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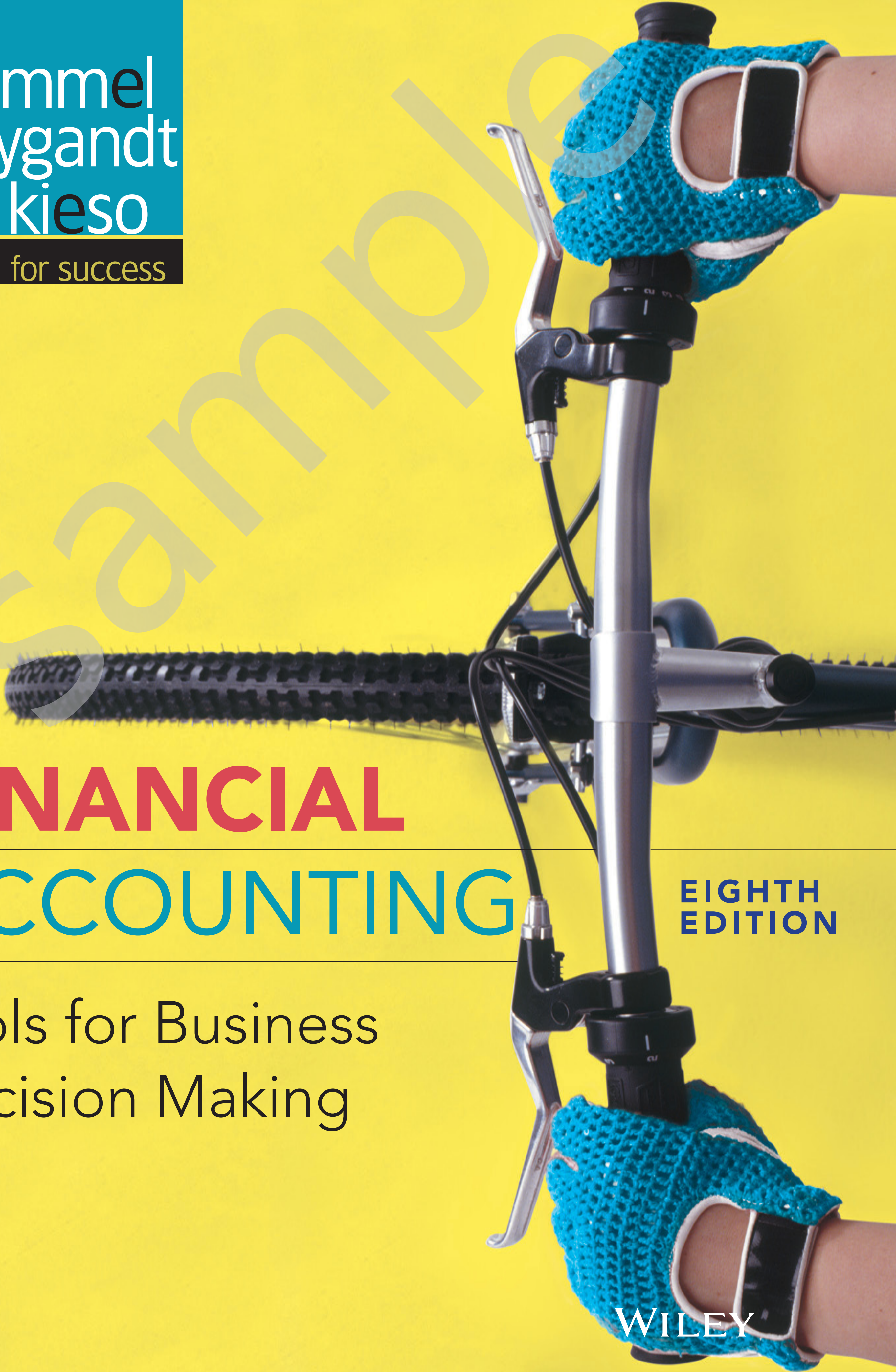


FINANCIAL ACCOUNTING

EIGHTH EDITION

Tools for Business Decision Making

WILEY

The following is a sample chart of accounts. It does not represent a comprehensive chart of all the accounts used in this textbook but rather those accounts that are commonly used. This sample chart of accounts is for a company that generates both service revenue as well as sales revenue. It uses the perpetual approach to inventory. If a periodic system was used, the following temporary accounts would be needed to record inventory purchases: Purchases, Freight-In, Purchase Returns and Allowances, and Purchase Discounts.

CHART OF ACCOUNTS

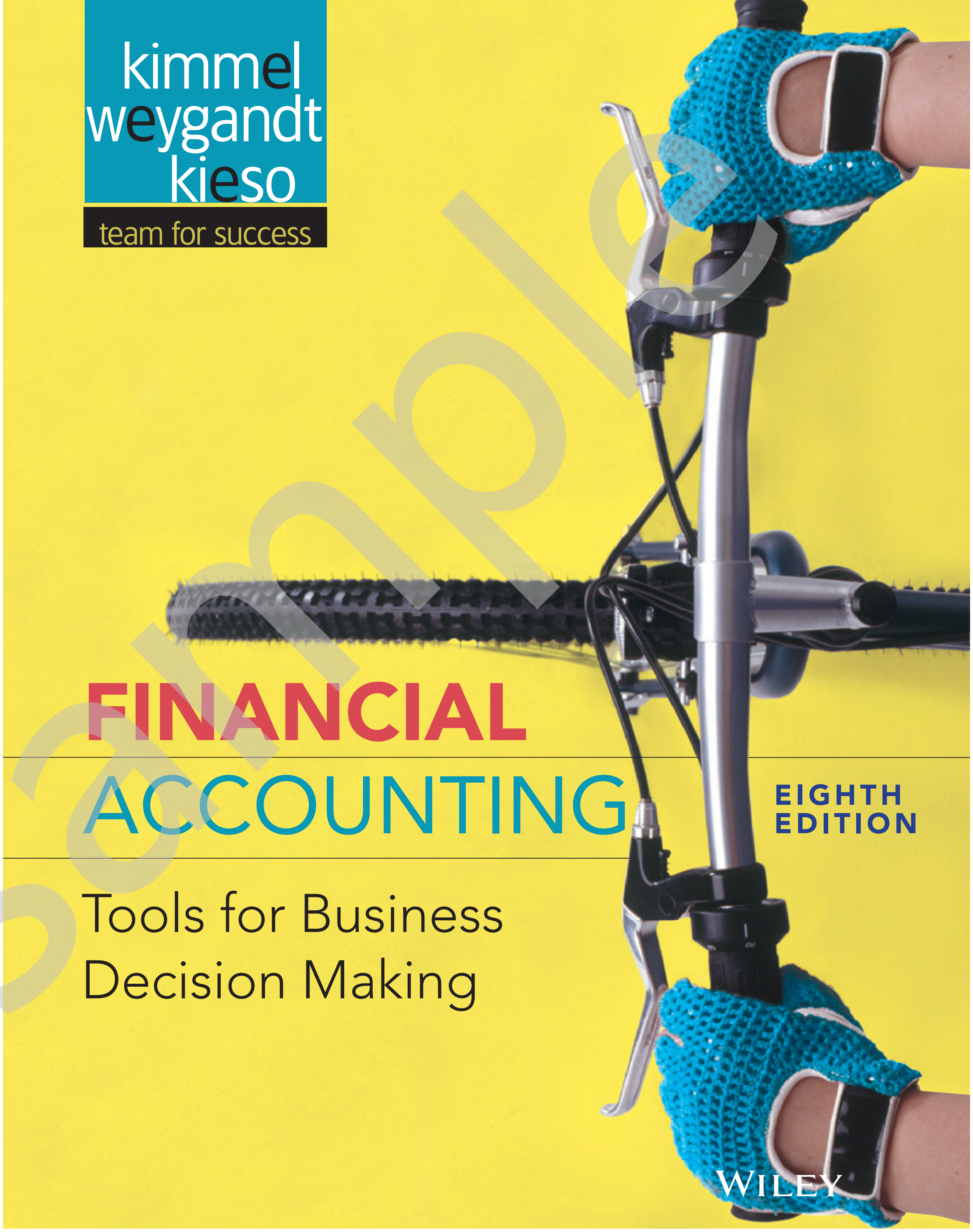
Assets	Liabilities	Stockholders' Equity	Revenues	Expenses
Cash	Notes Payable	Common Stock	Service Revenue	Administrative Expenses
Accounts Receivable	Accounts Payable	Paid-in Capital in Excess of Par Value—Common Stock	Sales Revenue	Amortization Expense
Allowance for Doubtful Accounts	Unearned Service Revenue	Preferred Stock	Sales Discounts	Bad Debt Expense
Interest Receivable	Salaries and Wages Payable	Paid-in Capital in Excess of Par Value—Preferred Stock	Sales Returns and Allowances	Cost of Goods Sold
Inventory	Interest Payable	Treasury Stock	Interest Revenue	Depreciation Expense
Supplies	Dividends Payable	Retained Earnings	Gain on Disposal of Plant Assets	Freight-Out
Prepaid Insurance	Income Taxes Payable	Dividends		Income Tax Expense
Prepaid Rent	Bonds Payable	Income Summary		Insurance Expense
Land	Discount on Bonds Payable			Interest Expense
Equipment	Premium on Bonds Payable			Loss on Disposal of Plant Assets
Accumulated Depreciation—Equipment	Mortgage Payable			Maintenance and Repairs Expense
Buildings				Rent Expense
Accumulated Depreciation—Buildings				Salaries and Wages Expense
Copyrights				Selling Expenses
Goodwill				Supplies Expense
Patents				Utilities Expense

ACCOUNT CLASSIFICATION AND PRESENTATION			
Account Title	**Classification**	**Financial Statement**	**Normal Balance**
A			
Accounts Payable	Current Liability	Balance Sheet	Credit
Accounts Receivable	Current Asset	Balance Sheet	Debit
Accumulated Depreciation—Buildings	Plant Asset—Contra	Balance Sheet	Credit
Accumulated Depreciation—Equipment	Plant Asset—Contra	Balance Sheet	Credit
Administrative Expenses	Operating Expense	Income Statement	Debit
Allowance for Doubtful Accounts	Current Asset—Contra	Balance Sheet	Credit
Amortization Expense	Operating Expense	Income Statement	Debit
B			
Bad Debt Expense	Operating Expense	Income Statement	Debit
Bonds Payable	Long-Term Liability	Balance Sheet	Credit
Buildings	Plant Asset	Balance Sheet	Debit
C			
Cash	Current Asset	Balance Sheet	Debit
Common Stock	Stockholders' Equity	Balance Sheet	Credit
Copyrights	Intangible Asset	Balance Sheet	Debit
Cost of Goods Sold	Cost of Goods Sold	Income Statement	Debit
D			
Debt Investments	Current Asset/ Long-Term Investment	Balance Sheet	Debit
Depreciation Expense	Operating Expense	Income Statement	Debit
Discount on Bonds Payable	Long-Term Liability—Contra	Balance Sheet	Debit
Dividend Revenue	Other Income	Income Statement	Credit
Dividends	Temporary account closed to Retained Earnings	Retained Earnings Statement	Debit
Dividends Payable	Current Liability	Balance Sheet	Credit
E			
Equipment	Plant Asset	Balance Sheet	Debit
F			
Freight-Out	Operating Expense	Income Statement	Debit
G			
Gain on Disposal of Plant Assets	Other Income	Income Statement	Credit
Goodwill	Intangible Asset	Balance Sheet	Debit
I			
Income Summary	Temporary account closed to Retained Earnings	Not Applicable	(1)
Income Tax Expense	Income Tax Expense	Income Statement	Debit
Income Taxes Payable	Current Liability	Balance Sheet	Credit
Insurance Expense	Operating Expense	Income Statement	Debit
Interest Expense	Other Expense	Income Statement	Debit
Interest Payable	Current Liability	Balance Sheet	Credit
Interest Receivable	Current Asset	Balance Sheet	Debit
Interest Revenue	Other Income	Income Statement	Credit
Inventory	Current Asset	Balance Sheet (2)	Debit

Account Title	Classification	Financial Statement	Normal Balance
L			
Land	Plant Asset	Balance Sheet	Debit
Loss on Disposal of Plant Assets	Other Expense	Income Statement	Debit
M			
Maintenance and Repairs Expense	Operating Expense	Income Statement	Debit
Mortgage Payable	Long-Term Liability	Balance Sheet	Credit
N			
Notes Payable	Current Liability/ Long-Term Liability	Balance Sheet	Credit
P			
Patents	Intangible Asset	Balance Sheet	Debit
Paid-in Capital in Excess of Par Value—Common Stock	Stockholders' Equity	Balance Sheet	Credit
Paid-in Capital in Excess of Par Value—Preferred Stock	Stockholders' Equity	Balance Sheet	Credit
Preferred Stock	Stockholders' Equity	Balance Sheet	Credit
Premium on Bonds Payable	Long-Term Liability—Contra	Balance Sheet	Credit
Prepaid Insurance	Current Asset	Balance Sheet	Debit
Prepaid Rent	Current Asset	Balance Sheet	Debit
R			
Rent Expense	Operating Expense	Income Statement	Debit
Retained Earnings	Stockholders' Equity	Balance Sheet and Retained Earnings Statement	Credit
S			
Salaries and Wages Expense	Operating Expense	Income Statement	Debit
Salaries and Wages Payable	Current Liability	Balance Sheet	Credit
Sales Discounts	Revenue—Contra	Income Statement	Debit
Sales Returns and Allowances	Revenue—Contra	Income Statement	Debit
Sales Revenue	Revenue	Income Statement	Credit
Selling Expenses	Operating Expense	Income Statement	Debit
Service Revenue	Revenue	Income Statement	Credit
Stock Investments	Current Asset/Long-Term Investment	Balance Sheet	Debit
Supplies	Current Asset	Balance Sheet	Debit
Supplies Expense	Operating Expense	Income Statement	Debit
T			
Treasury Stock	Stockholders' Equity	Balance Sheet	Debit
U			
Unearned Service Revenue	Current Liability	Balance Sheet	Credit
Utilities Expense	Operating Expense	Income Statement	Debit

(1) The normal balance for Income Summary will be credit when there is a net income, debit when there is a net loss. The Income Summary account does not appear on any financial statement.

(2) If a periodic system is used, Inventory also appears on the income statement in the calculation of cost of goods sold.



Paul D. Kimmel PhD, CPA
University of Wisconsin—Milwaukee
Milwaukee, Wisconsin

Jerry J. Weygandt PhD, CPA
University of Wisconsin—Madison
Madison, Wisconsin

Donald E. Kieso PhD, CPA
Northern Illinois University
DeKalb, Illinois

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This book was set in New Aster LT Std by Aptara®, Inc. and printed and bound by Courier/Versailles. The cover was printed by Courier/Versailles.

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ISBN-13 978-1-118-55255-1

Binder-Ready Version ISBN 978-1-118-95390-7

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

Brief Contents

From the Authors

Dear Student,

Why This Course? *Remember your biology course in high school? Did you have one of those "invisible man" models (or maybe something more high-tech than that) that gave you the opportunity to look "inside" the human body? This accounting course offers something similar. To understand a business, you have to understand the financial insides of a business organization. A financial accounting course will help you understand the essential financial components of businesses. Whether you are looking at a large multinational company like Apple or Starbucks or a single-owner software consulting business or coffee shop, knowing the fundamentals of financial accounting will help you understand what is happening. As an employee, a manager, an investor,a business owner, or a director of your own personal finances—any of which roles you will have at some point in your life—you will make better decisions for having taken this course.*

> "Whether you are looking at a large multinational company like Apple or Starbucks or a single-owner software consulting business or coffee shop, knowing the fundamentals of financial accounting will help you understand what is happening."

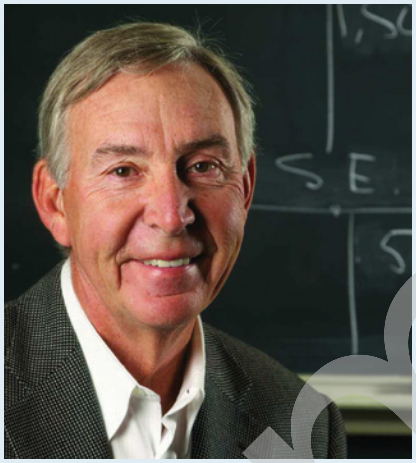
Why This Book? *Hundreds of thousands of students have used this textbook. Your instructor has chosen it for you because of its trusted reputation. The authors have worked hard to keep the book fresh, timely, and accurate.*

How to Succeed? *We've asked many students and many instructors whether there is a secret for success in this course. The nearly unanimous answer turns out to be not much of a secret: "Do the homework." This is one course where doing is learning. The more time you spend on the homework assignments—using the various tools that this textbook provides—the more likely you are to learn the essential concepts, techniques, and methods of accounting. Besides the textbook itself, WileyPLUS and the book's companion website also offer various support resources.*

Good luck in this course. We hope you enjoy the experience and that you put to good use throughout a lifetime of success the knowledge you obtain in this course. We are sure you will not be disappointed.

Paul D. Kimmel
Jerry J. Weygandt
Donald E. Kieso

Author Commitment



Jerry Weygandt

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

Paul Kimmel

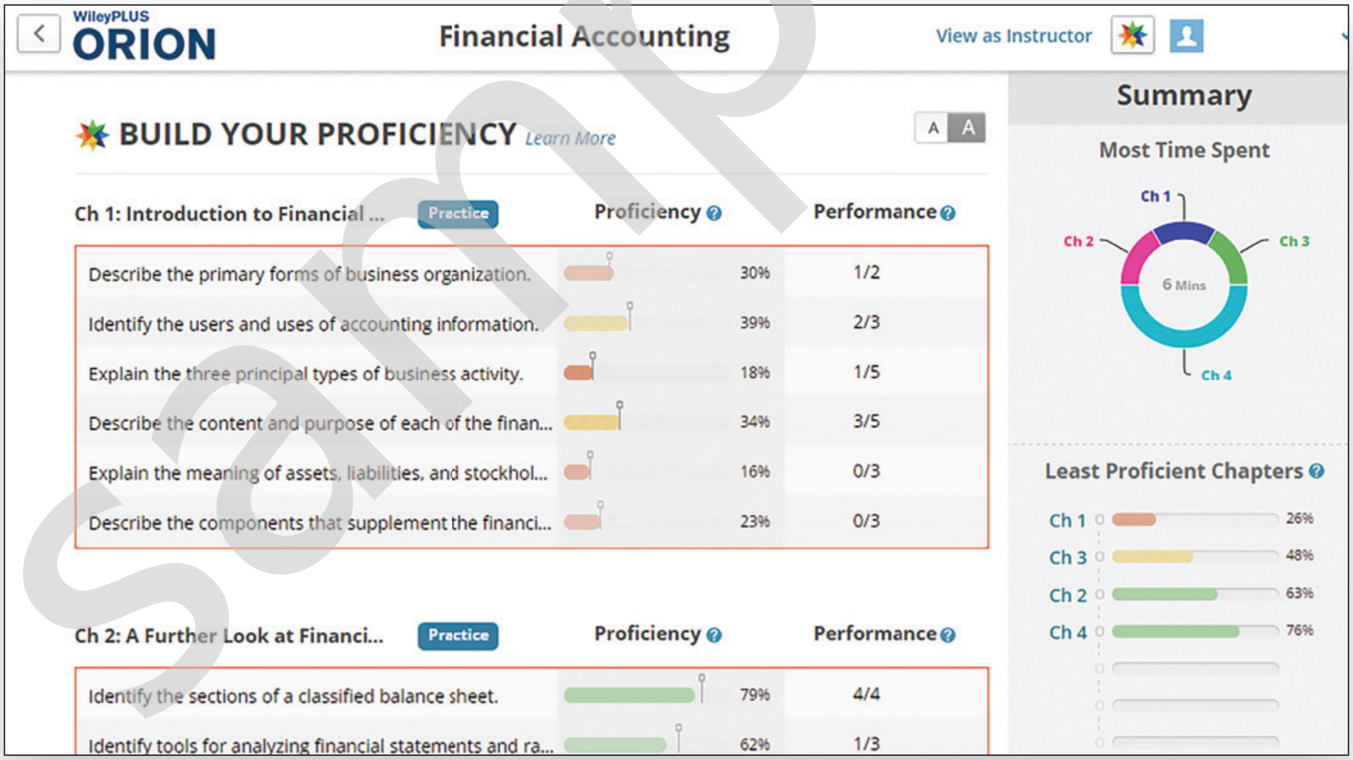
PAUL D. KIMMEL, PhD, CPA, received his bachelor's degree from the University of Minnesota and his doctorate in accounting from the University of Wisconsin. He is an Associate Professor at the University of Wisconsin—Milwaukee, and has public accounting experience with Deloitte & Touche (Minneapolis).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

Don Kieso

DONALD E. KIESO, PhD, CPA, received his bachelor's degree from Aurora University and his doctorate in accounting from the University of Illinois. He has served as chairman of the Department of Accountancy and is currently the KPMG Emeritus Professor of Accountancy at Northern Illinois University. He has public accounting experience with Price Waterhouse & Co. (San Francisco and Chicago) and Arthur Andersen & Co. (Chicago) and research experience with the Research Division of the American Institute of Certified Public Accountants (New York). He has done postdoctoral work as a Visiting Scholar at the University of California at Berkeley and is a recipient of NIU's Teaching Excellence Award and four Golden Apple Teaching Awards. Professor Kieso is the author of other accounting and business books and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Illinois CPA Society. He has served as a member of the Board of Directors of the Illinois CPA Society, then AACSB's Accounting Accreditation Committees, the State of Illinois Comptroller's Commission, as Secretary-Treasurer of the Federation of Schools of Accountancy, and as Secretary-Treasurer of the American Accounting Association. Professor Kieso is currently serving on the Board of Trustees and Executive Committee of Aurora University, as a member of the Board of Directors of Kishwaukee Community Hospital, and as Treasurer and Director of Valley West Community Hospital. From 1989 to 1993 he served as a charter member of the national Accounting Education Change Commission. He is the recipient of the Outstanding Accounting Educator Award from the Illinois CPA Society, the FSA's Joseph A. Silvoso Award of Merit, the NIU Foundation's Humanitarian Award for Service to Higher Education, a Distinguished Service Award from the Illinois CPA Society, and in 2003 an honorary doctorate from Aurora University.

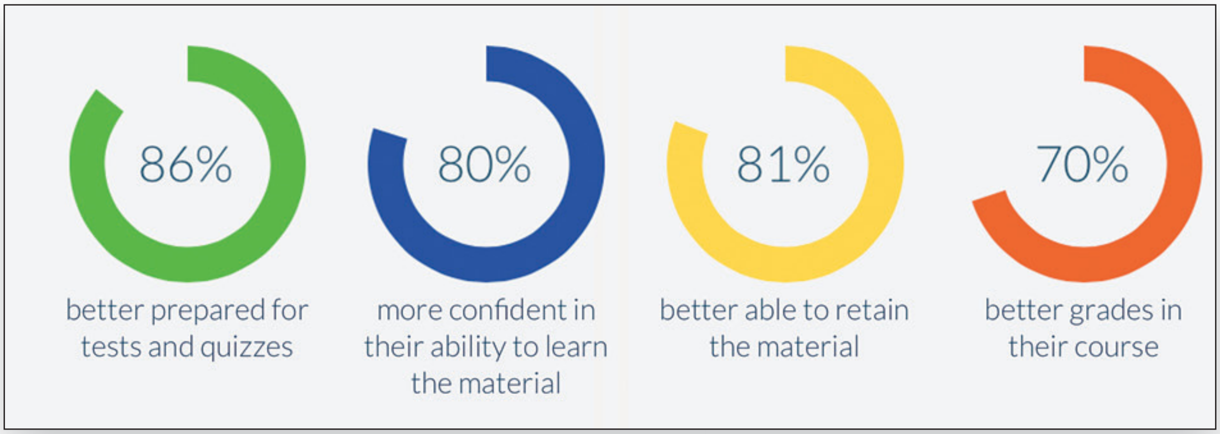
WileyPLUS with ORION

Quickly identify areas of strength and weakness before the first exam, and use the information to build a learning path to success.



A little time with ORION goes a long way.

Based on usage data, students who engage in ORION adaptive practice—just a few minutes per week—get better outcomes. In fact, students who used ORION five or more times over the course of a semester reported the following results:



Developing effective problem solving skills requires practice, relevant feedback, and insightful examples.

New PRACTICE QUESTIONS WITH SOLUTIONS include:

- BRIEF EXERCISES
- EXERCISES
- DO IT! Exercises
- PROBLEMS

All new practice questions provide **assessment**, helping students see what they understand and where they can improve.

Algorithmic versions of the questions allow students to revisit practice questions until they understand a topic completely.

CALCULATOR | PRINTER VERSION | ‹BACK | NEXT›

ASSIGNMENT RESOURCES
Chapter 07 Do It! Drill
Do It! Review 7-1
Do It! Review 7-3
Do It! Review 7-4
Review Score
RESET

Do It! Review 7-3

Your answer is partially correct. Try again.

Wilkinson Company established a $105 petty cash fund on August 1. On August 31, the fund had $7 cash remaining and petty cash receipts for postage $36, office supplies $31, and miscellaneous expense $28.

Prepare journal entries to establish the fund on August 1 and replenish the fund on August 31. *(Credit account titles are automatically indented when amount is entered. Do not indent manually.)*

Date	Account Titles and Explanation	Debit	Credit
Aug. 1	Petty Cash	105	
	Cash		105
Aug. 31	Postage Expense	36	
	Supplies	31	
	Miscellaneous Expense	28	
	Cash Over and Short		3

SOLUTIONS TO PRACTICE EXERCISES

1. (a)

Activity Cost Pools	Cost Drivers	Estimated Overhead
Cutting	Machine hours	$400,000
Design	Number of setups	555,000

Activity-based overhead rates:

Cutting: $\frac{\$400{,}000}{200{,}000} = \$2$ per machine hour

Design: $\frac{\$555{,}000}{1{,}500} = \$370$ per setup

	Wool	Cotton
Activity-based costing		
Cutting		
100,000 × $2	$200,000	
100,000 × $2		$200,000
Design		
1,000 × $370	370,000	
500 × $370		185,000
Total cost allocated	$570,000	$385,000

(b) $\frac{\text{Estimated overhead}}{\text{Direct labors hours}} = \frac{\$955{,}000}{477{,}500} = \$2$ per direct labor hour

Solutions to practice multiple-choice questions, exercises, and problems are now available at the end of each chapter.

REVIEW AND PRACTICE

LEARNING OBJECTIVES REVIEW

1 Discuss how to classify and determine inventory. Merchandisers need only one inventory classification, merchandise inventory, to describe the different items that make up total inventory. Manufacturers, on the other hand, usually classify inventory into three categories: finished goods, work in process, and raw materials. To determine inventory quantities, manufacturers (1) take a physical inventory of goods on hand and (2) determine the ownership of goods in transit or on consignment.

2 Apply inventory cost flow methods and discuss their financial effects. The primary basis of accounting for inventories is cost. Cost includes all expenditures necessary to acquire goods and place them in a condition ready for sale. Cost of goods available for sale includes (a) cost of beginning inventory and (b) cost of goods purchased. The inventory cost flow methods are specific identification and three assumed cost flow methods—FIFO, LIFO, and average-cost.

