FUNDAMENTALS OF

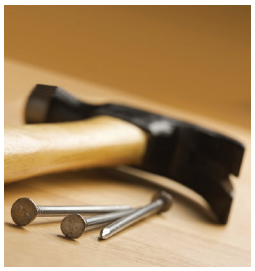
Financial Accounting

SIXTH EDITION

PHILLIPS LIBBY LIBBY

McGraw Hill Education

Fundamentals of FINANCIAL ACCOUNTING


Sixth Edition

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FUNDAMENTALS OF FINANCIAL ACCOUNTING, SIXTH EDITION

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Dedicated to

Barb, Harrison, and Daniel, my Mom, and (memory of) my Dad.

FRED PHILLIPS

Herman and Doris Hargenrater, Laura Libby, Oscar and Selma Libby

PATRICIA AND ROBERT LIBBY

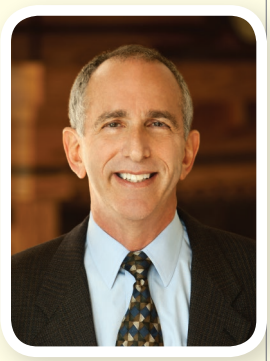
Meet the Authors

Courtesy of Fred Phillips

Fred Phillips

Fred Phillips is a professor at the University of Saskatchewan, where he teaches introductory financial accounting. He also has taught introductory accounting at the University of Texas at Austin and the University of Manitoba. Fred has an undergraduate accounting degree, a CPA, CA (Canada), and a PhD from the University of Texas at Austin. He previously worked as an audit manager at KPMG.

Fred's main career interest is accounting education. He has been recognized with more than 26 awards, as chosen by his students and peers. In 2006, Fred was awarded the title Master Teacher at the University of Saskatchewan. In 2011, he was admitted to the 3M National Teaching Fellowship, the highest honor for undergraduate teaching in Canada. In 2012, Fred received the L. S. Rosen Outstanding Educator Award, the American Accounting Association's Innovation in Auditing and Assurance Education Award, and the American Accounting Association's Award for Outstanding Research in Accounting Education. Most recently, he received the Edwards MPAcc Teaching Effectiveness Award and, for the third time in his career, the University of Saskatchewan Student Union's Teaching Excellence Award. His peer-reviewed publications include education-focused research and instructional cases in *Issues in Accounting Education,* as well as professional judgment studies in *Journal of Accounting Research* and *Organizational Behavior and Human Decision Processes,* among others. Fred is a current member of the Teaching, Curriculum, & Learning and Two-Year College sections of the American Accounting Association. In his spare time, he likes to play tennis, drink iced cappuccinos, and relax with his family.



Courtesy of Robert Libby

Robert Libby

Robert Libby is the David A. Thomas Professor of Accounting and Accounting Area Coordinator at Cornell University, where he teaches the introductory financial accounting course. He previously taught at the University of Illinois, Pennsylvania State University, the University of Texas at Austin, the University of Chicago, and the University of Michigan. He received his BS from Pennsylvania State University and his MAS and PhD from the University of Illinois; he also successfully completed the CPA exam (Illinois).

Bob was selected as the AAA Outstanding Educator in 2000 and received the AAA Outstanding Service Award in 2006 and the AAA Notable Contributions to the Literature Award in 1985 and 1996. He has received the Core Faculty Teaching Award multiple times at Cornell. Bob is a widely published author and researcher specializing in behavioral accounting. He has

published numerous articles in *The Accounting Review; Journal of Accounting Research; Accounting, Organizations, and Society;* and other accounting journals. He has held a variety of offices, including vice president, in the American Accounting Association, and he is a member of the American Institute of CPAs and the editorial boards of *The Accounting Review* and *Accounting, Organizations, and Society.*

Patricia A. Libby

Patricia Libby is associate professor of accounting at Ithaca College, where she teaches the undergraduate financial accounting course. She previously taught graduate and undergraduate financial accounting at Eastern Michigan University and the University of Texas. Before entering academe, she was an auditor with Price Waterhouse (now PricewaterhouseCoopers) and a financial administrator at the University of Chicago. She is also faculty advisor to Beta Alpha Psi and Ithaca College Accounting Association. She received her BS from Pennsylvania State University, her MBA from DePaul University, and her PhD from the University of Michigan; she also successfully completed the CPA exam (Illinois).

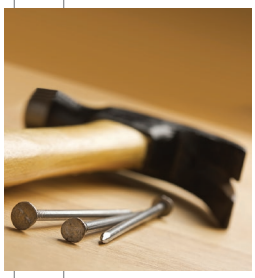
Courtesy of Patricia A. Libby

Pat conducts research on using cases in the introductory course and other parts of the accounting curriculum. She has published articles in *The Accounting Review, Issues in Accounting Education,* and *The Michigan CPA*.

Engaging Students with Real-World Context and Business

One of the most widely used introductory accounting textbooks, Phillips/Libby/Libby *Fundamentals of Financial Accounting* focuses on four key attributes.

Engaging Writing. *Fundamentals of Financial Accounting* introduces students to financial accounting using a balanced mix of conversational wording, clear and concise presentations, and everyday examples. Students can feel comfortable as they are introduced to the world of financial accounting. This measured approach allows students to grasp concepts fundamental to financial accounting, without sacrificing rigor or coverage.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Entrepreneurial Focus. Each chapter makes financial accounting engaging by using a real company whose products and services are popular with students. Students learn financial accounting concepts through the use of examples from such companies as **American Eagle** (clothing), **Koss Corporation** (headphones), and **Under Armour** (sportswear). The accounting cycle chapters tap into students' innate curiosity about start-up culture by focusing on an actual startup, **Noodlecake Studios**, providing details and financial accounting lessons through a real-life entrepreneurial story.

> *Practical, applicable to both accounting and non-accounting majors and a very thorough financial accounting textbook.*
>
> —Ronald Premuroso, *University of Montana*
>
> *Students should find the use of companies from their generation, as examples, interesting.*
>
> —Diane Marker, *University of Toledo*

Data-Driven Pedagogy. The authors' approach to introducing the accounting cycle and using visual aids has been tested in peer-reviewed, published research studies. One of these award-winning studies has shown this accounting cycle approach yields learning gains that outpace other approaches by a significant margin. By breaking the accounting cycle down into more cohesive, bite-sized segments, students develop a stronger foundational understanding. This paced introduction to the core concepts of accounting enables improved student success, allowing them to better retain and apply key concepts.

Video Asset Variety. *Fundamentals of Financial Accounting* offers a diverse range of video assets within the Connect platform that can fit nearly any instructor need. From reinforcing key lessons to painting the big picture, videos can be a critical and complementary learning tool for engaging students.

> *Phillips does an excellent job of writing at a level the average student will understand. [The authors] . . . know how to engage the students by using real companies; discussing relevant current events; using colorful, enticing-to-read graphs that are efficient at making a point; and most importantly, they know the frequent misconceptions and typical issues students have.*
>
> —Nancy Lynch, *West Virginia University*

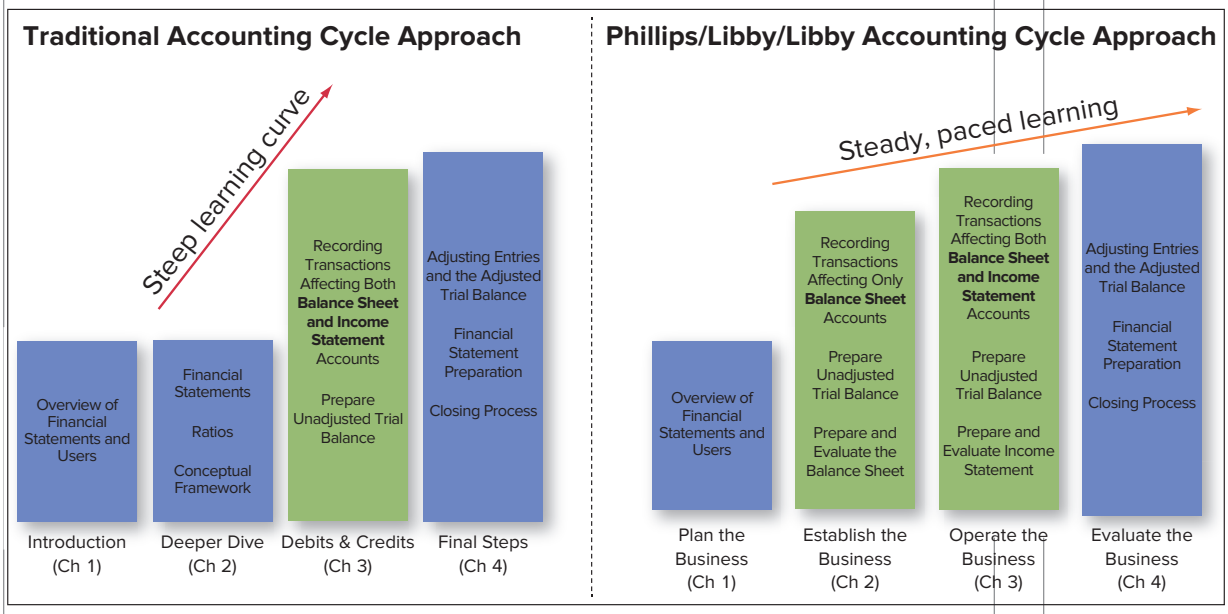
Driving Success with Clear, Effective, and Innovative Ideas

A Proven Teaching and Learning Methodology

Faculty agree that for students studying financial accounting, the accounting cycle is the most critical topic to learn and master. The approach to this topic in Phillips/Libby/Libby is based on the belief that students struggle with the accounting cycle when transaction analysis is covered in one chapter. If students are exposed to the accounting equation, journal entries, and T-accounts for both balance sheet and income statement accounts in a single chapter, many are left behind and are unable to grasp material in the next chapter, which typically covers adjustments and financial statement preparation.

