In Chapter 2, the discussion on "Errors Not Affecting the Trial Balance" has been revised to better aid student understanding and to simplify the preparation of correcting journal entries.
- In Chapter 4, the Accounting Cycle illustration in Exhibit 8 has been revised to facilitate student review.
- In Chapter 4, the "Fiscal Year" discussion has been moved to Chapter 1.
- In Chapter 4, the "Reversing Entry" appendix has been moved to an online appendix.
- A new "Why Is the Accrual Basis of Accounting Required by GAAP?" discussion has been added as Appendix 2 to Chapter 4. The understanding of why accrual accounting is required by GAAP is important for students' ability to analyze and evaluate financial statements. Why accrual accounting is required is illustrated by comparing NetSolutions' financial statements under the accrual basis (Chapters 1–4) with related cash basis financial statements.
- To simplify and give the instructor more flexibility in Chapter 6, the discussion of the accounting for customer merchandise refunds, including the related adjusting entries, has been moved to Appendix 2 at the end of the chapter.
- For those instructors who prefer to cover sales discounts using the gross method, Appendix 1, "Gross Method of Recording Sales Discounts," has been added to the end of Chapter 6.

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Terry R. Spray/InHisImage Studios

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Courtesy of Christine Jonick

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Courtesy of Jennifer Schneider

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Contents

Chapter 1 Introduction to Accounting and Business 2

Nature of Business and Accounting 5
Types of Businesses 5
Role of Accounting in Business 6
Role of Ethics in Accounting and Business 6

Integrity, Objectivity, and Ethics in Business: Bernie Madoff 9
Opportunities for Accountants 9

Business Connection: Pathways Commission 10

Generally Accepted Accounting Principles 10
Business Entity Concept 11

International Connection: International Financial Reporting Standards (IFRS) 11
Time Period Concept 12
Cost Concept 13

The Accounting Equation 13

Business Connection: The Accounting Equation 14

Business Transactions and the Accounting Equation 15
Summary 18

Financial Statements 19
Income Statement 20
Statement of Owner's Equity 21
Balance Sheet 21
Statement of Cash Flows 24
Interrelationships Among Financial Statements 25

Financial Analysis and Interpretation: Ratio of Liabilities to Owner's Equity 26

Continuing Problem 52

Chapter 2 Analyzing Transactions 56

Using Accounts to Record Transactions 59
Chart of Accounts 61

Business Connection: The Hijacking Receivable 61

Double-Entry Accounting System 62
Balance Sheet Accounts 62
Income Statement Accounts 63
Owner Withdrawals 63
Normal Balances 63
Journalizing 64

Integrity, Objectivity, and Ethics in Business: Will Journalizing Prevent Fraud? 67

Journalizing and Posting to Accounts 68

Business Connection: Microsoft's Unearned Revenue 70

Business Connection: Computerized Accounting Systems 72

Trial Balance 78
Errors Affecting the Trial Balance 79
Errors Not Affecting the Trial Balance 80

Financial Analysis and Interpretation: Horizontal Analysis 82

Continuing Problem 106

Chapter 3 The Adjusting Process 110

Nature of the Adjusting Process 113
Accrual and Cash Basis of Accounting 113
Revenue and Expense Recognition 114
The Adjusting Process 114
Types of Accounts Requiring Adjustment 115

Adjusting Entries for Accruals 116
Accrued Revenues 117
Accrued Expenses 118

Business Connection: Earning Revenues from Season Tickets 120

Adjusting Entries for Deferrals 120
Unearned Revenues 121
Prepaid Expenses 122

Business Connection: Sports Signing Bonus 122

Integrity, Objectivity, and Ethics in Business: Free Issue 123

Adjusting Entries for Depreciation 124

Summary of Adjusting Process 126

Business Connection: Microsoft's Deferred Revenues 126

Adjusted Trial Balance 130

Financial Analysis and Interpretation: Vertical Analysis 131

Continuing Problem 156

Chapter 4 Completing the Accounting Cycle 160

Flow of Accounting Information 163

Financial Statements 165

Income Statement 165

Integrity, Objectivity, and Ethics in Business: CEO's Health? 167

Statement of Owner's Equity 167
Balance Sheet 168

International Connection: International Differences 169

Closing Entries 169

Journalizing and Posting Closing Entries 170
Post-Closing Trial Balance 174

Accounting Cycle 174

Illustration of the Accounting Cycle 177

Step 1. Analyzing and Recording Transactions in the Journal 177
Step 2. Posting Transactions to the Ledger 179
Step 3. Preparing an Unadjusted Trial Balance 179
Step 4. Assembling and Analyzing Adjustment Data 180
Step 5. Preparing an Optional End-of-Period Spreadsheet 180
Step 6. Journalizing and Posting Adjusting Entries 180
Step 7. Preparing an Adjusted Trial Balance 182
Step 8. Preparing the Financial Statements 182
Step 9. Journalizing and Posting Closing Entries 184
Step 10. Preparing a Post-Closing Trial Balance 184

Financial Analysis and Interpretation: Working Capital and Current Ratio 187

Appendix 1: End-of-Period Spreadsheet 188

Step 1. Enter the Title 189
Step 2. Enter the Unadjusted Trial Balance 189
Step 3. Enter the Adjustments 190
Step 4. Enter the Adjusted Trial Balance 191
Step 5. Extend the Accounts to the Income Statement and Balance Sheet Columns 192
Step 6. Total the Income Statement and Balance Sheet Columns, Compute the Net Income or Net Loss, and Complete the Spreadsheet 192
Preparing the Financial Statements from the Spreadsheet 193

Appendix 2: Why Is the Accrual Basis of Accounting Required by GAAP? 195

Cash Basis of Accounting 195
Accrual Basis of Accounting 195
Illustration of Cash and Accrual Accounting 196

Continuing Problem 223

Comprehensive Problem 1 224

Chapter 5 Accounting Systems 228

Basic Accounting Systems 230

Manual Accounting Systems 231

Subsidiary Ledgers 231
Special Journals 231
Revenue Journal 233
Cash Receipts Journal 236
Accounts Receivable Control Account and Subsidiary Ledger 238
Purchases Journal 238
Cash Payments Journal 241
Accounts Payable Control Account and Subsidiary Ledger 243

Business Connection: Accounting Systems and Profit Measurement 244

Computerized Accounting Systems 245

Business Connection: TurboTax 247

E-Commerce 247

Integrity, Objectivity, and Ethics in Business: Online Fraud 248

Financial Analysis and Interpretation: Segment Analysis 248

Chapter 6 Accounting for Merchandising Businesses 278

Nature of Merchandising Businesses 280

Operating Cycle 280
Financial Statements 281

Business Connection: Comcast Versus Lowe's 282

Merchandising Transactions 282
Chart of Accounts for a Merchandising Business 282
Purchases Transactions 283
Sales Transactions 288

Integrity, Objectivity, and Ethics in Business: The Case of the Fraudulent Price Tags 291
Freight 292
Summary: Recording Merchandise Inventory Transactions 294
Dual Nature of Merchandise Transactions 294
Sales Taxes and Trade Discounts 296

Business Connection: Sales Taxes 297

The Adjusting Process 297
Adjusting Entry for Inventory Shrinkage 297

Integrity, Objectivity, and Ethics in Business: The Cost of Employee Theft 298
Adjusting Entries for Customer Refunds and Allowances 298

Financial Statements for a Merchandising Business 299
Multiple-Step Income Statement 299
Single-Step Income Statement 301
Statement of Owner's Equity 301
Balance Sheet 301
The Closing Process 302

Financial Analysis and Interpretation: Asset Turnover 303

Appendix 1: Gross Method of Recording Sales Discounts 305
Transactions 305

Adjusting Entry 306

Subsequent Period 306
Comparison with the Net Method 307

Appendix 2: Returns of Merchandise 308

Appendix 3: The Periodic Inventory System 310
Chart of Accounts Under the Periodic Inventory System 310
Recording Merchandise Transactions Under the Periodic Inventory System 311
Adjusting Process Under the Periodic Inventory System 311
Financial Statements Under the Periodic Inventory System 312
Closing Entries Under the Periodic Inventory System 313

Comprehensive Problem 2 341

Chapter 7 Inventories 346

Control of Inventory 348
Safeguarding Inventory 348
Reporting Inventory 349

Inventory Cost Flow Assumptions 349

Business Connection: Pawn Stars and Specific Identification 351

Inventory Costing Methods Under a Perpetual Inventory System 352
First-In, First-Out Method 352
Last-In, First-Out Method 353

International Connection: International Financial Reporting Standards (IFRS) 355
Weighted Average Cost Method 355

Business Connection: Computerized Perpetual Inventory Systems 357

Inventory Costing Methods Under a Periodic Inventory System 357
First-In, First-Out Method 357
Last-In, First-Out Method 358
Weighted Average Cost Method 359

Comparing Inventory Costing Methods 360

Integrity, Objectivity, and Ethics in Business: Where's the Bonus? 361

Reporting Merchandise Inventory in the Financial Statements 361
Valuation at Lower of Cost or Market 361

Business Connection: Good Samaritan 363
Merchandise Inventory on the Balance Sheet 363
Effect of Inventory Errors on the Financial Statements 364

Financial Analysis and Interpretation: Inventory Turnover and Days' Sales in Inventory 367

Business Connection: Rapid Inventory at Costco 367

Appendix: Estimating Inventory Cost 370
Retail Method of Inventory Costing 370
Gross Profit Method of Inventory Costing 371

Chapter 8 Internal Control and Cash 396

Sarbanes-Oxley Act 398

Internal Control 400
Objectives of Internal Control 400

Business Connection: Employee Fraud 400
Elements of Internal Control 400
Control Environment 401
Risk Assessment 402
Control Procedures 402

Integrity, Objectivity, and Ethics in Business: Tips on Preventing Employee Fraud in Small Companies 403
Monitoring 404
Information and Communication 404
Limitations of Internal Control 405

Cash Controls over Receipts and Payments 405

Business Connection: What Is Cryptocurrency? 406
Control of Cash Receipts 406
Control of Cash Payments 408

Business Connection: Mobile Payments 409

Bank Accounts 409
Bank Statement 409
Using the Bank Statement as a Control over Cash 412

Bank Reconciliation 412

Integrity, Objectivity, and Ethics in Business: Bank Error in Your Favor (or Maybe Not) 416

Special-Purpose Cash Funds 416

Financial Statement Reporting of Cash 417

Business Connection: Managing Apple's Cash 418

Financial Analysis and Interpretation: Ratio of Cash to Monthly Cash Expenses 418

Business Connection: Microsoft Corporation 420

Chapter 9 Receivables 444

Classification of Receivables 446
Accounts Receivable 446
Notes Receivable 446
Other Receivables 447

Uncollectible Receivables 447

Business Connection: Warning Signs 448

Direct Write-Off Method for Uncollectible Accounts 448

Allowance Method for Uncollectible Accounts 449

Integrity, Objectivity, and Ethics in Business: Collecting Past Due Accounts 450
Write-Offs to the Allowance Account 450

Business Connection: Failure to Collect 452
Estimating Uncollectibles 452

Business Connection: Allowance Percentages Across Companies 457

Comparing Direct Write-Off and Allowance Methods 457

Notes Receivable 458
Characteristics of Notes Receivable 458
Accounting for Notes Receivable 460

Reporting Receivables on the Balance Sheet 462

Business Connection: Delta Air Lines 462

Financial Analysis and Interpretation: Accounts Receivable Turnover and Days' Sales in Receivables 463

Chapter 10 Long-Term Assets: Fixed and Intangible 490

Nature of Fixed Assets 492
Classifying Costs 492

Business Connection: Fixed Assets 493
The Cost of Fixed Assets 494
Leasing Fixed Assets 495

Accounting for Depreciation 496
Factors in Computing Depreciation Expense 496
Straight-Line Method 497
Units-of-Activity Method 499
Double-Declining-Balance Method 501
Comparing Depreciation Methods 503
Partial-Year Depreciation 503

Business Connection: Depreciating Animals 504
Revising Depreciation Estimates 505
Repair and Improvements 506

Integrity, Objectivity, and Ethics in Business: Capital Crime 507

Disposal of Fixed Assets 508
Discarding Fixed Assets 508
Selling Fixed Assets 509

Business Connection: Downsizing 510

Natural Resources 511

Intangible Assets 512
Patents 512
Copyrights and Trademarks 513
Goodwill 513

International Connection: International Financial Reporting Standards (IFRS) 515

Financial Reporting for Long-Term Assets: Fixed and Intangible 515

Financial Analysis and Interpretation: Fixed Asset Turnover Ratio 516

Fixed Asset Turnover Ratio 516

Business Connection: Hub-and-Spoke or Point-to-Point? 517

Appendix: Exchanging Similar Fixed Assets 518

Gain on Exchange 518
Loss on Exchange 519

Chapter 11 Current Liabilities and Payroll 540

Current Liabilities 542

Accounts Payable 542
Current Portion of Long-Term Debt 542
Short-Term Notes Payable 543