The cost of goods available for sale may be allocated to cost of goods sold and ending inventory by specific identification or by a method based on an assumed cost flow. When prices are rising, the first-in, first-out (FIFO) method results in lower cost of goods sold and higher net income than the average-cost and the last-in, first-out (LIFO) methods. The reverse is true when prices are falling. In the balance sheet, FIFO results in an ending inventory that is closest to current value, whereas the inventory under LIFO is the farthest from current value. LIFO

Inventory turnover is calculated as cost of goods sold divided by average inventory. It can be converted to average days in inventory by dividing 365 days by the inventory turnover. A higher inventory turnover or lower average days in inventory suggests that management is trying to keep inventory levels low relative to its sales level.

The LIFO reserve represents the difference between ending inventory using LIFO and ending inventory if FIFO were employed instead. For some companies this difference can be significant, and ignoring it can lead to inappropriate conclusions when using the current ratio or inventory turnover.

***4 Apply inventory cost flow methods to perpetual inventory records.** Under FIFO, the cost of the earliest goods on hand prior to each sa… Under LIFO, the cost of… sale is charged to cost… cost method, a new ave… purchase.

***5 Indicate the effects… cial statements.** *In the… year:* (1) An error in… reverse effect on net… inventory results in un… vice versa). (2) An err… a similar effect on ne… inventory results in o… ending inventory error…

INSTRUCTIONS

Prepare a schedule to determine the correct inventory amount. Provide explanations for each item above, saying why you did or did not make an adjustment for each item.

SOLUTION

1. Ending inventory—as reported	$650,000
1. Subtract from inventory: The goods belong to Bosnia Corporation. Sergei is merely holding them for Bosnia.	(200,000)
2. Add to inventory: The goods belong to Sergei when they were shipped.	40,000
3. Subtract from inventory: Office supplies should be carried in a separate account. They are not considered inventory held for resale.	(15,000)
4. Add to inventory: The goods belong to Sergei until they are shipped (Jan. 1).	30,000

SOLUTIONS

1. **(d)** A physical inventory is usually taken when a limited number of goods are being sold or received, and at the end of the company's fiscal year. Choice (a) is incorrect because a physical inventory count is usually taken when the company has the least, not greatest, amount of inventory. Choices (b) and (c) are correct, but (d) is the better answer.
2. **(a)** Goods held on consignment should not be included because another company has title (ownership) to the goods. The other choices are incorrect because (b) goods shipped on consignment to another company and (c) goods in transit from another company shipped FOB shipping point should be included in a company's ending inventory. Choice (d) is incorrect because (a) is not included in the physical inventory.
3. **(b)** The inventory held on consignment by Rogers should be included in Railway's inventory balance at cost ($35,000). The purchased goods of $13,000 should not be included in inventory until January 3 because the goods are shipped FOB destination. Therefore, the correct amount of inventory is $215,000 ($180,000 + $35,000), not (a) $230,000, (c) $228,000, or (d) $193,000.
4. **(c)** Under FIFO, ending inventory will consist of 5,000 units from the Nov. 8 purchase and 4,000 units from the June 19 purchase. Therefore, ending inventory is (5,000 × $13) + (4,000 × $12) = $113,000, not (a) $99,000, (b) $108,000, or (d) $117,000.
5. **(d)** Under LIFO, ending inventory will consist of 8,000 units from the inventory at Jan. 1 and 1,000 units from the June 19 purchase. Therefore, ending inventory is (8,000 × $11) + (1,000 × $12) = $100,000, not (a) $113,000, (b) $108,000, or (c) $99,000.

What's New?

Focus on the Accounting Cycle

To help students master accounting cycle concepts, we added (1) new, recurring illustrations that show students the big picture of the accounting cycle, (2) new comprehensive accounting cycle exercises and problems, and (3) new accounting cycle questions in the Test Bank and **WileyPLUS with ORION**.

Student Practice and Solutions

New practice opportunities with solutions are integrated throughout the textbook and WileyPLUS course. Each textbook chapter now provides students with a **Review and Practice** section that includes learning objective summaries, multiple-choice questions with feedback for each answer choice, practice exercises with solutions, and a practice problem with a solution. Also, all learning objective modules in the textbook are followed by a **DO IT!** exercise with an accompanying solution.

In **WileyPLUS**, two brief exercises, two **DO IT!** exercises, two exercises, and a new problem are available for practice with each chapter. All of the new practice questions are algorithmic, providing students with multiple opportunities for advanced practice. WileyPLUS assessment now includes new narrative student feedback.

WileyPLUS with ORION

Over 3,500 questions, including new medium-level, computational, and accounting-cycle-based questions, are available for practice and review. **WileyPLUS with ORION** is an adaptive study and practice tool that helps students build proficiency in course topics.

Updated Content and Design

We scrutinized all content to find new ways to engage students and help them learn accounting concepts. A new learning objective structure helps students practice their understanding of concepts with **DO IT!** exercises before they move on to different topics in other learning objectives. Coupled with a new interior design, revised infographics, and the newly designed interactive chapter tutorials, the new outcomes-oriented approach motivates students and helps them make the best use of their time.

WileyPLUS Videos

Over 150 videos are available in WileyPLUS. More than 80 of the videos are new to the Eighth Edition. The videos walk students through relevant homework problems and solutions, review important concepts, provide overviews of Excel skills, and explore topics in a real-world context.

Real World Context: Feature Stories and Comprehensive Problems

New feature stories frame chapter topics in a real-world company example. Also, the feature stories now closely correlate with the Using Decision Tools problem at the end of each chapter. In WileyPLUS, real-world Insight boxes now have questions that can be assigned as homework.

More information about the Eighth Edition is available on the book's website at **www.wiley.com/college/kimmel**.

Table of Contents

Acknowledgments

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

Eighth Edition

Dennis Avola
Northeastern University

Thomas Bednarcik
Robert Morris University Illinois

Martin Blaine
Columbus State Community College

Bradley Blaylock
Oklahoma State University

Gary Bower
Community College of Rhode Island

Robert Braun
Southeastern Louisiana University

Lou Bravo
North Lake College

Myra Bruegger
Southeastern Community College

Barry Buchoff
Towson University

Matthew Calderisi
Fairleigh Dickinson University

Julia Camp
Providence College

Marian Canada
Ivy Tech Community College at Franklin

Bea Chiang
The College of New Jersey

Colleen Chung
Miami Dade College

Shifei Chung
Rowan University

Tony Cioffi
Lorain County Community College

Leslie Cohen
University of Arizona

Jim Coughlin
Robert Morris University

Patricia Crenny
Villanova University

Dori Danko
Grand Valley State University

Mingcherng Deng
Baruch College

Kathy Dunne
Rider University

Barbara Durham
University of Central Florida

David Emerson
Salisbury University

Caroline Falconetti
Nassau Community College

Nancy Fan
California State Polytechnic University, Pomona

Magdy Farag
California State Polytechnic University, Pomona

Linda Flaming
Monmouth University

Joseph Fournier
University of Rhode Island

Amy Geile
University of Arizona

Alan Glaser
Franklin & Marshall College

J. D. Golub
Northeastern University

Rita Grant
Grand Valley State University

Steve Groves
Ivy Tech Community College

Konrad Gunderson
Missouri Western State University

Marcye Hampton
University of Central Florida

Qian Hao
Wilkes University

Huong Higgins
Worcester Polytechnic Institute

Yongtao Hong
North Dakota State University

Robert Hurst
Franklin University

Wayne Ingalls
University of Maine

Jennifer Joe
University of Delaware

James B. Johnson
Community College of Philadelphia

Patricia Johnson
Canisius College

Jordan Kanter
University of Rhode Island

Ann Galligan Kelley
Providence College

Robert Kenny
The College of New Jersey

Emil Koren
Saint Leo University

Faith Lamprey
Providence College

Gary Laycock
Ivy Tech Community College

Charles Leflar
University of Arkansas

Jennifer LeSure
Ivy Tech Community College

Claudia Lubaski
Lorain County Community College

Yuanyuan Ma
University of Minnesota

Don McFall
Hiram College

Allison McLeod
University of North Texas

Maha Mitrelis
Providence College

Louella Moore
Washburn University

Sia Nassiripour
William Paterson University

Joseph Nesi
Monmouth University

Glenn Pate
Palm Beach State College

Suzy Pearse
Clemson University

Rachel Pernia
Essex County College

George Psaras
Aurora University

Patrick Reihing
Nassau Community College

John Ribezzo
Community College of Rhode Island

Vernon Richardson
University of Arkansas

Patrick Rogan
Consumnes River College

Juan Roman
Saint Leo University

John Rude
Bloomsburg University

Martin Rudnick
William Paterson University

August Saibeni
Consumnes River College

Barbara Sandler
Queens College

Barbara Scofield
Washburn University

Chris Severson
Franklin University

Suzanne Seymoure
Saint Leo University

Abdus Shahid
The College of New Jersey

Mike Shapeero
Bloomsburg University

Todd Shawver
Bloomsburg University

Eileen Shifflett
James Madison University

Ladd Simms
Mississippi Valley State University

Doug Stives
Monmouth University

Karen Tower
Ivy Tech Community College

Daniel Tschopp
Saint Leo University

Mark Ulrich
St. John's University

Nancy Wilburn
Northern Arizona University

Wayne W. Williams
Community College of Philadelphia

Hannah Wong
William Paterson University

Kenneth Zheng
University at Buffalo

Prior Editions

Thanks to the following reviewers and focus group participants of prior editions of Financial Accounting:

Dawn Addington, *Central New Mexico Community College;* Gilda Agacer, *Monmouth University;* Solochidi Ahiarah, *Buffalo State College;* C. Richard Aldridge, *Western Kentucky University;* Sylvia Allen, *Los Angeles Valley College;* Sheila Ammons, *Austin Community College;* Thomas G. Amyot, *College of Santa Rose;* Juanita Ardavany, *Los Angeles Valley College;* Brian Baick, *Montgomery College;* Timothy Baker, *California State University—Fresno;* Cheryl Bartlett, *Central New Mexico Community College;* Benjamin Bean, *Utah Valley State College.*

Victoria Beard, *University of North Dakota;* Angela H. Bell, *Jacksonville State University;* Charles Bokemeier, *Michigan State University;* John A. Booker, *Tennessee Technological University;* Duane Brandon, *Auburn University;* Gary Braun, *University of Texas—El Paso;* Jerold K. Braun, *Daytona State College;* Robert L. Braun, *Southeastern Louisiana University;* Daniel Brickner, *Eastern Michigan University;* Evangelie Brodie, *North Carolina State University;* Sarah Ruth Brown, *University of North Alabama;* Charles Bunn, *Wake Technical Community College;* Thane Butt, *Champlain College;* Sandra Byrd, *Missouri State University;* James Byrne, *Oregon State University.*

Judy Cadle, *Tarleton State University;* Julia Camp, *University of Massachusetts—Boston;* David Carr, *Austin Community College;* Jack Cathey, *University of North Carolina—Charlotte;* Andy Chen, *Northeast Illinois University;* Jim Christianson, *Austin Community College;* Siu Chung, *Los Angeles Valley College;* Laura Claus, *Louisiana State University;* Leslie A. Cohen, *University of Arizona;* Teresa L. Conover, *University of North Texas;* Rita Kingery Cook, *University of Delaware;* Cheryl Corke, *Genesee Community College;* Sue Counte, *St. Louis Community College—Meramec;* Janet Courts, *San Bernardino Valley College;* Samantha Cox, *Wake Technical Community College;* Cheryl Crespi, *Central Connecticut State University;* Dori Danko, *Grand Valley State University;* Brent W. Darwin, *Allan Hancock College;* Helen Davis, *Johnson and Wales University;* Paquita Davis-Friday, *Baruch College;* Michael Deschamps, *Mira Costa College;* Cheryl Dickerson, *Western Washington University;* Gadis Dillon, *Oakland University;* George M. Dow, *Valencia Community College—West;* Kathy J. Dow, *Salem State College;* Lola Dudley, *Eastern Illinois University.*

Mary Emery, *St. Olaf College;* Martin L. Epstein, *Central New Mexico Community College;* Ann Escaro, *McHenry County College;* Larry R. Falcetto, *Emporia State University;* Alan Falcon, *Loyola Marymount University;* Scott Fargason, *Louisiana State University;* Janet Farler, *Pima Community College;* Lance Fisher, *Oklahoma State University;* Sheila D. Foster, *The Citadel;* Jessica J. Frazier, *Eastern Kentucky University;* Roger Gee, *San Diego Mesa College;* Lisa Gillespie, *Loyola University—Chicago;* Hubert Glover, *Drexel University;* Norman H. Godwin, *Auburn University;* David Gotlob, *Indiana University—Purdue University—Fort Wayne;* Lisa Gray, *Seminole State College and Valencia Community College;* Emmett Griner, *Georgia State University;* Leon J. Hanouille, *Syracuse University;* Hassan Hefzi, *California State PolyTech University—Pomona;* Kenneth M. Hiltebeitel, *Villanova University;* Harry Hooper, *Santa Fe Community College;* Judith A. Hora, *University of San Diego;* Carol Olson Houston, *San Diego State University;* Ryan Huldah, *Iona College;* Sam Isley, *Wake Technical Community College.*

Norma Jacobs, *Austin Community College;* Marianne L. James, *California State University—Los Angeles;* Stanley Jenne, *University of Montana;* Christopher Jones, *George Washington University;* Siriyama Kanthi Herath, *Georgia Institute of Technology;* Jane Kaplan, *Drexel University;* John E. Karayan, *California State University—Pomona;* Susan Kattelus, *Eastern Michigan University;* Ann Kelly, *Providence College;* Dawn Kelly, *Texas Tech University;* Robert Kenny, *The College of New Jersey;* Cindi Khanlarian, *University of North Carolina—Greensboro;* Robert Kiddoo, *California State University—Northridge;* Marinilka Kimbro, *Gonzaga University;* Robert J. Kirsch, *Southern Connecticut State University;* Frank Korman, *Mountain View College;* Jerry G. Kreuze, *Western Michigan University.*

John Lacey, *California State University—Long Beach;* Joseph Larkin, *Saint Joseph's University;* Doulas Larson, *Salem State College;* Doug Laufer, *Metropolitan State College of Denver;* Keith Leeseberg, *Manatee Community College;* Glenda Levendowski, *Arizona State University;* Seth Levine, *DeVry University;* Lihon Liang, *Syracuse University;* James Lukawitz, *University of Memphis;* Nancy Lynch, *West Virginia University;* P. Merle Maddocks, *University of Alabama—Huntsville;* Janice Mardon, *Green River Community College;* Sal Marino, *Westchester Community College;* John Marts, *University of North Carolina—Wilmington;* Alan Mayer-Sommer, *Georgetown University;* Florence McGovern, *Bergen Community College;* Noel McKeon, *Florida Community College at Jacksonville;* Sara Melendy, *Gonzaga University;* Barbara Merino, *University of North Texas;* Paul Mihalek, *Central Connecticut State University;* Jeanne Miller, *Cypress College;* Robert Miller, *California State University—Fullerton;* Elizabeth Minbiole, *Northwood University;* Sherry Mirbod, *Montgomery College;* Andrew Morgret, *University of Memphis;* Michelle Moshier, *SUNY Albany;* Marguerite Muise, *Santa Ana College;* Kathy Munter, *Pima Community College;* William J. Nealon, *Schenectady County Community College;* James Neurath, *Central Michigan University;* Gale E. Newell, *Western Michigan University;* Garth Novack, *Utah State University;* Rosemary Nurre, *San Mateo Community College.*

Suzanne Ogilby, *Sacramento State University;* Sarah N. Palmer, *University of North Carolina—Charlotte;* Patricia Parker, *Columbus State Community College;* Terry Patton, *Midwestern State University;* Charles Pier, *Appalachian State University;* Ronald Pierno, *Florida State University;* Janice Pitera, *Broome Community College;* Franklin J. Plewa, *Idaho State University;* Meg Pollard, *American River College;* John Purisky, *Salem State College;* Donald J. Raux, *Siena College;* Ray Reisig, *Pace University, Pleasantville;* Judith Resnick, *Borough of Manhattan Community College;* Mary Ann Reynolds, *Western Washington University;* Ruthie G. Reynolds, *Howard University;* Carla Rich, *Pensacola Junior College;* Rod Ridenour, *Montana State University—Bozeman;* Ray Rigoli, *Ramapo College of New Jersey;* Larry Rittenberg, *University of Wisconsin;* Jeff Ritter, *St. Norbert College;* Cecile M. Roberti, *Community College of Rhode Island;* Brandi Roberts, *Southeastern Louisiana University;* Patricia A. Robinson, *Johnson and Wales University;* Nancy Rochman, *University of Arizona;* Lawrence Roman, *Cuyahoga Community College;* Marc A. Rubin, *Miami University;* John A. Rude, *Bloomsburg University;* Robert Russ, *Northern Kentucky University.*

Alfredo Salas, *El Paso Community College;* Christine Schalow, *California State University—San Bernardino;* Michael Schoderbek, *Rutgers University;* Richard Schroeder, *University of North Carolina—Charlotte;* Bill N. Schwartz, *Stevens Institute of Technology;* Jerry Searfoss, *University of Utah;* Cindy Seipel, *New Mexico State University;* Anne E. Selk, *University of Wisconsin—Green Bay;* William Seltz, *University of Massachusetts;* Suzanne Sevalstad, *University of Nevada;* Mary Alice Seville, *Oregon State University;* Donald Smillie, *Southwest Missouri State University;* Aileen Smith, *Stephen F. Austin State University;* Gerald Smith, *University of Northern Iowa;* Pam Smith, *Northern Illinois University;* Talitha Smith, *Auburn University;* William E. Smith, *Xavier University;* Will Snyder, *San Diego State University;* Naomi Soderstrom, *University of Colorado—Boulder;* Chris Solomon, *Trident Technical College;* Teresa A. Speck, *St. Mary's University of Minnesota;* Charles Stanley, *Baylor University;* Vic Stanton, *University of California, Berkeley;* Ron Stone, *California State University—Northridge;* Gary Stout, *California State University—Northridge;* Gracelyn Stuart, *Palm Beach Community College;* Paul Swanson, *Illinois Central College;* Ellen L. Sweatt, *Georgia Perimeter College.*

William Talbot, *Montgomery College;* Diane Tanner, *University of North Florida;* Pamadda Tantral, *Fairleigh Dickinson University;* Steve Teeter, *Utah Valley State College;* Michael Tydlaska, *Mountain View College;* Michael F. van Breda, *Texas Christian University;* Joan Van Hise, *Fairfield University;* Richard Van Ness, *Schenectady County Community College;* Christopher Wallace, *California State University—Sacramento;* Barbara Warschawski, *Schenectady County Community College;* Andrea B. Weickgenannt, *Northern Kentucky University;* David P. Weiner, *University of San Francisco;* Frederick Weis, *Claremont McKenna College;* T. Sterling Wetzel, *Oklahoma State University;* Wendy Wilson, *Southern Methodist University;* Allan Young, *DeVry University;* Linda G. Wade, *Tarleton State University;* Stuart K. Webster, *University of Wyoming;* Kathryn Yarbrough, *University of North Carolina—Charlotte;* V. Joyce Yearley, *New Mexico State University;* Judith Zander, *Grossmont College*

Ancillary Authors, Contributors, Proofers, and Accuracy Checkers

We sincerely thank the following individuals for their hard work in preparing the content that accompanies this textbook:

Ellen Bartley
St. Joseph's College

LuAnn Bean
Florida Institute of Technology

Jack Borke
University of Wisconsin—Platteville

Melanie Bunting
Edgewood College

Sandra Cohen
Columbia College—Chicago

James M. Emig
Villanova University

Larry R. Falcetto
Emporia State University

Heidi Hansel
Kirkwood Community College

Coby Harmon
University of California, Santa Barbara

DeAnna Kirchen
Golden West College

Laura McNally
Black Hills State University

Jill Mitchell
Northern Virginia Community College

Barb Muller
Arizona State University

George Psarsas
Aurora University

Laura Prosser
Black Hills State University

Alice Sineath
Forsyth Technical Community College

Teresa Speck
Saint Mary's University of Minnesota

Mark Ulrich
St. John's University

Sheila Viel
University of Wisconsin—Milwaukee

Dick D. Wasson
Southwestern College

Andrea Weickgenannt
Xavier University

Melanie Yon

Advisory Board

Robert Braun
Southeastern Louisiana University

Rita Grant
Grand Valley State University

Marcye Hampton
University of Central Florida

Michelle Moshier
State University of New York—Albany

Courtney Naismith
Collin College

Michael Newman
University of Houston

Pamela Rouse
Butler University

Chris Solomon
Trident Technical College

We appreciate the exemplary support and commitment given to us by executive editor Michael McDonald, executive marketing manager Karolina Zarychta Honsa, development editor Ed Brislin, market solutions assistant Elizabeth Kearns, development editors Terry Ann Tatro and Margaret Thompson, product design manager Allie Morris, product designer Matt Origoni, designer Maureen Eide, photo editor Mary Ann Price, and Jackie Henry at Aptara. All of these professionals provided innumerable services that helped the textbook take shape.

Finally, our thanks to George Hoffman, Tim Stookesberry, Douglas Reiner, Joe Heider, Brent Gordon, and Mark Allin for their support and leadership at Wiley. We will appreciate suggestions and comments from users—instructors and students alike. You can send your thoughts and ideas about the textbook to us via email at: *AccountingAuthors@yahoo.com*.

Paul D. Kimmel
Milwaukee, Wisconsin

Jerry J. Weygandt
Madison, Wisconsin

Donald E. Kieso
DeKalb, Illinois

1

Introduction to Financial Statements

CHAPTER PREVIEW

*The **Chapter Preview** describes the purpose of the chapter and highlights major topics.*

How do you start a business? How do you determine whether your business is making or losing money? How should you finance expansion—should you borrow, should you issue stock, should you use your own funds? How do you convince banks to lend you money or investors to buy your stock? Success in business requires making countless decisions, and decisions require financial information.

The purpose of this chapter is to show you what role accounting plays in providing financial information.

*The **Chapter Outline** presents the chapter's topics and subtopics, as well as practice opportunities.*

CHAPTER OUTLINE

LEARNING OBJECTIVES		PRACTICE
1 Identify the forms of business organization and the uses of accounting information.	• Forms of business organization • Users and uses of financial information • Ethics in financial reporting	DO IT! 1 Business Organization Forms
2 Explain the three principal types of business activity.	• Financing activities • Investing activities • Operating activities	DO IT! 2 Business Activities
3 Describe the four financial statements and how they are prepared.	• Income statement • Retained earnings statement • Balance sheet • Statement of cash flows • Interrelationships of statements • Other annual report elements	DO IT! 3 3a Financial Statements 3b Components of Annual Reports

Go to the ***REVIEW AND PRACTICE*** section at the end of the chapter for a targeted summary and exercises with solutions.

Visit **WileyPLUS** for additional tutorials and practice opportunities.

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FEATURE STORY

*The **Feature Story** helps you picture how the chapter topic relates to the real world of accounting and business.*

Knowing the Numbers

Many students who take this course do not plan to be accountants. If you are in that group, you might be thinking, "If I'm not going to be an accountant, why do I need to know accounting?" Well, consider this quote from Harold Geneen, the former chairman of IT&T: "To be good at your business, you have to know the numbers—cold." In business, accounting and financial statements are the means for communicating the numbers. If you don't know how to read financial statements, you can't really know your business.

Knowing the numbers is sometimes even a matter of corporate survival. Consider the story of Columbia Sportswear Company, headquartered in Portland, Oregon. Gert Boyle's family fled Nazi Germany when she was 13 years old and then purchased a small hat company in Oregon, Columbia Hat Company. In 1971, Gert's husband, who was then running the company, died suddenly of a heart attack. The company was in the midst of an aggressive expansion, which had taken its sales above $1 million for the first time but which had also left the company financially stressed. Gert took over the small, struggling company with help from her son Tim, who was then a senior at the University of Oregon. Somehow, they kept the company afloat. Today, Columbia has more than 4,000 employees and annual sales in excess of $1 billion. Its brands include Columbia, Mountain Hardwear, Sorel, and Montrail. Gert still heads up the Board of Directors, and Tim is the company's President and CEO.

Columbia doesn't just focus on financial success. The company is very committed to corporate, social, and environmental responsibility. For example, several of its factories have participated in a project to increase health awareness of female factory workers in developing countries. Columbia was also a founding member of the Sustainable Apparel Coalition, which is a group that strives to reduce the environmental and social impact of the apparel industry. In addition, it monitors all of the independent factories that produce its products to ensure that they comply with the company's Standards of Manufacturing Practices. These standards address issues including forced labor, child labor, harassment, wages and benefits, health and safety, and the environment.

Employers such as Columbia Sportswear generally assume that managers in all areas of the company are "financially literate." To help prepare you for that, in this textbook you will learn how to read and prepare financial statements, and how to use basic tools to evaluate financial results.

LEARNING OBJECTIVE 1

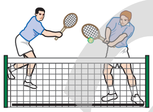
Identify the forms of business organization and the uses of accounting information.

Suppose you graduate with a business degree and decide you want to start your own business. But what kind of business? You enjoy working with people, especially teaching them new skills. You also spend most of your free time outdoors, kayaking, backpacking, skiing, rock climbing, and mountain biking. You think you might be successful in opening an outdoor guide service where you grew up, in the Sierra Nevada mountains.

FORMS OF BUSINESS ORGANIZATION

Your next decision is to determine the organizational form of your business. You have three choices—sole proprietorship, partnership, or corporation.

Sole Proprietorship
-Simple to establish
-Owner controlled
-Tax advantages



Partnership
-Simple to establish
-Shared control
-Broader skills and resources
-Tax advantages

Corporation
-Easier to transfer ownership
-Easier to raise funds
-No personal liability

SOLE PROPRIETORSHIP You might choose the sole proprietorship form for your outdoor guide service. A business owned by one person is a **sole proprietorship**. It is **simple to set up** and **gives you control** over the business. Small owner-operated businesses such as barber shops, law offices, and auto repair shops are often sole proprietorships, as are farms and small retail stores.

PARTNERSHIP Another possibility is for you to join forces with other individuals to form a partnership. A business owned by two or more persons associated as partners is a **partnership**. Partnerships often are formed because one individual does not have **enough economic resources** to initiate or expand the business. Sometimes **partners bring unique skills or resources** to the partnership. You and your partners should formalize your duties and contributions in a written partnership agreement. Retail and service-type businesses, including professional practices (lawyers, doctors, architects, and certified public accountants), often organize as partnerships.

CORPORATION As a third alternative, you might organize as a corporation. A business organized as a separate legal entity owned by stockholders is a **corporation**. Investors in a corporation receive shares of stock to indicate their ownership claim. Buying stock in a corporation is often more attractive than investing in a partnership because shares of stock are **easy to sell** (transfer ownership). Selling a proprietorship or partnership interest is much more involved. Also, individuals can become **stockholders** by investing relatively small amounts of money. Therefore, it is **easier for corporations to raise funds**. Successful corporations often have thousands of stockholders, and their stock is traded on organized stock exchanges like the New York Stock Exchange. Many businesses start as sole proprietorships or partnerships and eventually incorporate.

ALTERNATIVE TERMINOLOGY
Stockholders are sometimes called *shareholders*.