The graphic shows how, unlike other texts, the Phillips/Libby/Libby approach spreads transaction analysis coverage over two chapters so that students have the time to master the material. In Chapter 2, students are exposed to the accounting equation and transaction analysis for transactions that affect only balance sheet accounts. This provides students with the opportunity to learn the basic structure and tools used in accounting in a simpler setting. In Chapter 3, students are exposed to more complex transactions that affect both balance sheet and income statement accounts. As a result of this progressive approach to transaction analysis, students learn more, as documented in peer-reviewed research.* This innovative approach also prepares students to better understand adjustments, financial statement preparation, and more advanced topics.

In addition, the accounting cycle approach used here tells a natural business story—one that would be familiar to any modern entrepreneur. From planning and establishing the business to opening and evaluating the business, the first few chapters clearly break out each key stage in starting a company. The accounting cycle coverage steadily unfolds as students move along this company's journey, allowing them to keep pace and absorb how accounting events unfold in the real world of business.



Phillips/Libby/Libby ***introduces all of the financial statements*** *in the first chapter, then utilizes debits and credits combined with increases and decreases for transactions affecting the balance sheet, and then* *reinforces the methodology* *when presenting the transactions affecting the income statement in Chapter 3. This area is the toughest for students and requires the most practice. Phillips understands this and* ***expertly navigates*** *through the two statements and demonstrates how the two interconnect and depend upon each other, setting the stage for an easier adjustment and closing process ahead.*

—Margaret Costello Lambert, *Oakland Community College*

*F. Phillips and L. Heiser, "A Field Experiment Examining the Effects of Accounting Equation Emphasis and Transaction Scope on Students Learning to Journalize," *Issues in Accounting Education* 26 (2011), pp. 681–699.

Modern Businesses Bring Accounting Concepts to Life

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Not all students learn financial accounting with ease. With so many distractions these days, it is difficult to keep both majors and nonmajors focused on the big picture. The authors of *Fundamentals of Financial Accounting* understand the challenges instructors face and the need for a financial accounting text that is relevant, easy to read, and current.

Fundamentals of Financial Accounting responds by using **carefully chosen focus companies that students recognize and engage with in their everyday lives.** From tech start-ups to some of the world's most familiar trademark brands, each chapter opens with an engaging scenario or story using a familiar company. The same focus company, such as Walmart, Cedar Fair, American Eagle, National Beverage, Under Armour, or General Mills, is used throughout the entire chapter so that students can see how the concepts and calculations apply to a real-world company they are already familiar with.

Today's students have grown up hearing about start-up culture, and many are entrepreneurially minded having seen the rise of Apple, Facebook, and the "gig economy." The authors showcase accounting's relevance by using Noodlecake Studios, a digital start-up, as the company profiled in Chapters 1–4. With this example, students see how a new small business uses accounting, from planning to evaluation of financial performance.

Through crisp, clear, and engaging writing, the financial decisions these companies make and the financial statements they use come alive for students, who are able to see the big picture of how accounting relates to the real world—their world.

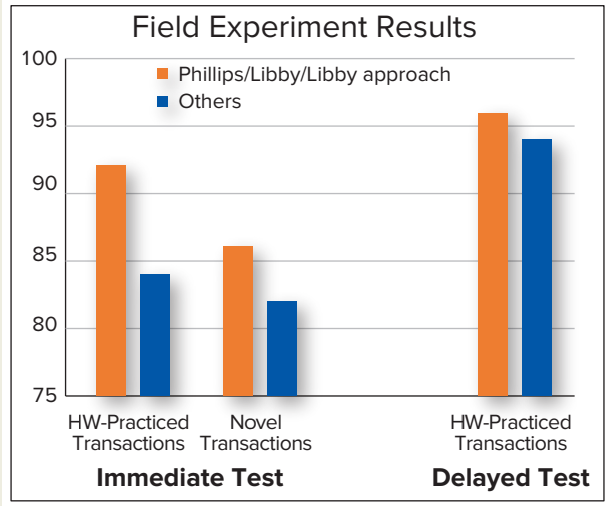
> *Written in **clear, understandable language** . . . The multiple **real-world examples, colorful and "clean" exhibits**, as well as other illustrations **enhance the student's learning process** by making the information relevant and understandable. The **"building block" approach** allows the student to gain a **solid understanding** of the fundamentals of each chapter before moving on to the next.*
>
> —Muriel Anderson, *SUNY–Buffalo*

> *The [Cedar Fair] focus company is fantastic; this keeps the classes on this chapter fast-paced. You could not have picked a better company for demonstration of acquisitions and impairments of PPE. Students love Chapter 9 because of great examples, such as the installation and shipping of a roller coaster and the impairment of a ride due to "vortex shedding." This chapter is simply exciting.*
>
> —Lisa McKinney, *University of Alabama*

Pedagogy Built on Research Data and Analysis

Fundamentals of Financial Accounting uses peer-reviewed research and careful analysis of data to inform decisions on pedagogy and presentation of concepts. For example, the authors' research on various approaches to teaching the accounting cycle informed the step-by-step model used in the text—a model proven to lead to better results in short-term assessment as well as in long-term understanding and application of the material.

In a peer-reviewed study published in *Issues in Accounting Education,* author Fred Phillips and his research partner Lindsay Heiser studied the effects of teaching the accounting cycle by initially restricting the scope of transactions to only those affecting balance sheet accounts, while waiting to introduce transactions involving both balance sheet and income statement accounts until later. The pair hypothesized that further scaffolding concepts would help ensure students didn't get overwhelmed. To test this theory, students were assigned to random groups, with each group learning the accounting cycle via a different approach. All students were evaluated with the same homework assignments and in-class tests.

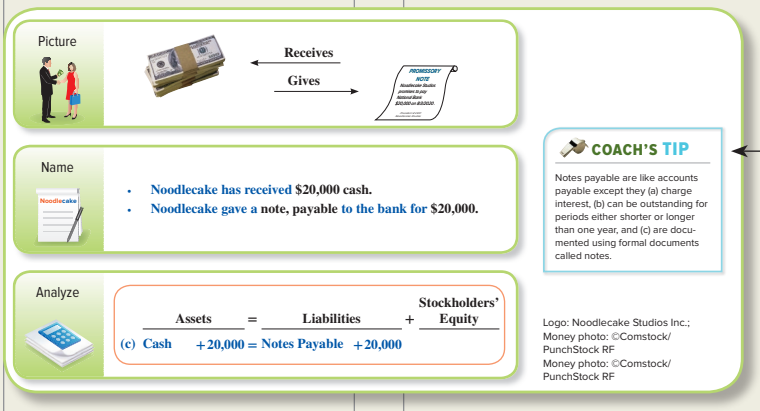


The results showed that students who learned the accounting cycle via the scaffolded approach were better able to prepare journal entries on similar types of transactions both immediately and one week later. Importantly, these same students later performed just as well on complex transactions affecting balance sheet *and* income statement accounts despite having had less practice with them. The scaffolded accounting cycle approach that proved so effective in this study is the same that is used in *Fundamentals of Financial Accounting,* helping students to "work smarter," and better preparing them for success in financial accounting and beyond.

> *"**Clear, concise,** and the **most reader friendly text** I've come across. Most importantly, **it is based on sound learning theory, which greatly enhances the learning experience.**"*
>
> —Professor Audrey Agnello, *Niagara County Community College*

From Concepts to Comprehension—Reinforcement Is Key

Whether you're presenting, discussing, or problem solving, you want materials that will motivate students and hold their interest. Motivating today's students requires materials that connect them with the workplace and encourage them to think about course topics before, during, and after class. *Fundamentals of Financial Accounting* offers students many tools to help reinforce the concepts discussed throughout the text.