Payroll and Payroll Taxes 545

Liability for Employee Earnings 545
Deductions from Employee Earnings 545
Computing Employee Net Pay 548
Liability for Employer's Payroll Taxes 549

Business Connection: The Most You Will Ever Pay 549

Accounting Systems for Payroll and Payroll Taxes 549

Payroll Register 550
Employee's Earnings Record 552
Payroll Checks 554
Computerized Payroll System 555
Internal Controls for Payroll Systems 555

Integrity, Objectivity, and Ethics in Business: Overbilling Clients 556

Employees' Fringe Benefits 556

Vacation Pay 556
Pensions 557
Postretirement Benefits Other Than Pensions 558
Current Liabilities on the Balance Sheet 558

Contingent Liabilities 559

Probable and Estimable 559
Probable and Not Estimable 560
Reasonably Possible 560
Remote 560

Financial Analysis and Interpretation: Quick Ratio 561

Comprehensive Problem 3 582

Chapter 12 Accounting for Partnerships and Limited Liability Companies 588

Proprietorships, Partnerships, and Limited Liability Companies 590

Proprietorships 590
Partnerships 591

Business Connection: Breaking Up Is Hard To Do 591

Limited Liability Companies 592
Comparing Proprietorships, Partnerships, and Limited Liability Companies 592

Business Connection: Organizational Forms in the Accounting Industry 592

Forming a Partnership and Dividing Income 593

Forming a Partnership 593
Dividing Income 594

Integrity, Objectivity, and Ethics in Business: Tyranny of the Majority 596

Partner Admission and Withdrawal 597

Admitting a Partner 597
Withdrawal of a Partner 603
Death of a Partner 603

Liquidating Partnerships 603

Gain on Realization 604
Loss on Realization 606
Loss on Realization—Capital Deficiency 607

Statement of Partnership Equity 610

Financial Analysis and Interpretation: Revenue per Employee 610

Chapter 13 Corporations: Organization, Stock Transactions, and Dividends 632

Nature of a Corporation 634

Characteristics of a Corporation 634
Forming a Corporation 635

Business Connection 636

Stockholders' Equity 637

Paid-In Capital from Stock 638

Characteristics of Stock 638
Classes of Stock 639

Business Connection: You Have No Vote 639

Issuing Stock 640

Premium on Stock 641
No-Par Stock 642

Integrity, Objectivity, and Ethics in Business: The Professor Who Knew Too Much 643

Accounting for Dividends 643
Cash Dividends 643
Stock Dividends 645

Stock Splits 646

Business Connection: Buffett on Stock Splits 647

Treasury Stock Transactions 648

Business Connection: Treasury Stock or Dividends? 649

Reporting Stockholders' Equity 649
Stockholders' Equity on the Balance Sheet 649
Reporting Retained Earnings 651
Statement of Stockholders' Equity 652

International Connection: International Financial Reporting Standards for SMEs 653
Reporting Stockholders' Equity for Mornin' Joe 653

Financial Analysis and Interpretation: Earnings per Share 655

Chapter 14 Long-Term Liabilities: Bonds and Notes 679

Financing Corporations 681

Nature of Bonds Payable 683
Bond Characteristics and Terminology 684
Proceeds from Issuing Bonds 684

Business Connection: Investor Bond Price Risk 685

Accounting for Bonds Payable 685
Bonds Issued at Face Amount 685
Bonds Issued at a Discount 686
Amortizing a Bond Discount 687

Business Connection: U.S. Government Debt 688
Bonds Issued at a Premium 689
Amortizing a Bond Premium 690

Business Connection: Bond Ratings 691
Bond Redemption 691

Installment Notes 692
Issuing an Installment Note 693
Annual Payments 693

Integrity, Objectivity, and Ethics in Business: The Ratings Game 695

Reporting Long-Term Liabilities 695

Financial Analysis and Interpretation: Times Interest Earned Ratio 695

Appendix 1: Present Value Concepts and Pricing Bonds Payable 697
Present Value Concepts 697
Pricing Bonds 700

Appendix 2: Interest Rate Method of Amortization 701
Amortization of Discount by the Interest Method 701
Amortization of Premium by the Interest Method 702

Chapter 15 Investments 723

Why Companies Invest 725
Investing Cash in Current Operations 725
Investing Cash in Temporary Investments 725
Investing Cash in Long-Term Investments 726

Equity Investments 726
Fair Value Method: Less Than 20% Ownership 726
Equity Method: Between 20%–50% Ownership 729
Consolidation: More Than 50% Ownership 731

Business Connection: More Cash Means More Investments for Drug Companies 731

Held-to-Maturity Investments 731
Purchase of Bonds 732
Receipt of Interest 732
Sale of Bonds 733
Reporting on Financial Statements 734

Trading and Available-for-Sale Investments 734
Trading Securities 735
Available-for-Sale Securities 736

Integrity, Objectivity, and Ethics in Business: Socially Responsible Investing 736
Summary 738

Business Connection: Warren Buffett: The Sage of Omaha 740

Financial Analysis and Interpretation: Dividend Yield 740

Appendix: Comprehensive Income 741

Comprehensive Problem 4 761

Chapter 16 Statement of Cash Flows 765

Reporting Cash Flows 767
- Cash Flows from (used for) Operating Activities 768

Business Connection: Cash Crunch! 770
- Cash Flows from (used for) Investing Activities 770
- Cash Flows from (used for) Financing Activities 770
- Noncash Investing and Financing Activities 770
- Format of the Statement of Cash Flows 771
- Cash Flow per Share 771

Cash Flows from (used for) Operating Activities 772
- Net Income 773
- Adjustments to Net Income 774

Integrity, Objectivity, and Ethics in Business: Credit Policy and Cash Flow 777

Cash Flows from (used for) Investing Activities 778
- Land 778
- Building and Accumulated Depreciation—Building 779

Cash Flows from (used for) Financing Activities 779
- Bonds Payable 780
- Common Stock 780
- Dividends and Dividends Payable 781

Prepare a Statement of Cash Flows—Indirect Method 782

International Connection: IFRS for Statement of Cash Flows 783

Financial Analysis and Interpretation: Free Cash Flow 783

Business Connection: Growing Pains 784

Appendix 1: Spreadsheet (Work Sheet) for Statement of Cash Flows—The Indirect Method 785
- Analyzing Accounts 785
- Retained Earnings 785
- Other Accounts 787
- Preparing the Statement of Cash Flows 787

Appendix 2: Preparing the Statement of Cash Flows—The Direct Method 788
- Cash Received from Customers 788
- Cash Paid for Merchandise 789
- Cash Paid for Operating Expenses 789
- Gain on Sale of Land 790
- Interest Expense 790
- Cash Paid for Income Taxes 790
- Reporting Cash Flows from (used for) Operating Activities—Direct Method 791

Chapter 17 Financial Statement Analysis 821

Analyzing and Interpreting Financial Statements 823
- The Value of Financial Statement Information 823
- Techniques for Analyzing Financial Statements 824

Basic Analytical Methods 824
- Horizontal Analysis 824
- Vertical Analysis 827
- Common-Sized Statements 828

Analyzing Liquidity 829
- Current Position Analysis 830
- Accounts Receivable Analysis 832
- Inventory Analysis 833

Business Connection: Flying Off the Shelves 835

Analyzing Solvency 835
- Ratio of Fixed Assets to Long-Term Liabilities 836
- Ratio of Liabilities to Stockholders' Equity 836
- Times Interest Earned 837

Business Connection: Liquidity Crunch 838

Analyzing Profitability 838
- Asset Turnover 838
- Return on Total Assets 839
- Return on Stockholders' Equity 840

Business Connection: Gearing for Profit 841
- Return on Common Stockholders' Equity 841
- Earnings per Share on Common Stock 842
- Price-Earnings Ratio 843
- Dividends per Share 844
- Dividend Yield 845

Business Connection: Investing for Yield 845
- Summary of Analytical Measures 845

Corporate Annual Reports 847
- Management Discussion and Analysis 847
- Report on Internal Control 847

Integrity, Objectivity, and Ethics in Business: Characteristics of Financial Statement Fraud 847
- Report on Fairness of the Financial Statements 848

Appendix: Unusual Items on the Income Statement 848
- Unusual Items Affecting the Current Period's Income Statement 848
- Unusual Items Affecting the Prior Period's Income Statement 850

Nike, Inc., Problem 877

Chapter 18 Introduction to Managerial Accounting 881

Managerial Accounting 883
Differences Between Managerial and Financial Accounting 883
The Management Accountant in the Organization 884
The Management Process 886

Business Connection: Line and Staff for Service Companies 886
Uses of Managerial Accounting Information 887

Manufacturing Operations: Costs and Terminology 888
Direct and Indirect Costs 889
Manufacturing Costs 890

Business Connection: Overhead Costs 891

Sustainability and Accounting 894
Sustainability 895
Eco-Efficiency Measures in Managerial Accounting 895

Integrity, Objectivity, and Ethics in Business: Environmental Managerial Accounting 896

Financial Statements for a Manufacturing Business 896
Balance Sheet for a Manufacturing Business 896
Income Statement for a Manufacturing Business 896

Service Focus: Managerial Accounting in the Service Industry 901

Chapter 19 Job Order Costing 922

Cost Accounting Systems Overview 924
Job Order Cost Systems 924
Process Cost Systems 924

Job Order Cost Systems for Manufacturing Businesses 925
Materials 925

Integrity, Objectivity, and Ethics in Business: Phony Invoice Scams 927
Factory Labor 928

Business Connection: 3D Printing 929
Factory Overhead 929

Business Connection: Advanced Robotics 930
Work in Process 934
Finished Goods 935
Sales and Cost of Goods Sold 936
Period Costs 936
Summary of Cost Flows for Legend Guitars 936

Job Order Costing for Decision Making 938

Job Order Cost Systems for Service Businesses 939
Types of Service Businesses 939
Flow of Costs in a Service Job Order Cost System 940

Service Focus: Job Order Costing in a Law Firm 941

Chapter 20 Process Cost Systems 966

Process Cost Systems 968

Integrity, Objectivity, and Ethics in Business: On Being Green 968
Comparing Job Order and Process Cost Systems 969
Cost Flows for a Process Manufacturer 971

Business Connection: Sustainable Papermaking 973

Cost of Production Report 974
Step 1: Determine the Units to Be Assigned Costs 974
Step 2: Compute Equivalent Units of Production 976
Step 3: Determine the Cost per Equivalent Unit 979
Step 4: Allocate Costs to Units Transferred Out and Partially Completed Units 980
Preparing the Cost of Production Report 982

Journal Entries for a Process Cost System 983

Service Focus: Costing the Power Stack 986

Using the Cost of Production Report for Decision Making 987
Cost per Equivalent Unit Between Periods 987
Cost Category Analysis 987
Yield 988

Lean Manufacturing 989
Traditional Production Process 989
Lean Production Process 990

Appendix: Weighted Average Cost Method 991
Determining Costs Using the Weighted Average Cost Method 991
The Cost of Production Report 993

Chapter 21 Cost-Volume-Profit Analysis 1018

Cost Behavior 1020
Variable Costs 1020
Fixed Costs 1022
Mixed Costs 1022
Summary of Cost Behavior Concepts 1025

Business Connection: Booking Fees 1026

Cost-Volume-Profit Relationships 1026
- Contribution Margin 1027
- Contribution Margin Ratio 1027
- Unit Contribution Margin 1028

Mathematical Approach to Cost-Volume-Profit Analysis 1029
- Break-Even Point 1029
- Target Profit 1033

Business Connection: Airline Industry Break-Even 1034

Integrity, Objectivity, and Ethics in Business: Orphan Drugs 1035

Graphic Approach to Cost-Volume-Profit Analysis 1035
- Cost-Volume-Profit (Break-Even) Chart 1035
- Profit-Volume Chart 1037
- Use of Spreadsheets in Cost-Volume-Profit Analysis 1040
- Assumptions of Cost-Volume-Profit Analysis 1040

Service Focus: Profit, Loss, and Break-Even in Major League Baseball 1040

Special Cost-Volume-Profit Relationships 1040
- Sales Mix Considerations 1041
- Operating Leverage 1042
- Margin of Safety 1044

Appendix: Variable Costing 1045

Chapter 22 Budgeting 1072

Nature and Objectives of Budgeting 1074
- Objectives of Budgeting 1074
- Human Behavior and Budgeting 1075

Integrity, Objectivity, and Ethics in Business: Budget Games 1076

Budgeting Systems 1076
- Static Budget 1077

Service Focus: Film Budgeting 1078
- Flexible Budget 1078
- Computerized Budgeting Systems 1079

Master Budget 1080

Operating Budgets 1080
- Sales Budget 1080
- Production Budget 1082
- Direct Materials Purchases Budget 1082
- Direct Labor Cost Budget 1084
- Factory Overhead Cost Budget 1086
- Cost of Goods Sold Budget 1086
- Selling and Administrative Expenses Budget 1088