Alternative Terminology *notes present synonymous terms that you may come across in practice.*

Other factors to consider in deciding which organizational form to choose are **taxes and legal liability**. If you choose a sole proprietorship or partnership, you generally receive more favorable tax treatment than a corporation. However, proprietors and partners are personally liable for all debts and legal obligations of the business; corporate stockholders are not. In other words, corporate stockholders generally pay higher taxes but have no personal legal liability. We will discuss these issues in more depth in a later chapter.

Finally, while sole proprietorships, partnerships, and corporations represent the main types of business organizations, hybrid forms are now allowed in all states. These hybrid business forms combine the tax advantages of partnerships with the limited liability of corporations. Probably the most common among these hybrids types are limited liability companies (LLCs) and subchapter S corporations. These forms are discussed extensively in business law classes.

The combined number of proprietorships and partnerships in the United States is more than five times the number of corporations. However, the revenue produced by corporations is eight times greater. Most of the largest businesses in the United States—for example, Coca-Cola, ExxonMobil, General Motors, Citigroup, and Microsoft—are corporations. Because the majority of U.S. business is done by corporations, the emphasis in this textbook is on the corporate form of organization.

USERS AND USES OF FINANCIAL INFORMATION

The purpose of financial information is to provide inputs for decision-making. **Accounting** is the information system that identifies, records, and communicates the economic events of an organization to interested users. **Users** of accounting information can be divided broadly into two groups: internal users and external users.

Internal Users

Internal users of accounting information are managers who plan, organize, and run a business. These include **marketing managers**, **production supervisors**, **finance directors**, **and company officers**. In running a business, managers must answer many important questions, as shown in Illustration 1-1.

ILLUSTRATION 1-1
Questions that internal users ask

Questions Asked by Internal Users

Finance
Is cash sufficient to pay dividends to Microsoft stockholders?

Marketing
What price should Apple charge for an iPad to maximize the company's net income?

Human Resources
Can General Motors afford to give its employees pay raises this year?

Management
Which PepsiCo product line is the most profitable? Should any product lines be eliminated?

To answer these and other questions, you need detailed information on a timely basis. For internal users, accounting provides internal reports, such as financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year. In addition, companies present summarized financial information in the form of financial statements.

Accounting Across the Organization *boxes show applications of accounting information in various business functions.*

ACCOUNTING ACROSS THE ORGANIZATION **Clif Bar & Company**


© Dan Moore/iStockphoto

Owning a Piece of the Bar

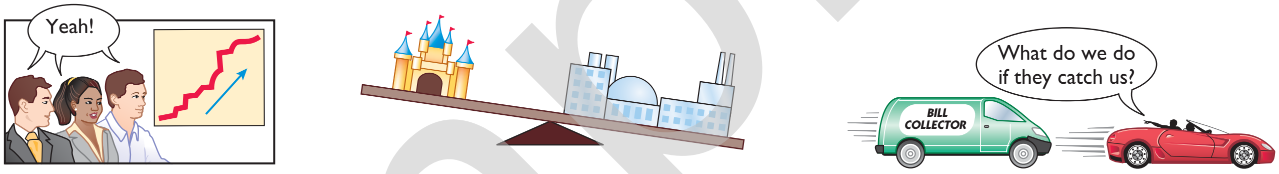
The original Clif Bar® energy bar was created in 1990 after six months of experimentation by Gary Erickson and his mother in her kitchen. Today, the company has almost 300 employees and is considered one of the leading Landor's Breakaway Brands®. One of Clif Bar & Company's proudest moments was the creation of an employee stock ownership plan (ESOP) in 2010. This plan gives its employees 20% ownership of the company. The ESOP also resulted in Clif Bar enacting an open-book management program, including the commitment to educate all employee-owners about its finances. Armed with basic accounting knowledge, employees are more aware of the financial impact of their actions, which leads to better decisions.

What are the benefits to the company and to the employees of making the financial statements available to all employees? (Go to WileyPLUS for this answer and additional questions.)

External Users

There are several types of **external users** of accounting information. **Investors** (owners) use accounting information to make decisions to buy, hold, or sell stock. **Creditors** such as suppliers and bankers use accounting information to evaluate the risks of selling on credit or lending money. Some questions that investors and creditors may ask about a company are shown in Illustration 1-2.

Questions Asked by External Users



Investors
Is General Electric earning satisfactory income?

Investors
How does Disney compare in size and profitability with Time Warner?

Creditors
Will United Airlines be able to pay its debts as they come due?

ILLUSTRATION 1-2
Questions that external users ask

The information needs and questions of other external users vary considerably. **Taxing authorities**, such as the Internal Revenue Service, want to know whether the company complies with the tax laws. **Customers** are interested in whether a company like General Motors will continue to honor product warranties and otherwise support its product lines. **Labor unions**, such as the Major League Baseball Players Association, want to know whether the owners have the ability to pay increased wages and benefits. **Regulatory agencies**, such as the Securities and Exchange Commission or the Federal Trade Commission, want to know whether the company is operating within prescribed rules. For example, Enron, Dynegy, Duke Energy, and other big energy-trading companies reported record profits at the same time as California was paying extremely high prices for energy and suffering from blackouts. This disparity caused regulators to investigate the energy traders to make sure that the profits were earned by legitimate and fair practices.

ACCOUNTING ACROSS THE ORGANIZATION

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Spinning the Career Wheel

How will the study of accounting help you? A working knowledge of accounting is desirable for virtually every field of business. Some examples of how accounting is used in business careers include the following.

General management: Managers of Ford Motors, Massachusetts General Hospital, California State University–Fullerton, a McDonald's franchise, and a Trek bike shop all need to understand accounting data in order to make wise business decisions.

Marketing: Marketing specialists at Procter & Gamble must be sensitive to costs and benefits, which accounting helps them quantify and understand. Making a sale is meaningless unless it is a profitable sale.

Finance: Do you want to be a banker for Citicorp, an investment analyst for Goldman Sachs, or a stock broker for Merrill Lynch? These fields rely heavily on accounting knowledge to analyze financial statements. In fact, it is difficult to get a good job in a finance function without two or three courses in accounting.

Real estate: Are you interested in being a real estate broker for Prudential Real Estate? Because a third party—the bank—is almost always involved in financing a real estate transaction, brokers must understand the numbers involved: Can the buyer afford to make the payments to the bank? Does the cash flow from an industrial property justify the purchase price? What are the tax benefits of the purchase?

How might accounting help you? (Go to WileyPLUS for this answer and additional questions.)

ETHICS IN FINANCIAL REPORTING

People won't gamble in a casino if they think it is "rigged." Similarly, people won't "play" the stock market if they think stock prices are rigged. At one time, the financial press was full of articles about financial scandals at Enron, WorldCom, HealthSouth, and AIG. As more scandals came to light, a mistrust of financial reporting in general seemed to be developing. One article in the *Wall Street Journal* noted that "repeated disclosures about questionable accounting practices have bruised investors' faith in the reliability of earnings reports, which in turn has sent stock prices tumbling." Imagine trying to carry on a business or invest money if you could not depend on the financial statements to be honestly prepared. Information would have no credibility. There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

United States regulators and lawmakers were very concerned that the economy would suffer if investors lost confidence in corporate accounting because of unethical financial reporting. Congress passed the **Sarbanes-Oxley Act (SOX)** to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals. As a result of SOX, top management must now certify the accuracy of financial information. In addition, penalties for fraudulent financial activity are much more severe. Also, SOX increased both the independence of the outside auditors who review the accuracy of corporate financial statements and the oversight role of boards of directors.

ETHICS NOTE

Circus-founder P.T. Barnum is alleged to have said, "Trust everyone, but cut the deck." What Sarbanes-Oxley does is to provide measures that (like cutting the deck of playing cards) help ensure that fraud will not occur.

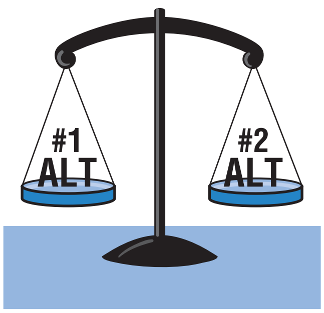
Ethics Notes *help sensitize you to some of the ethical issues in accounting.*

Effective financial reporting depends on sound ethical behavior. To sensitize you to ethical situations and to give you practice at solving ethical dilemmas, we address ethics in a number of ways in this textbook. (1) A number of the *Feature Stories* and other parts of the text discuss the central importance of ethical behavior to financial reporting. (2) *Ethics Insight boxes* and marginal *Ethics Notes* highlight ethics situations and issues in actual business settings. (3) Many of the *People, Planet, and Profit Insight boxes* focus on ethical issues that companies face in measuring and reporting social and environmental issues. (4) At the end of each chapter, an *Ethics Case* simulates a business situation and asks you to put yourself in the position of a decision-maker in that case.

When analyzing these various ethics cases and your own ethical experiences, you should apply the three steps outlined in Illustration 1-3.

ILLUSTRATION 1-3
Steps in analyzing ethics cases

Solving an Ethical Dilemma



1. Recognize an ethical situation and the ethical issues involved.
Use your personal ethics to identify ethical situations and issues. Some businesses and professional organizations provide written codes of ethics for guidance in some business situations.

2. Identify and analyze the principal elements in the situation.
Identify the **stakeholders**—persons or groups who may be harmed or benefited. Ask the question: What are the responsibilities and obligations of the parties involved?

3. Identify the alternatives, and weigh the impact of each alternative on various stakeholders.
Select the most ethical alternative, considering all the consequences. Sometimes there will be one right answer. Other situations involve more than one right solution; these situations require you to evaluate each alternative and select the best one.

ETHICS INSIGHT Dewey & LeBoeuf LLP

Alliance/Shutterstock

I Felt the Pressure—Would You?

"I felt the pressure." That's what some of the employees of the now-defunct law firm of Dewey & LeBoeuf LLP indicated when they helped to overstate revenue and use accounting tricks to hide losses and cover up cash shortages. These employees worked for the former finance director and former chief financial officer (CFO) of the firm. Here are some of their comments:

- "I was instructed by the CFO to create invoices, knowing they would not be sent to clients. When I created these invoices, I knew that it was inappropriate."
- "I intentionally gave the auditors incorrect information in the course of the audit."

What happened here is that a small group of lower-level employees over a period of years carried out the instructions of their bosses. Their bosses, however, seemed to have no concern as evidenced by various e-mails with one another in which they referred to their financial manipulations as accounting tricks, cooking the books, and fake income.

Source: Ashby Jones, "Guilty Pleas of Dewey Staff Detail the Alleged Fraud," *Wall Street Journal* (March 28, 2014).

Why did these employees lie, and what do you believe should be their penalty for these lies? (Go to WileyPLUS for this answer and additional questions.)

***Insight** boxes provide examples of business situations from various perspectives—ethics, investor, international, and corporate social responsibility. Guideline answers to the critical thinking questions are available in **WileyPLUS** and at **www.wiley.com/college/weygandt**. Additional questions are offered in **WileyPLUS**.*

DO IT! 1 Business Organization Forms

*DO IT! exercises prompt you to stop and review the key points you have just studied. The **Action Plan** offers you tips about how to approach the problem.*

In choosing the organizational form for your outdoor guide service, you should consider the pros and cons of each. Identify each of the following organizational characteristics with the organizational form or forms with which it is associated.

1. Easier to raise funds.
2. Simple to establish.
3. No personal legal liability.
4. Tax advantages.
5. Easier to transfer ownership.

Action Plan

✔ Know which organizational form best matches the business type, size, and preferences of the owner(s).

SOLUTION

1. Easier to raise funds: Corporation.
2. Simple to establish: Sole proprietorship and partnership.
3. No personal legal liability: Corporation.
4. Tax advantages: Sole proprietorship and partnership.
5. Easier to transfer ownership: Corporation.

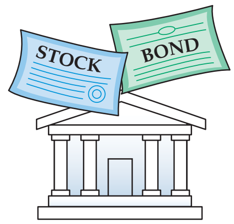
Related exercise material: **BE1-1** and **DO IT! 1-1.**

LEARNING OBJECTIVE 2 Explain the three principal types of business activity.

All businesses are involved in three types of activity—financing, investing, and operating. For example, Gert Boyle's parents, the founders of Columbia Sportswear, obtained cash through financing to start and grow their business. Some of this **financing** came from personal savings, and some likely came from outside sources like banks. The family then **invested** the cash in equipment to run the business, such as sewing equipment and delivery vehicles. Once this equipment was in place, they could begin the **operating** activities of making and selling clothing.

The **accounting information system** keeps track of the results of each of the various business activities—financing, investing, and operating. Let's look at each type of business activity in more detail.

FINANCING ACTIVITIES



Financing

It takes money to make money. The two primary sources of outside funds for corporations are borrowing money (debt financing) and issuing (selling) shares of stock in exchange for cash (equity financing).

Columbia Sportswear may borrow money in a variety of ways. For example, it can take out a loan at a bank or borrow directly from investors by issuing debt securities called bonds. Persons or entities to whom Columbia owes money are its **creditors**. Amounts owed to creditors—in the form of debt and other obligations—are called **liabilities**. Specific names are given to different types of liabilities, depending on their source. Columbia may have a **note payable** to a bank for the money borrowed to purchase delivery trucks. Debt securities sold to investors that must be repaid at a particular date some years in the future are **bonds payable**.

Corporations also obtain funds by selling shares of stock to investors. **Common stock** is the term used to describe the total amount paid in by stockholders for the shares they purchase.

The claims of creditors differ from those of stockholders. If you loan money to a company, you are one of its creditors. In lending money, you specify a payment schedule (e.g., payment at the end of three months). As a creditor, you have a legal right to be paid at the agreed time. In the event of nonpayment, you may legally force the company to sell property to pay its debts. In the case of financial difficulty, creditor claims must be paid before stockholders' claims.

Stockholders, on the other hand, have no claim to corporate cash until the claims of creditors are satisfied. Suppose you buy a company's stock instead of loaning it money. You have no legal right to expect any payments from your stock ownership until all of the company's creditors are paid amounts currently due. However, many corporations make payments to stockholders on a regular basis as long as there is sufficient cash to cover required payments to creditors. These cash payments to stockholders are called **dividends**.

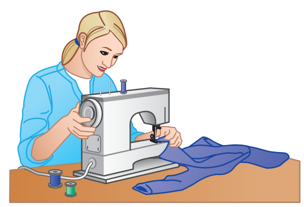
Investing

INVESTING ACTIVITIES

Once the company has raised cash through financing activities, it uses that cash in investing activities. Investing activities involve the purchase of the resources a company needs in order to operate. A growing company purchases many resources, such as computers, delivery trucks, furniture, and buildings. Resources owned by a business are called **assets**. Different types of assets are given different names. For example, Columbia Sportswear's sewing equipment is a type of asset referred to as **property**, **plant**, **and equipment**.

ALTERNATIVE TERMINOLOGY
Property, plant, and equipment is sometimes called *fixed assets*.

Cash is one of the more important assets owned by Columbia or any other business. If a company has excess cash that it does not need for a while, it might choose to invest in securities (stocks or bonds) of other corporations. **Investments** are another example of an investing activity.


Operating

OPERATING ACTIVITIES

Once a business has the assets it needs to get started, it begins operations. Columbia Sportswear is in the business of selling outdoor clothing and footwear. It sells TurboDown jackets, Millenium snowboard pants, Sorel® snow boots, Bugaboots™, rainwear, and anything else you might need to protect you from the elements. We call amounts earned on the sale of these products **revenues**. **Revenue** is the increase in assets or decrease in liabilities resulting from the sale of goods or the performance of services in the normal course of business. For example, Columbia records revenue when it sells a footwear product.

Revenues arise from different sources and are identified by various names depending on the nature of the business. For instance, Columbia's primary source of revenue is the sale of sportswear. However, it also generates interest revenue on debt securities held as investments. Sources of revenue common to many businesses are **sales revenue**, **service revenue**, and **interest revenue**.

The company purchases its longer-lived assets through investing activities as described earlier. Other assets with shorter lives, however, result from operating activities. For example, **supplies** are assets used in day-to-day operations. Goods available for future sales to customers are assets called **inventory**. Also, if Columbia sells goods to a customer and does not receive cash immediately, then the company has a right to expect payment from that customer in the near future. This right to receive money in the future is called an **account receivable**.

Before Columbia can sell a single Sorel® boot, it must purchase wool, rubber, leather, metal lace loops, laces, and other materials. It then must process, wrap, and ship the finished product. It also incurs costs like salaries, rents, and utilities. All of these costs, referred to as **expenses**, are necessary to produce and sell the product. In accounting language, **expenses** are the cost of assets consumed or services used in the process of generating revenues.

Expenses take many forms and are identified by various names depending on the type of asset consumed or service used. For example, Columbia keeps track of these types of expenses: **cost of goods sold** (such as the cost of materials), **selling expenses** (such as the cost of salespersons' salaries), **marketing expenses** (such as the cost of advertising), **administrative expenses** (such as the salaries of administrative staff, and telephone and heating costs incurred at the corporate office), **interest expense** (amounts of interest paid on various debts), and **income taxes** (corporate taxes paid to the government).

Columbia may also have liabilities arising from these expenses. For example, it may purchase goods on credit from suppliers. The obligations to pay for these goods are called **accounts payable**. Additionally, Columbia may have **interest payable** on the outstanding amounts owed to the bank. It may also have **wages payable** to its employees and **sales taxes payable**, **property taxes payable**, and **income taxes payable** to the government.

Columbia compares the revenues of a period with the expenses of that period to determine whether it earned a profit. When revenues exceed expenses, **net income** results. When expenses exceed revenues, a **net loss** results.

DO IT! 2 Business Activities

Classify each item as an asset, liability, common stock, revenue, or expense.

1. Cost of renting property.
2. Truck purchased.
3. Notes payable.
4. Issuance of ownership shares.
5. Amount earned from performing service.
6. Amounts owed to suppliers.

Action Plan

✔ Classify each item based on its economic characteristics. Proper classification of items is critical if accounting is to provide useful information.

SOLUTION

1. Cost of renting property: Expense.
2. Truck purchased: Asset.

3. Notes payable: Liabilities.
4. Issuance of ownership shares: Common stock.
5. Amount earned from performing service: Revenue.
6. Amounts owed to suppliers: Liabilities.

Related exercise material: **BE1-3,** DO IT! **1-2,** and **E1-3.**

LEARNING OBJECTIVE 3

Describe the four financial statements and how they are prepared.

Assets, liabilities, expenses, and revenues are of interest to users of accounting information. This information is arranged in the format of four different **financial statements**, which form the backbone of financial accounting:

- To show how successfully your business performed during a period of time, you report its revenues and expenses in an **income statement**.
- To indicate how much of previous income was distributed to you and the other owners of your business in the form of dividends, and how much was retained in the business to allow for future growth, you present a **retained earnings statement**.
- To present a picture at a point in time of what your business owns (its assets) and what it owes (its liabilities), you prepare a **balance sheet**.
- To show where your business obtained cash during a period of time and how that cash was used, you present a **statement of cash flows**.

To introduce you to these statements, we have prepared the financial statements for your outdoor guide service, Sierra Corporation, after your first month of operations. To summarize, you officially started your business in Truckee, California, on October 1, 2017. Sierra provides guide services in the Lake Tahoe area of the Sierra Nevada mountains. Its promotional materials describe outdoor day trips, such as rafting, snowshoeing, and hiking, as well as multi-day backcountry experiences. To minimize your initial investment, at this point the company has limited outdoor equipment for customer use. Instead, your customers either bring their own equipment or rent equipment through local outfitters. The financial statements for Sierra's first month of business are provided in the following pages.

INTERNATIONAL NOTE

The primary types of financial statements required by International Financial Reporting Standards (IFRS) and U.S. generally accepted accounting principles (GAAP) are the same. Neither IFRS nor GAAP is very specific regarding format requirements for the primary financial statements. However, in practice, some format differences do exist in presentations commonly employed by IFRS companies as compared to GAAP companies.

International Notes *highlight differences between U.S. and international accounting standards.*

INCOME STATEMENT

The **income statement** reports a company's revenues and expenses and resulting net income or loss for a period of time. To indicate that its income statement reports the results of operations for a **specific period of time**, Sierra dates the income statement "For the Month Ended October 31, 2017." The income statement lists the company's revenues followed by its expenses. Finally, Sierra determines the net income (or net loss) by deducting expenses from revenues. Sierra Corporation's income statement is shown in Illustration 1-4 (page 12). Congratulations, you are already showing a profit!

Decision Tools *that are useful for business decision-making are highlighted throughout the textbook. A summary of the Decision Tools, such as the one on page 21, is provided in each chapter.*

Why are financial statement users interested in net income? **Investors are interested in a company's past net income because it provides useful information for predicting future net income.** Investors buy and sell stock based on their beliefs about a company's future performance. If investors believe that Sierra will be successful in the future and that this will result in a higher stock price, they will

DECISION TOOLS

The income statement helps users determine if the company's operations are profitable.

ILLUSTRATION 1-4
Sierra Corporation's income statement

SIERRA CORPORATION
Income Statement
For the Month Ended October 31, 2017

Revenues		
Service revenue		$10,600
Expenses		
Salaries and wages expense	$5,200	
Rent expense	900	
Supplies expense	1,500	
Depreciation expense	40	
Interest expense	50	
Insurance expense	50	
Total expenses		7,740
Net income		$ 2,860

▼ HELPFUL HINT
The financial statement heading identifies the company, the type of statement, and the time period covered. Sometimes, another line indicates the unit of measure, e.g., "in thousands" or "in millions."

ETHICS NOTE
When companies find errors in previously released income statements, they restate those numbers. Perhaps because of the increased scrutiny shortly after Sarbanes-Oxley was implemented, companies filed a record 1,195 restatements.

buy its stock. Creditors also use the income statement to predict future earnings. When a bank loans money to a company, it believes that it will be repaid in the future. If it didn't think it would be repaid, it wouldn't loan the money. Therefore, prior to making the loan the bank loan officer uses the income statement as a source of information to predict whether the company will be profitable enough to repay its loan. Thus, reporting a strong profit will make it easier for Sierra to raise additional cash either by issuing shares of stock or borrowing.

Amounts received from issuing stock are not revenues, and amounts paid out as dividends are not expenses. As a result, they are not reported on the income statement. For example, Sierra Corporation does not treat as revenue the $10,000 of cash received from issuing new stock (see Illustration 1-7), nor does it regard as a business expense the $500 of dividends paid (see Illustration 1-5).

RETAINED EARNINGS STATEMENT

DECISION TOOLS
The retained earnings statement helps users determine the company's policy toward dividends and growth.

If Sierra is profitable, at the end of each period it must decide what portion of profits to pay to shareholders in dividends. In theory, it could pay all of its current-period profits, but few companies do this. Why? Because they want to retain part of the profits to allow for further expansion. High-growth companies, such as Google and Facebook, often pay no dividends. **Retained earnings** is the net income retained in the corporation.

The **retained earnings statement** shows the amounts and causes of changes in retained earnings for a specific time period. The time period is the same as that covered by the income statement. The beginning retained earnings amount appears on the first line of the statement. Then, the company adds net income and deducts dividends to determine the retained earnings at the end of the period. If a company has a net loss, it deducts (rather than adds) that amount in the retained earnings statement. Illustration 1-5 presents Sierra Corporation's retained earnings statement.

ILLUSTRATION 1-5
Sierra Corporation's retained earnings statement

SIERRA CORPORATION
Retained Earnings Statement
For the Month Ended October 31, 2017

Retained earnings, October 1	$ 0
Add: Net income	2,860
	2,860
Less: Dividends	500
Retained earnings, October 31	$2,360

▼ HELPFUL HINT
The heading of this statement identifies the company, the type of statement, and the time period covered by the statement.

By monitoring the retained earnings statement, financial statement users can evaluate dividend payment practices. Some investors seek companies, such as Dow Chemical, that have a history of paying high dividends. Other investors seek companies, such as Amazon.com, that reinvest earnings to increase the company's growth instead of paying dividends. Lenders monitor their corporate customers' dividend payments because any money paid in dividends reduces a company's ability to repay its debts.

BALANCE SHEET

The **balance sheet** reports assets and claims to assets at a specific **point** in time. Claims to assets are subdivided into two categories: claims of creditors and claims of owners. As noted earlier, claims of creditors are called **liabilities**. The owners' claim to assets is called **stockholders' equity**.

Illustration 1-6 shows the relationship among the categories on the balance sheet in equation form. This equation is referred to as the **basic accounting equation**.

DECISION TOOLS

The balance sheet helps users determine if the company relies on debt or stockholders' equity to finance its assets.

Assets = Liabilities + Stockholders' Equity

ILLUSTRATION 1-6
Basic accounting equation

This relationship is where the name "balance sheet" comes from. Assets must balance with the claims to assets.

As you can see from looking at Sierra's balance sheet in Illustration 1-7, the balance sheet presents the company's financial position as of a specific date—in this case, October 31, 2017. It lists assets first, followed by liabilities and stockholders' equity. Stockholders' equity is comprised of two parts: (1) common stock and (2) retained earnings. As noted earlier, common stock results when the company

ALTERNATIVE TERMINOLOGY
Liabilities are also referred to as *debt*.

ILLUSTRATION 1-7
Sierra Corporation's balance sheet

▼ HELPFUL HINT
The heading of a balance sheet must identify the company, the statement, and the date.

SIERRA CORPORATION
Balance Sheet
October 31, 2017

Assets		
Cash		$15,200
Accounts receivable		200
Supplies		1,000
Prepaid insurance		550
Equipment, net		4,960
Total assets		$21,910
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$ 5,000	
Accounts payable	2,500	
Unearned service revenue	800	
Salaries and wages payable	1,200	
Interest payable	50	
Total liabilities		$ 9,550
Stockholders' equity		
Common stock	10,000	
Retained earnings	2,360	
Total stockholders' equity		12,360
Total liabilities and stockholders' equity		$21,910

sells new shares of stock; retained earnings is the net income retained in the corporation. Sierra has common stock of $10,000 and retained earnings of $2,360, for total stockholders' equity of $12,360.

Creditors analyze a company's balance sheet to determine the likelihood that they will be repaid. They carefully evaluate the nature of the company's assets and liabilities. In operating the Sierra Corporation guide service, the balance sheet will be used to determine whether cash on hand is sufficient for immediate cash needs. The balance sheet will also be used to evaluate the relationship between debt and stockholders' equity to determine whether the company has a satisfactory proportion of debt and common stock financing.

STATEMENT OF CASH FLOWS

The primary purpose of a **statement of cash flows** is to provide financial information about the cash receipts and cash payments of a business for a specific period of time. To help investors, creditors, and others in their analysis of a company's cash position, the statement of cash flows reports the cash effects of a company's **operating**, **investing**, and **financing** activities. In addition, the statement shows the net increase or decrease in cash during the period, and the amount of cash at the end of the period.

DECISION TOOLS

The statement of cash flows helps users determine if the company generates enough cash from operations to fund its investing activities.

Users are interested in the statement of cash flows because they want to know what is happening to a company's most important resource. The statement of cash flows provides answers to these simple but important questions:

- Where did cash come from during the period?
- How was cash used during the period?
- What was the change in the cash balance during the period?

The statement of cash flows for Sierra, in Illustration 1-8, shows that cash increased $15,200 during the month. This increase resulted because operating activities (services to clients) increased cash $5,700, and financing activities increased cash $14,500. Investing activities used $5,000 of cash for the purchase of equipment.