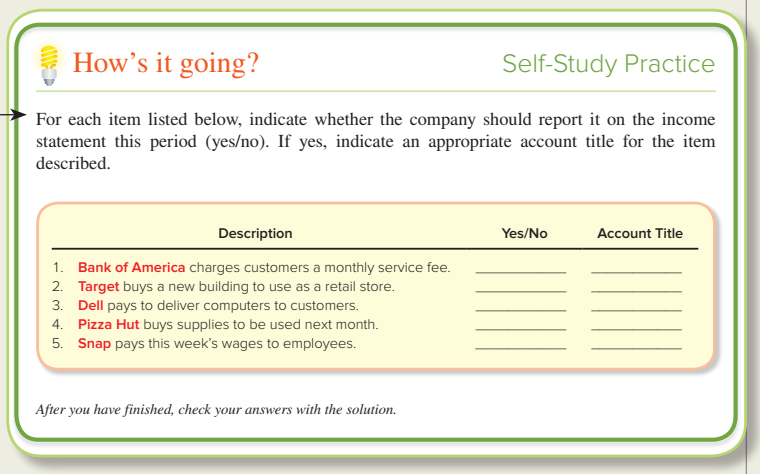


Coach's Tips

Every student needs encouragement and Coach's Tips are just one way *Fundamentals of Financial Accounting* fulfills that need. Coach's Tips appear throughout the text and in selected end-of-chapter problems to offer tips, advice, and suggestions.

How's it going? Self-Study Practice

Research shows that students learn best when they are actively engaged in the learning process. This active learning feature engages the student, provides interactivity, and promotes efficient learning. These quizzes ask students to pause at strategic points throughout each chapter to ensure they understand key points before moving ahead.



How's it going? Self-Study Practice

For each item listed below, indicate whether the company should report it on the income statement this period (yes/no). If yes, indicate an appropriate account title for the item described.

Description	Yes/No	Account Title
1. **Bank of America** charges customers a monthly service fee.		
2. **Target** buys a new building to use as a retail store.		
3. **Dell** pays to deliver computers to customers.		
4. **Pizza Hut** buys supplies to be used next month.		
5. **Snap** pays this week's wages to employees.		

After you have finished, check your answers with the solution.

> *Phillips does an **outstanding job of incorporating real world data into the text,** which increases a student's engagement with the material and enhances their learning. I think that the writing style is very conversational, which makes reading the chapter a manageable task for the students.*
>
> —Anne Clem, *Iowa State University*

SPOTLIGHT ON **The World**

IFRS Does Not Allow LIFO

SPOTLIGHT ON **Financial Reporting**

Revenue Recognition Policy

SPOTLIGHT ON **Controls**

Is That a Control, Too?

SPOTLIGHT ON **Ethics**

35 Days Hath September?

SPOTLIGHT ON **Business Decisions**

The New Bookkeeper Is a Robot

That's the headline of a *Wall Street Journal* article describing how mundane accounting tasks, such as entering data and paying suppliers, are increasingly being performed by com-

SPOTLIGHT ON **Big Data and Analytics**

Applying Inventory Turnover and Gross Profit to LCM/NRV Judgments

Accountants and managers often use **data visualization** techniques to identify key relationships between financial measures. For example, to identify particular inventory items at risk of requiring an LCM/NRV write-down, accounting analysts plot the *days to sell* and *gross profit percentage* by product line on a graph such as the following:

Spotlight Features

Each chapter includes Spotlight features focusing on business decisions, ethics, internal controls, financial reporting, big data and analytics, and the world (IFRS). These features are designed to further engage students and provide instructors with material for in-class discussion.

- **NEW Spotlight on Big Data and Analytics**—highlights topics relating to big data, data visualization, and data and business analytics.
- **Spotlight on the World**—highlights significant differences between U.S. GAAP and IFRS.
- **Spotlight on Financial Reporting**—connects chapter topics with real-world disclosures provided in the financial statements of our focus companies and other contrast companies.
- **Spotlight on Controls**—highlights applications of internal control principles in the workplace.
- **Spotlight on Ethics**—emphasizes ethical issues and the importance of acting responsibly.
- **Spotlight on Business Decisions**—helps students develop strong decision-making skills by illustrating the relevance of accounting in real-world decision making and the lessons learned from the global economic crisis.

Videos: Present, Expand, and Reinforce Key Concepts

Modern businesses expect their employees to be lifelong learners. As a result, businesses and educators increasingly rely on videos as "just-in-time" resources to present, reinforce, and augment critical concepts. Whether the viewer is a student in a classroom or a newly hired CPA at a Big 4 accounting firm, learning on the go via a variety of multimedia-based assets is key in both the corporate world and academic settings. *Fundamentals of Financial Accounting* provides a range of video offerings and formats to facilitate understanding and help students learn wherever and whenever they need to.

Instructional Video	Where to Find it?	Video Description
Concept Overview Videos	Assignable in Connect	**Assignable videos** cover each chapter's learning objectives followed by auto-graded knowledge checks that confirm students' comprehension. A great tool for introducing students to new topics.
Guided Examples	Hints for students in select exercises in Connect	A narrated, animated, step-by-step walkthrough of an exercise similar to the assigned exercise, these videos provide just-in-time help for students when they are working on assignments.
Spotlight Videos	Assignable in Connect or directly in the eBook	Selected **Spotlight on Ethics, Financial Reporting,** and **Business Decisions** features are brought to life in 2- to 5-minute news magazine–style videos, which are available and assignable in McGraw-Hill Education's Connect. These engaging investigative videos, written by author Fred Phillips, tie to specific topics in *Fundamentals of Financial Accounting.* Instructors can assign students to watch the videos and answer questions regarding the content in Connect.
In Action Videos	Select How's it going? Self-Study Practices in the eBook.	These tutorial videos illustrate the thought processes applicable to a sample of topics, including how to analyze transactions, adjust accounts, account for inventory and receivables, and prepare a statement of cash flows.
Flash Topic Videos	Assignable in Connect	Introduce students to hot topics in accounting including revenue recognition, big data, sales returns, stock buybacks, and sustainability. These videos extend the ideas presented in the text and are assignable in Connect.

I thought the coverage on fraud and SOX was very good. ***The information presented was easy to read and understand.***

—Victoria White, *Ivy Tech Community College of Indiana–Evansville*

Practice and Review Materials Build Confidence and Success

To effectively evaluate and guide student success with the appropriate feedback, instructors need homework and test materials that are easy to use and tied to the chapter discussions. Each chapter of *Fundamentals of Financial Accounting* is followed by an extensive variety of end-of-chapter material that applies and integrates topics presented in the chapter.

- **Demonstration Case:** End-of-chapter review material begins with a demonstration case that provides another self-study opportunity for students. The demonstration case is practice material that previews what students will see in the homework problems. The accompanying solution allows students to check their understanding of the material before completing and submitting homework for a grade. It also can serve as a study tool for exams.
- **Chapter Summary:** Each chapter concludes with an end-of-chapter summary organized by learning objectives. This allows students to revisit the learning objectives from the beginning and middle of the chapter.
- **Key Terms:** Key terms include the most important words and phrases, definitions, and page references. Full definitions for all key terms can be found in the glossary.
- **Homework Helper** immediately precedes each chapter's homework materials, highlighting subtleties discussed in the chapter and providing practical advice so students avoid common pitfalls when completing homework assignments.
- **Multiperspective Discussion Questions:** Each chapter includes 10–20 questions that ask students to explain and discuss terms and concepts presented in the chapter. Selected questions, denoted with an icon, are designed to help students begin developing critical thinking skills. These questions are ideal for sparking debate at the beginning of class or when transitioning between or reviewing topics.
- **Multiple-Choice Questions:** Each chapter includes 10 multiple-choice questions that let students practice basic concepts. Solutions for these questions are provided in the back of the text.

> *The end-of-chapter problems and exercises are ample, diverse (in terms of rigor), and congruent with the material covered in the chapter.*
>
> —Brian Nagle, *Duquesne University*

- **Mini-Exercises, Exercises, Problems (Coached, Group A, and Group B):** Each chapter includes a wide variety of assignment material from questions that illustrate and apply a single learning objective to problem sets that help students develop decision-making skills.

  - **Level-up Questions:**

    In each chapter, particularly challenging questions, designated by the level-up icon, require students to combine multiple concepts to advance to the next level of accounting knowledge.

- **Comprehensive Problems:** Selected chapters include problems that cover topics from earlier chapters to refresh, reinforce, and build an integrative understanding of the course material. These are a great resource for helping students stay up-to-date throughout the course.