Business Connection: Mad Men 1089
- Budgeted Income Statement 1089

Financial Budgets 1090
- Cash Budget 1090
- Capital Expenditures Budget 1093
- Budgeted Balance Sheet 1094

Chapter 23 Evaluating Variances from Standard Costs 1122

Standards 1124
- Setting Standards 1124
- Types of Standards 1125
- Reviewing and Revising Standards 1125
- Criticisms of Standard Costs 1125

Integrity, Objectivity, and Ethics in Business: Company Reputation: The Best of the Best 1125

Business Connection: Standard Costing in Action: Expanding Brewing Operations 1126

Budgetary Performance Evaluation 1126
- Budget Performance Report 1127
- Manufacturing Cost Variances 1127

Direct Materials and Direct Labor Variances 1129
- Direct Materials Variances 1129

Service Focus: Standard Costing in the Restaurant Industry 1131
- Direct Labor Variances 1132

Factory Overhead Variances 1134
- The Factory Overhead Flexible Budget 1134
- Variable Factory Overhead Controllable Variance 1136
- Fixed Factory Overhead Volume Variance 1137
- Reporting Factory Overhead Variances 1139
- Factory Overhead Account 1140

Recording and Reporting Variances from Standards 1141

Nonfinancial Performance Measures 1144

Comprehensive Problem 5 1164

Chapter 24 Decentralized Operations 1170

Centralized and Decentralized Operations 1172
- Advantages of Decentralization 1172
- Disadvantages of Decentralization 1173

Business Connection: Dover Corporation: Many Pieces, One Picture 1173
Responsibility Accounting 1173
Responsibility Accounting for Cost Centers 1174
Responsibility Accounting for Profit Centers 1176
Service Department Cost Allocations 1176
Profit Center Reporting 1178
Responsibility Accounting for Investment Centers 1179
Return on Investment 1180
Business Connection: Coca-Cola Company: Go West Young Man 1182
Residual Income 1183
The Balanced Scorecard 1185
Service Focus: Turning Around Charles Schwab 1186
Transfer Pricing 1186
Market Price Approach 1187
Negotiated Price Approach 1188
Cost Price Approach 1190
Integrity, Objectivity, and Ethics in Business: The Ethics of Transfer Prices 1191

Chapter 25 Differential Analysis, Product Pricing, and Activity-Based Costing 1216

Differential Analysis 1218
Lease or Sell 1220
Discontinue a Segment or Product 1221
Make or Buy 1223
Replace Equipment 1224
Process or Sell 1226
Accept Business at a Special Price 1227
Business Connection: 60% Off! 1228
Setting Normal Product Selling Prices 1229
Service Focus: Revenue Management 1230
Product Cost Concept 1230
Integrity, Objectivity, and Ethics in Business: Price Fixing 1232
Target Costing 1232
Production Bottlenecks 1233
Activity-Based Costing 1235
Estimated Activity Costs 1235
Activity Rates 1236
Overhead Allocation 1236
Business Connection: The ABC's of Schwab 1237
Dangers of Product Cost Distortion 1238
Appendix: Total and Variable Cost Concepts to Setting Normal Price 1239
Total Cost Concept 1239
Variable Cost Concept 1242

Chapter 26 Capital Investment Analysis 1270

Nature of Capital Investment Analysis 1272
Business Connection: Business Use of Investment Analysis Methods 1273
Methods Not Using Present Values 1273
Average Rate of Return Method 1273
Cash Payback Method 1274
Methods Using Present Values 1276
Present Value Concepts 1276
Net Present Value Method and Index 1279
Internal Rate of Return Method 1281
Business Connection: Panera Bread Rate of Return 1283
Additional Factors in Capital Investment Analysis 1284
Income Tax 1284
Unequal Proposal Lives 1284
Lease Versus Purchase 1286
Uncertainty 1286
Service Focus: If You Build It, They Will Come 1286
Changes in Price Levels 1287
Qualitative Considerations 1287
Capital Investment for Sustainability 1287
Integrity, Objectivity, and Ethics in Business: Assumption Fudging 1288
Capital Rationing 1288

Mornin' Joe MJ-1

Financial Statements for Mornin' Joe MJ-1

Appendix A: Interest Tables A-2
Appendix B: Revenue Recognition B-2
Appendix C: Selected Excerpts from Nike Inc., Form 10-K for the Fiscal Year Ended May 31, 2018 C-1

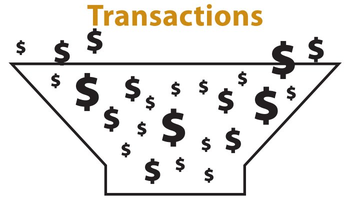
Glossary G-1
Index I-1

CHAPTER

1 Introduction to Accounting and Business

Chapter 1

Transactions



Accounting System

Accounting Equation

Assets = Liabilities + Owner's Equity

Chapter 2

Account

Debits	Credits

Rules of Debit and Credit

BALANCE SHEET ACCOUNTS

ASSETS = LIABILITIES + OWNER'S EQUITY

Asset Accounts

Debit for increases (+)	Credit for decreases (–)
Balance	

Liability Accounts

Debit for decreases (–)	Credit for increases (+)
	Balance

Owner's Capital Account

Debit for decreases (–)	Credit for increases (+)
	Balance

Owner's Drawing Account

Debit for increases (+)	Credit for decreases (–)
Balance	

Income Statement Accounts

Revenue Accounts

Debit for decreases (–)	Credit for increases (+)
	Balance

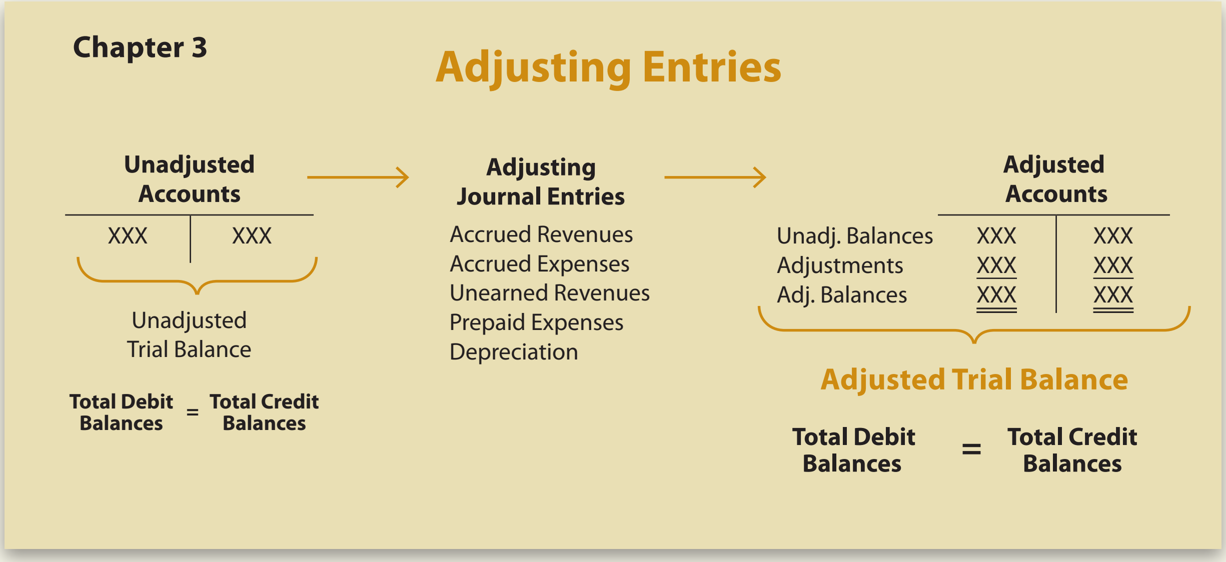
Expense Accounts

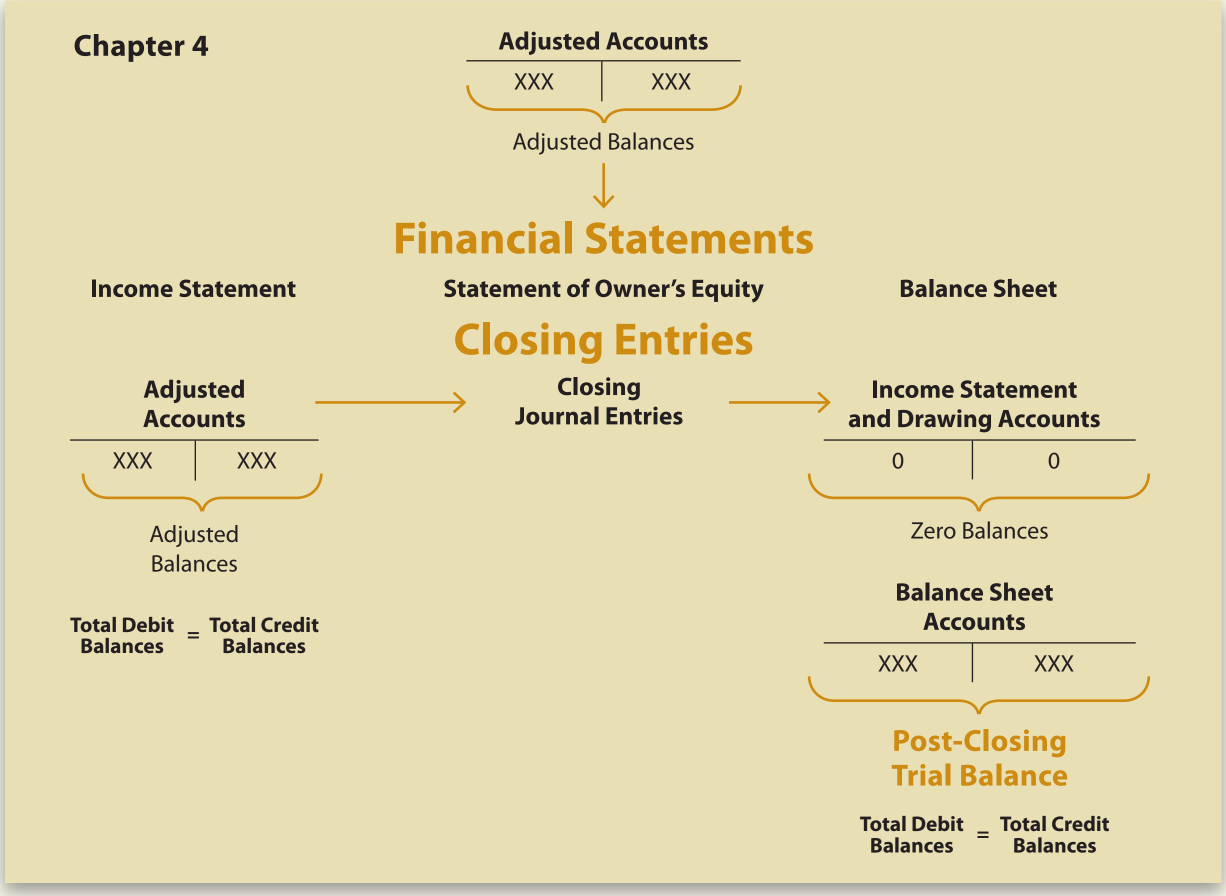
Debit for increases (+)	Credit for decreases (–)
Balance	

Unadjusted Trial Balance

Total Debit Balances = Total Credit Balances

CHAPTER 1


Chapter 3
Adjusting Entries
Unadjusted Accounts
XXX
XXX
Unadjusted Trial Balance
Total Debit Balances = Total Credit Balances
Adjusting Journal Entries
Accrued Revenues
Accrued Expenses
Unearned Revenues
Prepaid Expenses
Depreciation
Adjusted Accounts
Unadj. Balances XXX XXX
Adjustments XXX XXX
Adj. Balances XXX XXX
Adjusted Trial Balance
Total Debit Balances = Total Credit Balances


Chapter 4
Adjusted Accounts
XXX
XXX
Adjusted Balances
Financial Statements
Income Statement
Statement of Owner's Equity
Balance Sheet
Closing Entries
Adjusted Accounts
XXX
XXX
Adjusted Balances
Total Debit Balances = Total Credit Balances
Closing Journal Entries
Income Statement and Drawing Accounts
0
0
Zero Balances
Balance Sheet Accounts
XXX
XXX
Post-Closing Trial Balance
Total Debit Balances = Total Credit Balances

CHAPTER 1

PHOTOMIX-COMPANY/PIXABAY

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, Inc. 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.