ILLUSTRATION 1-8
Sierra Corporation's statement of cash flows

SIERRA CORPORATION
Statement of Cash Flows
For the Month Ended October 31, 2017

Cash flows from operating activities		
Cash receipts from operating activities	$11,200	
Cash payments for operating activities	(5,500)	
Net cash provided by operating activities		$ 5,700
Cash flows from investing activities		
Purchased office equipment	(5,000)	
Net cash used by investing activities		(5,000)
Cash flows from financing activities		
Issuance of common stock	10,000	
Issuance of note payable	5,000	
Payment of dividend	(500)	
Net cash provided by financing activities		14,500
Net increase in cash		15,200
Cash at beginning of period		0
Cash at end of period		$15,200

▼ HELPFUL HINT
The heading of this statement identifies the company, the type of statement, and the time period covered by the statement. Negative numbers are shown in parentheses.

PEOPLE, PLANET, AND PROFIT INSIGHT

© Marek Uliasz/iStockphoto

Beyond Financial Statements

Should we expand our corporate reports beyond the income statement, retained earnings statement, balance sheet, and statement of cash flows? Some believe we should take into account ecological and social performance, in addition to financial results, in evaluating a company. The argument is that a company's responsibility lies with anyone who is influenced by its actions. In other words, a company should be interested in benefiting many different parties, instead of only maximizing stockholders' interests.

A socially responsible business does not exploit or endanger any group of individuals. It follows fair trade practices, provides safe environments for workers, and bears responsibility for environmental damage. Granted, measurement of these factors is difficult. How to report this information is also controversial. But many interesting and useful efforts are underway. Throughout this textbook, we provide additional insights into how companies are attempting to meet the challenge of measuring and reporting their contributions to society, as well as their financial results, to stockholders.

Why might a company's stockholders be interested in its environmental and social performance? (Go to WileyPLUS for this answer and additional questions.)

INTERRELATIONSHIPS OF STATEMENTS

Illustration 1-9 (page 16) shows the financial statements of Sierra Corporation. Because the results on some financial statements become inputs to other statements, the statements are interrelated. These interrelationships can be seen in Sierra's financial statements, as follows.

1. The retained earnings statement uses the results of the income statement. Sierra reported net income of $2,860 for the period. Net income is added to the beginning amount of retained earnings to determine ending retained earnings.
2. The balance sheet and retained earnings statement are also interrelated. Sierra reports the ending amount of $2,360 on the retained earnings statement as the retained earnings amount on the balance sheet.
3. Finally, the statement of cash flows relates to information on the balance sheet. The statement of cash flows shows how the Cash account changed during the period. It shows the amount of cash at the beginning of the period, the sources and uses of cash during the period, and the $15,200 of cash at the end of the period. The ending amount of cash shown on the statement of cash flows must agree with the amount of cash on the balance sheet.

Study these interrelationships carefully. **To prepare financial statements, you must understand the sequence in which these amounts are determined and how each statement impacts the next.**

ILLUSTRATION 1-9
Sierra Corporation's financial statements

SIERRA CORPORATION
Income Statement
For the Month Ended October 31, 2017

Revenues		
Service revenue		$10,600
Expenses		
Salaries expense	$5,200	
Rent expense	900	
Supplies expense	1,500	
Depreciation expense	40	
Interest expense	50	
Insurance expense	50	
Total expenses		7,740
Net income		$ 2,860

▼ HELPFUL HINT
Note that final sums are double-underlined.

SIERRA CORPORATION
Retained Earnings Statement
For the Month Ended October 31, 2017

Retained earnings, October 1	$ 0
Add: Net income	2,860
	2,860
Less: Dividends	500
Retained earnings, October 31	$ 2,360

▼ HELPFUL HINT
The arrows in this illustration show interrelationships of the four financial statements.

SIERRA CORPORATION
Balance Sheet
October 31, 2017

Assets

Cash		$15,200
Accounts receivable		200
Advertising supplies		1,000
Prepaid insurance		550
Equipment, net		4,960
Total assets		$21,910

Liabilities and Stockholders' Equity

Liabilities		
Notes payable	$ 5,000	
Accounts payable	2,500	
Unearned service revenue	800	
Salaries and wages payable	1,200	
Interest payable	50	
Total liabilities		$ 9,550
Stockholders' equity		
Common stock	10,000	
Retained earnings	2,360	
Total stockholders' equity		12,360
Total liabilities and stockholders' equity		$21,910

SIERRA CORPORATION
Statement of Cash Flows
For the Month Ended October 31, 2017

Cash flows from operating activities		
Cash receipts from operating activities	$11,200	
Cash payments for operating activities	(5,500)	
Net cash provided by operating activities		$ 5,700
Cash flows from investing activities		
Purchased office equipment	(5,000)	
Net cash used by investing activities		(5,000)
Cash flows from financing activities		
Issuance of common stock	10,000	
Issued note payable	5,000	
Payment of dividend	(500)	
Net cash provided by financing activities		14,500
Net increase in cash		15,200
Cash at beginning of period		0
Cash at end of period		$15,200

▼ HELPFUL HINT
Negative amounts are presented in parentheses.

DO IT! 3a Financial Statements

CSU Corporation began operations on January 1, 2017. The following information is available for CSU on December 31, 2017:

Accounts receivable	1,800	Retained earnings	?	Supplies expense	200
Accounts payable	2,000	Equipment	16,000	Cash	1,400
Rent expense	9,000	Insurance expense	1,000	Dividends	600
Notes payable	5,000	Service revenue	17,000		
Common stock	10,000	Supplies	4,000		

Prepare an income statement, a retained earnings statement, and a balance sheet.

SOLUTION

CSU CORPORATION
Income Statement
For the Year Ended December 31, 2017

Revenues		
Service revenue		$17,000
Expenses		
Rent expense	$9,000	
Insurance expense	1,000	
Supplies expense	200	
Total expenses		10,200
Net income		$ 6,800

CSU CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2017

Retained earnings, January 1	$ 0
Add: Net income	6,800
	6,800
Less: Dividends	600
Retained earnings, December 31	$6,200

CSU CORPORATION
Balance Sheet
December 31, 2017

Assets		
Cash		$ 1,400
Accounts receivable		1,800
Supplies		4,000
Equipment		16,000
Total assets		$23,200
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$ 5,000	
Accounts payable	2,000	
Total liabilities		$ 7,000
Stockholders' equity		
Common stock	10,000	
Retained earnings	6,200	
Total stockholders' equity		16,200
Total liabilities and stockholders' equity		$23,200

Action Plan

- ✔ Report the revenues and expenses for a period of time in an income statement.
- ✔ Show the amounts and causes (net income and dividends) of changes in retained earnings during the period in the retained earnings statement.
- ✔ Present the assets and claims to those assets (liabilities and equity) at a specific point in time in the balance sheet.

Related exercise material: **BE1-5, BE1-6, BE1-7, BE1-8, BE1-9, BE1-10,** DO IT! **1-3a, E1-4, E1-5, E1-6, E1-7, E1-8, E1-9, E1-10, E1-11,** and **E1-14.**

OTHER ELEMENTS OF AN ANNUAL REPORT

Publicly traded U.S. companies must provide shareholders with an **annual report**. The annual report always includes the financial statements introduced in this chapter. The annual report also includes other important information such as a management discussion and analysis section, notes to the financial statements, and an independent auditor's report. No analysis of a company's financial situation and performance is complete without a review of these items.

Management Discussion and Analysis

The **management discussion and analysis (MD&A)** section presents management's views on the company's **ability to pay near-term obligations, its ability to fund operations and expansion, and its results of operations**. Management must highlight favorable or unfavorable trends and identify significant events and uncertainties that affect these three factors. This discussion obviously involves a number of subjective estimates and opinions. A brief excerpt from the MD&A section of Columbia Sportswear's annual report, which addresses its liquidity requirements, is presented in Illustration 1-10.

ILLUSTRATION 1-10
Columbia Sportswear's management discussion and analysis

Real World

COLUMBIA SPORTSWEAR COMPANY
Management's Discussion and Analysis of
Seasonality and Variability of Business

Our operations are affected by seasonal trends typical in the outdoor apparel and footwear industry and have historically resulted in higher sales and profits in the third and fourth calendar quarters. This pattern has resulted primarily from the timing of shipments of fall season products to wholesale customers in the third and fourth quarters and proportionally higher sales in our direct-to-consumer operations in the fourth quarter, combined with an expense base that is spread more evenly throughout the year. We believe that our liquidity requirements for at least the next 12 months will be adequately covered by existing cash, cash provided by operations and existing short-term borrowing arrangements.

Notes to the Financial Statements

Explanatory notes and supporting schedules accompany every set of financial statements and are an integral part of the statements. The **notes to the financial statements** clarify the financial statements and provide additional detail. Information in the notes does not have to be quantifiable (numeric). Examples of notes are descriptions of the significant accounting policies and methods used in preparing the statements, explanations of uncertainties and contingencies, and various statistics and details too voluminous to be included in the statements. The notes are essential to understanding a company's operating performance and financial position.

Illustration 1-11 is an excerpt from the notes to Columbia Sportswear's financial statements. It describes the methods that the company uses to account for revenues.

ILLUSTRATION 1-11
Notes to Columbia Sportswear's financial statements

Real World

COLUMBIA SPORTSWEAR COMPANY
Notes to Financial Statements
Revenue Recognition

We record wholesale, distributor, e-commerce and licensed product revenues when title passes and the risks and rewards of ownership have passed to the customer. Title generally passes upon shipment to, or upon receipt by, the customer depending on the terms of sale with the customer. Retail store revenues are recorded at the time of sale.

Auditor's Report

An **auditor's report** is prepared by an independent outside auditor. It states the auditor's opinion as to the fairness of the presentation of the financial position and results of operations and their conformance with generally accepted accounting principles.

An **auditor** is an accounting professional who conducts an independent examination of a company's financial statements. Only accountants who meet certain criteria and thereby attain the designation **certified public accountant (CPA)** may perform audits. If the auditor is satisfied that the financial statements provide a fair representation of the company's financial position and results of operations in accordance with generally accepted accounting principles, then the auditor expresses an **unqualified opinion**. If the auditor expresses anything other than an unqualified opinion, then readers should only use the financial statements with caution. That is, without an unqualified opinion, we cannot have complete confidence that the financial statements give an accurate picture of the company's financial health. For example, recently Blockbuster, Inc.'s auditor stated that its financial situation raised "substantial doubt about the Company's ability to continue as a going concern."

Illustration 1-12 is an excerpt from the auditor's report from Columbia Sportswear's 2014 annual report. Columbia received an unqualified opinion from its auditor, Deloitte & Touche.

Real World

COLUMBIA SPORTSWEAR COMPANY
Excerpt from Auditor's Report

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Columbia Sportswear Company and subsidiaries as of December 31, 2014 and 2013, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2014, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

ILLUSTRATION 1-12
Excerpt from auditor's report on Columbia Sportswear's financial statements

DO IT! 3b Components of Annual Reports

State whether each of the following items is most closely associated with the management discussion and analysis (MD&A), the notes to the financial statements, or the auditor's report.

1. Descriptions of significant accounting policies.
2. Unqualified opinion.
3. Explanations of uncertainties and contingencies.
4. Description of ability to fund operations and expansion.
5. Description of results of operations.
6. Certified public accountant (CPA).

SOLUTION

1. Descriptions of significant accounting policies: Notes.
2. Unqualified opinion: Auditor's report.
3. Explanations of uncertainties and contingencies: Notes.
4. Description of ability to fund operations and expansion: MD&A.
5. Description of results of operations: MD&A.
6. Certified public accountant (CPA): Auditor's report.

Related exercise material: **BE1-11,** DO IT! **1-3b,** and **E1-17.**

Action Plan

✔ Realize that financial statements provide information about a company's performance and financial position.

✔ Be familiar with the other elements of the annual report in order to gain a fuller understanding of a company.

USING DECISION TOOLS—VF CORPORATION

There is a good chance that you may have never heard of VF Corporation. There is also a very good chance that you are wearing one of VF's products right now. VF owns North Face, Lee, Vans, Nautica, Wrangler, Timberland, and numerous other brands. VF is a direct competitor to Columbia Sportswear. Suppose that you are considering investing in shares of VF's common stock.

INSTRUCTIONS

Answer these questions related to your decision whether to invest.

(a) What financial statements should you evaluate?
(b) What should these financial statements tell you?
(c) Do you care if the financial statements have been audited? Explain.
(d) Appendix B at the end of this textbook contains financial statements for Columbia, and Appendix C contains those for VF. You can make many comparisons between Columbia and VF in terms of their respective results from operations and financial position. Compare their respective total assets, total revenues, and net cash provided by operating activities.

SOLUTION

(a) Before you invest, you should evaluate the income statement, retained earnings statement, balance sheet, and statement of cash flows.
(b) You would probably be most interested in the income statement because it tells about past performance and thus gives an indication of future performance. The retained earnings statement provides a record of the company's dividend history. The balance sheet reveals the relationship between assets and liabilities. The statement of cash flows reveals where the company is getting and spending its cash. This is especially important for a company that wants to grow.
(c) You would want audited financial statements. These statements indicate that a CPA (certified public accountant) has examined and expressed an opinion that the statements present fairly the financial position and results of operations of the company. Investors and creditors should not make decisions without studying audited financial statements.
(d) Many interesting comparisons can be made between the two companies (all numbers are in thousands). Columbia is smaller, with total assets of $1,792,209 versus $9,980,140 for VF, and it has lower revenue—$2,100,590 versus $12,282,161 for VF. In addition, Columbia's net cash provided by operating activities of $185,783 is less than VF's $1,697,629. However, while useful, these basic measures are not enough to determine whether one company is a better investment than the other. In later chapters, you will learn tools that will allow you to compare the relative profitability and financial health of these and other companies.

__Using Decision Tools__ comprehensive exercises ask you to apply business information and the decision tools presented in the chapter. Most of these exercises are based on the companies highlighted in the Feature Story.

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

REVIEW AND PRACTICE

LEARNING OBJECTIVES REVIEW

1 Identify the forms of business organization and the uses of accounting information. A sole proprietorship is a business owned by one person. A partnership is a business owned by two or more people associated as partners. A corporation is a separate legal entity for which evidence of ownership is provided by shares of stock.

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

2 Explain the three principal types of business activity. Financing activities involve collecting the necessary funds to support the business. Investing activities involve acquiring the resources necessary to run the business. Operating activities involve putting the resources of the business into action to generate a profit.

3 Describe the four financial statements and how they are prepared. An income statement presents the revenues and expenses of a company for a specific period of time. A retained earnings statement summarizes the changes in retained earnings that have occurred for a specific period of time. A balance sheet reports the assets, liabilities, and stockholders' equity of a business at a specific date. A statement of cash flows summarizes information concerning the cash inflows (receipts) and outflows (payments) for a specific period of time.

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

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

DECISION TOOLS REVIEW

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
Are the company's operations profitable?	Income statement	The income statement reports a company's revenues and expenses and resulting net income or loss for a period of time.	If the company's revenues exceed its expenses, it will report net income; otherwise, it will report a net loss.
What is the company's policy toward dividends and growth?	Retained earnings statement	The retained earnings statement reports how much of this year's income the company paid out in dividends to shareholders.	A company striving for rapid growth will pay a low (or no) dividend.
Does the company rely primarily on debt or stockholders' equity to finance its assets?	Balance sheet	The balance sheet reports the company's resources and claims to those resources. There are two types of claims: liabilities and stockholders' equity.	Compare the amount of debt versus the amount of stockholders' equity to determine whether the company relies more on creditors or owners for its financing.
Does the company generate sufficient cash from operations to fund its investing activities?	Statement of cash flows	The statement of cash flows shows the amount of net cash provided or used by operating activities, investing activities, and financing activities.	Compare the amount of net cash provided by operating activities with the amount of net cash used by investing activities. Any deficiency in cash from operating activities must be made up with cash from financing activities.

GLOSSARY REVIEW

Accounting The information system that identifies, records, and communicates the economic events of an organization to interested users. (p. 5).

Annual report A report prepared by corporate management that presents financial information including financial statements, a management discussion and analysis section, notes, and an independent auditor's report. (p. 18).

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

Auditor's report A report prepared by an independent outside auditor stating the auditor's opinion as to the fairness of the presentation of the financial position and results of operations and their conformance with generally accepted accounting principles. (p. 19).

Balance sheet A financial statement that reports the assets and claims to those assets at a specific point in time. (p. 13).

Basic accounting equation Assets = Liabilities + Stockholders' Equity. (p. 13).

Certified public accountant (CPA) An individual who has met certain criteria and is thus allowed to perform audits of corporations. (p. 19).

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

Corporation A business organized as a separate legal entity owned by stockholders. (p. 4).

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

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

Income statement A financial statement that reports a company's revenues and expenses and resulting net income or net loss for a specific period of time. (p. 11).

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

Management discussion and analysis (MD&A) A section of the annual report that presents management's views on the company's ability to pay near-term obligations, its ability to fund operations and expansion, and its results of operations. (p. 18).

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

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

Notes to the financial statements Notes clarify information presented in the financial statements and provide additional detail. (p. 18).

Partnership A business owned by two or more persons associated as partners. (p. 4).

Retained earnings The amount of net income retained in the corporation. (p. 12).

Retained earnings statement A financial statement that summarizes the amounts and causes of changes in retained earnings for a specific time period. (p. 12).

Revenue The increase in assets or decrease in liabilities resulting from the sale of goods or the performance of services in the normal course of business. (p. 10).

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

Sole proprietorship A business owned by one person. (p. 4).

Statement of cash flows A financial statement that provides financial information about the cash receipts and cash payments of a business for a specific period of time. (p. 14).

Stockholders' equity The owners' claim to assets. (p. 13).

PRACTICE MULTIPLE-CHOICE QUESTIONS

(LO 1) **1.** Which is **not** one of the three forms of business organization?
(a) Sole proprietorship. (c) Partnership.
(b) Creditorship. (d) Corporation.

(LO 1) **2.** Which is an advantage of corporations relative to partnerships and sole proprietorships?
(a) Lower taxes.
(b) Harder to transfer ownership.
(c) Reduced legal liability for investors.
(d) Most common form of organization.

(LO 1) **3.** Which statement about users of accounting information is **incorrect**?
(a) Management is considered an internal user.
(b) Taxing authorities are considered external users.
(c) Present creditors are considered external users.
(d) Regulatory authorities are considered internal users.

(LO 1) **4.** Which of the following did **not** result from the Sarbanes-Oxley Act?
(a) Top management must now certify the accuracy of financial information.
(b) Penalties for fraudulent activity increased.
(c) Independence of auditors increased.
(d) Tax rates on corporations increased.

(LO 2) **5.** Which is **not** one of the three primary business activities?
(a) Financing. (c) Advertising.
(b) Operating. (d) Investing.

(LO 2) **6.** Which of the following is an example of a financing activity?
(a) Issuing shares of common stock.
(b) Selling goods on account.
(c) Buying delivery equipment.
(d) Buying inventory.

7. Net income will result during a time period when: (LO 2)
(a) assets exceed liabilities.
(b) assets exceed revenues.
(c) expenses exceed revenues.
(d) revenues exceed expenses.

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

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

What was Macias Corporation's net income?
(a) $60,000. (c) $65,000.
(b) $15,000. (d) $45,000.

9. What section of a statement of cash flows indicates the cash spent on new equipment during the past accounting period? (LO 3)
(a) The investing activities section.
(b) The operating activities section.
(c) The financing activities section.
(d) The statement of cash flows does not give this information.

10. Which statement presents information as of a specific point in time? (LO 3)
(a) Income statement.
(b) Balance sheet.
(c) Statement of cash flows.
(d) Retained earnings statement.

11. Which financial statement reports assets, liabilities, and stockholders' equity? (LO 3)
(a) Income statement.
(b) Retained earnings statement.

(c) Balance sheet.
(d) Statement of cash flows.

(LO 3) **12.** Stockholders' equity represents:
(a) claims of creditors.
(b) claims of employees.
(c) the difference between revenues and expenses.
(d) claims of owners.

(LO 3) **13.** As of December 31, 2017, Rockford Corporation has assets of $3,500 and stockholders' equity of $1,500. What are the liabilities for Rockford Corporation as of December 31, 2017?
(a) $1,500. (c) $2,500.
(b) $1,000. (d) $2,000.

14. The element of a corporation's annual report that describes the corporation's accounting methods is/are the: (LO 3)
(a) notes to the financial statements.
(b) management discussion and analysis.
(c) auditor's report.
(d) income statement.

15. The element of the annual report that presents an opinion regarding the fairness of the presentation of the financial position and results of operations is/are the: (LO 3)
(a) income statement.
(b) auditor's opinion.
(c) balance sheet.
(d) comparative statements.

SOLUTIONS

1. **(b)** Creditorship is not a form of business organization. The other choices are incorrect because (a) sole proprietorship, (c) partnership, and (d) corporation are all forms of business organization.
2. **(c)** An advantage of corporations is that investors are not personally liable for debts of the business. The other choices are incorrect because (a) lower taxes, (b) harder to transfer ownership, and (d) most common form of organization are not true of corporations.
3. **(d)** Regulatory authorities are considered external, not internal, users. The other choices are true statements.
4. **(d)** The Sarbanes-Oxley Act (SOX) was created to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals, not to address tax rates. The other choices are incorrect because (a) top management must now certify the accuracy of financial information, (b) penalties for fraudulent activity increased, and (c) increased independence of auditors all resulted from SOX.
5. **(c)** Advertising is a type of operating activity. The other choices are incorrect because (a) financing, (b) operating, and (d) investing are the three primary business activities.
6. **(a)** Issuing shares of common stock is a financing activity. The other choices are incorrect because (b) selling goods on account is an operating activity, (c) buying delivery equipment is an investing activity, and (d) buying inventory is an operating activity.
7. **(d)** When a company earns more revenues than expenses, it will report net income during a time period. The other choices are incorrect because (a) assets and liabilities are on the balance sheet, not the income statement; (b) assets are on the balance sheet, not the income statement; and (c) net income results when revenues exceed expenses, not when expenses exceed revenues.
8. **(d)** Net income = Sales revenue ($75,000) − Salaries and wages expense ($20,000) − Rent expense ($10,000) = $45,000. The other choices are therefore incorrect.
9. **(a)** The investing activities section of the statement of cash flows provides information about property, plant, and equipment accounts, not (b) the operating activities section or (c) the financing activities section. Choice (d) is incorrect as the statement of cash flows does provide this information.
10. **(b)** The balance sheet presents information as of a specific point in time. The other choices are incorrect because the (a) income statement, (c) statement of cash flows, and (d) retained earnings statement all cover a period of time.
11. **(c)** The balance sheet is a formal presentation of the accounting equation, such that Assets = Liabilities + Stockholders' Equity, not the (a) income statement, (b) retained earnings statement, or (d) statement of cash flows.
12. **(d)** Stockholders' equity represents claims of owners. The other choices are incorrect because (a) claims of creditors and (b) claims of employees are liabilities. Choice (c) is incorrect because the difference between revenues and expenses is net income.
13. **(d)** Using the accounting equation, liabilities can be computed by subtracting stockholders' equity from assets, or $3,500 − $1,500 = $2,000, not (a) $1,500, (b) $1,000, or (c) $2,500.
14. **(a)** The corporation's accounting methods are described in the notes to the financial statements, not in the (b) management discussion and analysis, (c) auditor's report, or (d) income statement.
15. **(b)** The element of the annual report that presents an opinion regarding the fairness of the presentation of the financial position and results of operations is the auditor's opinion, not the (a) income statement, (c) balance sheet, or (d) comparative statements.

PRACTICE EXERCISES

Prepare an income statement.
(LO 3)

1. The following items and amounts were taken from Ricardo Inc.'s 2017 income statement and balance sheet.

Cash	$ 84,700	Inventory	$ 64,618
Retained earnings	123,192	Accounts receivable	88,419
Cost of goods sold	483,854	Sales revenue	693,485
Salaries and wages expense	125,000	Income taxes payable	6,499
Prepaid insurance	7,818	Accounts payable	49,384
Interest expense	994	Service revenue	8,998

INSTRUCTIONS

Prepare an income statement for Ricardo Inc. for the year ended December 31, 2017.

SOLUTION

1.

RICARDO INC.
Income Statement
For the Year Ended December 31, 2017

Revenues		
Sales revenue	$693,485	
Service revenue	8,998	
Total revenues		$702,483
Expenses		
Cost of goods sold	483,854	
Salaries and wages expense	125,000	
Interest expense	994	
Total expenses		609,848
Net income		$ 92,635

Compute net income and prepare a balance sheet.
(LO 3)

2. Cozy Bear is a private camping ground near the Mountain Home Recreation Area. It has compiled the following financial information as of December 31, 2017.

Service revenue (from camping fees)	$148,000	Dividends	$ 9,000
Sales revenue (from general store)	35,000	Notes payable	50,000
Accounts payable	16,000	Expenses during 2017	135,000
Cash	18,500	Supplies	12,500
Equipment	129,000	Common stock	40,000
		Retained earnings (1/1/2017)	15,000

INSTRUCTIONS

(a) Determine net income from Cozy Bear for 2017.

(b) Prepare a retained earnings statement and a balance sheet for Cozy Bear as of December 31, 2017.

SOLUTION

2. (a)

Service revenue	$148,000
Sales revenue	35,000
Total revenue	183,000
Expenses	135,000
Net income	$ 48,000

(b)

COZY BEAR
Retained Earnings Statement
For the Year Ended December 31, 2017

Retained earnings, January 1	$15,000
Add: Net income	48,000
	63,000
Less: Dividends	9,000
Retained earnings, December 31	$54,000

COZY BEAR
Balance Sheet
December 31, 2017

Assets		
Cash		$ 18,500
Supplies		12,500
Equipment		129,000
Total assets		$160,000
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$50,000	
Accounts payable	16,000	
Total liabilities		$ 66,000
Stockholders' equity		
Common stock	40,000	
Retained earnings	54,000	
Total stockholders' equity		94,000
Total liabilities and stockholders' equity		$160,000

PRACTICE PROBLEM

Prepare financial statements.
(LO 3)

Jeff Andringa, a former college hockey player, quit his job and started Ice Camp, a hockey camp for kids ages 8 to 18. Eventually, he would like to open hockey camps nationwide. Jeff has asked you to help him prepare financial statements at the end of his first year of operations. He relates the following facts about his business activities.

In order to get the business off the ground, Jeff decided to incorporate. He sold shares of common stock to a few close friends, as well as bought some of the shares himself. He initially raised $25,000 through the sale of these shares. In addition, the company took out a $10,000 loan at a local bank.

Ice Camp purchased, for $12,000 cash, a bus for transporting kids. The company also bought hockey goals and other miscellaneous equipment with $1,500 cash. The company earned camp tuition during the year of $100,000 but had collected only $80,000 of this amount. Thus, at the end of the year, its customers still owed $20,000. The company rents time at a local rink for $50 per hour. Total rink rental costs during the year were $8,000, insurance was $10,000, salary expense was $20,000, and supplies used totaled $9,000, all of which were paid in cash. The company incurred $800 in interest expense on the bank loan, which it still owed at the end of the year.

The company paid dividends during the year of $5,000 cash. The balance in the corporate bank account at December 31, 2017, was $49,500.