- **Questions** designated with the **general ledger** icon have been written to take advantage of Connect's general ledger simulation. A much-improved student experience when working with accounting cycle questions, students' work in the general journal is automatically posted to the ledger, navigation is much simpler, and students can easily link back to their original entries simply by clicking in the ledger if edits are needed. These questions include critical thinking components to maximize students' foundational knowledge of accounting concepts and principles.

- **Skills Development Cases:** Each chapter offers cases designed to help students develop analytical, critical thinking, and technology skills. These cases are ideal for individual assignments, class discussions, and group projects.

  - Encourage your students to find financial information in an actual annual report. The first case of every chapter presents, in multiple-choice format, an opportunity to connect your students with real-world financial reporting. These are assignable in Connect.

- **Continuing Case:** In Chapter 1, students are introduced to Nicole's Getaway Spa (NGS). In the following chapters, this continuing case is extended to encompass each new topic.

What's New in the Sixth Edition?

In response to feedback and guidance from numerous financial accounting faculty, the authors have made many important changes in the sixth edition of *Fundamentals of Financial Accounting,* including the following:

- Introduced the **new 5-step revenue model** as it applies to service companies (Chapter 3) and merchandisers (Chapter 6). As part of these changes, all references to Unearned Revenue have been replaced with Deferred Revenue. Additional changes to Chapter 6 are summarized below.
- Integrated **new companies**, including a new focus company (Noodlecake Studios) that won an Apple Design Award and many other companies familiar to students (Alphabet, Apple, Facebook, Fitbit, Samsung, and so on).
- **New Spotlight on Big Data and Analytics** highlights topics relating to big data, data visualization, and data and business analytics.
- Reviewed, updated, and introduced new end-of-chapter material in each chapter to support new topics and learning objectives, including **Connect problems that auto-post** from journal entries to T-accounts to trial balances.
- Fine **line-editing guided by student data from LearnSmart**.

CHAPTER 1: BUSINESS DECISIONS AND FINANCIAL ACCOUNTING

Focus Company: Noodlecake Studios

- **New** contemporary focus company: a private company that develops award-winning game apps for smart-phones and tablets
- **Updated** Spotlight on Ethics to refer to fraud allegations at Valeant Pharmaceuticals
- **New** chapter supplement explaining financial reporting by public companies
- Updated demonstration case featuring Under Armour
- Reviewed and updated all end-of-chapter material, including financial data for Activision Blizzard, DSW, Cinemark, Fitbit, and others

CHAPTER 2: THE BALANCE SHEET

Focus Company: Noodlecake Studios

- **New** contemporary focus company: continuation of business case from Chapter 1
- **New** Spotlight on Business Decisions to highlight the value of accounting automation
- Updated analysis of current ratios in Exhibit 2.14 and Spotlight on Financial Reporting to focus on technology companies, including Apple, Expedia, Electronic Arts, Facebook, and TripAdvisor
- Reviewed and updated all end-of-chapter material, including financial data for Columbia Sportswear, Ethan Allen Interiors, Starbucks, and others

CHAPTER 3: THE INCOME STATEMENT

Focus Company: Noodlecake Studios

- **New** contemporary focus company: continuation of business case from Chapter 2
- **New** discussion and illustration to introduce the five-step revenue model (Exhibit 3.5)
- **New** Spotlight on Financial Reporting to illustrate revenue recognition policy of Noodlecake Studios
- **Updated** net profit margin ratios at Electronic Arts, Activision Blizzard, TripAdvisor, and Facebook in Spotlight on Financial Reporting
- Updated demonstration case featuring Carnival Corporation
- Reviewed and updated all end-of-chapter material, including financial data for Expedia, Priceline, and others

CHAPTER 4: ADJUSTMENTS, FINANCIAL STATEMENTS, AND FINANCIAL RESULTS

Focus Company: Noodlecake Studios

- **New** contemporary focus company: continuation of business case from Chapter 3
- Reviewed and updated all end-of-chapter material, including financial data for FedEx Corporation, Regis Corporation, and others

CHAPTER 5: FRAUD, INTERNAL CONTROL, AND CASH

Focus Company: Koss Corporation

- **Updated** data relating to frequency and losses from employee fraud in Exhibit 5.1

CHAPTER 5: (continued)

- Updated discussion of p-cards in Spotlight on Controls
- Updated illustration of restricted cash reporting at Whole Foods Market (Exhibit 5.10)
- Reviewed, updated, and introduced new end-of-chapter material, including financial data for Expedia, Home Depot, and others

CHAPTER 6: MERCHANDISING OPERATIONS AND THE MULTISTEP INCOME STATEMENT

Focus Company: Walmart

- Substantially changed from the fifth edition to incorporate the five-step revenue model's requirement to report revenue at the amount an entity expects *to be entitled* to receive from customers
  - Simplified chapter by discussing purchase and sale discounts in the chapter and relocating journal entries to chapter supplement 6A
  - Simplified chapter by recording sales allowances directly against sales rather than in a contra-revenue account
  - Clarified accounting for sales returns by distinguishing actual and estimated returns
  - **New** learning objective and Exhibit 6.7 to demonstrate application of the five-step revenue model to the sale of bundled goods/services
- Updated focus company illustrations (Walmart) and introduced Planet Fitness to contrast financial statements of service company with merchandiser (Exhibit 6.2)
- Updated data regarding inventory shrinkage costs in Spotlight on Controls
- **New** Spotlight on Business Decisions to discuss the shift in credit terms away from 2/10, n/30
- **New** Spotlight on Financial Reporting on misreporting of sales rebates at Monsanto Company
- **New** Spotlight on Business Decisions to demonstrate the prevalence of bundled goods/services and multiple performance obligations including Apple's iPhone upgrades
- Updated illustration of gross profit percentage analysis at Walmart and Neiman Marcus
- **New** chapter supplement 6A to illustrate journal entries for purchase and sale discounts using the gross and net methods
- **New** demonstration case B to illustrate the application of the new five-step revenue model to sales of bundled goods/services
- Added new end-of-chapter material for bundled sales, and reviewed and updated all other end-of-chapter material, including financial data for Luxottica, Fortune Brands, The Gap, Macy's, and others

CHAPTER 7: INVENTORY AND COST OF GOODS SOLD

Focus Company: American Eagle Outfitters

- Updated focus company illustrations
- **New** discussion of FASB's simplification in reporting inventory at the lower of cost or market/net realizable value (LCM/NRV)
- **New** Spotlight on Financial Reporting discussing the $2.5 billion LCM/NRV write-down at Samsung for its exploding Galaxy Note 7 smartphones
- Updated inventory turnover analysis in Exhibit 7.7, involving Harley-Davidson, McDonald's, and American Eagle
- **New** Spotlight on Big Data and Analytics to demonstrate data visualization that combines inventory turnover and gross profit analysis when evaluating LCM/NRV
- Restructured selected exercises to focus on individual inventory costing methods, and reviewed and updated all end-of-chapter material, including financial data for BlackBerry, Amazon, Polaris Industries, GameStop, and others

CHAPTER 8: RECEIVABLES, BAD DEBT EXPENSE, AND INTEREST REVENUE

Focus Company: VF Corporation (VFC)

- Updated focus company illustrations for VF Corp.—the maker of North Face jackets, JanSport backpacks, Wrangler jeans, and Vans shoes
- Updated Spotlight on Business Decisions showing credit card costs at Nordstrom
- Revised description of bad debt estimates to reflect the current expected credit loss model in ASC 326-20
- Updated receivables turnover analysis in Exhibit 8.7, involving VF Corp., Post, and Apple
- **New** Spotlight on Big Data and Analytics to demonstrate data visualization that combines customer location information with measures of liquidity and profitability
- Reviewed and updated all end-of-chapter material, including financial data for Adobe, Callaway Golf, Microsoft, Sears, and others

CHAPTER 9: LONG-LIVED TANGIBLE AND INTANGIBLE ASSETS

Focus Company: Cedar Fair

- Updated focus company illustrations
- Updated Spotlight on the World to include component allocation of golf course bunkers at TWC Enterprises
- Clarified that asset impairment involves two steps: (1) eliminate accumulated depreciation against the asset (cost) account and (2) write down the asset account for its impairment in fair value
- New Spotlight on Financial Reporting about interpreting gains on disposal (involving tragic events)
- Updated fixed asset turnover analysis in Exhibit 9.5, involving Cedar Fair, Six Flags, and Facebook
- New Spotlight on Financial Reporting to explain how Intel's longer estimated life was bad news
- Reviewed and updated all end-of-chapter material, including financial data for Amazon, Hasbro, Alphabet, TripAdvisor, and others

CHAPTER 10: LIABILITIES

Focus Company: General Mills

- Updated focus company illustrations
- Updated analysis of debt-to-assets and times interest earned ratios for Kellogg, Post, and Campbell Soup comparison companies
- Chapter supplement 10D on installment notes now included in chapter (previously available online only)
- Reviewed and updated all end-of-chapter material, including financial data for FedEx Corporation, Lowe's, and others

CHAPTER 11: STOCKHOLDERS' EQUITY

Focus Company: National Beverage Corp.