Link to Twitter . . . . Pages 6, 12, 14, 20, 24

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

Example Exercises (EE) are shown in **red.**

OBJ. 1 **Describe the nature of business and the role of accounting and ethics in business.**

Nature of Business and Accounting
Types of Businesses
Role of Accounting in Business
Role of Ethics in Accounting and Business
Opportunities for Accountants

OBJ. 2 **Summarize the development of accounting principles and relate them to practice.**

Generally Accepted Accounting Principles
Business Entity Concept
Time Period Concept
Cost Concept — EE **1-1**

OBJ. 3 **State the accounting equation and define each element of the equation.**

The Accounting Equation
Solving the Accounting Equation — EE **1-2**

OBJ. 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
Recording Transactions — EE **1-3**

OBJ. 5 **Describe the financial statements of a proprietorship and explain how they interrelate.**

Financial Statements
Income Statement — EE **1-4**
Statement of Owner's Equity — EE **1-5**
Balance Sheet — EE **1-6**
Statement of Cash Flows — EE **1-7**
Interrelationships Among Financial Statements

OBJ. 6 **Describe and illustrate the use of the ratio of liabilities to owner's equity in evaluating a company's financial condition.**

Financial Analysis and Interpretation: Ratio of Liabilities to Owner's Equity
Computing and Interpreting Ratio of Liabilities to Owner's Equity — EE **1-8**

At a Glance 1 Page 28

Nature of Business and Accounting

OBJ. 1 Describe the nature of business and the role of accounting and ethics in business.

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 $24 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 Air Lines (transportation services)
  The Walt Disney Company (entertainment services)

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

Link to Twitter

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

- **Merchandising businesses** sell products they purchase from other businesses to customers.
  Wal-Mart Stores, Inc. (general merchandise)
  Amazon.com (general merchandise)
- **Manufacturing businesses** convert basic inputs into products that are sold to customers.
  Ford Motor Co. (cars, trucks, vans)
  Dell Inc. (personal computers)

Role of Accounting in Business

Note

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

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.

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. Oftentimes, 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**.

Link to Twitter

One of the ways **Twitter** provides information to its investors is by publishing an annual report, which includes general-purpose financial statements.

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**.

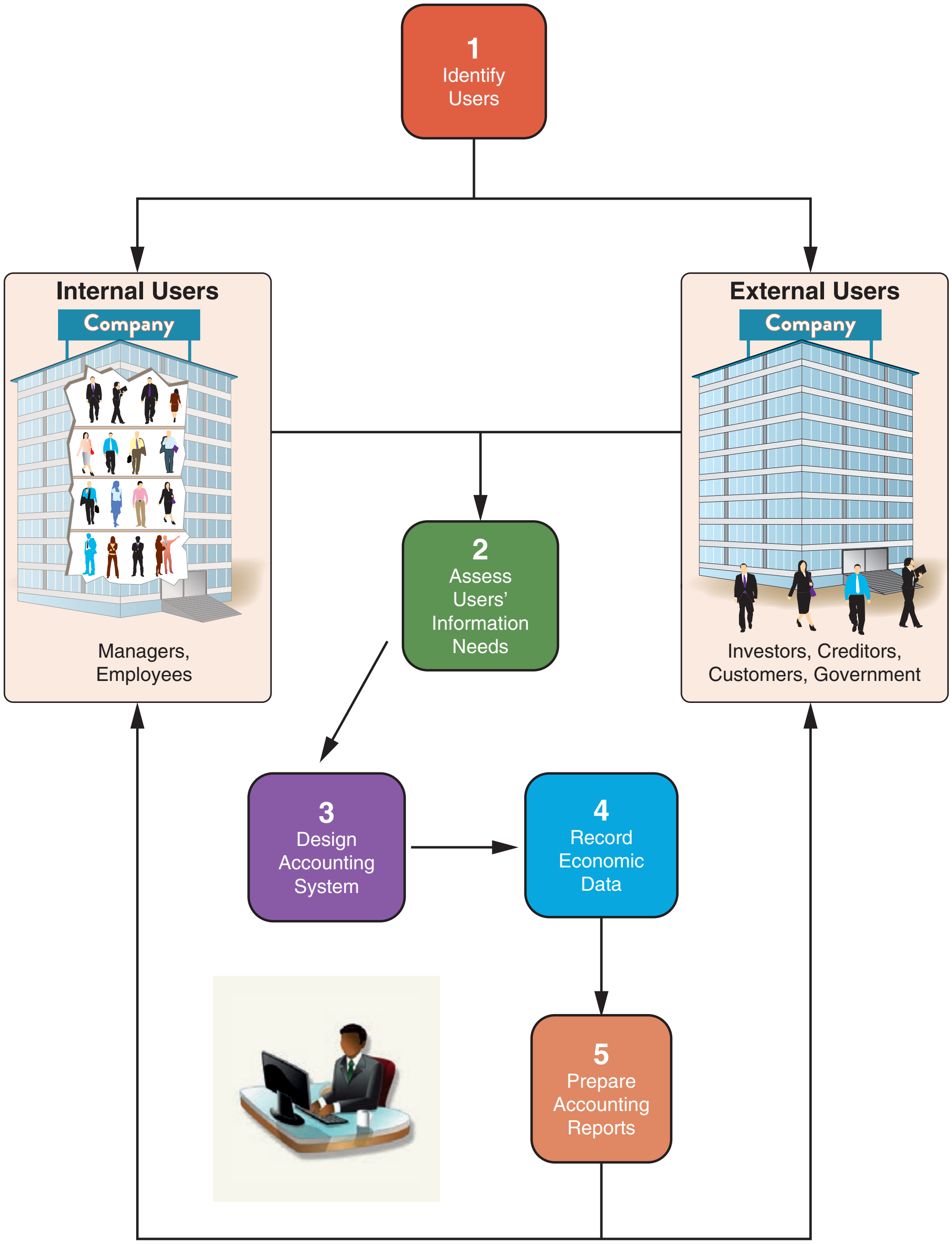
The objective of financial accounting is to provide relevant and timely information for the decision-making needs of users outside the business. For example, financial reports on the operations and condition of the business are useful for banks and other creditors in deciding whether to lend money to 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.

Role of Ethics in Accounting and Business

ETHICS

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.

Accounting as an Information System **EXHIBIT 1**



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
Computer Associates International, Inc.	Fraudulently reported its financial results.	CEO and senior executives indicted. Five executives pled guilty. $225 million fine.
Enron	Fraudulently reported 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 reported $3 billion in false receipts.	CEO and six other executives criminally convicted of "massive financial fraud." $250 million SEC fine.
Xerox 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 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.

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 websites at www.imanet.org and www.aicpa.org, respectively.

Integrity, Objectivity, and Ethics in Business

BERNIE MADOFF

In June 2009, 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.

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 who work for 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. Accountants who provide audit services, called auditors, attest to the accuracy of financial records, accounts, and systems. As shown in Exhibit 3, several private accounting careers have certification options.

Accounting Career Paths and Salaries **EXHIBIT 3**

Accounting Career Track	Description	Career Options	Annual Starting Salaries*	Certification
Private Accounting	Accountants employed by companies, government, and not-for-profit entities.	Bookkeeper	$43,000	
		Payroll clerk	$39,000	Certified Payroll Professional (CPP)
		General accountant	$47,000	
		Budget analyst	$51,000	
		Cost accountant	$49,000	Certified Management Accountant (CMA)
		Internal auditor	$46,000	Certified Internal Auditor (CIA)
		Information technology auditor	$51,000	Certified Information Systems Auditor (CISA)
Public Accounting	Accountants employed individually or within a public accounting firm in audit, tax, or management advisory services.		$47,000	Certified Public Accountant (CPA)

*Average salaries rounded to the nearest thousand. Salaries may vary by size of company and region.
Source: Robert Half *2019 U.S. Salary Guide (Finance and Accounting)*, Robert Half International, Inc. (www.roberthalf.com/workplace-research/salary-guides).

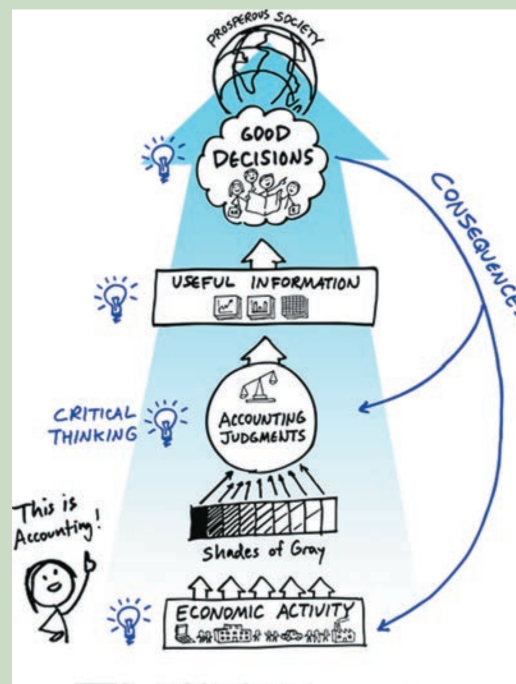
Accountants who provide services on a fee basis are said to be employed in **public accounting**. In public accounting, an accountant may practice as an individual or as a member of a public accounting firm. Public accountants who have met a state's education, experience, and examination requirements may become **Certified Public Accountants (CPAs)**.

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

Business Connection

PATHWAYS COMMISSION

The Pathways Commission 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.

OBJ. 2 Summarize the development of accounting principles and relate them to practice.

Generally Accepted Accounting Principles

If companies did not follow the same rules when reporting financial information, comparisons among companies would be difficult, if not impossible. Thus, financial accountants follow **generally accepted accounting principles (GAAP)** in preparing reports. These reports allow investors and other users to compare one company to another.

Accounting principles and concepts develop from research, accepted accounting practices, and pronouncements of regulators. Within the United States, the

Financial Accounting Standards Board (FASB) has the primary responsibility for developing accounting principles. The FASB maintains an electronic database, called the **Accounting Standards Codification**, that contains all the accounting standards that make up GAAP. Changes in the FASB Codification are made using **Accounting Standards Updates**.

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 principles 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.

Many countries outside the United States use accounting 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. Investors and other stakeholders should be aware of these differences in analyzing financial reports of international companies. Throughout this text, International Connection boxes, such as the one at the bottom of this page, highlight many of these differences. In addition, Appendix B at the end of this text summarizes differences between U.S. GAAP and IFRS.

In this chapter and text, accounting principles and concepts are emphasized. It is through this emphasis on the "why" as well as the "how" that you will gain an understanding of accounting.

Business Entity Concept

The **business entity concept** limits the economic data in an accounting system to data related directly 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.

Note

Under the business entity concept, the activities of a business are recorded separately from the activities of its owners, creditors, or other businesses.

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.

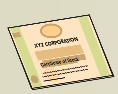
The three types of businesses discussed earlier—service, merchandising, and manufacturing—may be organized as proprietorships, partnerships, corporations, or limited liability companies. Because of the large amount of resources required to operate a manufacturing business, most manufacturers such as **Ford Motor Company** are corporations. Most large retailers such as **Wal-Mart** and **The Home Depot** are also corporations.

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.

EXHIBIT 4 Forms of Business Entities

Form of Business Entity		Characteristics	Examples
	**Proprietorship** is owned by one individual.	• 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.	• A & B Painting
	**Partnership** is owned by two or more individuals.	• 10% of business organizations in the United States (combined with limited liability companies). • Combines the skills and resources of more than one person.	• Jones & Smith, Architects
	**Corporation** is organized under state or federal statutes as a separate legal taxable entity.	• 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.	• **Alphabet (Google)** • **Apple** • **Ford Motor Company** • **Twitter**
	**Limited liability company (LLC)** combines the attributes of a partnership and a corporation.	• 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.	• Mosel & Farmer, CPAs, LLC

Time Period Concept

The **time period concept** requires a company to report its economic activities on a regular basis for a specific period. In doing so, financial condition and operating results of the company are reported periodically on a consistent basis. Financial accounting reports are often prepared monthly, quarterly, and yearly.

The annual accounting period adopted by a company is called its **fiscal year**. The fiscal year most commonly used is the calendar year beginning January 1 and ending December 31. However, other periods are not unusual, especially for companies organized as corporations.

Link to Twitter

Twitter uses an annual accounting period ending December 31.

Corporations often use a fiscal year that ends when business activities have reached the lowest point in their annual operating cycle, which allows more time to prepare financial reports. Such a fiscal year is called the **natural business year**. For example, the natural business year for most retail businesses is January 31, which is after the busy holiday season and end-of-year sales. To illustrate, **Wal-Mart Stores, Inc.** recently reported its annual financial results for the year ending January 31.

Throughout this text, we use the notation 20Y1, 20Y2, 20Y3, etc., to indicate years.[3] For example, a company's fiscal year could begin August 1, 20Y7, and end on July 31, 20Y8, as follows:

3 We use this notation to reduce the number of changes necessary when revising this and future editions of the text. This, in turn, reduces the cost of each revision, which helps reduce the need to increase the retail price of the text.