INSTRUCTIONS

Using the format of the Sierra Corporation statements in this chapter, prepare an income statement, retained earnings statement, balance sheet, and statement of cash flows. (*Hint:* Prepare the statements in the order stated to take advantage of the flow of information from one statement to the next, as shown in Illustration 1-9 on page 16.)

SOLUTION

ICE CAMP
Income Statement
For the Year Ended December 31, 2017

Revenues		
Service revenue		$100,000
Expenses		
Salaries and wages expense	$20,000	
Insurance expense	10,000	
Supplies expense	9,000	
Rent expense	8,000	
Interest expense	800	
Total expenses		47,800
Net income		$ 52,200

ICE CAMP
Retained Earnings Statement
For the Year Ended December 31, 2017

Retained earnings, January 1, 2017	$ 0
Add: Net income	52,200
	52,200
Less: Dividends	5,000
Retained earnings, December 31, 2017	$ 47,200

ICE CAMP
Balance Sheet
December 31, 2017

Assets		
Cash		$ 49,500
Accounts receivable		20,000
Equipment ($12,000 + $1,500)		13,500
Total assets		$ 83,000
Liabilities and Stockholders' Equity		
Liabilities		
Notes payable	$10,000	
Interest payable	800	
Total liabilities		$ 10,800
Stockholders' equity		
Common stock	25,000	
Retained earnings	47,200	
Total stockholders' equity		72,200
Total liabilities and stockholders' equity		$ 83,000

ICE CAMP
Statement of Cash Flows
For the Year Ended December 31, 2017

Cash flows from operating activities		
Cash receipts from operating activities	$80,000	
Cash payments for operating activities	(47,000)	
Net cash provided by operating activities		$33,000
Cash flows from investing activities		
Purchase of equipment	(13,500)	
Net cash used by investing activities		(13,500)
Cash flows from financing activities		
Issuance of common stock	25,000	
Issuance of notes payable	10,000	
Dividends paid	(5,000)	
Net cash provided by financing activities		30,000
Net increase in cash		49,500
Cash at beginning of period		0
Cash at end of period		$49,500

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The tool icon indicates that an activity employs one of the decision tools presented in the chapter. The indicates that an activity relates to a business function beyond accounting. The pencil icon indicates that an activity requires written communication.

QUESTIONS

1. What are the three basic forms of business organizations?
2. What are the advantages to a business of being formed as a corporation? What are the disadvantages?
3. What are the advantages to a business of being formed as a partnership or sole proprietorship? What are the disadvantages?
4. "Accounting is ingrained in our society and is vital to our economic system." Do you agree? Explain.
5. Who are the internal users of accounting data? How does accounting provide relevant data to the internal users?
6. Who are the external users of accounting data? Give examples.
7. What are the three main types of business activity? Give examples of each activity.
8. Listed here are some items found in the financial statements of Finzelberg. Indicate in which financial statement(s) each item would appear.
   (a) Service revenue.
   (b) Equipment.
   (c) Advertising expense.
   (d) Accounts receivable.
   (e) Common stock.
   (f) Interest payable.
9. Why would a bank want to monitor the dividend payment practices of the corporations to which it lends money?
10. "A company's net income appears directly on the income statement and the retained earnings statement, and it is included indirectly in the company's balance sheet." Do you agree? Explain.
11. What is the primary purpose of the statement of cash flows?
12. What are the three main categories of the statement of cash flows? Why do you think these categories were chosen?
13. What is retained earnings? What items increase the balance in retained earnings? What items decrease the balance in retained earnings?
14. What is the basic accounting equation?
15. (a) Define the terms assets, liabilities, and stockholders' equity.
    (b) What items affect stockholders' equity?

16. Which of these items are liabilities of White Glove Cleaning Service?

(a) Cash.
(b) Accounts payable.
(c) Dividends.
(d) Accounts receivable.
(e) Supplies.
(f) Equipment.
(g) Salaries and wages payable.
(h) Service revenue.
(i) Rent expense.

17. How are each of the following financial statements interrelated? (a) Retained earnings statement and income statement. (b) Retained earnings statement and balance sheet. (c) Balance sheet and statement of cash flows.

18. What is the purpose of the management discussion and analysis section (MD&A)?

19. Why is it important for financial statements to receive an unqualified auditor's opinion?

20. What types of information are presented in the notes to the financial statements?

21. The accounting equation is Assets = Liabilities + Stockholders' Equity. Appendix A, at the end of this textbook, reproduces Apple's financial statements. Replacing words in the equation with dollar amounts, what is Apple's accounting equation at September 27, 2014?

BRIEF EXERCISES

Describe forms of business organization.
(LO 1), K

BE1-1 Match each of the following forms of business organization with a set of characteristics: sole proprietorship (SP), partnership (P), corporation (C).
(a) _____ Shared control, tax advantages, increased skills and resources.
(b) _____ Simple to set up and maintains control with owner.
(c) _____ Easier to transfer ownership and raise funds, no personal liability.

Identify users of accounting information.
(LO 1), K

BE1-2 Match each of the following types of evaluation with one of the listed users of accounting information.
1. Trying to determine whether the company complied with tax laws.
2. Trying to determine whether the company can pay its obligations.
3. Trying to determine whether an advertising proposal will be cost-effective.
4. Trying to determine whether the company's net income will result in a stock price increase.
5. Trying to determine whether the company should employ debt or equity financing.

(a) _____ Investors in common stock.
(b) _____ Marketing managers.
(c) _____ Creditors.
(d) _____ Chief Financial Officer.
(e) _____ Internal Revenue Service.

Classify items by activity.
(LO 2), K

BE1-3 Indicate in which part of the statement of cash flows each item would appear: operating activities (O), investing activities (I), or financing activities (F).
(a) _____ Cash received from customers.
(b) _____ Cash paid to stockholders (dividends).
(c) _____ Cash received from issuing new common stock.
(d) _____ Cash paid to suppliers.
(e) _____ Cash paid to purchase a new office building.

Determine effect of transactions on stockholders' equity.
(LO 3), C

BE1-4 Presented below are a number of transactions. Determine whether each transaction affects common stock (C), dividends (D), revenues (R), expenses (E), or does not affect stockholders' equity (NSE). Provide titles for the revenues and expenses.
(a) Costs incurred for advertising.
(b) Cash received for services performed.
(c) Costs incurred for insurance.
(d) Amounts paid to employees.
(e) Cash distributed to stockholders.
(f) Cash received in exchange for allowing the use of the company's building.
(g) Costs incurred for utilities used.
(h) Cash purchase of equipment.
(i) Cash received from investors.

Prepare a balance sheet.
(LO 3), AP

BE1-5 In alphabetical order below are balance sheet items for Karol Company at December 31, 2017. Prepare a balance sheet following the format of Illustration 1-7 (page 13).

Accounts payable	$65,000
Accounts receivable	71,000
Cash	22,000
Common stock	18,000
Retained earnings	10,000

BE1-6 Eskimo Pie Corporation markets a broad range of frozen treats, including its famous Eskimo Pie ice cream bars. The following items were taken from a recent income statement and balance sheet. In each case, identify whether the item would appear on the balance sheet (BS) or income statement (IS).

Determine where items appear on financial statements.

(LO 3), K

(a) _____ Income tax expense.
(b) _____ Inventory.
(c) _____ Accounts payable.
(d) _____ Retained earnings.
(e) _____ Equipment.
(f) _____ Sales revenue.
(g) _____ Cost of goods sold.
(h) _____ Common stock.
(i) _____ Accounts receivable.
(j) _____ Interest expense.

BE1-7 Indicate which statement you would examine to find each of the following items: income statement (IS), balance sheet (BS), retained earnings statement (RES), or statement of cash flows (SCF).

Determine proper financial statement.

(LO 3), K

(a) Revenue during the period.
(b) Supplies on hand at the end of the year.
(c) Cash received from issuing new bonds during the period.
(d) Total debts outstanding at the end of the period.

BE1-8 Use the basic accounting equation to answer these questions.

Use basic accounting equation.

(LO 3), AP

(a) The liabilities of Lantz Company are $90,000 and the stockholders' equity is $230,000. What is the amount of Lantz Company's total assets?
(b) The total assets of Salley Company are $170,000 and its stockholders' equity is $80,000. What is the amount of its total liabilities?
(c) The total assets of Brandon Co. are $800,000 and its liabilities are equal to one-fourth of its total assets. What is the amount of Brandon Co.'s stockholders' equity?

BE1-9 At the beginning of the year, Morales Company had total assets of $800,000 and total liabilities of $500,000. (Treat each item independently.)

Use basic accounting equation.

(LO 3), AP

(a) If total assets increased $150,000 during the year and total liabilities decreased $80,000, what is the amount of stockholders' equity at the end of the year?
(b) During the year, total liabilities increased $100,000 and stockholders' equity decreased $70,000. What is the amount of total assets at the end of the year?
(c) If total assets decreased $80,000 and stockholders' equity increased $110,000 during the year, what is the amount of total liabilities at the end of the year?

BE1-10 Indicate whether each of these items is an asset (A), a liability (L), or part of stockholders' equity (SE).

Identify assets, liabilities, and stockholders' equity.

(LO 3), K

(a) Accounts receivable.
(b) Salaries and wages payable.
(c) Equipment.
(d) Supplies.
(e) Common stock.
(f) Notes payable.

BE1-11 Which is **not** a required part of an annual report of a publicly traded company?

Determine required parts of annual report.

(LO 3), K

(a) Statement of cash flows.
(b) Notes to the financial statements.
(c) Management discussion and analysis.
(d) All of these are required.

DO IT! EXERCISES

DO IT! 1-1 Identify each of the following organizational characteristics with the business organizational form or forms with which it is associated.

Identify benefits of business organization forms.

(LO 1), C

(a) Easier to transfer ownership.
(b) Easier to raise funds.
(c) More owner control.
(d) Tax advantages.
(e) No personal legal liability.

DO IT! 1-2 Classify each item as an asset, liability, common stock, revenue, or expense.

Classify financial statement elements.

(LO 2), K

(a) Issuance of ownership shares.
(b) Land purchased.
(c) Amounts owed to suppliers.
(d) Bonds payable.
(e) Amount earned from selling a product.
(f) Cost of advertising.

Prepare financial statements.
(LO 3), AP

DO IT! 1-3a Gray Corporation began operations on January 1, 2017. The following information is available for Gray Corporation on December 31, 2017.

Accounts payable	$ 5,000	Notes payable	$ 7,000
Accounts receivable	2,000	Rent expense	10,000
Advertising expense	4,000	Retained earnings	?
Cash	3,100	Service revenue	25,000
Common stock	15,000	Supplies	1,900
Dividends	2,500	Supplies expense	1,700
Equipment	26,800		

Prepare an income statement, a retained earnings statement, and a balance sheet for Gray Corporation.

Identify components of annual reports.
(LO 3), K

DO IT! 1-3b Indicate whether each of the following items is most closely associated with the management discussion and analysis (MD&A), the notes to the financial statements, or the auditor's report.

(a) Description of ability to pay near-term obligations.
(b) Unqualified opinion.
(c) Details concerning liabilities, too voluminous to be included in the statements.
(d) Description of favorable and unfavorable trends.
(e) Certified public accountant (CPA).
(f) Descriptions of significant accounting policies.

EXERCISES

Match items with descriptions.
(LO 1, 2, 3), K

E1-1 Here is a list of words or phrases discussed in this chapter:

1. Corporation
2. Creditor
3. Accounts receivable
4. Partnership
5. Stockholder
6. Common stock
7. Accounts payable
8. Auditor's opinion

Instructions

Match each word or phrase with the best description of it.

______ (a) An expression about whether financial statements conform with generally accepted accounting principles.
______ (b) A business that raises money by issuing shares of stock.
______ (c) The portion of stockholders' equity that results from receiving cash from investors.
______ (d) Obligations to suppliers of goods.
______ (e) Amounts due from customers.
______ (f) A party to whom a business owes money.
______ (g) A party that invests in common stock.
______ (h) A business that is owned jointly by two or more individuals but does not issue stock.

Identify business activities.
(LO 2), C

E1-2 All businesses are involved in three types of activities—financing, investing, and operating. Listed below are the names and descriptions of companies in several different industries.

Abitibi Consolidated Inc.—manufacturer and marketer of newsprint
Cal State–Northridge Stdt Union—university student union
Oracle Corporation—computer software developer and retailer
Sportsco Investments—owner of the Vancouver Canucks hockey club
Grant Thornton LLP—professional accounting and business advisory firm
Southwest Airlines—low-cost airline

Instructions

(a) For each of the above companies, provide examples of (1) a financing activity, (2) an investing activity, and (3) an operating activity that the company likely engages in.
(b) Which of the activities that you identified in (a) are common to most businesses? Which activities are not?

E1-3 The Bonita Vista Golf & Country Club details the following accounts in its financial statements.

Classify accounts.
(LO 2, 3), C

Accounts payable	_____
Accounts receivable	_____
Equipment	_____
Sales revenue	_____
Service revenue	_____
Inventory	_____
Mortgage payable	_____
Supplies expense	_____
Rent expense	_____
Salaries and wages expense	_____

Instructions
Classify each of the above accounts as an asset (A), liability (L), stockholders' equity (SE), revenue (R), or expense (E) item.

E1-4 This information relates to Benser Co. for the year 2017.

Prepare income statement and retained earnings statement.
(LO 3), AP

Retained earnings, January 1, 2017	$67,000
Advertising expense	1,800
Dividends	6,000
Rent expense	10,400
Service revenue	58,000
Utilities expense	2,400
Salaries and wages expense	30,000

Instructions
After analyzing the data, prepare an income statement and a retained earnings statement for the year ending December 31, 2017.

E1-5 Suppose the following information was taken from the 2017 financial statements of pharmaceutical giant Merck and Co. (All dollar amounts are in millions.)

Prepare income statement and retained earnings statement.
(LO 3), AP

Retained earnings, January 1, 2017	$43,698.8
Cost of goods sold	9,018.9
Selling and administrative expenses	8,543.2
Dividends	3,597.7
Sales revenue	38,576.0
Research and development expense	5,845.0
Income tax expense	2,267.6

Instructions
(a) After analyzing the data, prepare an income statement and a retained earnings statement for the year ending December 31, 2017.
(b) Suppose that Merck decided to reduce its research and development expense by 50%. What would be the short-term implications? What would be the long-term implications? How do you think the stock market would react?

E1-6 Presented here is information for Zheng Inc. for 2017.

Prepare a retained earnings statement.
(LO 3), AP

Retained earnings, January 1	$130,000
Service revenue	400,000
Total expenses	175,000
Dividends	65,000

Instructions
Prepare the 2017 retained earnings statement for Zheng Inc.

E1-7 Consider each of the following independent situations.

Interpret financial facts.
(LO 3), AP

(a) The retained earnings statement of Lee Corporation shows dividends of $68,000, while net income for the year was $75,000.
(b) The statement of cash flows for Steele Corporation shows that cash provided by operating activities was $10,000, cash used in investing activities was $110,000, and cash provided by financing activities was $130,000.

Instructions

For each company, provide a brief discussion interpreting these financial facts. For example, you might discuss the company's financial health or its apparent growth philosophy.

Identify financial statement components and prepare income statement.

(LO 3), C

E1-8 The following items and amounts were taken from Lonyear Inc.'s 2017 income statement and balance sheet.

______	Cash	$ 84,700	______	Accounts receivable	$ 88,419
______	Retained earnings	123,192	______	Sales revenue	584,951
______	Cost of goods sold	438,458	______	Notes payable	6,499
______	Salaries and wages expense	115,131	______	Accounts payable	49,384
______	Prepaid insurance	7,818	______	Service revenue	4,806
______	Inventory	64,618	______	Interest expense	1,882

Instructions

(a) In each case, identify on the blank line whether the item is an asset (A), liability (L), stockholders' equity (SE), revenue (R), or expense (E) item.

(b) Prepare an income statement for Lonyear Inc. for the year ended December 31, 2017.

Calculate missing amounts.

(LO 3), AN

E1-9 Here are incomplete financial statements for Donavan, Inc.

DONAVAN, INC.
Balance Sheet

Assets		**Liabilities and Stockholders' Equity**	
Cash	$ 7,000	Liabilities	
Inventory	10,000	Accounts payable	$ 5,000
Buildings	45,000	Stockholders' equity	
Total assets	$62,000	Common stock	(a)
		Retained earnings	(b)
		Total liabilities and stockholders' equity	$62,000

Income Statement

Revenues	$85,000
Cost of goods sold	(c)
Salaries and wages expense	10,000
Net income	$ (d)

Retained Earnings Statement

Beginning retained earnings	$12,000
Add: Net income	(e)
Less: Dividends	5,000
Ending retained earnings	$27,000

Instructions

Calculate the missing amounts.

Compute net income and prepare a balance sheet.

(LO 3), AP

E1-10 Otay Lakes Park is a private camping ground near the Mount Miguel Recreation Area. It has compiled the following financial information as of December 31, 2017.

Service revenue (from camping fees)	$132,000	Dividends	$ 9,000
Sales revenue (from general store)	25,000	Notes payable	50,000
Accounts payable	11,000	Expenses during 2017	126,000
Cash	8,500	Supplies	5,500
Equipment	114,000	Common stock	40,000
		Retained earnings (1/1/2017)	5,000

Instructions

(a) Determine Otay Lakes Park's net income for 2017.

(b) Prepare a retained earnings statement and a balance sheet for Otay Lakes Park as of December 31, 2017.

(c) Upon seeing this income statement, Walt Jones, the campground manager, immediately concluded, "The general store is more trouble than it is worth—let's get rid of it." The marketing director isn't so sure this is a good idea. What do you think?

E1-11 Kellogg Company is the world's leading producer of ready-to-eat cereal and a leading producer of grain-based convenience foods such as frozen waffles and cereal bars. Suppose the following items were taken from its 2017 income statement and balance sheet. (All dollars are in millions.)

Identify financial statement components and prepare an income statement.

(LO 3), AP

____	Retained earnings	$5,481	____	Bonds payable	$ 4,835
____	Cost of goods sold	7,184	____	Inventory	910
____	Selling and administrative expenses	3,390	____	Sales revenue	12,575
____	Cash	334	____	Accounts payable	1,077
____	Notes payable	44	____	Common stock	105
____	Interest expense	295	____	Income tax expense	498

Instructions

(a) In each case, identify whether the item is an asset (A), liability (L), stockholders' equity (SE), revenue (R), or expense (E).

(b) Prepare an income statement for Kellogg Company for the year ended December 31, 2017.

E1-12 This information is for Williams Corporation for the year ended December 31, 2017.

Prepare a statement of cash flows.

(LO 3), AP

Cash received from lenders	$20,000
Cash received from customers	50,000
Cash paid for new equipment	28,000
Cash dividends paid	8,000
Cash paid to suppliers	16,000
Cash balance 1/1/17	12,000

Instructions

(a) Prepare the 2017 statement of cash flows for Williams Corporation.

(b) Suppose you are one of Williams' creditors. Referring to the statement of cash flows, evaluate Williams' ability to repay its creditors.

E1-13 Suppose the following data are derived from the 2017 financial statements of Southwest Airlines. (All dollars are in millions.) Southwest has a December 31 year-end.

Prepare a statement of cash flows.

(LO 3), AP

Cash balance, January 1, 2017	$1,390
Cash paid for repayment of debt	122
Cash received from issuance of common stock	144
Cash received from issuance of long-term debt	500
Cash received from customers	9,823
Cash paid for property and equipment	1,529
Cash paid for dividends	14
Cash paid for repurchase of common stock	1,001
Cash paid for goods and services	6,978

Instructions

(a) After analyzing the data, prepare a statement of cash flows for Southwest Airlines for the year ended December 31, 2017.

(b) Discuss whether the company's net cash provided by operating activities was sufficient to finance its investing activities. If it was not, how did the company finance its investing activities?

E1-14 Wayne Holtz is the bookkeeper for Beeson Company. Wayne has been trying to get the balance sheet of Beeson Company to balance. It finally balanced, but now he's not sure it is correct.

Correct an incorrectly prepared balance sheet.

(LO 3), AP

BEESON COMPANY
Balance Sheet
December 31, 2017

Assets		Liabilities and Stockholders' Equity	
Cash	$18,000	Accounts payable	$16,000
Supplies	9,500	Accounts receivable	(12,000)
Equipment	40,000	Common stock	40,000
Dividends	8,000	Retained earnings	31,500
Total assets	$75,500	Total liabilities and stockholders' equity	$75,500

Instructions
Prepare a correct balance sheet.

Classify items as assets, liabilities, and stockholders' equity and prepare accounting equation.
(LO 3), AP

XLS

E1-15 Suppose the following items were taken from the balance sheet of Nike, Inc. (All dollars are in millions.)

1. Cash	$2,291.1	7. Inventory	$2,357.0
2. Accounts receivable	2,883.9	8. Income taxes payable	86.3
3. Common stock	2,874.2	9. Equipment	1,957.7
4. Notes payable	342.9	10. Retained earnings	5,818.9
5. Buildings	3,759.9	11. Accounts payable	2,815.8
6. Mortgage payable	1,311.5		

Instructions
Perform each of the following.
(a) Classify each of these items as an asset, liability, or stockholders' equity, and determine the total dollar amount for each classification.
(b) Determine Nike's accounting equation by calculating the value of total assets, total liabilities, and total stockholders' equity.
(c) To what extent does Nike rely on debt versus equity financing?

Use financial statement relationships to determine missing amounts.
(LO 3), AN

E1-16 The summaries of data from the balance sheet, income statement, and retained earnings statement for two corporations, Walco Corporation and Gunther Enterprises, are presented as follows for 2017.

	Walco Corporation	Gunther Enterprises
Beginning of year		
Total assets	$110,000	$150,000
Total liabilities	70,000	(d)
Total stockholders' equity	(a)	70,000
End of year		
Total assets	(b)	180,000
Total liabilities	120,000	55,000
Total stockholders' equity	60,000	(e)
Changes during year in retained earnings		
Dividends	(c)	5,000
Total revenues	215,000	(f)
Total expenses	165,000	80,000

Instructions
Determine the missing amounts. Assume all changes in stockholders' equity are due to changes in retained earnings.

Classify various items in an annual report.
(LO 3), K

E1-17 The annual report provides financial information in a variety of formats, including the following.

Management discussion and analysis (MD&A)
Financial statements
Notes to the financial statements
Auditor's opinion

Instructions
For each of the following, state in what area of the annual report the item would be presented. If the item would probably not be found in an annual report, state "Not disclosed."

(a) The total cumulative amount received from stockholders in exchange for common stock.
(b) An independent assessment concerning whether the financial statements present a fair depiction of the company's results and financial position.
(c) The interest rate that the company is being charged on all outstanding debts.
(d) Total revenue from operating activities.
(e) Management's assessment of the company's results.
(f) The names and positions of all employees hired in the last year.

EXERCISES: SET B AND CHALLENGE EXERCISES

Visit the book's companion website, at **www.wiley.com/college/kimmel**, and choose the Student Companion site to access Exercises: Set B and Challenge Exercises.

PROBLEMS: SET A

Determine forms of business organization.
(LO 1), C

P1-1A Presented below are five independent situations.

(a) Three physics professors at MIT have formed a business to improve the speed of information transfer over the Internet for stock exchange transactions. Each has contributed an equal amount of cash and knowledge to the venture. Although their approach looks promising, they are concerned about the legal liabilities that their business might confront.
(b) Bob Colt, a college student looking for summer employment, opened a bait shop in a small shed at a local marina.
(c) Alma Ortiz and Jaime Falco each owned separate shoe manufacturing businesses. They have decided to combine their businesses. They expect that within the coming year they will need significant funds to expand their operations.
(d) Alice, Donna, and Sam recently graduated with marketing degrees. They have been friends since childhood. They have decided to start a consulting business focused on marketing sporting goods over the Internet.
(e) Don Rolls has developed a low-cost GPS device that can be implanted into pets so that they can be easily located when lost. He would like to build a small manufacturing facility to make the devices and then sell them to veterinarians across the country. Don has no savings or personal assets. He wants to maintain control over the business.

Instructions
In each case, explain what form of organization the business is likely to take—sole proprietorship, partnership, or corporation. Give reasons for your choice.

Identify users and uses of financial statements.
(LO 3), C

P1-2A Financial decisions often place heavier emphasis on one type of financial statement over the others. Consider each of the following hypothetical situations independently.

(a) The North Face is considering extending credit to a new customer. The terms of the credit would require the customer to pay within 30 days of receipt of goods.
(b) An investor is considering purchasing common stock of Amazon.com. The investor plans to hold the investment for at least 5 years.
(c) JPMorgan Chase Bank is considering extending a loan to a small company. The company would be required to make interest payments at the end of each year for 5 years, and to repay the loan at the end of the fifth year.
(d) The president of Campbell Soup is trying to determine whether the company is generating enough cash to increase the amount of dividends paid to investors in this and future years, and still have enough cash to buy equipment as it is needed.

Instructions

In each situation, state whether the decision-maker would be most likely to place primary emphasis on information provided by the income statement, balance sheet, or statement of cash flows. In each case provide a brief justification for your choice. Choose only one financial statement in each case.

Prepare an income statement, retained earnings statement, and balance sheet; discuss results.

(LO 3), AP

P1-3A On June 1, 2017, Elite Service Co. was started with an initial investment in the company of $22,100 cash. Here are the assets, liabilities, and common stock of the company at June 30, 2017, and the revenues and expenses for the month of June, its first month of operations:

Cash	$ 4,600	Notes payable	$12,000
Accounts receivable	4,000	Accounts payable	500
Service revenue	7,500	Supplies expense	1,000
Supplies	2,400	Maintenance and repairs expense	600
Advertising expense	400	Utilities expense	300
Equipment	26,000	Salaries and wages expense	1,400
Common stock	22,100		

In June, the company issued no additional stock but paid dividends of $1,400.

***Check figures** provide a key number to let you know you are on the right track.*

(a) Net income	$ 3,800
Ret. earnings	$ 2,400
Tot. assets	$37,000

Instructions

(a) Prepare an income statement and a retained earnings statement for the month of June and a balance sheet at June 30, 2017.
(b) Briefly discuss whether the company's first month of operations was a success.
(c) Discuss the company's decision to distribute a dividend.

Determine items included in a statement of cash flows, prepare the statement, and comment.

(LO 3), AP

P1-4A Presented below is selected financial information for Rojo Corporation for December 31, 2017.

Inventory	$ 25,000	Cash paid to purchase equipment	$ 12,000
Cash paid to suppliers	104,000	Equipment	40,000
Buildings	200,000	Service revenue	100,000
Common stock	50,000	Cash received from customers	132,000
Cash dividends paid	7,000	Cash received from issuing common stock	22,000
Cash at beginning of period	9,000		

Instructions

(a) Net increase $31,000

(a) Determine which items should be included in a statement of cash flows and then prepare the statement for Rojo Corporation.
(b) Comment on the adequacy of net cash provided by operating activities to fund the company's investing activities and dividend payments.

Comment on proper accounting treatment and prepare a corrected balance sheet.

(LO 3), AN

P1-5A Micado Corporation was formed on January 1, 2017. At December 31, 2017, Miko Liu, the president and sole stockholder, decided to prepare a balance sheet, which appeared as follows.