- Updated focus company illustrations, as well as stock prices of rivals Coca-Cola and PepsiCo
- Updated Spotlight on Business Decisions to discuss the SEC's oversight of crowdfunding equity portals, such as Wefunder.com
- New Spotlight on Business Decisions involving Boeing's treasury stock purchase to boost EPS
- Revised Spotlight on Business Decisions to describe National Beverage's dividend program to reward stockholder loyalty
- New discussion of preferred stock redemptions
- Updated ratio analyses in Exhibit 11.6, involving National Beverage and PepsiCo
- Reviewed and updated all end-of-chapter material, including financial data for General Mills, Stanley Black & Decker, Delta, Southwest Airlines, and others

CHAPTER 12: STATEMENT OF CASH FLOWS

Focus Company: Under Armour Inc.

- Updated focus company illustrations
- Reviewed and updated all end-of-chapter material, including financial data for Colgate-Palmolive, Walt Disney Company, Gibraltar Industries, and others

CHAPTER 13: MEASURING AND EVALUATING FINANCIAL PERFORMANCE

Focus Company: Lowe's

- Updated focus company analyses
- Revised Exhibit 13.5 and related discussion to reflect changes made to all other chapters
- Updated discussion to reflect FASB's going concern standards update
- Reviewed and updated all end-of-chapter material, including financial data for Chevron, Cintas Corporation, Procter & Gamble, Dollar General, Kohl's, and others

APPENDIXES A & B: EXCERPTS FROM ANNUAL REPORTS OF THE HOME DEPOT AND LOWE'S

- Updated excerpts from the Fiscal 2016 Annual Reports of The Home Depot and Lowe's

APPENDIX C: PRESENT AND FUTURE VALUE CONCEPTS

- Reviewed and updated all end-of-chapter material

APPENDIX D: INVESTMENTS IN OTHER CORPORATIONS

Focus Company: Alphabet Inc.

- New focus company (Alphabet Inc.) to provide contemporary context for topics
- New discussion of fair value method, as applied to all investments in equity securities with readily determinable fair values (ASC 321)
- Eliminated discussion of available-for-sale equity securities and reporting fair value through OCI

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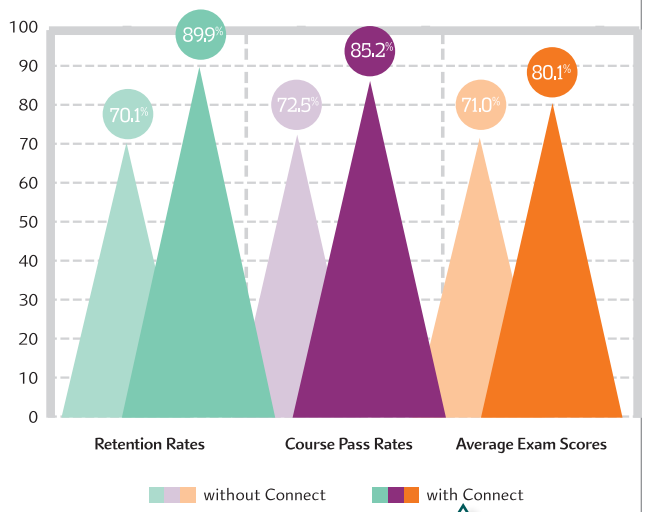

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- Connect automatically grades assignments and quizzes, providing easy-to-read reports on individual and class performance.

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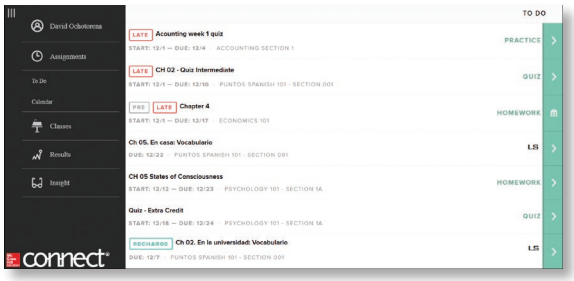

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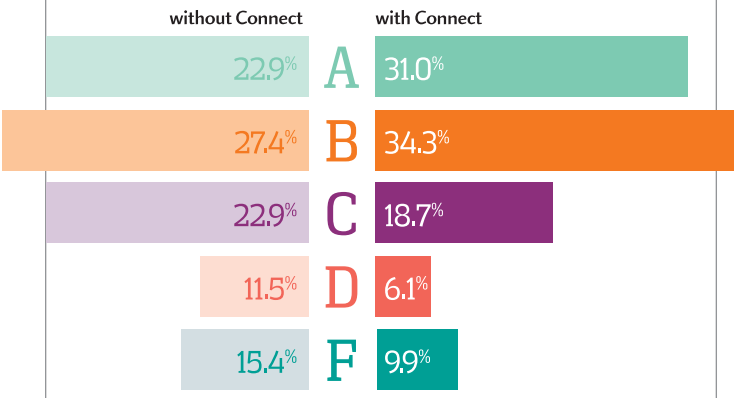

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- Connect offers comprehensive service, support, and training throughout every phase of your implementation.
- If you're looking for some guidance on how to use Connect, or want to learn tips and tricks from super users, you can find tutorials as you work. Our Digital Faculty Consultants and Student Ambassadors offer insight into how to achieve the results you want with Connect.

Online Assignments

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

End-of-chapter questions in Connect include

- Mini-Exercises
- Exercises
- Problems (Coached, Group A, and Group B)
- Comprehensive Problems
- Skills Development Cases
- Continuing Cases

M2-10 Preparing Journal Entries [LO 3]

The following are the transactions of Spotlighter, Inc., for the month of January 2013:

a. Borrowed $3,940 from a local bank on a note due in six months.
b. Received $4,630 cash from investors and issued stock to them.
c. Purchased $1000 in equipment, paying $200 cash and promising the rest on a note due in one year.
d. Paid $300 cash for supplies.
e. Bought and received $700 of supplies on account.

Prepare journal entries for each transaction. **(If no entry is required for a transaction/event, select "No Journal Entry Required" in the first account field.)**

view transaction list | view general journal

Journal Entry Worksheet

1 2 3 4 5

Record the borrowing of $3,940 from a local bank on a note due in six months.

Transaction	General Journal	Debit	Credit
a	Cash	3,940	
	no		
	No Journal Entry Required		
	Notes Payable (long-term)		
	Notes Payable (short-term)		
	Notes Receivable		
	Other Noncurrent Assets		

*Enter debits before credits

done | clear transaction | record transaction

> *"The textbook's General Ledger, Concept Overview Videos, and Excel Simulations are outstanding."*
>
> —Professor Kaye Sheridan, *Troy University*

General Ledger Problems

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

Requirement | General Journal | General Ledger | Trial Balance | Income Statement | Statement of Retained | Balance Sheet | Analysis

Each journal entry is posted automatically to the general ledger. Use the drop-down button to view the unadjusted, adjusted, or post-closing balances.

Post-closing

General Ledger Account

Cash			
Date	Debit	Credit	Balance
Jan 01, 2015			3
Mar 01, 2015	12		15
Mar 02, 2015		9	6
Apr 03, 2015	23		29
Jul 04, 2015		10	19
Nov 06, 2015		13	6

Accounts Receivable			
Date	Debit	Credit	Balance
Jan 01, 2015			5

Supplies			
Date	Debit	Credit	Balance
Jan 01, 2015			12
Oct 05, 2015	18		30

Land			
Date	Debit	Credit	Balance
Jan 01, 2015			0
Mar 02, 2015	9		9

Equipment			
Date	Debit	Credit	Balance
Jan 01, 2015			60

Accumulated Depreciation—Equipment			
Date	Debit	Credit	Balance
Jan 01, 2015			6

Software			
Date	Debit	Credit	Balance
Jan 01, 2015			15
Jul 04, 2015	10		25

Accumulated Amortization			
Date	Debit	Credit	Balance
Jan 01, 2015			5

Accounts Payable			
Date	Debit	Credit	Balance
Jan 01, 2015			5
Oct 05, 2015		18	23
Nov 06, 2015	13		10

Notes Payable (short-term)			
Date	Debit	Credit	Balance
Jan 01, 2015			0
Mar 01, 2015		12	12

Common Stock			
Date	Debit	Credit	Balance
Jan 01, 2015			71
Apr 03, 2015		23	94

Retained Earnings			
Date	Debit	Credit	Balance
Jan 01, 2015			8

previous | next

Requirement | General Journal | General Ledger | Trial Balance | Income Statement | Statement of Retained | Balance Sheet | Analysis