Cost Concept

Under the **cost concept**, amounts are initially recorded in the accounting records at their cost or purchase price. To illustrate, assume that Aaron Publishers purchased a building on February 20, 20Y2, for $150,000. The following additional information applies to the building:

Price listed by seller on January 1, 20Y2	$160,000
Aaron Publishers' initial offer to buy on January 31, 20Y2	140,000
Purchase price on February 20, 20Y2	150,000
Estimated selling price on December 31, 20Y7	220,000
Assessed value for property taxes, December 31, 20Y7	190,000

Under the cost concept, Aaron Publishers records the purchase of the building on February 20, 20Y2, at the purchase price of $150,000. The other amounts listed have no effect on the accounting records.

The fact that the building has an estimated selling price of $220,000 on December 31, 20Y7, indicates that the building has increased in value. However, to use the $220,000 in the accounting records would be to record a profit before selling the building. If Aaron Publishers sells the building on January 9, 20Y9, for $240,000, a profit of $90,000 ($240,000 – $150,000) is then realized and recorded. The new owner would record $240,000 as its cost of the building.

The cost concept also involves the objectivity and unit of measure concepts. The **objectivity concept** requires that the amounts recorded in the accounting records be based on unbiased evidence. In exchanges between a buyer and a seller, both try to get the best price. Only the final agreed-upon amount is objective enough to be recorded in the accounting records. If amounts in the accounting records were constantly being revised upward or downward based on offers, appraisals, and opinions, accounting reports could become unstable and unreliable.

The **unit of measure concept** requires that economic data be recorded in dollars. Money is a common unit of measurement for reporting financial data and reports.

EXAMPLE EXERCISE 1-1 Cost Concept — OBJ. 2

On August 25, Gallatin Repair Service extended an offer of $400,000 for land that had been priced for sale at $500,000. On September 3, Gallatin Repair Service accepted the seller's counteroffer of $460,000. On October 20, the land was assessed at a value of $300,000 for property tax purposes. On December 4, a national retail chain offered Gallatin Repair Service $525,000 for the land. At what value should the land be recorded in Gallatin Repair Service's records?

Follow My Example 1-1

$460,000. Under the cost concept, the land should be recorded at the cost to Gallatin Repair Service.

Practice Exercises: PE 1-1A, PE 1-1B

The Accounting Equation

OBJ. 3 State the accounting equation and define each element of the 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 the owners of a proprietorship, partnership, or limited liability company are called **owner's equity**. Since stockholders own a corporation, the rights of owners of a corporation are called **stockholders' equity**.

Link to Twitter

Twitter's accounting equation for a recent year: Assets ($10,163 million) = Liabilities ($3,357 million) + Stockholders' Equity ($6,806 million)

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

Assets = Liabilities + Owner's Equity

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

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

Assets	**–**	**Liabilities**	**=**	**Owner's Equity**
$100,000	–	$30,000	=	$70,000

Business Connection

THE ACCOUNTING EQUATION

The accounting equation serves as the basic foundation for the accounting systems of all companies. From the smallest business, such as the local convenience store, to the largest business, such as **The Coca-Cola Company**, companies use the accounting equation. Some examples taken from recent financial reports of well-known corporations follow:

Company	Assets*	=	Liabilities	+	Stockholders' Equity
Alphabet (Google)	$232,792	=	$55,164	+	$177,628
The Coca-Cola Company	$83,216	=	$66,235	+	$16,981
DowDuPont	$188,030	=	$93,459	+	$94,571
eBay	$22,819	=	$16,538	+	$6,281
Target	$37,431	=	$26,478	+	$10,953
Microsoft Corporation	$258,848	=	$176,130	+	$82,718
Southwest Airlines Co.	$26,243	=	$16,390	+	$9,853
Wal-Mart Stores, Inc.	$204,522	=	$123,700	+	$80,822

*Amounts are shown in millions of dollars.

EXAMPLE EXERCISE 1-2 Accounting Equation — OBJ. 3

John Joos is the owner and operator of You're A Star, a motivational consulting business. At the end of its accounting period, December 31, 20Y8, You're A Star has assets of $800,000 and liabilities of $350,000. Using the accounting equation, determine the following amounts:

a. Owner's equity as of December 31, 20Y8.
b. Owner's equity as of December 31, 20Y9, assuming that assets increased by $130,000 and liabilities decreased by $25,000 during 20Y9.

Follow My Example 1-2

a. Assets = Liabilities + Owner's Equity
$800,000 = $350,000 + Owner's Equity
Owner's Equity = $450,000

b. First, determine the change in owner's equity during 20Y9 as follows:
Assets = Liabilities + Owner's Equity
$130,000 = –$25,000 + Owner's Equity
Owner's Equity = $155,000

Next, add the change in owner's equity during 20Y9 to the owner's equity on December 31, 20Y8, to arrive at owner's equity on December 31, 20Y9, as follows:

Owner's Equity on December 31, 20Y9 = $450,000 (Owner's Equity on December 31, 20Y8) + $155,000 (change in Owner's Equity) = $605,000

Practice Exercises: PE 1-2A, PE 1-2B

Business Transactions and the Accounting 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.

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 owner's 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.

Note

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

Assume that on November 1, 20Y3, Chris Clark begins a business 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.

Nov. 1, 20Y3 *Chris Clark deposited $25,000 in a bank account in the name of NetSolutions.* ***Transaction A***

This transaction increases the asset cash (on the left side of the equation) by $25,000. To balance the equation, the owner's equity (on the right side of the equation) increases by the same amount. The equity of the owner is identified using the owner's name and "Capital," such as "Chris Clark, Capital."

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

Assets	=	**Owner's Equity**
Cash		Chris Clark, Capital
a. 25,000	=	25,000

Since Chris Clark is the sole owner, NetSolutions is a proprietorship. Also, the preceding accounting equation is only for the business, NetSolutions. Under the business entity assumption, Chris's personal assets, such as his home, personal bank account, and personal liabilities are excluded from the equation.

Nov. 5, 20Y3 *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 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*.

	Assets			=	**Owner's Equity**
	Cash	+	Land	=	Chris Clark, Capital
Bal.	25,000				25,000
b.	−20,000		+20,000		
Bal.	5,000		20,000		25,000
	25,000			=	25,000

Transaction C *Nov. 10, 20Y3 NetSolutions purchased supplies for $1,350 and agreed to pay the supplier in the near future.*

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 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 + Owner's Equity**		
	Cash	+	Supplies	+	Land	=	Accounts Payable	+	Chris Clark, Capital
Bal.	5,000				20,000				25,000
c.			+1,350				+1,350		
Bal.	5,000		1,350		20,000		1,350		25,000
	26,350					=	26,350		

Transaction D *Nov. 18, 20Y3 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 Chris Clark's equity in the business. The revenues of $7,500 are recorded in a Fees Earned column to the right of Chris Clark, Capital. The effect of this transaction is to increase Cash and Fees Earned by $7,500, as follows:

	Assets					=	**Liabilities**	+	**Owner's Equity**		
	Cash	+	Supplies	+	Land	=	Accounts Payable	+	Chris Clark, Capital	+	Fees Earned
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
	33,850					=	33,850				

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. Fees earned on account are recorded as increases in Accounts Receivable and Fees Earned. When customers pay their accounts, Cash increases, and Accounts Receivable decreases.

Nov. 30, 20Y3 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 owner's equity. Like fees earned, the expenses are recorded in columns to the right of Chris Clark, Capital. However, since expenses reduce owner's equity, the expenses are entered as negative amounts. The effect of this transaction is as follows:

	Assets			=	Liabilities +	Owner's Equity					
	Cash	+ Supplies	+ Land	=	Accounts Payable	+ Chris Clark, Capital	+ 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, 20Y3 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 +	Owner's Equity					
	Cash	+ Supplies	+ Land	=	Accounts Payable	+ Chris Clark, Capital	+ 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 owner's equity, as illustrated in transaction (e). Paying an amount on account reduces the amount owed on a liability.

Nov. 30, 20Y3 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 +	Owner's Equity					
	Cash	+ Supplies +	Land	=	Accounts Payable +	Chris Clark, Capital	+ 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, 20Y3 Chris Clark withdrew $2,000 from NetSolutions for personal use.*

At the end of the month, Chris Clark withdrew $2,000 in cash from the business for personal use. This transaction is the opposite of an investment in the business by the owner. Withdrawals by the owner should not be confused with expenses. Withdrawals *do not* represent assets or services used in the process of earning revenues. Instead, withdrawals are a distribution of capital to the owner. Owner withdrawals are identified by the owner's name and *Drawing*. For example, Chris's withdrawal is identified as Chris Clark, Drawing. Like expenses, withdrawals are recorded in a column to the right of Chris Clark, Capital. The effect of the $2,000 withdrawal is as follows:

	Assets			=	Liabilities +	Owner's Equity							
	Cash	+ Supp. +	Land	=	Accounts Payable +	Chris Clark, Capital −	Chris Clark, Drawing	+ 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					

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 +	Owner's Equity							
	Cash	+ Supp. +	Land	=	Accounts Payable +	Chris Clark, Capital −	Chris Clark, Drawing	+ 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 owner's equity is *increased by amounts invested by the owner* and is *decreased by withdrawals by the owner*. In addition, the owner's equity is *increased by revenues* and is *decreased by expenses*.

The four types of transactions affecting owner's equity are illustrated in Exhibit 6.

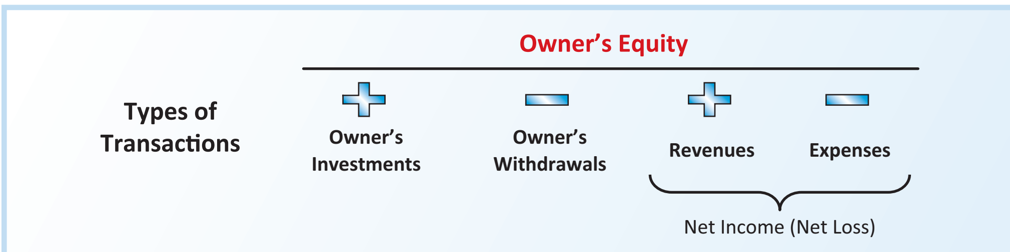


EXHIBIT 6
Types of Transactions Affecting Owner's Equity

EXAMPLE EXERCISE 1-3 Transactions

OBJ. 4

Salvo Delivery Service is owned and operated by Joel Salvo. The following selected transactions were completed by Salvo Delivery Service during February:

1. Received cash from owner as additional investment, $35,000.
2. Paid creditors on account, $1,800.
3. Billed customers for delivery services on account, $11,250.
4. Received cash from customers on account, $6,740.
5. Paid cash to owner for personal use, $1,000.

Indicate the effect of each transaction on the accounting equation elements (Assets, Liabilities, Owner's Equity, Drawing, Revenue, and Expense). Also indicate the specific item within the accounting equation element that is affected. To illustrate, the answer to (1) follows:

(1) Asset (Cash) increases by $35,000; Owner's Equity (Joel Salvo, Capital) increases by $35,000.

Follow My Example 1-3

(2) Asset (Cash) decreases by $1,800; Liability (Accounts Payable) decreases by $1,800.

(3) Asset (Accounts Receivable) increases by $11,250; Revenue (Delivery Service Fees) increases by $11,250.

(4) Asset (Cash) increases by $6,740; Asset (Accounts Receivable) decreases by $6,740.

(5) Asset (Cash) decreases by $1,000; Drawing (Joel Salvo, Drawing) increases by $1,000.

Practice Exercises: PE 1-3A, PE 1-3B

Financial Statements

OBJ. 5 Describe the financial statements of a proprietorship and explain how they interrelate.

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 proprietorship are the income statement, the statement of owner's equity, 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.

The four financial statements and their interrelationships are illustrated later in this chapter. 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,

EXHIBIT 7

Financial Statements

Order Prepared	Financial Statement	Description of Statement
1.	**Income statement**	A summary of the revenue and expenses *for a specific period of time*, such as a month or a year.
2.	**Statement of owner's equity**	A summary of the changes in the owner's equity that have occurred *during a specific period of time*, such as a month or a year.
3.	**Balance sheet**	A list of the assets, liabilities, and owner's equity *as of a specific date*, 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 for a *specific period of time*, such as a month or a year.

the statement of owner's equity, and the statement of cash flows are for a period of time. The data presented in the balance sheet are for a specific date.

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 **matching concept**. This concept is applied by *matching* the expenses incurred during a period with the revenue that those expenses generated. 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**.

The revenue and expenses for **NetSolutions** were shown in the accounting equation as separate increases and decreases. Net income for a period increases the owner's equity (capital) for the period. A net loss decreases the owner's equity (capital) for the period.

The revenue, the expenses, and the 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.

Link to Twitter

For a recent year, **Twitter** reported net income of $1.2 billion.

EXAMPLE EXERCISE 1-4 Income Statement

OBJ. 5

The revenues and expenses of Chickadee Travel Service for the year ended December 31, 20Y9, follow:

Fees earned	$263,200
Miscellaneous expense	12,950
Office expense	63,000
Wages expense	131,700

Prepare an income statement for the year ended December 31, 20Y9.