MICADO CORPORATION
Balance Sheet
December 31, 2017

Assets		Liabilities and Stockholders' Equity	
Cash	$20,000	Accounts payable	$30,000
Accounts receivable	50,000	Notes payable	15,000
Inventory	36,000	Boat loan	22,000
Boat	24,000	Stockholders' equity	63,000

Miko willingly admits that she is not an accountant by training. She is concerned that her balance sheet might not be correct. She has provided you with the following additional information.

1. The boat actually belongs to Miko, not to Micado Corporation. However, because she thinks she might take customers out on the boat occasionally, she decided to list it as an asset of the company. To be consistent, she also listed as a liability of the corporation her personal loan that she took out at the bank to buy the boat.
2. The inventory was originally purchased for $25,000, but due to a surge in demand Miko now thinks she could sell it for $36,000. She thought it would be best to record it at $36,000.

3. Included in the accounts receivable balance is $10,000 that Miko loaned to her brother 5 years ago. Miko included this in the receivables of Micado Corporation so she wouldn't forget that her brother owes her money.

Instructions

(a) Comment on the proper accounting treatment of the three items above.

(b) Provide a corrected balance sheet for Micado Corporation. (*Hint:* To get the balance sheet to balance, adjust stockholders' equity.)

(b) Tot. assets $85,000

PROBLEMS: SET B AND SET C

Visit the book's companion website, at **www.wiley.com/college/kimmel**, and choose the Student Companion site to access Problems: Set B and Set C.

CONTINUING PROBLEM Cookie Creations

CC1 Natalie Koebel spent much of her childhood learning the art of cookie-making from her grandmother. They spent many happy hours mastering every type of cookie imaginable and later devised new recipes that were both healthy and delicious. Now at the start of her second year in college, Natalie is investigating possibilities for starting her own business as part of the entrepreneurship program in which she is enrolled.

A long-time friend insists that Natalie has to include cookies in her business plan. After a series of brainstorming sessions, Natalie settles on the idea of operating a cookie-making school. She will start on a part-time basis and offer her services in people's homes. Now that she has started thinking about it, the possibilities seem endless. During the fall, she will concentrate on holiday cookies. She will offer group sessions (which will probably be more entertainment than education) and individual lessons. Natalie also decides to include children in her target market. The first difficult decision is coming up with the perfect name for her business. She settles on "Cookie Creations," and then moves on to more important issues.

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*The **Cookie Creations** problem starts in Chapter 1 and continues in every chapter. You can also find this problem at the book's companion website.*

Instructions

(a) What form of business organization—proprietorship, partnership, or corporation—do you recommend that Natalie use for her business? Discuss the benefits and weaknesses of each form that Natalie might consider.

(b) Will Natalie need accounting information? If yes, what information will she need and why? How often will she need this information?

(c) Identify specific asset, liability, revenue, and expense accounts that Cookie Creations will likely use to record its business transactions.

(d) Should Natalie open a separate bank account for the business? Why or why not?

(e) Natalie expects she will have to use her car to drive to people's homes and to pick up supplies, but she also needs to use her car for personal reasons. She recalls from her first-year accounting course something about keeping business and personal assets separate. She wonders what she should do for accounting purposes. What do you recommend?

EXPAND YOUR CRITICAL THINKING

FINANCIAL REPORTING PROBLEM: Apple Inc.

Financial Reporting

E

CT1-1 The financial statements of Apple Inc. for 2014 are presented in Appendix A.

Instructions

Refer to Apple's financial statements and answer the following questions.

(a) What were Apple's total assets at September 27, 2014? At September 28, 2013?

(b) How much cash (and cash equivalents) did Apple have on September 27, 2014?

(c) What amount of accounts payable did Apple report on September 27, 2014? On September 28, 2013?

(d) What were Apple's net sales in 2012? In 2013? In 2014?

(e) What is the amount of the change in Apple's net income from 2013 to 2014?

Financial Analysis

COMPARATIVE ANALYSIS PROBLEM: Columbia Sportswear Company vs. VF Corporation

E **CT1-2** Columbia Sportswear Company's financial statements are presented in Appendix B. Financial statements of VF Corporation are presented in Appendix C.

Instructions

(a) Based on the information in these financial statements, determine the following for each company.
   (1) Total liabilities at December 31, 2014.
   (2) Net property, plant, and equipment at December 31, 2014.
   (3) Net cash provided or (used) in investing activities for 2014.
   (4) Net income for 2014.

(b) What conclusions concerning the two companies can you draw from these data?

Financial Analysis

COMPARATIVE ANALYSIS PROBLEM: Amazon.com, Inc. vs. Wal-Mart Stores, Inc.

E **CT1-3** Amazon.com, Inc.'s financial statements are presented in Appendix D. Financial statements of Wal-Mart Stores, Inc. are presented in Appendix E.

Instructions

(a) Based on the information contained in these financial statements, determine the following for each company.
   (1) Total assets at December 31, 2014, for Amazon and for Wal-Mart at January 31, 2015.
   (2) Receivables (net) at December 31, 2014, for Amazon and for Wal-Mart at January 31, 2015.
   (3) Net sales (product only) for the year ended in 2014 (2015 for Wal-Mart).
   (4) Net income for year ended in 2014 (2015 for Wal-Mart).

(b) What conclusions concerning these two companies can be drawn from these data?

Financial Analysis

INTERPRETING FINANCIAL STATEMENTS

E **CT1-4** Xerox was not having a particularly pleasant year. The company's stock price had already fallen in the previous year from $60 per share to $30. Just when it seemed things couldn't get worse, Xerox's stock fell to $4 per share. The data below were taken from the statement of cash flows of Xerox. (All dollars are in millions.)

Cash used in operating activities		$ (663)
Cash used in investing activities		(644)
Financing activities		
Dividends paid	$ (587)	
Net cash received from issuing debt	3,498	
Cash provided by financing activities		2,911

Instructions

Analyze the information, and then answer the following questions.

(a) If you were a creditor of Xerox, what reaction might you have to the above information?
(b) If you were an investor in Xerox, what reaction might you have to the above information?
(c) If you were evaluating the company as either a creditor or a stockholder, what other information would you be interested in seeing?
(d) Xerox decided to pay a cash dividend. This dividend was approximately equal to the amount paid in the previous year. Discuss the issues that were probably considered in making this decision.

REAL-WORLD FOCUS

E **CT1-5** ***Purpose:*** Identify summary information about companies. This information includes basic descriptions of the company's location, activities, industry, financial health, and financial performance.

Address: **http://biz.yahoo.com/i**

Steps

1. Type in a company name, or use the index to find company name.
2. Under **Financials**, choose **Income Statement**. Perform instructions (a) and (b) below.
3. Under **Company**, choose **Industry** to identify others in this industry. Perform instructions (c)–(e) below.

Instructions

Answer the following questions.

(a) What is the company's net income? Over what period was this measured?
(b) What is the company's total sales? Over what period was this measured?
(c) What is the company's industry?
(d) What are the names of four companies in this industry?
(e) Choose one of the competitors. What is this competitor's name? What is its total sales? What is its net income?

S

CT1-6 The June 22, 2011, issue of the *Wall Street Journal Online* includes an article by Michael Rapoport entitled "Auditors Urged to Tell More." It provides an interesting discussion of the possible expanding role of CPAs.

Instructions

Read the article and answer the following questions.

(a) What are some of the ideas that the Public Company Accounting Oversight Board proposed for expanding the role of auditors in "passing judgment on more of what a company does and says?"
(b) How might the financial crisis influence the public's opinion regarding the need for more information from auditors?
(c) Describe the proposed "Auditor's Discussion and Analysis."
(d) Discuss whether you think that auditors will view these proposals positively or negatively.

DECISION-MAKING ACROSS THE ORGANIZATION

Financial Analysis

Writing

Group Project

CT1-7 Sylvia Ayala recently accepted a job in the production department at Apple. Before she starts work, she decides to review the company's annual report to better understand its operations.

The content and organization of corporate annual reports have become fairly standardized. Excluding the public relations part of the report (pictures, products, etc.), the following are the traditional financial portions of the annual report:

- Financial Highlights
- Letter to the Stockholders
- Management's Discussion and Analysis
- Financial Statements
- Notes to the Financial Statements
- Management's Responsibility for Financial Reporting
- Management's Report on Internal Control over Financial Reporting
- Report of Independent Registered Public Accounting Firm
- Selected Financial Data

E

The official SEC filing of the annual report is called a **Form 10-K**, which often omits the public relations pieces found in most standard annual reports. To access Apple's Form 10-K, including notes to the financial statements, follow these steps:

1. Go to **http://investor.apple.com**.
2. Select the Financial Information tab.
3. Select the 10-K annual report dated September 2014.
4. The financial portions of the annual report begin on page 21.

Instructions

Use Apple's annual report to answer the following questions.

(a) What CPA firm performed the audit of Apple's financial statements?
(b) What was the amount of Apple's basic earnings per share in 2014?

(c) What are the company's net sales in foreign countries in 2014?
(d) What were net sales in 2012?
(e) How many shares of common stock have been authorized?
(f) How much cash was spent on capital expenditures in 2014?
(g) Over what life does the company depreciate its buildings?
(h) What was the value of inventory in 2013?

COMMUNICATION ACTIVITY

S **CT1-8** Marci Ling is the bookkeeper for Samco Company, Inc. Marci has been trying to get the company's balance sheet to balance. She finally got it to balance, but she still isn't sure that it is correct.

SAMCO COMPANY, INC.
Balance Sheet
For the Month Ended December 31, 2017

Assets		**Liabilities and Stockholders' Equity**	
Equipment	$18,000	Common stock	$12,000
Cash	9,000	Accounts receivable	(6,000)
Supplies	1,000	Dividends	(2,000)
Accounts payable	(4,000)	Notes payable	10,000
Total assets	$24,000	Retained earnings	10,000
		Total liabilities and stockholders' equity	$24,000

Instructions
Explain to Marci Ling in a memo (a) the purpose of a balance sheet, and (b) why this balance sheet is incorrect and what she should do to correct it.

ETHICS CASE

E **CT1-9** Rules governing the investment practices of individual certified public accountants prohibit them from investing in the stock of a company that their firm audits. The Securities and Exchange Commission (SEC) became concerned that some accountants were violating this rule. In response to an SEC investigation, PricewaterhouseCoopers fired 10 people and spent $25 million educating employees about the investment rules and installing an investment tracking system.

Instructions
Answer the following questions.

(a) Why do you think rules exist that restrict auditors from investing in companies that are audited by their firms?
(b) Some accountants argue that they should be allowed to invest in a company's stock as long as they themselves aren't involved in working on the company's audit or consulting. What do you think of this idea?
(c) Today, a very high percentage of publicly traded companies are audited by only four very large public accounting firms. These firms also do a high percentage of the consulting work that is done for publicly traded companies. How does this fact complicate the decision regarding whether CPAs should be allowed to invest in companies audited by their firm?
(d) Suppose you were a CPA and you had invested in IBM when IBM was not one of your firm's clients. Two years later, after IBM's stock price had fallen considerably, your firm won the IBM audit contract. You will be involved in working with the IBM audit. You know that your firm's rules require that you sell your shares immediately. If you do sell immediately, you will sustain a large loss. Do you think this is fair? What would you do?
(e) Why do you think PricewaterhouseCoopers took such extreme steps in response to the SEC investigation?

ALL ABOUT YOU

CT1-10 Some people are tempted to make their finances look worse to get financial aid. Companies sometimes also manage their financial numbers in order to accomplish certain goals. Earnings management is the planned timing of revenues, expenses, gains, and losses to smooth out bumps in net income. In managing earnings, companies' actions vary from being within the range of ethical activity, to being both unethical and illegal attempts to mislead investors and creditors. E

Instructions
Provide responses for each of the following questions.

(a) Discuss whether you think each of the following actions (adapted from **www.finaid.org/fafsa/maximize.phtml**) to increase the chances of receiving financial aid is ethical.
  (i) Spend down the student's assets and income first, before spending parents' assets and income.
  (ii) Accelerate necessary expenses to reduce available cash. For example, if you need a new car, buy it before applying for financial aid.
  (iii) State that a truly financially dependent child is independent.
  (iv) Have a parent take an unpaid leave of absence for long enough to get below the "threshold" level of income.

(b) What are some reasons why a **company** might want to overstate its earnings?
(c) What are some reasons why a **company** might want to understate its earnings?
(d) Under what circumstances might an otherwise ethical person decide to illegally overstate or understate earnings?

FASB CODIFICATION ACTIVITY

CT1-11 The FASB has developed the Financial Accounting Standards Board Accounting Standards Codification (or more simply "the Codification"). The FASB's primary goal in developing the Codification is to provide in one place all the authoritative literature related to a particular topic. To provide easy access to the Codification, the FASB also developed the Financial Accounting Standards Board Codification Research System (CRS). CRS is an online, real-time database that provides easy access to the Codification. The Codification and the related CRS provide a topically organized structure, subdivided into topic, subtopics, sections, and paragraphs, using a numerical index system. C

You may find this system useful in your present and future studies, and so we have provided an opportunity to use this online system as part of the *Expand Your Critical Thinking* section.

Instructions
Academic access to the FASB Codification is available through university subscriptions, obtained from the American Accounting Association (at **http://aaahq.org/FASB/Access.cfm**), for an annual fee of $150. This subscription covers an unlimited number of students within a single institution. Once this access has been obtained by your school, you should log in (at **http://aaahq.org/ascLogin.cfm**) and familiarize yourself with the resources that are accessible at the FASB Codification site.

CONSIDERING PEOPLE, PLANET, AND PROFIT

CT1-12 Although Clif Bar & Company is not a public company, it does share its financial information with its employees as part of its open-book management approach. Further, although it does not publicly share its financial information, it does provide a different form of an annual report to external users. In this report, the company provides information regarding its sustainability efforts. E

Address: **www.clifbar.com/article/our-five-aspirations**

Instructions
Access the article at the site shown above and then answer the following questions.

(a) What are the Five Aspirations?
(b) Click on the "All Aspirations Annual Report" link at the bottom of the page. How does this annual report differ from the annual report discussed in the chapter? Are there any similarities?

A Look at IFRS

LEARNING OBJECTIVE 4

Describe the impact of international accounting standards on U.S. financial reporting.

Most agree that there is a need for one set of international accounting standards. Here is why:

Multinational corporations. Today's companies view the entire world as their market. For example, Coca-Cola, Intel, and McDonald's generate more than 50% of their sales outside the United States. Many foreign companies, such as Toyota, Nestlé, and Sony, find their largest market to be the United States.

Mergers and acquisitions. The mergers between Fiat/Chrysler and Vodafone/Mannesmann suggest that we will see even more such business combinations of companies from different countries in the future.

Information technology. As communication barriers continue to topple through advances in technology, companies and individuals in different countries and markets are becoming more comfortable buying and selling goods and services from one another.

Financial markets. Financial markets are of international significance today. Whether it is currency, equity securities (stocks), bonds, or derivatives, there are active markets throughout the world trading these types of instruments.

KEY POINTS

Following are the key similarities and differences between GAAP and IFRS as related to accounting fundamentals.

Similarities

- The basic techniques for recording business transactions are the same for U.S. and international companies.
- Both international and U.S. accounting standards emphasize transparency in financial reporting. Both sets of standards are primarily driven by meeting the needs of investors and creditors.
- The three most common forms of business organizations, proprietorships, partnerships, and corporations, are also found in countries that use international accounting standards.

Differences

- International standards are referred to as International Financial Reporting Standards (IFRS), developed by the International Accounting Standards Board. Accounting standards in the United States are referred to as generally accepted accounting principles (GAAP) and are developed by the Financial Accounting Standards Board.
- IFRS tends to be simpler in its accounting and disclosure requirements; some people say it is more "principles-based." GAAP is more detailed; some people say it is more "rules-based."
- The internal control standards applicable to Sarbanes-Oxley (SOX) apply only to large public companies listed on U.S. exchanges. There is continuing debate as to whether non-U.S. companies should have to comply with this extra layer of regulation.

LOOKING TO THE FUTURE

Both the IASB and the FASB are hard at work developing standards that will lead to the elimination of major differences in the way certain transactions are accounted for and reported.

IFRS Practice

IFRS SELF-TEST QUESTIONS

1. Which of the following is **not** a reason why a single set of high-quality international accounting standards would be beneficial?
   (a) Mergers and acquisition activity.
   (b) Financial markets.
   (c) Multinational corporations.
   (d) GAAP is widely considered to be a superior reporting system.

2. The Sarbanes-Oxley Act determines:
   (a) international tax regulations.
   (b) internal control standards as enforced by the IASB.
   (c) internal control standards of U.S. publicly traded companies.
   (d) U.S. tax regulations.

3. IFRS is considered to be more:
   (a) principles-based and less rules-based than GAAP.
   (b) rules-based and less principles-based than GAAP.
   (c) detailed than GAAP.
   (d) None of the above.

IFRS EXERCISES

IFRS1-1 Who are the two key international players in the development of international accounting standards? Explain their role.

IFRS1-2 What is the benefit of a single set of high-quality accounting standards?

INTERNATIONAL FINANCIAL REPORTING PROBLEM: Louis Vuitton

IFRS1-3 The financial statements of Louis Vuitton are presented in Appendix F. Instructions for accessing and using the company's complete annual report, including the notes to its financial statements, are also provided in Appendix F.

Instructions

Visit Louis Vuitton's corporate website and answer the following questions from the company's 2014 annual report.

(a) What accounting firm performed the audit of Louis Vuitton's financial statements?
(b) What is the address of the company's corporate headquarters?
(c) What is the company's reporting currency?

Answers to IFRS Self-Test Questions

1. d **2.** c **3.** a

2

A Further Look at Financial Statements

CHAPTER PREVIEW

If you are thinking of purchasing Best Buy stock, or any stock, how can you decide what the shares are worth? If you manage Columbia Sportswear's credit department, how should you determine whether to extend credit to a new customer? If you are a financial executive at Google, how do you decide whether your company is generating adequate cash to expand operations without borrowing? Your decision in each of these situations will be influenced by a variety of considerations. One of them should be your careful analysis of a company's financial statements. The reason: Financial statements offer relevant and reliable information, which will help you in your decision-making.

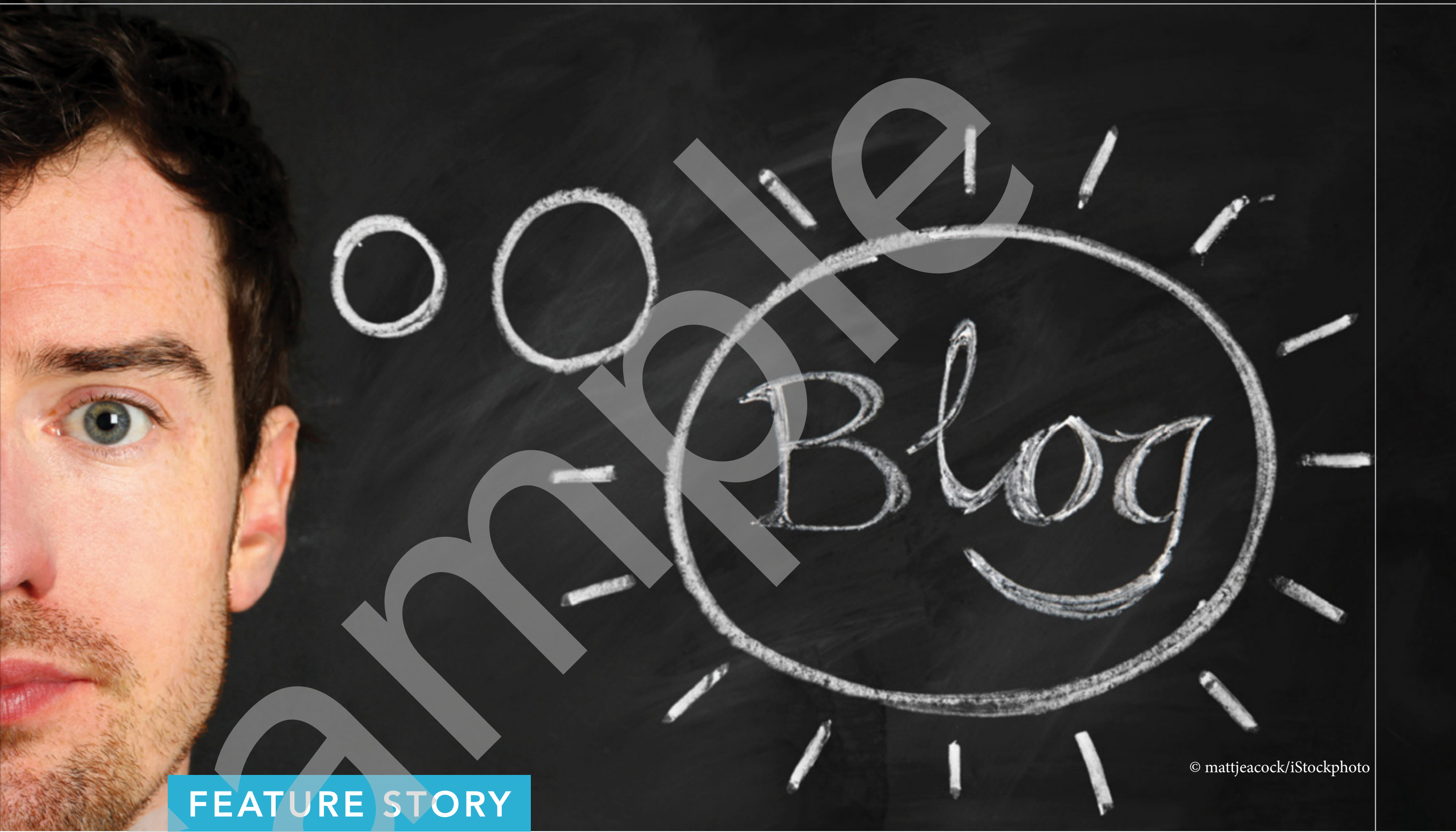
In this chapter, we take a closer look at the balance sheet and introduce some useful ways for evaluating the information provided by the financial statements. We also examine the financial reporting concepts underlying the financial statements. We begin by introducing the classified balance sheet.

CHAPTER OUTLINE

LEARNING OBJECTIVES		PRACTICE
1 Identify the sections of a classified balance sheet.	• Current assets • Long-term investments • Property, plant, and equipment • Intangible assets • Current liabilities • Long-term liabilities • Stockholders' equity	DO IT! 1 1a Assets Section of Classified Balance Sheet 1b Balance Sheet Classifications
2 Use ratios to evaluate a company's profitability, liquidity, and solvency.	• Ratio analysis • Using the income statement • Using a classified balance sheet • Using the statement of cash flows	DO IT! 2 Ratio Analysis
3 Discuss financial reporting concepts.	• The standard-setting environment • Qualities of useful information • Assumptions in financial reporting • Principles in financial reporting • Cost constraint	DO IT! 3 Financial Accounting Concepts and Principles

Go to the ***REVIEW AND PRACTICE*** section at the end of the chapter for a targeted summary and exercises with solutions.

Visit **WileyPLUS** for additional tutorials and practice opportunities.



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FEATURE STORY

Just Fooling Around?

Few people could have predicted how dramatically the Internet would change the investment world. One of the most interesting results is how it has changed the way ordinary people invest their savings. More and more people are striking out on their own, making their own investment decisions.

Two early pioneers in providing investment information to the masses were Tom and David Gardner, brothers who created an online investor website called The Motley Fool. The name comes from Shakespeare's *As You Like It*. The fool in Shakespeare's play was the only one who could speak unpleasant truths to kings and queens without being killed. Tom and David view themselves as 21st-century "fools," revealing the "truths" of the stock market to the small investor, who they feel has been taken advantage of by Wall Street insiders. The Motley Fool's online bulletin board enables investors to exchange information and insights about companies.

Critics of these bulletin boards contend that they are simply high-tech rumor mills that cause investors to bid up stock prices to unreasonable levels. For example, the stock of PairGain Technologies jumped 32% in a single day as a result of a bogus takeover rumor on an investment bulletin board. Some observers are concerned that small investors—ironically, the very people the Gardner brothers are trying to help—will be hurt the most by misinformation and intentional scams.

To show how these bulletin boards work, suppose that you had $10,000 to invest. You were considering Best Buy Company, the largest seller of electronics equipment in the United States. You scanned the Internet investment bulletin boards and found messages posted by two different investors. Here are excerpts from actual postings:

> *TMPVenus:* "Where are the prospects for positive movement for this company? Poor margins, poor management, astronomical P/E!"
>
> *broachman:* "I believe that this is a LONG TERM winner, and presently at a good price."

One says sell, and one says buy. Whom should you believe? If you had taken "broachman's" advice and purchased the stock, the $10,000 you invested would have been worth over $300,000 five years later. Best Buy was one of America's best-performing stocks during that period of time.

Rather than getting swept away by rumors, investors must sort out the good information from the bad. One thing is certain—as information services such as The Motley Fool increase in number, gathering information will become even easier. Evaluating it will be the harder task.

LEARNING OBJECTIVE 1

Identify the sections of a classified balance sheet.

In Chapter 1, you learned that a balance sheet presents a snapshot of a company's financial position at a point in time. It lists individual asset, liability, and stockholders' equity items. However, to improve users' understanding of a company's financial position, companies often use a **classified** balance sheet instead. A **classified balance sheet** groups together similar assets and similar liabilities, using a number of standard classifications and sections. This is useful because items within a group have similar economic characteristics. A classified balance sheet generally contains the standard classifications listed in Illustration 2-1.

ILLUSTRATION 2-1
Standard balance sheet classifications

Assets	Liabilities and Stockholders' Equity
Current assets	Current liabilities
Long-term investments	Long-term liabilities
Property, plant, and equipment	Stockholders' equity
Intangible assets	

These groupings help financial statement readers determine such things as (1) whether the company has enough assets to pay its debts as they come due, and (2) the claims of short- and long-term creditors on the company's total assets. Many of these groupings can be seen in the balance sheet of Franklin Corporation shown in Illustration 2-2 on the next page. In the sections that follow, we explain each of these groupings.

CURRENT ASSETS

Current assets are assets that a company expects to convert to cash or use up within one year or its operating cycle, whichever is longer. In Illustration 2-2, Franklin Corporation had current assets of $22,100. For most businesses, the cutoff for classification as current assets is one year from the balance sheet date. For example, accounts receivable are current assets because the company will collect them and convert them to cash within one year. Supplies is a current asset because the company expects to use the supplies in operations within one year.