Notice the dropdown below that gives the options to select the unadjusted, adjusted or post-closing trial balance. The option you choose will be the values used to populate the income statement and balance sheet tabs. **Do not complete and review the financial statements until you have verified that total debits equal total credits.**

Post-closing

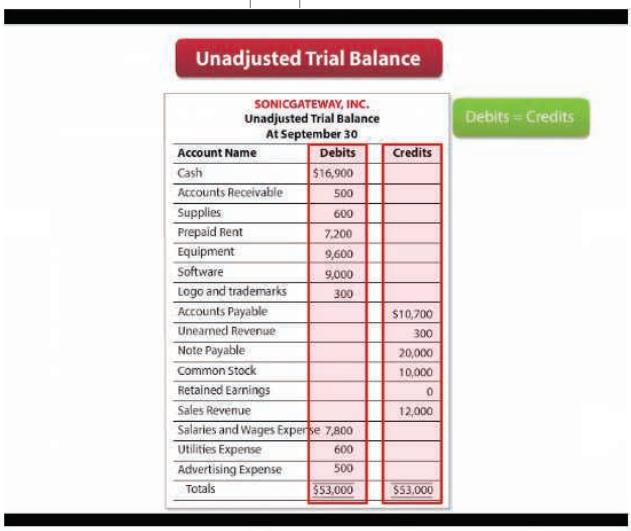
H & H TOOL, INC
Trial Balance
December 31, 2015

Account Title	Debit	Credit
Cash	$ 6	
Accounts Receivable	5	
Supplies	30	
Land	9	
Equipment	60	
Accumulated Depreciation—Equipment		6
Software	25	
Accumulated Amortization		5
Accounts Payable		10
Notes Payable (short-term)		12
Common Stock		94
Retained Earnings		8
Total	$ 135	$ 135

previous | next

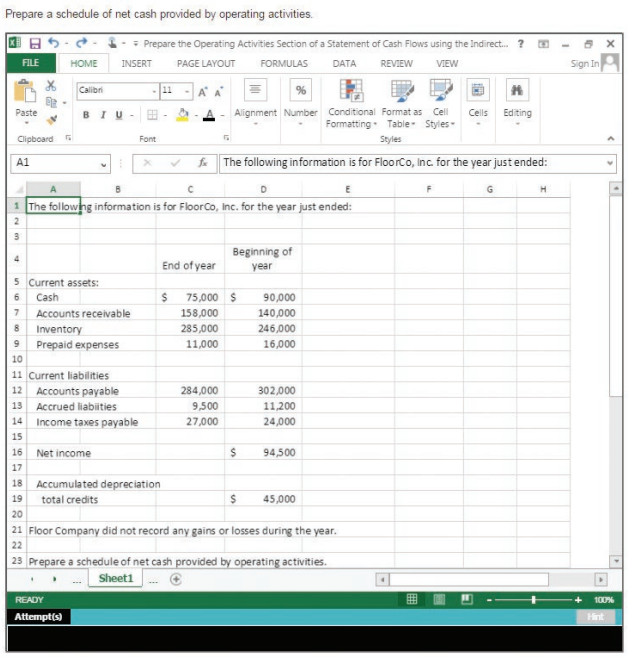
NEW! Concept Overview Videos

The **Concept Overview Videos** provide engaging narratives of key topics in an assignable and interactive online format. They follow the structure of the text and are organized to match the chapter's learning objectives. The Concept Overview Videos provide additional explanation and enhancement of material from the text chapter, allowing students to learn, study, and practice with instant feedback, at their own pace.



NEW! Excel Simulations

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



Guided Examples

The **Guided Examples** in Connect provide a narrated, animated, step-by-step walk-through of select exercises similar to those assigned. These short presentations can be turned on or off by instructors and provide reinforcement when students need it most.

> *"As a student I need to interact with course material in order to retain it, and **Connect** offers a perfect platform for this kind of learning. Rather than just reading through textbooks, **Connect** has given me the tools to feel engaged in the learning process."*
>
> —Jennah Epstein Kraus, *student, Bunker Hill Community College*

ASSURANCE OF LEARNING READY

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

Each test bank question for *Fundamentals of Financial Accounting* maps to a specific chapter learning objective listed in the text. You can use Connect to easily query for learning outcomes/objectives that directly relate to the learning objectives for your course. You can then use the reporting features of Connect to aggregate student results in a similar fashion, making the collection and presentation of assurance of learning data simple and easy.

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McGraw-Hill Education is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *Fundamentals of Financial Accounting* recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the test bank to the six general knowledge and skill guidelines in the AACSB standards.

The statements contained in *Fundamentals of Financial Accounting* are provided only as a guide for the users of this textbook. The AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the faculty. While *Fundamentals of Financial Accounting* and the teaching package make no claim of any specific AACSB qualification or evaluation, within the test bank to accompany *Fundamentals of Financial Accounting* we have labeled selected questions according to the six general knowledge and skill areas.

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Cheryl Westen, *Western Illinois University*
Vicki White, *Ivy Tech Community College of Indiana–Evansville*
Linda Whitten, *Skyline College*
Jane Wiese, *Valencia Community College*
Satina Williams, *Marist College*
Darryl Woolley, *University of Idaho*
Christian Wurst, *Temple University*
Michael Yampuler, *University of Houston–Houston*
Kathryn Yarbrough, *University of North Carolina–Charlotte*
Myung-Ho Yoon, *Northeastern Illinois University*
Gregory Yost, *University of West Florida*
Lin Zheng, *Georgia College State University*
Ping Zhou, *Baruch College*

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Fundamentals of

FINANCIAL ACCOUNTING

1

CHAPTER ONE

Business Decisions and Financial Accounting

YOUR LEARNING OBJECTIVES

LO 1-1 Describe various organizational forms and business decision makers.

LO 1-2 Describe the purpose, structure, and content of the four basic financial statements.

LO 1-3 Explain how financial statements are used by decision makers.

LO 1-4 Describe factors that contribute to useful financial information.

LO 1-S1 Describe examples where accounting helps in pursuing other business careers.

LO 1-S2 Describe the decision to become a public company and explain the implications for accounting.

THAT WAS THEN

If you think accounting is far removed from your personal life, you might be in for a surprise. Your ordinary life experiences, especially as a student, actually prepare you well to learn accounting.

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FOCUS COMPANY: NOODLECAKE STUDIOS, INC.

Welcome to the world of business and financial accounting. One of our goals for this book is to help you see the role accounting plays in helping people turn their good ideas into successful businesses. The founder of **FedEx** first introduced his ideas about a nationwide transportation business in a college essay. With the help of accounting, FedEx has become a multibillion-dollar business. Perhaps the only thing stopping you from doing this is you need to know more about starting and running a business. We're here to help with that.

Another important goal for us is to explain topics in ways that connect with your personal life experiences. Often, we will explain topics in the context of a real business. For example, in the first four chapters, you will learn the steps to starting a successful business. By reading about these experiences, you'll gain a realistic understanding of how accounting is a key part of all businesses. So, let's get started.

For Jordan Schidlowsky and Ty Bader, the last few years have been incredible. Their *Super Stickman Golf* series and other game apps they've developed for mobile devices have won awards and recognitions on iTunes and Google Play. The crowning achievement (so far) was being awarded an Apple Design Award for their game *Chameleon Run*. Their marketing director, Ryan Holowaty, says it's like winning an Academy Award. They continue to grow their business, now developing and publishing games for not only the iPhone and Android, but also game consoles and PCs. They have benefited greatly from the advice of Laurie Norris—a CPA (certified public accountant)—who has helped them establish their business and understand how to monitor its success. As you will read in this chapter, Laurie met with Jordan in June to answer his many questions about getting started. By following Laurie's business and accounting advice, Jordan and Ty successfully launched their company, named **Noodlecake Studios, Inc.** (noodlecake.com).

THIS IS NOW

This chapter focuses on the key financial reports that business people rely on when evaluating a company's performance.

Logo: Noodlecake Studios, Inc.

ORGANIZATION OF THE CHAPTER

Understand the business	Study the accounting methods	Evaluate the results	Supplement 1A	Supplement 1B	Review the chapter
• Organizational forms • Accounting for business decisions	• The basic accounting equation • Financial statements	• Using financial statements • Useful financial information	• Careers that depend on accounting knowledge	• Public companies	• Demonstration case • Chapter summary • Key terms • Homework helper • Practice material

Understand the Business

"Jordan, we should start by talking about how you want to organize your business."

"Well, I'm starting a technology company to sell apps in Apple's App Store and on Google Play. What else do I need to know?"

Learning Objective 1-1
Describe various organizational forms and business decision makers.

ORGANIZATIONAL FORMS

Laurie outlined three primary ways businesses can be organized: sole proprietorship, partnership, and corporation.