Follow My Example 1-4

Chickadee Travel Service
Income Statement
For the Year Ended December 31, 20Y9

Fees earned		$263,200
Expenses:		
Wages expense	$131,700	
Office expense	63,000	
Miscellaneous expense	12,950	
Total expenses		207,650
Net income		$ 55,550

Practice Exercises: PE 1-4A, PE 1-4B

Statement of Owner's Equity

The statement of owner's equity reports the changes in the owner's equity 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 because the amount of owner's equity at the end of the period must be reported on the balance sheet. As a result, the statement of owner's equity is often viewed as the connecting link between the income statement and balance sheet.

Three types of transactions affected owner's equity of **NetSolutions** during November:

- the original investment of $25,000,
- the revenue of $7,500 and expenses of $4,450 that resulted in net income of $3,050 for the month, and
- a withdrawal of $2,000 by the owner.

The preceding information is summarized in the statement of owner's equity in Exhibit 8.

EXAMPLE EXERCISE 1-5 Statement of Owner's Equity

OBJ. 5

Using the income statement for Chickadee Travel Service shown in Example Exercise 1-4, prepare a statement of owner's equity for the year ended December 31, 20Y9. Adam Cellini, the owner, invested an additional $50,000 in the business and withdrew cash of $30,000 for personal use during the year. The capital of Adam Cellini was $80,000 on January 1, 20Y9.

Follow My Example 1-5

Chickadee Travel Service
Statement of Owner's Equity
For the Year Ended December 31, 20Y9

Adam Cellini, capital, January 1, 20Y9		$ 80,000
Additional investment by owner during year	$ 50,000	
Net income for the year	55,550	
Withdrawals	(30,000)	
Increase in owner's equity		75,550
Adam Cellini, capital, December 31, 20Y9		$155,550

Practice Exercises: PE 1-5A, PE 1-5B

Balance Sheet

The balance sheet in Exhibit 8 reports the amounts of **NetSolutions**' assets, liabilities, and owner's equity as of November 30, 20Y3. The asset and liability amounts are taken from the last line of the summary of transactions in Exhibit 5. Chris Clark, Capital as of November 30, 20Y3, is taken from the statement of owner's equity. The form of balance sheet shown in Exhibit 8 is called the **account form**. This is because it resembles the basic format of the accounting equation, with assets on the left side and the liabilities and owner's equity sections on the right side.

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	2,570	
Total liabilities		$15,470

REAL WORLD Bank loan officers use a business's financial statements in deciding whether to grant a loan to the business. Once the loan is granted, the borrower may be required to maintain a certain level of assets in excess of liabilities. The business's financial statements are used to monitor this level.

EXHIBIT 8

Financial Statements for NetSolutions

NetSolutions
Income Statement
For the Month Ended November 30, 20Y3

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

NetSolutions
Statement of Owner's Equity
For the Month Ended November 30, 20Y3

Chris Clark, capital, November 1, 20Y3		$ 0
Investment on November 1, 20Y3	$25,000	
Net income for November	3,050	
Withdrawals	(2,000)	
Increase in owner's equity		26,050
Chris Clark, capital, November 30, 20Y3		$26,050

NetSolutions
Balance Sheet
November 30, 20Y3

Assets		**Liabilities**	
Cash	$ 5,900	Accounts payable	$ 400
Supplies	550	**Owner's Equity**	
Land	20,000	Chris Clark, capital	26,050
Total assets	$26,450	Total liabilities and owner's equity	$26,450

NetSolutions
Statement of Cash Flows
For the Month Ended November 30, 20Y3

Cash flows from (used for) operating activities:		
Cash received from customers	$ 7,500	
Cash paid for expenses and to creditors	(4,600)	
Net cash flows from operating activities		$ 2,900
Cash flows from (used for) for investing activities:		
Cash paid for acquisition of land		(20,000)
Cash flows from (used for) financing activities:		
Cash received from owner's investment	$25,000	
Cash withdrawal by owner	(2,000)	
Net cash flows from financing activities		23,000
Net increase in cash		$ 5,900
Cash balance, November 1, 20Y3		0
Cash balance, November 30, 20Y3		$ 5,900

The form of balance sheet shown in Exhibit 9 is called the **report form**. It lists the assets, liabilities, and owner's equity in a downward sequence. The report form is the most common form of reporting the balance sheet and for that reason is used in the remainder of this text.

EXHIBIT 9

Report Form of Balance Sheet

NetSolutions
Balance Sheet
November 30, 20Y3

Assets	
Cash	$ 5,900
Supplies	550
Land	20,000
Total assets	$26,450
Liabilities	
Accounts payable	$ 400
Owner's Equity	
Chris Clark, capital	26,050
Total liabilities and owner's equity	$26,450

EXAMPLE EXERCISE 1-6 Balance Sheet

OBJ. 5

Using the following data for Chickadee Travel Service as well as the statement of owner's equity shown in Example Exercise 1-5, prepare a balance sheet as of December 31, 20Y9.

Accounts payable	$12,200
Accounts receivable	31,350
Cash	53,050
Land	80,000
Supplies	3,350

Follow My Example 1-6

Chickadee Travel Service
Balance Sheet
December 31, 20Y9

Assets	
Cash	$ 53,050
Accounts receivable	31,350
Supplies	3,350
Land	80,000
Total assets	$167,750
Liabilities	
Accounts payable	$ 12,200
Owner's Equity	
Adam Cellini, capital	155,550
Total liabilities and owner's equity	$167,750

Practice Exercises: PE 1-6A, PE 1-6B

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

Each of these sections is briefly described in this section.

Cash Flows from (Used for) Operating Activities This section reports a summary of cash receipts and cash payments from operations. The net cash flows 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 (Used for) Investing Activities This section reports the cash transactions for the acquisition and sale of relatively permanent assets such as land, buildings, and equipment. Exhibit 8 reports that **NetSolutions** paid $20,000 for the purchase of land during November.

Cash Flows from (Used for) Financing Activities This section reports the cash transactions related to cash investments by the owner, borrowings, and withdrawals by the owner. Exhibit 8 shows that Chris Clark invested $25,000 in **NetSolutions** and withdrew $2,000 during November.

Link to Twitter

For a recent year, **Twitter** reported $1,340 million of cash inflows from operating activities, $2,056 million of cash used for investing activities, $978 million of cash from financing activities, and net increase in cash of $262 million.

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 (Investment by Chris Clark)
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 (Withdrawal by Chris Clark)

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 operations. Using the preceding classifications of November cash transactions, the statement of cash flows is prepared as shown in Exhibit 8.[4]

The ending cash balance shown on the statement of cash flows is also reported on the balance sheet as of the end of the period. To illustrate, the ending cash of $5,900 reported on the November statement of cash flows in Exhibit 8 is also reported as the amount of cash on hand in the November 30, 20Y3, balance sheet.

Since November is NetSolutions' first period of operations, the increase in cash for November and the November 30, 20Y3, cash balance are the same amount, $5,900, as shown in Exhibit 8. In later periods, NetSolutions will report in its statement of cash flows a beginning cash balance, an increase or a decrease in cash for the period, and an ending cash balance. For example, assume that for December NetSolutions has

4 This method of preparing the statement of cash flows is called the "direct method." This method and the indirect method are discussed further in Chapter 16.

a decrease in cash of $3,835. The last three lines of NetSolutions' statement of cash flows for December would be as follows:

Net decrease in cash	$(3,835)
Cash balance, December 1, 20Y3	5,900
Cash balance, December 31, 20Y3	$ 2,065

EXAMPLE EXERCISE 1-7 Statement of Cash Flows

OBJ. 5

A summary of cash flows for Chickadee Travel Service for the year ended December 31, 20Y9, follows:

Cash receipts:	
Cash received from customers	$251,000
Cash received from additional investment of owner	50,000
Cash payments:	
Cash paid for expenses	210,000
Cash paid for land	80,000
Cash paid to owner for personal use	30,000

The cash balance as of January 1, 20Y9, was $72,050. Prepare a statement of cash flows for Chickadee Travel Service for the year ended December 31, 20Y9.

Follow My Example 1-7

Chickadee Travel Service
Statement of Cash Flows
For the Year Ended December 31, 20Y9

Cash flows from (used for) operating activities:		
Cash received from customers	$ 251,000	
Cash paid for expenses	(210,000)	
Net cash flows from operating activities		$ 41,000
Cash flows from (used for) investing activities:		
Cash payments for purchase of land		(80,000)
Cash flows from (used for) financing activities:		
Cash received from owner as investment	$ 50,000	
Cash withdrawals by owner	(30,000)	
Net cash flows from financing activities		20,000
Net decrease in cash		$(19,000)
Cash balance, January 1, 20Y9		72,050
Cash balance, December 31, 20Y9		$ 53,050

Practice Exercises: PE 1-7A, PE 1-7B

Interrelationships Among Financial Statements

Financial statements are prepared in the order of the income statement, statement of owner's equity, balance sheet, and statement of cash flows. This order is important because the financial statements are interrelated. These interrelationships for **NetSolutions** are shown in Exhibit 8 and are described in Exhibit 10.[5]

The preceding interrelationships are important in analyzing financial statements and the impact of transactions on a business. In addition, these interrelationships serve as a check on whether the financial statements are prepared correctly. For example, if the ending cash on the statement of cash flows does not agree with the balance sheet cash, then an error has occurred.

5 Depending on the method of preparing the Cash Flows from (Used for) Operating Activities section of the statement of cash flows, net income (or net loss) may also appear on the statement of cash flows. This interrelationship or method of preparing the statement of cash flows, called the "indirect method," is described and illustrated in Chapter 16.

EXHIBIT 10 **Financial Statement Interrelationships**

Financial Statements	Interrelationship	NetSolutions Example (Exhibit 8)
Income Statement *and* Statement of Owner's Equity	Net income or net loss reported on the income statement is also reported on the statement of owner's equity as either an addition (net income) to or deduction (net loss) from the beginning owner's equity and any additional investments by the owner during the period.	NetSolutions' net income of $3,050 for November is added to Chris Clark's investment of $25,000 on the statement of owner's equity.
Statement of Owner's Equity *and* Balance Sheet	Owner's capital at the end of the period reported on the statement of owner's equity is also reported on the balance sheet as owner's capital.	Chris Clark, Capital of $26,050 as of November 30, 20Y3, on the statement of owner's equity also appears on the November 30, 20Y3, balance sheet as Chris Clark, Capital.
Balance Sheet *and* Statement of Cash Flows	The cash reported on the balance sheet is also reported as the end-of-period cash on the statement of cash flows.	Cash of $5,900 reported on the balance sheet as of November 30, 20Y3, is also reported on the November statement of cash flows as the end-of-period cash.

OBJ. 6 Describe and illustrate the use of the ratio of liabilities to owner's equity in evaluating a company's financial condition.

FAI

Financial Analysis and Interpretation: Ratio of Liabilities to Owner's Equity

The basic financial statements illustrated in this chapter are useful to bankers, creditors, owners, and others in analyzing and interpreting the financial performance and condition of a company. Throughout this text, various tools and techniques that are often used to analyze and interpret a company's financial performance and condition are described and illustrated. The first such tool that is discussed is useful in analyzing the ability of a company to pay its creditors.

The relationship between liabilities and owner's equity, expressed as a **ratio of liabilities to owner's equity**, is computed as follows:

$$\text{Ratio of Liabilities to Owner's Equity} = \frac{\text{Total Liabilities}}{\text{Total Owner's Equity (or Total Stockholders' Equity)}}$$

NetSolutions' ratio of liabilities to owner's equity at the end of November is 0.015, computed as follows:

$$\text{Ratio of Liabilities to Owner's Equity} = \frac{\$400}{\$26{,}050} = 0.015\ \text{(Rounded)}$$

Corporations refer to total owner's equity as total stockholders' equity. Thus, total stockholders' equity is substituted for total owner's equity when computing this ratio.

To illustrate, recent balance sheet data (in millions) for **Alphabet (Google) Inc.** and **Amazon.com, Inc.** follow:

	Recent Year	Prior Year
Alphabet Inc.		
Total liabilities	$ 55,164	$ 44,793
Total stockholders' equity	177,628	152,502
Amazon.com, Inc.		
Total liabilities	$119,099	$103,601
Total stockholders' equity	43,549	27,709

The ratio of liabilities to stockholders' equity for Alphabet and Amazon.com for a recent year and the prior year is computed as follows:

	Recent Year*	Prior Year*
Alphabet Inc.		
Ratio of liabilities to stockholders' equity	0.31	0.29
	($55,164 ÷ $177,628)	($44,793 ÷ $152,502)
Amazon.com, Inc.		
Ratio of liabilities to stockholders' equity	2.73	3.74
	($119,099 ÷ $43,549)	($103,601 ÷ $27,709)

*Rounded to two decimal places.

The rights of creditors to a business's assets come before the rights of the owners or stockholders. Thus, the lower the ratio of liabilities to owner's equity, the better able the company is to withstand poor business conditions and to pay its obligations to creditors.