Some companies use a period longer than one year to classify assets and liabilities as current because they have an operating cycle longer than one year. The **operating cycle** of a company is the average time required to go from cash to cash in producing revenue—to purchase inventory, sell it on account, and then collect cash from customers. For most businesses, this cycle takes less than a year, so they use a one-year cutoff. But for some businesses, such as vineyards or airplane manufacturers, this period may be longer than a year. **Except where noted, we will assume that companies use one year to determine whether an asset or liability is current or long-term.**

Common types of current assets are (1) cash, (2) investments (such as short-term U.S. government securities), (3) receivables (accounts receivable, notes receivable, and interest receivable), (4) inventories, and (5) prepaid expenses (insurance and supplies). **Companies list current assets in the order in which they expect to convert them into cash**. *Follow this rule when doing your homework.*

ILLUSTRATION 2-2
Classified balance sheet

FRANKLIN CORPORATION
Balance Sheet
October 31, 2017

Assets			
Current assets			
Cash		$ 6,600	
Debt investments		2,000	
Accounts receivable		7,000	
Notes receivable		1,000	
Inventory		3,000	
Supplies		2,100	
Prepaid insurance		400	
Total current assets			$22,100
Long-term investments			
Stock investments		5,200	
Investment in real estate		2,000	7,200
Property, plant, and equipment			
Land		10,000	
Equipment	$24,000		
Less: Accumulated depreciation—equipment	5,000	19,000	29,000
Intangible assets			
Patents			3,100
Total assets			$61,400
Liabilities and Stockholders' Equity			
Current liabilities			
Notes payable		$11,000	
Accounts payable		2,100	
Unearned sales revenue		900	
Salaries and wages payable		1,600	
Interest payable		450	
Total current liabilities			$16,050
Long-term liabilities			
Mortgage payable		10,000	
Notes payable		1,300	
Total long-term liabilities			11,300
Total liabilities			27,350
Stockholders' equity			
Common stock		14,000	
Retained earnings		20,050	
Total stockholders' equity			34,050
Total liabilities and stockholders' equity			$61,400

▼ HELPFUL HINT
Recall that the accounting equation is Assets = Liabilities + Stockholders' Equity.

Illustration 2-3 presents the current assets of Southwest Airlines Co. in a recent year.

ILLUSTRATION 2-3
Current assets section

Real World

SOUTHWEST AIRLINES CO.
Balance Sheet (partial)
(in millions)

Current assets	
Cash and cash equivalents	$1,355
Short-term investments	1,797
Accounts receivable	419
Inventories	467
Prepaid expenses and other current assets	418
Total current assets	$4,456

As explained later in the chapter, a company's current assets are important in assessing its short-term debt-paying ability.

LONG-TERM INVESTMENTS

ALTERNATIVE TERMINOLOGY
Long-term investments are often referred to simply as *investments*.

Long-term investments are generally (1) investments in stocks and bonds of other corporations that are held for more than one year, (2) long-term assets such as land or buildings that a company is not currently using in its operating activities, and (3) long-term notes receivable. In Illustration 2-2, Franklin Corporation reported total long-term investments of $7,200 on its balance sheet.

Google Inc. reported long-term investments on its balance sheet in a recent year as shown in Illustration 2-4.

ILLUSTRATION 2-4
Long-term investments section

Real World

GOOGLE INC.
Balance Sheet (partial)
(in millions)

Long-term investments	
Non-marketable equity investments	$1,469

PROPERTY, PLANT, AND EQUIPMENT

ALTERNATIVE TERMINOLOGY
Property, plant, and equipment is sometimes called *fixed assets* or *plant assets*.

Property, plant, and equipment are assets with relatively long useful lives that are currently used in operating the business. This category includes land, buildings, equipment, delivery vehicles, and furniture. In Illustration 2-2, Franklin Corporation reported property, plant, and equipment of $29,000.

Depreciation is the allocation of the cost of an asset to a number of years. Companies do this by systematically assigning a portion of an asset's cost as an expense each year (rather than expensing the full purchase price in the year of purchase). The assets that the company depreciates are reported on the balance sheet at cost less accumulated depreciation. The **accumulated depreciation** account shows the total amount of depreciation that the company has expensed thus far in the asset's life. In Illustration 2-2, Franklin Corporation reported accumulated depreciation of $5,000.

Illustration 2-5 presents the property, plant, and equipment of Tesla Motors, Inc. in a recent year.

ILLUSTRATION 2-5
Property, plant, and equipment section

Real World

TESLA MOTORS, INC.
Balance Sheet (partial)
(in thousands)

Property, plant, and equipment	
Machinery, equipment and office furniture	$ 322,394
Tooling	230,385
Leasehold improvements	94,763
Building and building improvements	67,707
Land	45,020
Computer equipment and software	42,073
Construction in progress	76,294
	878,636
Less: Accumulated depreciation and amortization	(140,142)
Total	$ 738,494

INTANGIBLE ASSETS

▼ HELPFUL HINT
Sometimes intangible assets are reported under a broader heading called "*Other assets.*"

Many companies have assets that do not have physical substance and yet often are very valuable. We call these assets **intangible assets**. One common intangible is goodwill. Others include patents, copyrights, and trademarks or trade names that give the company **exclusive right** of use for a specified period of time. In Illustration 2-2, Franklin Corporation reported intangible assets of $3,100.

Illustration 2-6 shows the intangible assets of media and theme park giant The Walt Disney Company in a recent year.

ILLUSTRATION 2-6
Intangible assets section

Real World

THE WALT DISNEY COMPANY
Balance Sheet (partial)
(in millions)

Intangible assets and goodwill		
Character/franchise intangibles and copyrights	$ 5,830	
Other amortizable intangible assets	903	
Accumulated amortization	(1,204)	
Net amortizable intangible assets	5,529	
FCC licenses	667	
Trademarks	1,218	
Other indefinite lived intangible assets	20	
	7,434	
Goodwill	27,881	
	$35,315	

DO IT! 1a Assets Section of Classified Balance Sheet

Baxter Hoffman recently received the following information related to Hoffman Corporation's December 31, 2017, balance sheet.

Prepaid insurance	$ 2,300	Inventory	$3,400
Cash	800	Accumulated depreciation—equipment	2,700
Equipment	10,700	Accounts receivable	1,100

Prepare the assets section of Hoffman Corporation's classified balance sheet.

SOLUTION

HOFFMAN CORPORATION
Balance Sheet (partial)
December 31, 2017

Assets		
Current assets		
Cash	$ 800	
Accounts receivable	1,100	
Inventory	3,400	
Prepaid insurance	2,300	
Total current assets		$ 7,600
Property, plant, and equipment		
Equipment	10,700	
Less: Accumulated depreciation—equipment	2,700	8,000
Total assets		$15,600

Action Plan

- ✔ Present current assets first. Current assets are cash and other resources that the company expects to convert to cash or use up within one year.
- ✔ Present current assets in the order in which the company expects to convert them into cash.
- ✔ Subtract accumulated depreciation—equipment from equipment to determine net equipment.

Related exercise material: **BE2-2, DO IT! 2-1a, E2-3,** and **E2-4.**

CURRENT LIABILITIES

In the liabilities and stockholders' equity section of the balance sheet, the first grouping is current liabilities. **Current liabilities** are obligations that the company is to pay within the next year or operating cycle, whichever is longer. Common examples are accounts payable, salaries and wages payable, notes payable, interest payable, and income taxes payable. Also included as current liabilities are current maturities of long-term obligations—payments to be made within the next year on long-term obligations. In Illustration 2-2, Franklin Corporation reported five different types of current liabilities, for a total of $16,050.

Illustration 2-7 shows the current liabilities section adapted from the balance sheet of Google Inc. in a recent year.

ILLUSTRATION 2-7
Current liabilities section

Real World

GOOGLE INC.
Balance Sheet (partial)
(in millions)

Current liabilities	
Accounts payable	$ 2,012
Short-term debt	2,549
Accrued compensation and benefits	2,239
Accrued expenses and other current liabilities	7,297
Income taxes payable, net	240
Total current liabilities	$14,337

LONG-TERM LIABILITIES

Long-term liabilities (long-term debt) are obligations that a company expects to pay **after** one year. Liabilities in this category include bonds payable, mortgages payable, long-term notes payable, lease liabilities, and pension liabilities. Many companies report long-term debt maturing after one year as a single amount in the balance sheet and show the details of the debt in notes that accompany the financial statements. Others list the various types of long-term liabilities. In Illustration 2-2, Franklin Corporation reported long-term liabilities of $11,300.

Illustration 2-8 shows the long-term liabilities that Nike, Inc. reported in its balance sheet in a recent year.

ILLUSTRATION 2-8
Long-term liabilities section

Real World

NIKE, INC.
Balance Sheet (partial)
(in millions)

Long-term liabilities	
Bonds payable	$1,106
Notes payable	51
Deferred income taxes and other	1,544
Total long-term liabilities	$2,701

STOCKHOLDERS' EQUITY

ALTERNATIVE TERMINOLOGY
Common stock is sometimes called *capital stock*.

Stockholders' equity consists of two parts: common stock and retained earnings. Companies record as **common stock** the investments of assets into the business by the stockholders. They record as **retained earnings** the income retained for use in the business. These two parts, combined, make up **stockholders' equity** on the balance sheet. In Illustration 2-2, Franklin Corporation reported common stock of $14,000 and retained earnings of $20,050.

DO IT! ▶1b Balance Sheet Classifications

The following financial statement items were taken from the financial statements of Callahan Corp.

______ Salaries and wages payable
______ Service revenue
______ Interest payable
______ Goodwill
______ Debt investments (short-term)
______ Mortgage payable (due in 3 years)
______ Investment in real estate
______ Equipment
______ Accumulated depreciation—equipment
______ Depreciation expense
______ Retained earnings
______ Unearned service revenue

Match each of the items to its proper balance sheet classification, shown below. If the item would not appear on a balance sheet, use "NA."

Current assets (CA)
Long-term investments (LTI)
Property, plant, and equipment (PPE)
Intangible assets (IA)
Current liabilities (CL)
Long-term liabilities (LTL)
Stockholders' equity (SE)

SOLUTION

CL Salaries and wages payable
NA Service revenue
CL Interest payable
IA Goodwill
CA Debt investments (short-term)
LTL Mortgage payable (due in 3 years)
LTI Investment in real estate
PPE Equipment
PPE Accumulated depreciation—equipment
NA Depreciation expense
SE Retained earnings
CL Unearned service revenue

Action Plan

✔ Analyze whether each financial statement item is an asset, liability, or stockholders' equity item.

✔ Determine if asset and liability items are current or long-term.

Related exercise material: **BE2-1, DO IT! 2-1b, E2-1, E2-2, E2-3, E2-5,** and **E2-6.**

LEARNING OBJECTIVE ▶2 Use ratios to evaluate a company's profitability, liquidity, and solvency.

In Chapter 1, we introduced the four financial statements. We discussed how these statements provide information about a company's performance and financial position. In this chapter, we extend this discussion by showing you specific tools that you can use to analyze financial statements in order to make a more meaningful evaluation of a company.

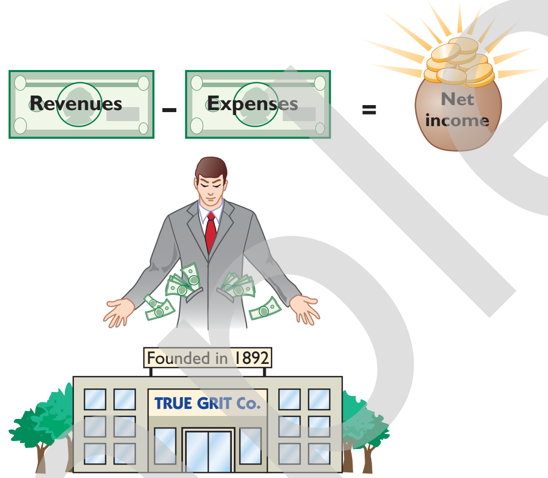
RATIO ANALYSIS

Ratio analysis expresses the relationship among selected items of financial statement data. A **ratio** expresses the mathematical relationship between one quantity and another. For analysis of the primary financial statements, we classify ratios as shown in Illustration 2-9 (page 52).

A single ratio by itself is not very meaningful. Accordingly, in this and the following chapters, we will use various comparisons to shed light on company performance:

1. **Intracompany comparisons** covering two years for the same company.
2. **Industry-average comparisons** based on average ratios for particular industries.
3. **Intercompany comparisons** based on comparisons with a competitor in the same industry.

ILLUSTRATION 2-9
Financial ratio classifications



Profitability Ratios
Measure the income or operating success of a company for a given period of time

Liquidity Ratios
Measure short-term ability of the company to pay its maturing obligations and to meet unexpected needs for cash

Solvency Ratios
Measure the ability of the company to survive over a long period of time

Next, we use some ratios and comparisons to analyze the financial statements of Best Buy.

USING THE INCOME STATEMENT

Best Buy generates profits for its stockholders by selling electronics. The income statement reveals how successful the company is at generating a profit from its sales. The income statement reports the amount earned during the period (revenues) and the costs incurred during the period (expenses). Illustration 2-10 shows a simplified income statement for Best Buy.

ILLUSTRATION 2-10
Best Buy's income statement

Real World

BEST BUY CO., INC.
Income Statements
For the 12 Months Ended February 1, 2014,
and 11 Months Ended February 2, 2013 (in millions)

	2014	2013
Revenues		
Net sales and other revenue	$42,410	$39,827
Expenses		
Cost of goods sold	32,720	30,528
Selling, general, and administrative expenses and other	8,760	9,471
Income tax expense	398	269
Total expenses	41,878	40,268
Net income/(loss)	$ 532	$ (441)

From this income statement, we can see that Best Buy's sales and net income increased during the period. Net income increased from a $441 million loss to a positive $532 million. One extremely unusual aspect of Best Buy's income statement is that the 2013 comparative column only covers 11 months. This occurred because Best Buy changed its year-end from "the Saturday nearest the end of February to the Saturday nearest the end of January." Such a change is very uncommon and complicates efforts to compare performance across years.

A much smaller competitor of Best Buy is hhgregg. hhgregg operates 228 stores in 20 states and is headquartered in Indianapolis, Indiana. It reported net income of $228,000 for the year ended March 31, 2014.

To evaluate the profitability of Best Buy, we will use ratio analysis. **Profitability ratios**, such as earnings per share, measure the operating success of a company for a given period of time.

Earnings per Share

Earnings per share (EPS) measures the net income earned on each share of common stock. Stockholders usually think in terms of the number of shares they own or plan to buy or sell, so stating net income earned as a per share amount provides a useful perspective for determining the investment return. Advanced accounting courses present more refined techniques for calculating earnings per share.

DECISION TOOLS

Earnings per share helps users compare a company's performance with that of previous years.

For now, a basic approach for calculating earnings per share is to divide earnings available to common stockholders by weighted-average common shares outstanding during the year. What is "earnings available to common stockholders"? It is an earnings amount calculated as net income less dividends paid on another type of stock, called preferred stock (Net income − Preferred dividends).

By comparing earnings per share of **a single company over time**, we can evaluate its relative earnings performance from the perspective of a stockholder—that is, on a per share basis. It is very important to note that comparisons of earnings per share across companies are **not meaningful** because of the wide variations in the numbers of shares of outstanding stock among companies.

Illustration 2-11 shows the earnings per share calculation for Best Buy in 2014 and 2013, based on the information presented below. Recall that Best Buy's 2013 income is based on 11 months of results. Further, to simplify our calculations, we assumed that any change in the number of shares for Best Buy occurred in the middle of the year.

(in millions)	2014	2013
Net income (loss)	$532	$(441)
Preferred dividends	–0–	–0–
Shares outstanding at beginning of year	338	341
Shares outstanding at end of year	347	338

ILLUSTRATION 2-11
Best Buy's earnings per share

$$\text{Earnings per Share} = \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Weighted-Average Common Shares Outstanding}}$$

($ and shares in millions)	2014	2013
Earnings per share	$\frac{\$532 - \$0}{(347 + 338)/2} = \$1.55$	$\frac{-\$441 - \$0}{(338 + 341)/2} = -\$1.30$

USING A CLASSIFIED BALANCE SHEET

You can learn a lot about a company's financial health by also evaluating the relationship between its various assets and liabilities. Illustration 2-12 (page 54) provides a simplified balance sheet for Best Buy.

Liquidity

Suppose you are a banker at CitiGroup considering lending money to Best Buy, or you are a sales manager at Hewlett-Packard interested in selling computers to Best Buy on credit. You would be concerned about Best Buy's **liquidity**—its ability to pay obligations expected to become due within the next year or operating cycle. You would look closely at the relationship of its current assets to current liabilities.

ILLUSTRATION 2-12
Best Buy's balance sheet

Real World

BEST BUY CO., INC.
Balance Sheets
(in millions)

	February 1, 2014	February 2, 2013
Assets		
Current assets		
Cash and cash equivalents	$ 2,678	$ 1,826
Short-term investments	223	0
Receivables	1,308	2,704
Merchandise inventories	5,376	6,571
Other current assets	900	946
Total current assets	10,485	12,047
Property and equipment	7,575	8,375
Less: Accumulated depreciation	4,977	5,105
Net property and equipment	2,598	3,270
Other assets	930	1,470
Total assets	$14,013	$16,787
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$ 5,122	$ 6,951
Accrued liabilities	873	1,188
Accrued income taxes	147	129
Accrued compensation payable	444	520
Other current liabilities	850	2,022
Total current liabilities	7,436	10,810
Long-term liabilities		
Long-term debt	976	1,109
Other long-term liabilities	1,612	1,153
Total long-term liabilities	2,588	2,262
Total liabilities	10,024	13,072
Stockholders' equity		
Common stock	335	88
Retained earnings and other	3,654	3,627
Total stockholders' equity	3,989	3,715
Total liabilities and stockholders' equity	$14,013	$16,787

WORKING CAPITAL One measure of liquidity is **working capital**, which is the difference between the amounts of current assets and current liabilities:

ILLUSTRATION 2-13
Working capital

Working Capital = Current Assets − Current Liabilities

When current assets exceed current liabilities, working capital is positive. When this occurs, there is a greater likelihood that the company will pay its liabilities. When working capital is negative, a company might not be able to pay short-term creditors, and the company might ultimately be forced into bankruptcy. Best Buy had working capital in 2014 of $3,049 million ($10,485 million − $7,436 million).

DECISION TOOLS

The current ratio helps users determine if a company can meet its near-term obligations.

CURRENT RATIO **Liquidity ratios** measure the short-term ability of the company to pay its maturing obligations and to meet unexpected needs for cash. One liquidity ratio is the **current ratio**, computed as current assets divided by current liabilities.

The current ratio is a more dependable indicator of liquidity than working capital. Two companies with the same amount of working capital may have significantly different current ratios. Illustration 2-14 shows the 2014 and 2013 current ratios for Best Buy and for hhgregg, along with the 2014 industry average.

ILLUSTRATION 2-14
Current ratio

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Best Buy ($ in millions)		hhgregg	Industry Average
2014	2013	2014	2014
$\frac{\$10{,}485}{\$7{,}436} = 1.41{:}1$	1.11:1	1.68:1	.88:1

What does the ratio actually mean? Best Buy's 2014 current ratio of 1.41:1 means that for every dollar of current liabilities, Best Buy has $1.41 of current assets. Best Buy's current ratio increased in 2014. When compared to the industry average of .88:1, Best Buy's liquidity seems strong. It is lower than hhgregg's but not significantly so.

One potential weakness of the current ratio is that it does not take into account the **composition** of the current assets. For example, a satisfactory current ratio does not disclose whether a portion of the current assets is tied up in slow-moving inventory. The composition of the current assets matters because a dollar of cash is more readily available to pay the bills than is a dollar of inventory. For example, suppose a company's cash balance declined while its merchandise inventory increased substantially. If inventory increased because the company is having difficulty selling its products, then the current ratio might not fully reflect the reduction in the company's liquidity.

ETHICS NOTE
A company that has more current assets than current liabilities can increase the ratio of current assets to current liabilities by using cash to pay off some current liabilities. This gives the appearance of being more liquid. Do you think this move is ethical?

ACCOUNTING ACROSS THE ORGANIZATION — REL Consultancy Group


Jorge Salcedo/iStockphoto

Can a Company Be Too Liquid?

There actually is a point where a company can be too liquid—that is, it can have too much working capital. While it is important to be liquid enough to be able to pay short-term bills as they come due, a company does not want to tie up its cash in extra inventory or receivables that are not earning the company money.

By one estimate from the REL Consultancy Group, the thousand largest U.S. companies had cumulative excess working capital of $1.017 trillion in a recent year. This was an 18% increase, which REL said represented a "deterioration in the management of operations." Given that managers throughout a company are interested in improving profitability, it is clear that they should have an eye toward managing working capital. They need to aim for a "Goldilocks solution"—not too much, not too little, but just right.

Source: Maxwell Murphy, "The Big Number," *Wall Street Journal* (November 9, 2011).

What can various company managers do to ensure that working capital is managed efficiently to maximize net income? (Go to WileyPLUS for this answer and additional questions.)

Solvency

Now suppose that instead of being a short-term creditor, you are interested in either buying Best Buy's stock or extending the company a long-term loan. Long-term creditors and stockholders are interested in a company's **solvency**—its ability to pay interest as it comes due and to repay the balance of a debt due at its maturity. **Solvency ratios** measure the ability of the company to survive over a long period of time.

▼ HELPFUL HINT
Some users evaluate solvency using a ratio of liabilities divided by stockholders' equity. The higher this "debt to equity" ratio, the lower is a company's solvency.

DEBT TO ASSETS RATIO The **debt to assets ratio** is one measure of solvency. It is calculated by dividing total liabilities (both current and long-term) by total assets. It measures the percentage of total financing provided by creditors rather than stockholders. Debt financing is more risky than equity financing because debt must be repaid at specific points in time, whether the company is performing well or not. Thus, the higher the percentage of debt financing, the riskier the company.

The higher the percentage of total liabilities (debt) to total assets, the greater the risk that the company may be unable to pay its debts as they come due. Illustration 2-15 shows the debt to assets ratios for Best Buy and hhgregg, along with the industry average.

ILLUSTRATION 2-15
Debt to assets ratio

$$\text{Debt to Assets Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

Best Buy ($ in millions)		hhgregg	Industry Average
2014	2013	2014	2014
$\frac{\$10,024}{\$14,013} = 72\%$	78%	51%	88%

The 2014 ratio of 72% means that every dollar of assets was financed by 72 cents of debt. Best Buy's ratio is less than the industry average of 88% and is significantly higher than hhgregg's ratio of 51%. The higher the ratio, the more reliant the company is on debt financing. This means that Best Buy has a lower equity "buffer" available to creditors if the company becomes insolvent when compared to hhgregg. Thus, from the creditors' point of view, a high ratio of debt to assets is undesirable. Best Buy's solvency appears lower than hhgregg's and higher than the average company in the industry.

The adequacy of this ratio is often judged in light of the company's earnings. Generally, companies with relatively stable earnings, such as public utilities, can support higher debt to assets ratios than can cyclical companies with widely fluctuating earnings, such as many high-tech companies. In later chapters, you will learn additional ways to evaluate solvency.

DECISION TOOLS
The debt to assets ratio helps users determine if a company can meet its long-term obligations.

INVESTOR INSIGHT

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When Debt Is Good

Debt financing differs greatly across industries and companies. Here are some debt to assets ratios for selected companies in a recent year:

	Debt to Assets Ratio
Google	23%
Nike	41%
Microsoft	48%
ExxonMobil	48%
General Motors	74%

Discuss the difference in the debt to assets ratio of Microsoft and General Motors. (Go to WileyPLUS for this answer and additional questions.)

USING THE STATEMENT OF CASH FLOWS

In the statement of cash flows, net cash provided by operating activities is intended to indicate the cash-generating capability of the company. Analysts have noted, however, that **net cash provided by operating activities fails to take into account that a company must invest in new property, plant, and equipment** (capital expenditures) just to maintain its current level of operations. Companies also must at least **maintain dividends at current levels** to satisfy investors. A measurement to provide additional insight regarding a company's cash-generating ability is free cash flow. **Free cash flow** describes the net cash provided by operating activities after adjusting for capital expenditures and dividends paid.

Consider the following example. Suppose that MPC produced and sold 10,000 personal computers this year. It reported $100,000 net cash provided by operating activities. In order to maintain production at 10,000 computers, MPC invested $15,000 in equipment. It chose to pay $5,000 in dividends. Its free cash flow was $80,000 ($100,000 − $15,000 − $5,000). The company could use this $80,000 to purchase new assets to expand the business, pay off debts, or increase its dividend distribution. In practice, analysts often calculate free cash flow with the formula shown in Illustration 2-16. (Alternative definitions also exist.)

DECISION TOOLS

Free cash flow helps users determine the amount of cash a company generated to expand operations, pay off debts, or increase dividends.

ILLUSTRATION 2-16
Free cash flow

Free Cash Flow = Net Cash Provided by Operating Activities − Capital Expenditures − Cash Dividends

We can calculate Best Buy's 2014 free cash flow as shown in Illustration 2-17 (dollars in millions).

ILLUSTRATION 2-17
Best Buy's free cash flow

Net cash provided by operating activities	$1,094
Less: Expenditures on property, plant, and equipment	547
Dividends paid	233
Free cash flow	$ 314

Best Buy generated free cash flow of $314 million, which is available for the acquisition of new assets, the retirement of stock or debt, or the payment of additional dividends. Long-term creditors consider a high free cash flow amount an indication of solvency. hhgregg's free cash flow for 2014 is $60 million. Given that hhgregg is considerably smaller than Best Buy, we would expect its free cash flow to be much lower.

DO IT! 2 Ratio Analysis

The following information is available for Ozone Inc.

	2017	2016
Current assets	$ 88,000	$ 60,800
Total assets	400,000	341,000
Current liabilities	40,000	38,000
Total liabilities	120,000	150,000
Net income	100,000	50,000
Net cash provided by operating activities	110,000	70,000
Preferred dividends	10,000	10,000
Common dividends	5,000	2,500
Expenditures on property, plant, and equipment	45,000	20,000
Shares outstanding at beginning of year	60,000	40,000
Shares outstanding at end of year	120,000	60,000

(a) Compute earnings per share for 2017 and 2016 for Ozone, and comment on the change. Ozone's primary competitor, Frost Corporation, had earnings per share of $2 in 2017. Comment on the difference in the ratios of the two companies.

(b) Compute the current ratio and debt to assets ratio for each year, and comment on the changes.

(c) Compute free cash flow for each year, and comment on the changes.

Action Plan

✔ Use the formula for earnings per share (EPS): (Net income − Preferred dividends) ÷ Weighted-average common shares outstanding.

✔ Use the formula for the current ratio: Current assets ÷ Current liabilities.

✔ Use the formula for the debt to assets ratio: Total liabilities ÷ Total assets.

✔ Use the formula for free cash flow: Net cash provided by operating activities − Capital expenditures − Cash dividends.

SOLUTION

(a) Earnings per share

2017	**2016**
$\dfrac{(\$100{,}000 - \$10{,}000)}{(120{,}000 + 60{,}000)/2} = \$1.00$	$\dfrac{(\$50{,}000 - \$10{,}000)}{(60{,}000 + 40{,}000)/2} = \$0.80$

Ozone's profitability, as measured by the amount of income available to each share of common stock, increased by 25% [($1.00 − $0.80) ÷ $0.80] during 2017. Earnings per share should not be compared across companies because the number of shares issued by companies varies widely. Thus, we cannot conclude that Frost Corporation is more profitable than Ozone based on its higher EPS.

(b)

	2017	**2016**
Current ratio	$\dfrac{\$88{,}000}{\$40{,}000} = 2.20{:}1$	$\dfrac{\$60{,}800}{\$38{,}000} = 1.60{:}1$
Debt to assets ratio	$\dfrac{\$120{,}000}{\$400{,}000} = 30\%$	$\dfrac{\$150{,}000}{\$341{,}000} = 44\%$

The company's liquidity, as measured by the current ratio, improved from 1.60:1 to 2.20:1. Its solvency also improved, as measured by the debt to assets ratio, which declined from 44% to 30%.