Sole Proprietorship

This is a form of business owned (and usually operated) by one individual. It is the easiest form of business to start because it doesn't require any special legal maneuvers. Just get a business license and you're good to go. A sole proprietorship is considered a part of the owner's life, with all profits (or losses) becoming part of the taxable income of the owner, and the owner being personally liable for all debts of the business.

Partnership

A partnership is similar to a sole proprietorship, except that profits, taxes, and legal liability are the responsibility of two or more owners instead of just one. It is slightly more expensive to form than a sole proprietorship because a lawyer typically is needed to draw up a partnership agreement, which describes how profits are shared between partners and how that would

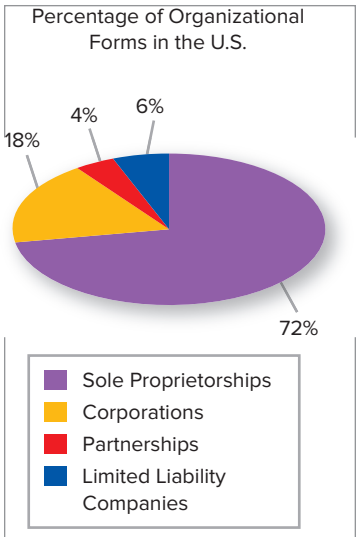
Photo: ©McGraw-Hill Education;
Photo: ©McGraw-Hill Education.
Jill Braaten, photographer

change if new partners are added or existing partners leave. The key advantage of a partnership over a sole proprietorship is that, by having more owners, a partnership typically has more resources available to it, which can fuel the business's growth.

Corporation

Unlike sole proprietorships and partnerships, a corporation is a separate entity from both legal and accounting perspectives. This means the corporation, not its owners, is legally responsible for its own taxes and debts. Thus, owners cannot lose more than their investment in the corporation, which is a major advantage to the owners. Two disadvantages of incorporation are the legal fees for creating a corporation can be expensive and income taxes must be paid by both the corporation and its owners.

Corporations can raise large amounts of money for growth because they divide ownership of the corporation into shares that can be sold to new owners. A share of the corporation's ownership is indicated on a legal document called a stock certificate. The owners of a company's stock (stockholders) can buy and sell stock privately or publicly on a stock exchange if the company has legally registered to do so. Most corporations start out as **private companies** and, as explained in Chapter Supplement 1B, will apply to become **public companies** ("go public") if they need a lot of financing, which they obtain from issuing new stock certificates to investors. Some big-name corporations, like Cargill and Chick-fil-A, haven't gone public because they get enough financing from private sources, but many that you are familiar with (and most examples in this book) are public companies.



Source: IRS.gov.

Other

Other organizational forms exist, such as a limited liability company (LLC), which combines characteristics of a partnership and a corporation. We focus on corporations in this book.

"I'm interested in limiting my legal liability and getting some financing by selling ownership shares to investors, so I will create a private corporation called Noodlecake Studios, Inc. What's next?"

ACCOUNTING FOR BUSINESS DECISIONS

Most companies exist to earn profits for their stockholders. They earn profits by selling goods or services to customers for more than they cost to produce. Noodlecake will be successful if it is able to sell enough apps to cover the costs of making them and running the company. To know just how successful the company is, Jordan and Ty will need to establish and maintain a good system of financial record-keeping—an accounting system. **Accounting** is an information system designed by an organization to capture (analyze, record, and summarize) the activities affecting its financial condition and performance and then report the results to decision makers, both inside and outside the organization. It's such a key part of business that business people typically talk about their companies using accounting terms, which is why they often call it the "language of business."

YOU SHOULD KNOW

Accounting: A system of analyzing, recording, and summarizing the results of a business's operating, investing, and financing activities and then reporting them to decision makers.

Every organization needs accountants to assist in reporting financial information for decision making and to help its owners understand the financial effects of those business decisions. Jordan can get this help in one of two ways. He can hire an accountant to work as an employee of his business (a **private accountant**) or he can contract with someone like Laurie who provides advice to several businesses (a **public accountant**). Because Jordan's business is small, he doesn't yet need a full-time accountant. Instead, he agrees for Noodlecake to pay fees to Laurie for basic services. She'll help him to set up an accounting system and advise him on key business decisions.

"How will an accounting system help me run my business?"

EXHIBIT 1.1 The Accounting System Reports Information for Decision Makers

The main goal of an accounting system is to capture information about the operating, investing, and financing activities of a company so that it can be reported to decision makers, both inside and outside the business. Exhibit 1.1 illustrates this role and shows that this information can be presented in two kinds of reports. **Managerial accounting reports** include detailed financial plans and continually updated reports about the operating performance of the company. These reports are made available only to the company's employees (internal users) for making business decisions related to production, marketing, human resources, and finance. For example, managerial accounting reports are needed when determining whether to build, buy, or rent a building; whether to continue or discontinue making particular products; how much to pay employees; and how much to borrow. As manager of Noodlecake, Jordan will regularly need managerial accounting reports to monitor the number of app downloads and evaluate the various costs associated with making and selling apps.

"Financial information about your business will be needed by others outside your company. For example, where will the money come from to start your business?"

"Ty and I will contribute $5,000 each from personal savings. But I'll still need to ask the bank for a $20,000 loan to buy computer equipment and software. What will the bank want to know?"

YOU SHOULD KNOW

Financial Statements: Reports that summarize the financial results of business activities.

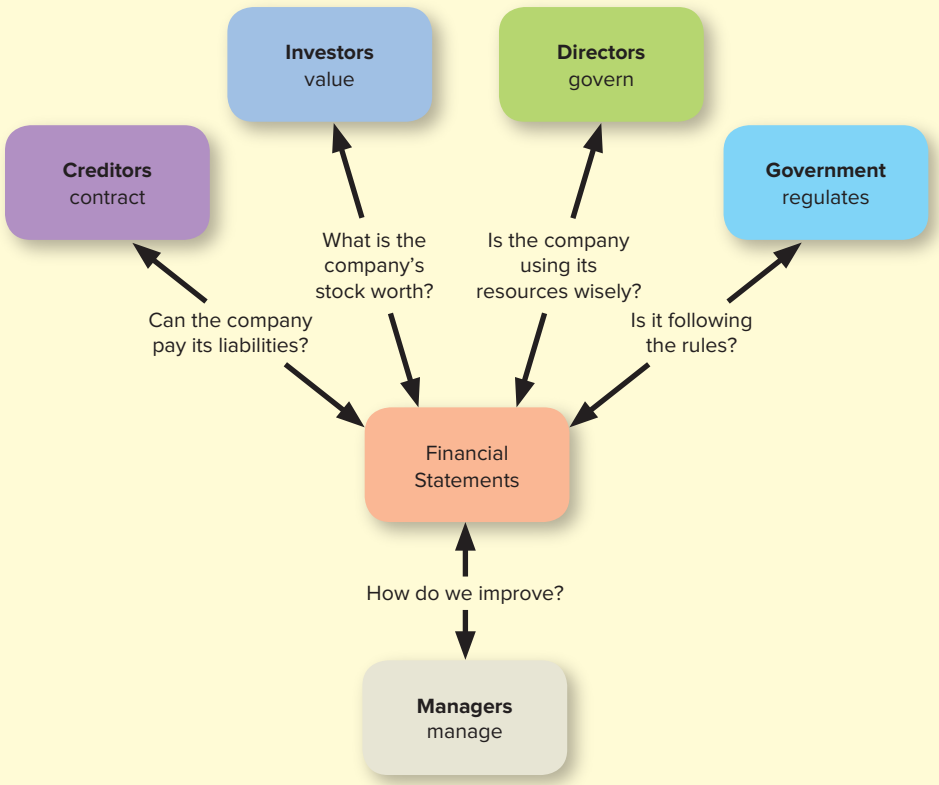
Laurie described **financial accounting reports,** called **financial statements**, which are prepared periodically to provide information to people not employed by the business. These external financial statement users aren't given access to detailed internal records of

the company, so they rely extensively on the financial statements. The four main groups of external users are (1) creditors, (2) investors, (3) directors, and (4) government.

1. **Creditors** include suppliers, banks, and anyone to whom money is owed. *Suppliers* want to be sure they will be paid for the goods and services they deliver, so they will evaluate a company's financial statements and check its credit history before allowing it to buy on credit. *Banks* use financial statements to evaluate the risk they will not be repaid the money they've loaned to a company. Because banks take a risk when they loan money to a company, they want periodic financial reports to evaluate how well the company is doing so they can intervene if it looks like the company will have trouble repaying its loan.
2. **Investors** include existing and potential stockholders. *Stockholders* look to accounting information to assess the financial strength of a business and, ultimately, to estimate its value.
3. **Directors** is the short title for the members of a company's *board of directors.* The stockholders of public companies or large private companies elect directors to oversee the company's managers. Directors use financial statements to ensure the company's managers make decisions that are in the best financial interests of its stockholders.
4. **Government** agencies look closely at companies' financial statements. The *Securities and Exchange Commission (SEC),* for example, is responsible for the functioning of stock markets, so it keeps a close watch on the information public companies report in financial statements. Also, the *Internal Revenue Service (IRS)* and state and local governments use financial statement information to ensure taxes are computed using correct amounts.