Alphabet is unusual in that it has a very low amount of liabilities. Its ratio of liabilities to stockholders' equity of 0.31 in the recent year and 0.29 in the prior year is low. In contrast, Amazon.com, Inc. has more liabilities; its ratio of liabilities to stockholders' equity is 2.73 in the recent year and 3.74 in the prior year. Because Amazon.com, Inc.'s ratio of liabilities to stockholders' equity decreased, its creditors are less at risk at the end of the recent year. However, Amazon.com, Inc.'s creditors are more at risk than are Alphabet's creditors.

EXAMPLE EXERCISE 1-8 Ratio of Liabilities to Owner's Equity

OBJ. 6

The following data were taken from Hawthorne Company's balance sheet:

	Dec. 31, 20Y5	Dec. 31, 20Y4
Total liabilities	$120,000	$105,000
Total owner's equity	80,000	75,000

a. Compute the ratio of liabilities to owner's equity.

b. Has the creditors' risk increased or decreased from December 31, 20Y4, to December 31, 20Y5?

Follow My Example 1-8

a.

	Dec. 31, 20Y5	Dec. 31, 20Y4
Total liabilities	$120,000	$105,000
Total owner's equity	80,000	75,000
Ratio of liabilities to owner's equity	1.50	1.40
	($120,000 ÷ $80,000)	($105,000 ÷ $75,000)

b. Increased

Practice Exercises: PE 1-8A, PE 1-8B

At a Glance 1

OBJ. 1 Describe the nature of business and the role of accounting and ethics in business.

Key Points A business provides goods or services (outputs) to customers with the objective of earning a profit. Three types of businesses include service, merchandising, and manufacturing businesses.

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

Ethics are moral principles that guide the conduct of individuals. Good ethical conduct depends on individual character and firm culture.

Accountants are engaged in private accounting or public accounting.

Learning Outcomes	Example Exercises	Practice Exercises
• Distinguish among service, merchandising, and manufacturing businesses.		
• Describe the role of accounting in business and explain why accounting is called the "language of business."		
• Define ethics and list two factors affecting ethical conduct.		
• Differentiate between private and public accounting.		

OBJ. 2 Summarize the development of accounting principles and relate them to practice.

Key Points Generally accepted accounting principles (GAAP) are used in preparing financial statements. Accounting principles and assumptions develop from research, practice, and pronouncements of authoritative bodies.

The business entity assumption views the business as an entity separate from its owners, creditors, or other businesses. Businesses may be organized as proprietorships, partnerships, corporations, and limited liability companies. The time period concept requires businesses to report their financial condition and results on a regular basis for a specific period of time. The cost concept requires that purchases by a business be recorded in terms of actual cost. The objectivity concept requires that the accounting records and reports be based on unbiased evidence. The unit of measure concept requires that economic data be recorded in dollars.

Learning Outcomes	Example Exercises	Practice Exercises
• Explain what is meant by generally accepted accounting principles.		
• Describe how generally accepted accounting principles are developed.		
• Describe and give an example of what is meant by the business entity concept.		
• Describe the characteristics of a proprietorship, partnership, corporation, and limited liability company.		
• Describe and give an example of the time period concept.		
• Describe and give an example of what is meant by the cost concept.	**EE1-1**	**PE1-1A, 1-1B**
• Describe and give an example of what is meant by the objectivity concept.		
• Describe and give an example of what is meant by the unit of measure concept.		

OBJ.3 State the accounting equation and define each element of the equation.

Key Points The resources owned by a business and the rights or claims to these resources may be stated in the form of an equation, as follows: Assets = Liabilities + Owner's Equity

Learning Outcomes	Example Exercises	Practice Exercises
• State the accounting equation.		
• Define assets, liabilities, and owner's equity.		
• Given two elements of the accounting equation, solve for the third element.	**EE1-2**	**PE1-2A, 1-2B**

OBJ.4 Describe and illustrate how business transactions can be recorded in terms of the resulting change in the elements of the accounting equation.

Key Points All business transactions can be stated in terms of the change in one or more of the three elements of the accounting equation.

Learning Outcomes	Example Exercises	Practice Exercises
• Define a business transaction.		
• Using the accounting equation as a framework, record transactions.	**EE1-3**	**PE1-3A, 1-3B**

OBJ.5 Describe the financial statements of a proprietorship and explain how they interrelate.

Key Points The primary financial statements of a proprietorship are the income statement, the statement of owner's equity, the balance sheet, and the statement of cash flows. The income statement reports a period's net income or net loss, which is also reported on the statement of owner's equity. The ending owner's capital reported on the statement of owner's equity is also reported on the balance sheet. The ending cash balance is reported on the balance sheet and the statement of cash flows.

Learning Outcomes	Example Exercises	Practice Exercises
• List and describe the financial statements of a proprietorship.		
• Prepare an income statement.	**EE1-4**	**PE1-4A, 1-4B**
• Prepare a statement of owner's equity.	**EE1-5**	**PE1-5A, 1-5B**
• Prepare a balance sheet.	**EE1-6**	**PE1-6A, 1-6B**
• Prepare a statement of cash flows.	**EE1-7**	**PE1-7A, 1-7B**
• Explain how the financial statements of a proprietorship are interrelated.		

OBJ.6 Describe and illustrate the use of the ratio of liabilities to owner's equity in evaluating a company's financial condition.

Key Points A ratio useful in analyzing the ability of a business to pay its creditors is the ratio of liabilities to owner's (stockholders') equity. The lower the ratio of liabilities to owner's equity, the better able the company is to withstand poor business conditions and to pay its obligations to creditors.

Learning Outcomes	Example Exercises	Practice Exercises
• Describe the usefulness of the ratio of liabilities to owner's (stockholders') equity.		
• Compute the ratio of liabilities to owner's (stockholders') equity.	**EE1-8**	**PE1-8A, 1-8B**

Illustrative Problem

Cecil Jameson, Attorney-at-Law, is a proprietorship owned and operated by Cecil Jameson. On July 1, 20Y5, the company has the following assets and liabilities: cash, $1,000; accounts receivable, $3,200; supplies, $850; land, $10,000; accounts payable, $1,530. Office space and office equipment are currently being rented, pending the construction of an office complex on land purchased last year. Business transactions during July are summarized as follows:

a. Received cash from clients for services, $3,928.

b. Paid creditors on account, $1,055.

c. Received cash from Cecil Jameson as an additional investment, $3,700.

d. Paid office rent for the month, $1,200.

e. Charged clients for legal services on account, $2,025.

f. Purchased supplies on account, $245.

g. Received cash from clients on account, $3,000.

h. Received invoice for paralegal services from Legal Aid Inc. for July (to be paid on August 10), $1,635.

i. Paid the following: wages expense, $850; utilities expense, $325; answering service expense, $250; and miscellaneous expense, $75.

j. Determined that the cost of supplies on hand was $980; therefore, the cost of supplies used during the month was $115.

k. Jameson withdrew $1,000 in cash from the business for personal use.

Instructions

1. Determine the amount of owner's equity (Cecil Jameson's capital) as of July 1, 20Y5.
2. State the assets, liabilities, and owner's equity as of July 1 in equation form similar to that shown in this chapter. In tabular form below the equation, indicate the increases and decreases resulting from each transaction and the new balances after each transaction.
3. Prepare an income statement for July, a statement of owner's equity for July, and a balance sheet as of July 31, 20Y5.
4. (Optional) Prepare a statement of cash flows for July.

Solution

1.

$$
\begin{aligned}
\text{Assets} - \text{Liabilities} &= \text{Owner's Equity (Cecil Jameson, capital)}\\
(\$1,000 + \$3,200 + \$850 + \$10,000) - \$1,530 &= \text{Owner's Equity (Cecil Jameson, capital)}\\
\$15,050 - \$1,530 &= \text{Owner's Equity (Cecil Jameson, capital)}\\
\$13,520 &= \text{Owner's Equity (Cecil Jameson, capital)}
\end{aligned}
$$

2.

	Assets				= **Liabilities** +				**Owner's Equity**						
	Cash +	Accts. Rec. +	Supp. +	Land =	Accts. Pay. +	Cecil Jameson, Capital −	Cecil Jameson, Drawing +	Fees Earned −	Paralegal Exp. −	Rent Exp. −	Wages Exp. −	Utilities Exp. −	Answering Service Exp. −	Supp. Exp. −	Misc. Exp.
Bal.	1,000	3,200	850	10,000	1,530	13,520									
a.	+3,928							3,928							
Bal.	4,928	3,200	850	10,000	1,530	13,520		3,928							
b.	−1,055				−1,055										
Bal.	3,873	3,200	850	10,000	475	13,520		3,928							
c.	+3,700					+3,700									
Bal.	7,573	3,200	850	10,000	475	17,220		3,928							
d.	−1,200									−1,200					
Bal.	6,373	3,200	850	10,000	475	17,220		3,928		−1,200					
e.		+ 2,025						+ 2,025							
Bal.	6,373	5,225	850	10,000	475	17,220		5,953		−1,200					
f.			+245		+245										
Bal.	6,373	5,225	1,095	10,000	720	17,220		5,953		−1,200					
g.	+3,000	−3,000													
Bal.	9,373	2,225	1,095	10,000	720	17,220		5,953		−1,200					
h.					+1,635				−1,635						
Bal.	9,373	2,225	1,095	10,000	2,355	17,220		5,953	−1,635	−1,200					
i.	−1,500										−850	−325	−250		−75
Bal.	7,873	2,225	1,095	10,000	2,355	17,220		5,953	−1,635	−1,200	−850	−325	−250		−75
j.			−115											−115	
Bal.	7,873	2,225	980	10,000	2,355	17,220		5,953	−1,635	−1,200	−850	−325	−250	−115	−75
k.	−1,000						−1,000								
Bal.	6,873	2,225	980	10,000	2,355	17,220	−1,000	5,953	−1,635	−1,200	−850	−325	−250	−115	−75

3.

Cecil Jameson, Attorney-at-Law
Income Statement
For the Month Ended July 31, 20Y5

Fees earned		$5,953
Expenses:		
Paralegal expense	$1,635	
Rent expense	1,200	
Wages expense	850	
Utilities expense	325	
Answering service expense	250	
Supplies expense	115	
Miscellaneous expense	75	
Total expenses		4,450
Net income		$1,503

Cecil Jameson, Attorney-at-Law
Statement of Owner's Equity
For the Month Ended July 31, 20Y5

Cecil Jameson, capital, July 1, 20Y5		$13,520
Additional investment by owner	$ 3,700	
Net income for the month	1,503	
Withdrawals	(1,000)	
Increase in owner's equity		4,203
Cecil Jameson, capital, July 31, 20Y5		$17,723

(*Continued*)

Cecil Jameson, Attorney-at-Law
Balance Sheet
July 31, 20Y5

Assets	
Cash	$ 6,873
Accounts receivable	2,225
Supplies	980
Land	10,000
Total assets	$20,078
Liabilities	
Accounts payable	$ 2,355
Owner's Equity	
Cecil Jameson, capital	17,723
Total liabilities and owner's equity	$20,078

4. (Optional)

Cecil Jameson, Attorney-at-Law
Statement of Cash Flows
For the Month Ended July 31, 20Y5

Cash flows from (used for) operating activities:		
Cash received from customers	$ 6,928*	
Cash paid for operating expenses	(3,755)**	
Net cash flows from operating activities		$ 3,173
Cash flows from (used for) investing activities		—
Cash flows from (used for) financing activities:		
Cash received from owner as investment	$ 3,700	
Cash withdrawal by owner	(1,000)	
Net cash flows from financing activities		2,700
Net increase in cash		$ 5,873
Cash balance, July 1, 20Y5		1,000
Cash balance, July 31, 20Y5		$ 6,873

*$6,928 = $3,928 + $3,000 (from Cash column in Part 2)
**$3,755 = $1,055 + $1,200 + $1,500 (from Cash column in Part 2)

Key Terms

account form (21)
account payable (16)
account receivable (17)
accounting (6)
accounting equation (14)
Accounting Standards Codification (11)
Accounting Standards Updates (11)
assets (13)
balance sheet (20)
business (5)
business entity concept (11)
business transaction (15)
Certified Public Accountant (CPA) (10)
corporation (12)
cost concept (13)
earnings (20)
ethics (7)
expenses (17)
fees earned (16)
financial accounting (6)
Financial Accounting Standards Board (FASB) (11)
financial statements (19)
fiscal year (12)
generally accepted accounting principles (GAAP) (10)
general-purpose financial statements (6)
income statement (20)
interest revenue (16)
International Accounting Standards Board (IASB) (11)
liabilities (13)
limited liability company (LLC) (11)

management (or managerial) accounting (6)
manufacturing business (6)
matching concept (20)
merchandising business (6)
natural business year (12)
net income (or net profit) (20)
net loss (20)
objectivity concept (13)
owner's equity (13)
partnership (12)
prepaid expenses (16)
private accounting (6)
profit (5)
proprietorship (12)
public accounting (10)
Public Company Accounting Oversight Board (PCAOB) (8)
ratio of liabilities to owner's (stockholders') equity (26)
rent revenue (16)
report form (23)
revenue (16)
sales (16)
Sarbanes-Oxley Act (SOX) (8)
Securities and Exchange Commission (SEC) (11)
service business (5)
statement of cash flows (20)
statement of owner's equity (20)
stockholders' equity (13)
time period concept (12)
unit of measure concept (13)