(c) Free cash flow

2017: $110,000 − $45,000 − ($10,000 + $5,000) = $50,000
2016: $70,000 − $20,000 − ($10,000 + $2,500) = $37,500

The amount of cash generated by the company above its needs for dividends and capital expenditures increased from $37,500 to $50,000.

Related exercise material: **BE2-3, BE2-4, BE2-5, DO IT! 2-2, E2-7, E2-9, E2-10,** and **E2-11.**

LEARNING OBJECTIVE 3

Discuss financial reporting concepts.

You have now learned about the four financial statements and some basic ways to interpret those statements. In this last section, we will discuss concepts that underlie these financial statements. It would be unwise to make business decisions based on financial statements without understanding the implications of these concepts.

THE STANDARD-SETTING ENVIRONMENT

How does Best Buy decide on the type of financial information to disclose? What format should it use? How should it measure assets, liabilities, revenues, and expenses? Accounting professionals at Best Buy and all other U.S. companies get guidance from a set of accounting standards that have authoritative support, referred to as **generally accepted accounting principles (GAAP)**. Standard-setting bodies, in consultation with the accounting profession and the business community, determine these accounting standards.

The **Securities and Exchange Commission (SEC)** is the agency of the U.S. government that oversees U.S. financial markets and accounting standard-setting bodies. The **Financial Accounting Standards Board (FASB)** is the primary accounting standard-setting body in the United States. The **International Accounting Standards Board (IASB)** issues standards called **International Financial Reporting Standards (IFRS)**, which have been adopted by many countries outside of the United States. Today, the FASB and IASB are working closely together to minimize the differences in their standards. Recently, the SEC announced that foreign companies that wish to have their shares traded on U.S stock exchanges no longer have to prepare reports that conform with GAAP, as long as their reports conform with IFRS. The SEC is currently evaluating whether the United States should eventually adopt IFRS as the required set of standards for U.S. publicly traded companies. Another relatively recent change to the financial reporting environment was that, as a result of the Sarbanes-Oxley Act, the **Public Company Accounting Oversight Board (PCAOB)** was created. Its job is to determine auditing standards and review the performance of auditing firms. If the United States adopts IFRS for its accounting standards, it will also have to coordinate its auditing regulations with those of other countries.

INTERNATIONAL NOTE

Over 115 countries use international standards (called IFRS). For example, all companies in the European Union follow IFRS. In this textbook, we highlight any significant differences using International Notes like this one, as well as a more in-depth discussion in the *A Look at IFRS* section at the end of each chapter.

INTERNATIONAL INSIGHT

SeongJoon Cho/Bloomberg/Getty Images, Inc.

The Korean Discount

If you think that accounting standards don't matter, consider recent events in South Korea. For many years, international investors complained that the financial reports of South Korean companies were inadequate and inaccurate. Accounting practices there often resulted in huge differences between stated revenues and actual revenues. Because investors did not have faith in the accuracy of the numbers, they were unwilling to pay as much for the shares of these companies relative to shares of comparable companies in different countries. This difference in share price was often referred to as the "Korean discount."

In response, Korean regulators decided that companies would have to comply with international accounting standards. This change was motivated by a desire to "make the country's businesses more transparent" in order to build investor confidence and spur economic growth. Many other Asian countries, including China, India, Japan, and Hong Kong, have also decided either to adopt international standards or to create standards that are based on the international standards.

Source: Evan Ramstad, "End to 'Korea Discount'?" *Wall Street Journal* (March 16, 2007).

What is meant by the phrase "make the country's businesses more transparent"? Why would increasing transparency spur economic growth? (Go to WileyPLUS for this answer and additional questions.)

QUALITIES OF USEFUL INFORMATION

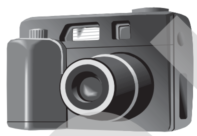
Recently, the FASB and IASB completed the first phase of a joint project in which they developed a conceptual framework to serve as the basis for future accounting standards. The framework begins by stating that the primary objective of financial reporting is to provide financial information that is **useful** to investors and creditors for making decisions about providing capital. According to the FASB, useful information should possess two fundamental qualities, relevance and faithful representation, as shown in Illustration 2-18 (page 60).

Enhancing Qualities

In addition to the two fundamental qualities, the FASB and IASB also describe a number of enhancing qualities of useful information. These include **comparability**, **verifiability**, **timeliness**, and **understandability**. In accounting,

ILLUSTRATION 2-18
Fundamental qualities of useful information

Relevance Accounting information has **relevance** if it would make a difference in a business decision. Information is considered relevant if it provides information that has **predictive value**, that is, helps provide accurate expectations about the future, and has **confirmatory value**, that is, confirms or corrects prior expectations. **Materiality** is a company-specific aspect of relevance. An item is material when its **size** makes it likely to influence the decision of an investor or creditor.



Faithful Representation **Faithful representation** means that information accurately depicts what really happened. To provide a faithful representation, information must be **complete** (nothing important has been omitted), **neutral** (is not biased toward one position or another), and **free from error**.

comparability results when different companies use the same accounting principles. Another type of comparability is consistency. **Consistency** means that a company uses the same accounting principles and methods from year to year. Information is **verifiable** if independent observers, using the same methods, obtain similar results. As noted in Chapter 1, certified public accountants (CPAs) perform audits of financial statements to verify their accuracy. For accounting information to have relevance, it must be **timely**. That is, it must be available to decision-makers before it loses its capacity to influence decisions. The SEC requires that large public companies provide their annual reports to investors within 60 days of their year-end. Information has the quality of **understandability** if it is presented in a clear and concise fashion, so that reasonably informed users of that information can interpret it and comprehend its meaning.

ACCOUNTING ACROSS THE ORGANIZATION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What Do These Companies Have in Common?

Another issue related to comparability is the accounting time period. An accounting period that is one-year long is called a **fiscal year**. But a fiscal year need not match the calendar year. For example, a company could end its fiscal year on April 30 rather than on December 31.

Why do companies choose the particular year-ends that they do? For example, why doesn't every company use December 31 as its accounting year-end? Many companies choose to end their accounting year when inventory or operations are at a low point. This is advantageous because compiling accounting information requires much time and effort by managers, so they would rather do it when they aren't as busy operating the business. Also, inventory is easier and less costly to count when its volume is low.

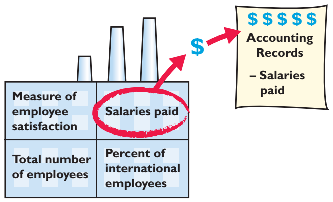
Some companies whose year-ends differ from December 31 are Delta Air Lines, June 30; The Walt Disney Company, September 30; and Dunkin' Donuts, Inc., October 31. In the notes to its financial statements, Best Buy states that its accounting year-end is the Saturday nearest the end of January.

What problems might Best Buy's year-end create for analysts? (Go to WileyPLUS for this answer and additional questions.)

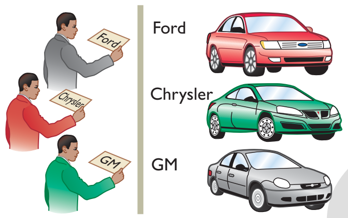
ASSUMPTIONS IN FINANCIAL REPORTING

To develop accounting standards, the FASB relies on some key assumptions, as shown in Illustration 2-19. These include assumptions about the monetary unit, economic entity, periodicity, and going concern.

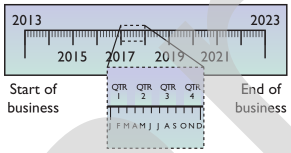
ILLUSTRATION 2-19
Key assumptions in financial reporting



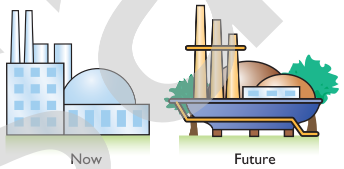
Monetary Unit Assumption The **monetary unit assumption** requires that only those things that can be expressed in money are included in the accounting records. This means that certain important information needed by investors, creditors, and managers, such as customer satisfaction, is not reported in the financial statements. This assumption relies on the monetary unit remaining relatively stable in value.



Economic Entity Assumption The **economic entity assumption** states that every economic entity can be separately identified and accounted for. In order to assess a company's performance and financial position accurately, it is important to not blur company transactions with personal transactions (especially those of its managers) or transactions of other companies.



Periodicity Assumption Notice that the income statement, retained earnings statement, and statement of cash flows all cover periods of one year, and the balance sheet is prepared at the end of each year. The **periodicity assumption** states that the life of a business can be divided into artificial time periods and that useful reports covering those periods can be prepared for the business.



Going Concern Assumption The **going concern assumption** states that the business will remain in operation for the foreseeable future. Of course, many businesses do fail, but in general it is reasonable to assume that the business will continue operating.

ETHICS NOTE

The importance of the economic entity assumption is illustrated by scandals involving Adelphia. In this case, senior company employees entered into transactions that blurred the line between the employees' financial interests and those of the company. For example, Adelphia guaranteed over $2 billion of loans to the founding family.

PRINCIPLES IN FINANCIAL REPORTING

Measurement Principles

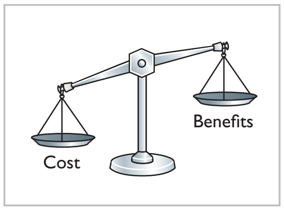
GAAP generally uses one of two measurement principles, the historical cost principle or the fair value principle. Selection of which principle to follow generally relates to trade-offs between relevance and faithful representation.

HISTORICAL COST PRINCIPLE The **historical cost principle** (or cost principle) dictates that companies record assets at their cost. This is true not only at the time the asset is purchased but also over the time the asset is held. For example, if land that was purchased for $30,000 increases in value to $40,000, it continues to be reported at $30,000.

FAIR VALUE PRINCIPLE The **fair value principle** indicates that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability). Fair value information may be more useful than historical cost for certain types of assets and liabilities. For example, certain investment securities are reported at fair value because market price information is often readily available for these types of assets. In choosing between cost and fair value, the FASB uses two qualities that make accounting information useful for decision-making—relevance and faithful representation. In determining which measurement principle to use, the FASB weighs the factual nature of cost figures versus the relevance of fair value. In general, the FASB indicates that most assets must follow the historical cost principle because market values may not be representationally faithful. Only in situations where assets are actively traded, such as investment securities, is the fair value principle applied.

Full Disclosure Principle

The **full disclosure principle** requires that companies disclose all circumstances and events that would make a difference to financial statement users. If an important item cannot reasonably be reported directly in one of the four types of financial statements, then it should be discussed in notes that accompany the statements.



COST CONSTRAINT

Providing information is costly. In deciding whether companies should be required to provide a certain type of information, accounting standard-setters consider the **cost constraint**. It weighs the cost that companies will incur to provide the information against the benefit that financial statement users will gain from having the information available.

DO IT! ▶3 Financial Accounting Concepts and Principles

The following items guide the FASB when it creates accounting standards.

Relevance	Periodicity assumption
Faithful representation	Going concern assumption
Comparability	Historical cost principle
Consistency	Full disclosure principle
Monetary unit assumption	Materiality
Economic entity assumption	

Match each item above with a description below.

1. ________ Ability to easily evaluate one company's results relative to another's.
2. ________ Belief that a company will continue to operate for the foreseeable future.
3. ________ The judgment concerning whether an item is large enough to matter to decision-makers.
4. ________ The reporting of all information that would make a difference to financial statement users.
5. ________ The practice of preparing financial statements at regular intervals.
6. ________ The quality of information that indicates the information makes a difference in a decision.
7. ________ A belief that items should be reported on the balance sheet at the price that was paid to acquire the item.
8. ________ A company's use of the same accounting principles and methods from year to year.
9. ________ Tracing accounting events to particular companies.
10. ________ The desire to minimize errors and bias in financial statements.
11. ________ Reporting only those things that can be measured in dollars.

Action Plan

✔ Understand the need for conceptual guidelines in accounting.
✔ List the characteristics of useful financial information.
✔ Review the assumptions, principles, and constraint that comprise the guidelines in accounting.

SOLUTION

1. Comparability
2. Going concern assumption
3. Materiality
4. Full disclosure principle
5. Periodicity assumption
6. Relevance
7. Historical cost principle
8. Consistency
9. Economic entity assumption
10. Faithful representation
11. Monetary unit assumption

Related exercise material: **BE2-8, BE2-9, BE2-10,** DO IT! **2-3, E2-12,** and **E2-13.**

USING DECISION TOOLS—TWEETER HOME ENTERTAINMENT

In this chapter, we evaluated a home electronics giant, Best Buy. Tweeter Home Entertainment sold consumer electronics products from 154 stores on the East Coast under various names. It specialized in products with high-end features. Tweeter filed for bankruptcy in June 2007 and was acquired by another company in July 2007. Financial data for Tweeter, prior to its bankruptcy, are provided below.

	September 30	
(amounts in millions)	**2006**	**2005**
Current assets	$146.4	$158.2
Total assets	258.6	284.0
Current liabilities	107.1	119.0
Total liabilities	190.4	201.1
Total common stockholders' equity	68.2	82.9
Net income (loss)	(16.5)	(74.4)
Net cash provided (used) by operating activities	15.6	(26.7)
Capital expenditures (net)	17.4	22.2
Dividends paid	0	0
Weighted-average shares of common stock (millions)	25.2	24.6

INSTRUCTIONS

Using the data provided, answer the following questions and discuss how these results might have provided an indication of Tweeter's financial troubles.

1. Calculate the current ratio for Tweeter for 2006 and 2005 and discuss its liquidity position.
2. Calculate the debt to assets ratio and free cash flow for Tweeter for 2006 and 2005 and discuss its solvency.
3. Calculate the earnings per share for Tweeter for 2006 and 2005, and discuss its change in profitability.
4. Best Buy's accounting year-end was February 28, 2006; Tweeter's was September 30, 2006. How does this difference affect your ability to compare their profitability?

SOLUTION

1. Current ratio:

   2006: \$146.4 ÷ \$107.1 = 1.37:1   *2005:* \$158.2 ÷ \$119.0 = 1.33:1

   Tweeter's liquidity improved slightly from 2005 to 2006, but in both years it would most likely have been considered inadequate. In 2006, Tweeter had only $1.37 in current assets for every dollar of current liabilities. Sometimes larger companies, such as Best Buy, can function with lower current ratios because they have alternative sources of working capital. But a company of Tweeter's size would normally want a higher ratio.

2. Debt to assets ratio:

   2006: \$190.4 ÷ \$258.6 = 73.6%   *2005:* \$201.1 ÷ \$284.0 = 70.8%

   Tweeter's solvency, as measured by its debt to assets ratio, declined from 2005 to 2006. Its ratio of 73.6% meant that every dollar of assets was financed by 73.6 cents of debt. For a retailer, this is extremely high reliance on debt. This low solvency suggests Tweeter's ability to meet its debt payments was questionable.

   Free cash flow:

   2006: \$15.6 − \$17.4 − \$0 = −\$1.8 million

   2005: −\$26.7 − \$22.2 − \$0 = −\$48.9 million

   Tweeter's free cash flow was negative in both years. The company did not generate enough net cash provided by operating activities even to cover its capital expenditures, and it was not paying a dividend. While this is not unusual for new companies in their early years, it is also not sustainable for very long. Part of the reason that its debt to assets ratio, discussed above, was so high was that it had to borrow money to make up for its deficient free cash flow.

3. Loss per share:

   2006: −\$16.5 ÷ 25.2 = −\$0.65 per share

   2005: −\$74.4 ÷ 24.6 = −\$3.02 per share

   Tweeter's loss per share declined substantially. However, this was little consolation for its shareholders, who experienced losses in previous years as well. The company's lack of profitability, combined with its poor liquidity and solvency, increased the likelihood that it would eventually file for bankruptcy.

4. Tweeter's income statement covers 7 months not covered by Best Buy's. Suppose that the economy changed dramatically during this 7-month period, either improving or declining. This change in the economy would be reflected in Tweeter's income statement but would not be reflected in Best Buy's income statement until the following March, thus reducing the usefulness of a comparison of the income statements of the two companies.

REVIEW AND PRACTICE

LEARNING OBJECTIVES REVIEW

1 Identify the sections of a classified balance sheet. In a classified balance sheet, companies classify assets as current assets; long-term investments; property, plant, and equipment; and intangibles. They classify liabilities as either current or long-term. A stockholders' equity section shows common stock and retained earnings.

2 Use ratios to evaluate a company's profitability, liquidity, and solvency. Ratio analysis expresses the relationship among selected items of financial statement data. Profitability ratios, such as earnings per share (EPS), measure aspects of the operating success of a company for a given period of time.

Liquidity ratios, such as the current ratio, measure the short-term ability of a company to pay its maturing obligations and to meet unexpected needs for cash. Solvency ratios, such as the debt to assets ratio, measure the ability of a company to survive over a long period. Free cash flow indicates a company's ability to generate net cash provided by operating activities that is sufficient to pay debts, acquire assets, and distribute dividends.

3 Discuss financial reporting concepts. Generally accepted accounting principles are a set of rules and practices recognized as a general guide for financial reporting purposes. The basic objective of financial reporting is to provide information that is useful for decision-making.

To be judged useful, information should have the primary characteristics of relevance and faithful representation. In addition, useful information is comparable, consistent, verifiable, timely, and understandable.

The **monetary unit assumption** requires that companies include in the accounting records only transaction data that can be expressed in terms of money. The **economic entity assumption** states that economic events can be identified with a particular unit of accountability. The **periodicity assumption** states that the economic life of a business can be divided into artificial time periods and that meaningful accounting reports can be prepared for each period. The **going concern assumption** states that the company will continue in operation long enough to carry out its existing objectives and commitments.

The **historical cost principle** states that companies should record assets at their cost. The **fair value principle** indicates that assets and liabilities should be reported at fair value. The **full disclosure principle** requires that companies disclose circumstances and events that matter to financial statement users.

The **cost constraint** weighs the cost that companies incur to provide a type of information against its benefit to financial statement users.

DECISION TOOLS REVIEW

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
How does the company's earnings performance compare with that of previous years?	Net income available to common stockholders and weighted-average common shares outstanding	$\text{Earnings per share} = \dfrac{\text{Net income} - \text{Preferred dividends}}{\text{Weighted-average common shares outstanding}}$	A higher measure suggests improved performance, although the number is subject to manipulation. Values should not be compared across companies.
Can the company meet its near-term obligations?	Current assets and current liabilities	$\text{Current ratio} = \dfrac{\text{Current assets}}{\text{Current liabilities}}$	Higher ratio suggests favorable liquidity.
Can the company meet its long-term obligations?	Total liabilities and total assets	$\text{Debt to assets ratio} = \dfrac{\text{Total liabilities}}{\text{Total assets}}$	Lower value suggests favorable solvency.
How much cash did the company generate to expand operations, pay off debts, or distribute dividends?	Net cash provided by operating activities, cash spent on fixed assets, and cash dividends	$\text{Free cash flow} = \text{Net cash provided by operating activities} - \text{Capital expenditures} - \text{Cash dividends}$	Significant free cash flow indicates greater potential to finance new investments and pay additional dividends.

GLOSSARY REVIEW

Classified balance sheet A balance sheet that groups together similar assets and similar liabilities, using a number of standard classifications and sections. (p. 46).

Comparability Ability to compare the accounting information of different companies because they use the same accounting principles. (p. 60).

Consistency Use of the same accounting principles and methods from year to year within a company. (p. 60).

Cost constraint Constraint that weighs the cost that companies will incur to provide the information against the benefit that financial statement users will gain from having the information available. (p. 62).

Current assets Assets that companies expect to convert to cash or use up within one year or the operating cycle, whichever is longer. (p. 46).

Current liabilities Obligations that a company expects to pay within the next year or operating cycle, whichever is longer. (p. 50).

Current ratio A measure of liquidity computed as current assets divided by current liabilities. (p. 54).

Debt to assets ratio A measure of solvency calculated as total liabilities divided by total assets. It measures the percentage of total financing provided by creditors. (p. 56).

Earnings per share (EPS) A measure of the net income earned on each share of common stock; computed as net income minus preferred dividends divided by the weighted-average number of common shares outstanding during the year. (p. 53).

Economic entity assumption An assumption that every economic entity can be separately identified and accounted for. (p. 61).

Fair value principle Assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability). (p. 61).

Faithful representation Information that is complete, neutral, and free from error. (p. 60).

Financial Accounting Standards Board (FASB) The primary accounting standard-setting body in the United States. (p. 59).

Free cash flow Net cash provided by operating activities after adjusting for capital expenditures and cash dividends paid. (p. 57).

Full disclosure principle Accounting principle that dictates that companies disclose circumstances and events that make a difference to financial statement users. (p. 62).

Generally accepted accounting principles (GAAP) A set of accounting standards that have substantial authoritative support and which guide accounting professionals. (p. 58).

Going concern assumption The assumption that the company will continue in operation for the foreseeable future. (p. 61).

Historical cost principle An accounting principle that states that companies should record assets at their cost. (p. 61).

Intangible assets Assets that do not have physical substance. (p. 48).

International Accounting Standards Board (IASB) An accounting standard-setting body that issues standards adopted by many countries outside of the United States. (p. 59).

International Financial Reporting Standards (IFRS) Accounting standards, issued by the IASB, that have been adopted by many countries outside of the United States. (p. 59).

Liquidity The ability of a company to pay obligations that are expected to become due within the next year or operating cycle. (p. 53).

Liquidity ratios Measures of the short-term ability of the company to pay its maturing obligations and to meet unexpected needs for cash. (p. 54).

Long-term investments Generally, (1) investments in stocks and bonds of other corporations that companies hold for more than one year; (2) long-term assets, such as land and buildings, not currently being used in the company's operations; and (3) long-term notes receivable. (p. 48).

Long-term liabilities (long-term debt) Obligations that a company expects to pay after one year. (p. 50).

Materiality Whether an item is large enough to likely influence the decision of an investor or creditor. (p. 60).

Monetary unit assumption An assumption that requires that only those things that can be expressed in money are included in the accounting records. (p. 61).

Operating cycle The average time required to purchase inventory, sell it on account, and then collect cash from customers—that is, go from cash to cash. (p. 46).

Periodicity assumption An assumption that the life of a business can be divided into artificial time periods and that useful reports covering those periods can be prepared for the business. (p. 61).

Profitability ratios Measures of the operating success of a company for a given period of time. (p. 53).

Property, plant, and equipment Assets with relatively long useful lives that are currently used in operating the business. (p. 48).

Public Company Accounting Oversight Board (PCAOB) The group charged with determining auditing standards and reviewing the performance of auditing firms. (p. 59).

Ratio An expression of the mathematical relationship between one quantity and another. (p. 51).

Ratio analysis A technique that expresses the relationship among selected items of financial statement data. (p. 51).

Relevance The quality of information that indicates the information makes a difference in a decision. (p. 60).

Securities and Exchange Commission (SEC) The agency of the U.S. government that oversees U.S. financial markets and accounting standard-setting bodies. (p. 59).

Solvency The ability of a company to pay interest as it comes due and to repay the balance of debt due at its maturity. (p. 55).

Solvency ratios Measures of the ability of the company to survive over a long period of time. (p. 56).

Timely Information that is available to decision-makers before it loses its capacity to influence decisions. (p. 60).

Understandability Information presented in a clear and concise fashion so that users can interpret it and comprehend its meaning. (p. 60).

Verifiable The quality of information that occurs when independent observers, using the same methods, obtain similar results. (p. 60).

Working capital The difference between the amounts of current assets and current liabilities. (p. 54).

PRACTICE MULTIPLE-CHOICE QUESTIONS

(LO 1) **1.** In a classified balance sheet, assets are usually classified as:
(a) current assets; long-term assets; property, plant, and equipment; and intangible assets.
(b) current assets; long-term investments; property, plant, and equipment; and common stock.
(c) current assets; long-term investments; tangible assets; and intangible assets.
(d) current assets; long-term investments; property, plant, and equipment; and intangible assets.

(LO 1) **2.** Current assets are listed:
(a) by order of expected conversion to cash.
(b) by importance.
(c) by longevity.
(d) alphabetically.

(LO 1) **3.** The correct order of presentation in a classified balance sheet for the following current assets is:
(a) accounts receivable, cash, prepaid insurance, inventory.
(b) cash, inventory, accounts receivable, prepaid insurance.
(c) cash, accounts receivable, inventory, prepaid insurance.
(d) inventory, cash, accounts receivable, prepaid insurance.

(LO 1) **4.** A company has purchased a tract of land. It expects to build a production plant on the land in approximately 5 years. During the 5 years before construction, the land will be idle. The land should be reported as:
(a) property, plant, and equipment.
(b) land expense.
(c) a long-term investment.
(d) an intangible asset.

(LO 1) **5.** The balance in retained earnings is **not** affected by:
(a) net income.
(b) net loss.
(c) issuance of common stock.
(d) dividends.

(LO 2) **6.** Which is an indicator of profitability?
(a) Current ratio.
(b) Earnings per share.
(c) Debt to assets ratio.
(d) Free cash flow.

(LO 2) **7.** For 2017, Spanos Corporation reported net income $26,000, net sales $400,000, and weighted-average shares outstanding 4,000. There were preferred dividends of $2,000. What was the 2017 earnings per share?
(a) $6.00. (c) $99.50.
(b) $6.50. (d) $100.00.

(LO 2) **8.** Which of these measures is an evaluation of a company's ability to pay current liabilities?
(a) Earnings per share.
(b) Current ratio.
(c) Both (a) and (b).
(d) None of the above.

9. The following ratios are available for Reilly Inc. and O'Hare Inc. (LO 2)

	Current Ratio	Debt to Assets Ratio	Earnings per Share
Reilly Inc.	2:1	75%	$3.50
O'Hare Inc.	1.5:1	40%	$2.75

Compared to O'Hare Inc., Reilly Inc. has:
(a) higher liquidity, higher solvency, and higher profitability.
(b) lower liquidity, higher solvency, and higher profitability.
(c) higher liquidity, lower solvency, and higher profitability.
(d) higher liquidity and lower solvency, but profitability cannot be compared based on information provided.

10. Companies can use free cash flow to: (LO 2)
(a) pay additional dividends.
(b) acquire more property, plant, and equipment.
(c) pay off debts.
(d) All of the above.

11. Generally accepted accounting principles are: (LO 3)
(a) a set of standards and rules that are recognized as a general guide for financial reporting.
(b) usually established by the Internal Revenue Service.
(c) the guidelines used to resolve ethical dilemmas.
(d) fundamental truths that can be derived from the laws of nature.

12. What organization issues U.S. accounting standards? (LO 3)
(a) Financial Accounting Standards Board.
(b) International Accounting Standards Committee.
(c) International Auditing Standards Committee.
(d) None of the above.

13. What is the primary criterion by which accounting information can be judged? (LO 3)
(a) Consistency.
(b) Predictive value.
(c) Usefulness for decision-making.
(d) Comparability.

14. Neutrality is an ingredient of: (LO 3)

	Faithful Representation	Relevance
(a)	Yes	Yes
(b)	No	No
(c)	Yes	No
(d)	No	Yes

15. The characteristic of information that evaluates whether it is large enough to impact a decision. (LO 3)
(a) Comparability. (c) Cost.
(b) Materiality. (d) Consistency.

SOLUTIONS

1. **(d)** Assets are classified as current assets; long-term investments; property, plant and equipment; and intangible assets. The other choices are incorrect because (a) long-term assets includes long-term investments; property, plant, and equipment; and intangible assets; (b) common stock refers to the equity of the firm and is not an asset; and