Discussion Questions

1. Name some users of accounting information.
2. What is the role of accounting in business?
3. REAL WORLD Why are most large companies like **Microsoft**, **PepsiCo**, **Caterpillar**, and **AutoZone** organized as corporations?
4. Josh Reilly is the owner of Dispatch Delivery Service. Recently, Josh paid interest of $4,500 on a personal loan of $75,000 that he used to begin the business. Should Dispatch Delivery Service record the interest payment? Explain.
5. On July 12, Reliable Repair Service extended an offer of $150,000 for land that had been priced for sale at $185,000. On September 3, Reliable Repair Service accepted the seller's counteroffer of $167,500. Describe how Reliable Repair Service should record the land.
6. a. Land with an assessed value of $750,000 for property tax purposes is acquired by a business for $900,000. Ten years later, the plot of land has an assessed value of $1,200,000 and the business receives an offer of $2,000,000 for it. Should the monetary amount assigned to the land in the business records now be increased?
   b. Assuming that the land acquired in (a) was sold for $2,125,000, how would the various elements of the accounting equation be affected?
7. Describe the difference between an account receivable and an account payable.
8. A business had revenues of $679,000 and operating expenses of $588,000. Did the business (a) incur a net loss or (b) realize net income?
9. A business had revenues of $640,000 and operating expenses of $715,000. Did the business (a) incur a net loss or (b) realize net income?
10. The financial statements are interrelated. (a) What item of financial or operating data appears on both the income statement and the statement of owner's equity? (b) What item appears on both the balance sheet and the statement of owner's equity? (c) What item appears on both the balance sheet and the statement of cash flows?

Practice Exercises

Example Exercises

SHOW ME HOW **EE 1-1** *p. 13*

PE 1-1A Cost concept **OBJ. 2**

On February 3, Boulder Repair Service extended an offer of $566,000 for land that had been priced for sale at $629,000. On February 28, Boulder Repair Service accepted the seller's counteroffer of $597,000. On October 23, the land was assessed at a value of $613,000 for property tax purposes. On January 15 of the next year, Boulder Repair Service was offered $708,000 for the land by a national retail chain. At what value should the land be recorded in Boulder Repair Service's records?

SHOW ME HOW **EE 1-1** *p. 13*

PE 1-1B Cost concept **OBJ. 2**

On March 31, Clementine Repair Service extended an offer of $350,500 for land that had been priced for sale at $388,500. On April 15, Clementine Repair Service accepted the seller's counteroffer of $369,500. On September 9, the land was assessed at a value

(Continued)

of $316,700 for property tax purposes. On December 8, Clementine Repair Service was offered $401,200 for the land by a national retail chain. At what value should the land be recorded in Clementine Repair Service's records?

SHOW ME HOW EE 1-2 *p. 14*

PE 1-2A Accounting equation **OBJ. 3**

Patrick Miller is the owner and operator of Chicopee LLC, a motivational consulting business. At the end of its accounting period, December 31, 20Y8, Chicopee has assets of $518,000 and liabilities of $165,000. Using the accounting equation, determine the following amounts:

a. Owner's equity as of December 31, 20Y8.

b. Owner's equity as of December 31, 20Y9, assuming that assets increased by $86,200 and liabilities increased by $25,000 during 20Y9.

SHOW ME HOW EE 1-2 *p. 14*

PE 1-2B Accounting equation **OBJ. 3**

Pauline Emm is the owner and operator of Power Thoughts, a motivational consulting business. At the end of its accounting period, December 31, 20Y8, Power Thoughts has assets of $382,000 and liabilities of $94,000. Using the accounting equation, determine the following amounts:

a. Owner's equity as of December 31, 20Y8.

b. Owner's equity as of December 31, 20Y9, assuming that assets decreased by $63,000 and liabilities increased by $35,000 during 20Y9.

SHOW ME HOW EE 1-3 *p. 19*

PE 1-3A Transactions **OBJ. 4**

Peachtree Delivery Service is owned and operated by Terry Young. The following selected transactions were completed by Peachtree Delivery Service during February:

1. Received cash from owner as additional investment, $65,200.
2. Billed customers for delivery services on account, $22,400.
3. Paid creditors on account, $4,100.
4. Received cash from customers on account, $14,700.
5. Paid cash to owner for personal use, $1,600.

Indicate the effect of each transaction on the accounting equation elements (Assets, Liabilities, and Owner's Equity). Also indicate the specific item within the accounting equation element that is affected. To illustrate, the answer to (1) follows:

(1) Asset (Cash) increases by $65,200; Owner's Equity (Terry Young, Capital) increases by $65,200.

SHOW ME HOW EE 1-3 *p. 19*

PE 1-3B Transactions **OBJ. 4**

Cross Country Delivery Service is owned and operated by Pedro Gonzalez. The following selected transactions were completed by Cross Country Delivery Service during May:

1. Received cash from owner as additional investment, $25,050.
2. Paid advertising expense, $6,750.
3. Purchased supplies on account, $2,920.
4. Billed customers for delivery services on account, $20,460.
5. Received cash from customers on account, $11,410.

Indicate the effect of each transaction on the accounting equation elements (Assets, Liabilities, and Owner's Equity). Also indicate the specific item within the accounting equation element that is affected. To illustrate, the answer to (1) follows:

(1) Asset (Cash) increases by $25,050; Owner's Equity (Pedro Gonzalez, Capital) increases by $25,050.

SHOW ME HOW EE 1-4 *p. 20*

PE 1-4A Income statement **OBJ. 5**

The revenues and expenses of Up-in-the-Air Travel Service for the year ended April 30, 20Y7, follow:

Fees earned	$1,870,000
Office expense	343,000
Miscellaneous expense	21,000
Wages expense	1,115,000

Prepare an income statement for the year ended April 30, 20Y7.

SHOW ME HOW EE 1-4 *p. 20*

PE 1-4B Income statement **OBJ. 5**

The revenues and expenses of Zenith Travel Service for the year ended August 31, 20Y4, follow:

Fees earned	$899,600
Office expense	353,800
Miscellaneous expense	14,400
Wages expense	539,800

Prepare an income statement for the year ended August 31, 20Y4.

SHOW ME HOW EE 1-5 *p. 21*

PE 1-5A Statement of owner's equity **OBJ. 5**

Using the income statement for Up-in-the-Air Travel Service shown in Practice Exercise 1-4A, prepare a statement of owner's equity for the year ended April 30, 20Y7. Jerome Foley, the owner, invested an additional $52,000 in the business during the year and withdrew cash of $34,000 for personal use. Jerome Foley, capital as of May 1, 20Y6, was $876,000.

SHOW ME HOW EE 1-5 *p. 21*

PE 1-5B Statement of owner's equity **OBJ. 5**

Using the income statement for Zenith Travel Service shown in Practice Exercise 1-4B, prepare a statement of owner's equity for the year ended August 31, 20Y4. Megan Cox, the owner, invested an additional $43,200 in the business during the year and withdrew cash of $21,600 for personal use. Megan Cox, capital as of September 1, 20Y3, was $456,000.

SHOW ME HOW EE 1-6 *p. 23*

PE 1-6A Balance sheet **OBJ. 5**

Using the following data for Up-in-the-Air Travel Service as well as the statement of owner's equity shown in Practice Exercise 1-5A, prepare a report form balance sheet as of April 30, 20Y7:

Accounts payable	$ 90,000
Accounts receivable	417,000
Cash	170,000
Land	772,000
Supplies	16,000

SHOW ME HOW EE 1-6 *p. 23*

PE 1-6B Balance sheet **OBJ. 5**

Using the following data for Zenith Travel Service as well as the statement of owner's equity shown in Practice Exercise 1-5B, prepare a report form balance sheet as of August 31, 20Y4:

Accounts payable	$ 53,500
Accounts receivable	90,600
Cash	54,500
Land	372,000
Supplies	5,600

SHOW ME HOW

EE 1-7 *p. 25*

PE 1-7A Statement of cash flows **OBJ. 5**

A summary of cash flows for Up-in-the-Air Travel Service for the year ended April 30, 20Y7, follows:

Cash receipts:	
Cash received from customers	$1,803,000
Cash received from additional investment of owner	52,000
Cash payments:	
Cash paid for operating expenses	1,479,000
Cash paid for land	347,000
Cash paid to owner for personal use	34,000

The cash balance as of May 1, 20Y6, was $175,000.

Prepare a statement of cash flows for Up-in-the-Air Travel Service for the year ended April 30, 20Y7.

SHOW ME HOW

EE 1-7 *p. 25*

PE 1-7B Statement of cash flows **OBJ. 5**

A summary of cash flows for Zenith Travel Service for the year ended August 31, 20Y4, follows:

Cash receipts:	
Cash received from customers	$881,000
Cash received from additional investment of owner	43,200
Cash payments:	
Cash paid for operating expenses	895,000
Cash paid for land	60,000
Cash paid to owner for personal use	21,600

The cash balance as of September 1, 20Y3, was $106,900.

Prepare a statement of cash flows for Zenith Travel Service for the year ended August 31, 20Y4.

SHOW ME HOW

FAI

EE 1-8 *p. 27*

PE 1-8A Ratio of liabilities to owner's equity **OBJ. 6**

The following data were taken from Nakajima Company's balance sheet:

	Dec. 31, 20Y6	Dec. 31, 20Y5
Total liabilities	$598,000	$569,900
Total owner's equity	460,000	410,000

a. Compute the ratio of liabilities to owner's equity.

b. Has the creditor's risk increased or decreased from December 31, 20Y5, to December 31, 20Y6?

SHOW ME HOW

FAI

EE 1-8 *p. 27*

PE 1-8B Ratio of liabilities to owner's equity **OBJ. 6**

The following data were taken from McClean Company's balance sheet:

	Dec. 31, 20Y6	Dec. 31, 20Y5
Total liabilities	$4,042,000	$3,096,000
Total owner's equity	4,300,000	3,600,000

a. Compute the ratio of liabilities to owner's equity.

b. Has the creditor's risk increased or decreased from December 31, 20Y5, to December 31, 20Y6?

Exercises

REAL WORLD

EX 1-1 Types of businesses — OBJ. 1

The following is a list of well-known companies:

1. **Alcoa Inc.**
2. **Boeing**
3. **Caterpillar**
4. **Citigroup Inc.**
5. **CVS**
6. **Delta Air Lines**
7. **eBay Inc.**
8. **FedEx**
9. **Ford Motor Company**
10. **Gap Inc.**
11. **H&R Block**
12. **Hilton Hospitality, Inc.**
13. **Procter & Gamble**
14. **SunTrust**
15. **Wal-Mart Stores, Inc.**

a. Indicate whether each of these companies is primarily a service, merchandise, or manufacturing business. If you are unfamiliar with the company, use the Internet to locate the company's home page or use the finance website of **Yahoo** (finance.yahoo.com).

b. For which of the preceding companies is the accounting equation relevant?

ETHICS

EX 1-2 Professional ethics — OBJ. 1

A fertilizer manufacturing company wants to relocate to Lakeside County. A report from a fired researcher at the company indicates the company's product is releasing toxic by-products. The company suppressed that report. A later report commissioned by the company shows there is no problem with the fertilizer.

Should the company's chief executive officer reveal the content of the unfavorable report in discussions with Lakeside County representatives? Discuss.

EX 1-3 Business entity assumption — OBJ. 2

Big Sky Sports sells hunting and fishing equipment and provides guided hunting and fishing trips. Big Sky Sports is owned and operated by Joe Flannery, a well-known sports enthusiast and hunter. Joe's wife, Pam, owns and operates Glacier Boutique, a women's clothing store. Joe and Pam have established a trust fund to finance their children's college education. The trust fund is maintained by Kalispell State Bank in the name of the children, Trey and Brooke.

a. For each of the following transactions, identify which of the entities listed should record the transaction in its records:

Entities	
G	Glacier Boutique
K	Kalispell State Bank
B	Big Sky Sports
X	None of the above

1. Pam deposited a $2,000 personal check in the trust fund at Kalispell State Bank.
2. Pam purchased two dozen spring dresses from a Spokane designer for a special spring sale.
3. Joe paid a breeder's fee for an English Springer Spaniel to be used as a hunting guide dog.
4. Pam authorized the trust fund to purchase mutual fund shares.
5. Joe paid a local doctor for his annual physical, which was required by the workmen's compensation insurance policy carried by Big Sky Sports.
6. Received a cash advance from customers for a guided hunting trip.
7. Pam paid her dues to the YWCA.
8. Pam donated several dresses from inventory for a local charity auction for the benefit of a women's abuse shelter.

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