Exhibit 1.2 shows that, along with managers inside the company, these external user groups are key users of financial statement information. In Noodlecake's case, the bank will be the

EXHIBIT 1.2 External and Internal Users and Uses of Financial Statements



main external user. Jordan will be expected to prepare financial statements to obtain a bank loan and then regularly provide updated financial reports until the loan is repaid.

While Jordan understood everything Laurie had told him up to this point, he had another major concern.

"I want to sound intelligent when I talk to my banker, but I don't know much about accounting."

"This is a common concern for new business owners, so let's start with the most basic thing you need to know about accounting."

Study the Accounting Methods

Learning Objective 1-2
Describe the purpose, structure, and content of the four basic financial statements.

THE BASIC ACCOUNTING EQUATION

One of the central concepts to understanding financial reports is that **what a company owns must equal what a company owes to its creditors and stockholders.** In accounting, there are special names for the items a company owns (assets) and the claims on these items by creditors (liabilities) and stockholders (equity), as shown below.

Resources Owned . . .	=	Resources Owed . . .		
by the **company**		to **creditors**		to **stockholders**
Assets	=	**Liabilities**	+	**Stockholders' Equity**

YOU SHOULD KNOW

Basic Accounting Equation: Assets = Liabilities + Stockholders' Equity.

Separate Entity Assumption: States that business transactions are separate from and should exclude the personal transactions of the owners.

The relationship between assets (A), liabilities (L), and stockholders' equity (SE) is known as the **basic accounting equation**. The business itself, not the stockholders who own the business, is viewed as owning the assets and owing the liabilities. This separation between stockholders and business is called the **separate entity assumption**, which requires that a business's financial reports include only the activities of the business and not the personal dealings of its stockholders.

The elements of the basic accounting equation are fundamental to reading and understanding financial statements, so let's look at each in detail.

Assets

An **asset** is an economic resource presently controlled by the company; it has measurable value and is expected to benefit the company by producing cash inflows or reducing cash outflows in the future. For Noodlecake, assets include things like cash, supplies, equipment, and software. Other companies, such as Nike and Target, have an asset called inventory, which consists of merchandise held for sale.

Liabilities

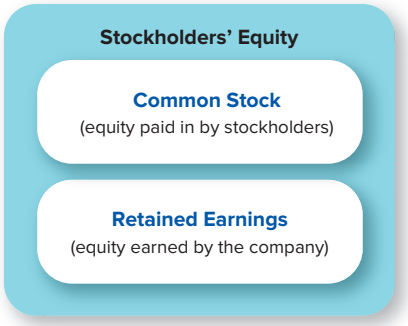
Liabilities are measurable amounts the company owes to creditors. If Noodlecake borrows from a bank, it would owe a liability called a Note Payable. This particular name is used because banks require borrowers to sign a legal document called a *note* that describes details

about the company's promise to repay the bank. Noodlecake is likely to also owe suppliers for paper, pens, business cards, and other supplies delivered to its office. When a company buys goods from another company, it usually does so on credit by promising to pay for them at a later date. The amount owed is called an Account Payable because purchases made using credit are said to be "on account." Noodlecake could also owe salaries and wages to employees (Salaries and Wages Payable) and taxes to governments (Taxes Payable). From a legal perspective, creditors have priority over stockholders. Thus, if a company goes out of business, liabilities must be paid before any amounts are paid to stockholders.

Stockholders' Equity

Stockholders' equity represents the owners' claims on the business. These claims arise from two sources.

1. **Paid-in capital.** The owners have a claim on amounts they contributed directly to the company in exchange for its stock (Common Stock).
2. **Earned capital.** The owners have a claim on profits the company has earned for them through its business operations (Retained Earnings).



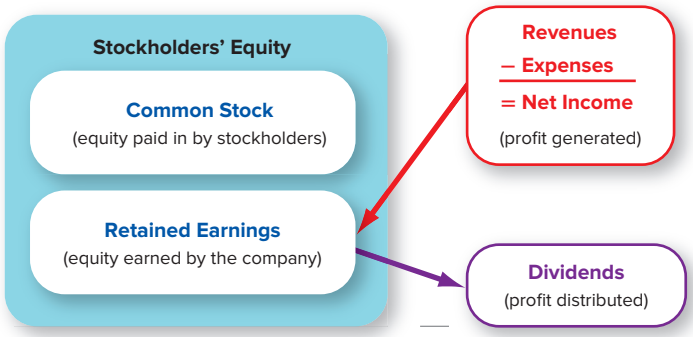
The second item listed above is particularly important because a business can survive only if it is profitable. It will be profitable if the total amount earned from selling goods and services is greater than the costs incurred to generate those sales. Theoretically, these profits belong to the company's owners, so they increase stockholders' equity. Through these profits, owners can get more money back from the company than they paid in (a return on their investment).

Given the importance of a company's profits, accounting systems separately track the two components of profit: revenues and expenses.

Revenues Revenues are earned by selling goods or services to customers. For Noodlecake, revenues are measured at the amount the company charges customers for its apps.

Expenses Expenses are all costs of doing business that are necessary to earn revenues. Noodlecake incurs expenses for advertising, utilities, rent, salaries and wages, insurance, and supplies used up in the office. Notice that expenses are said to be "incurred" to generate revenues. The word *incurred* means the activities giving rise to a cost (e.g., running an ad, using electricity) have occurred in the period in which the related revenues have been generated.

Net Income Although *profit* is used in casual conversation, the preferred term in accounting is *net income.* Net income is calculated as revenues minus expenses. For Noodlecake to be profitable, its revenues must be greater than its expenses. (If revenues are less than expenses, the company would have a net loss, but for now we'll assume Noodlecake is going to earn a profit.) **By generating net income, a company increases its stockholders' equity,** as illustrated below. This net income can be left in the company to accumulate (with earnings that have been retained from prior years) or it can be paid out to the company's stockholders for their own personal use (called *dividends*).



Dividends A company's profits are accumulated in Retained Earnings until a decision is made to distribute them to stockholders in what is called a dividend. The simplest type of dividend, and the most common for a small business like Noodlecake, is a dividend paid in cash. Dividends are reported as a reduction in Retained Earnings. **Dividends are not an expense incurred to generate earnings.** Rather, dividends are an optional distribution of earnings to stockholders, approved by the company's board of directors. If Jordan and Ty wanted, they could choose to leave all the profits in Noodlecake by never declaring a dividend.

"Okay, I think I get it, but can you tell me how all those items relate to each other and where they are reported in the financial statements?"

FINANCIAL STATEMENTS

Assets, liabilities, stockholders' equity, revenues, expenses, and dividends appear in different reports that collectively are called financial statements. The term *financial statements* refers to four accounting reports, typically prepared in the following order:

1. **Income Statement**
2. **Statement of Retained Earnings**
3. **Balance Sheet**
4. **Statement of Cash Flows**

Financial statements can be prepared at any time during the year, although they are most commonly prepared monthly, every three months (quarterly reports), and at the end of the year (annual reports). Companies are allowed to choose a calendar or fiscal year-end. A calendar year is a 12-month period ending on December 31, and a fiscal year is a 12-month period ending on a day other than December 31. The toy maker Mattel uses a calendar year-end because this is the start of its slow business period. The Green Bay Packers, Inc., has chosen a fiscal year-end of March 31, after the football season ends.

The Income Statement

The first financial statement prepared is the **income statement** (also called the statement of operations). Laurie gives Jordan Exhibit 1.3 to show what Noodlecake's income statement might look like for one month of operations ended September 30. The heading of the income statement identifies who, what, and when: the name of the business, the title of the report, and the time period covered by the financial statement. Larger businesses with thousands or millions of dollars in revenues and expenses add a fourth line under the date to indicate if the reported numbers are rounded to the nearest thousand or million. For international companies, this fourth line also reports the currency used in the report. An international company based in the United States, like Apple, will translate any foreign currency into U.S. dollars—basically assuming all its business was done in U.S. dollars. This is the **unit of measure assumption**. We see it in the reporting currency used by Nestlé (Swiss franc), LEGO (Danish krone), and Adidas (euro). Companies with complex activities report a statement of comprehensive income that shows net income as well as gains and losses relating to pensions, foreign currency translations, and other complex financial transactions. But companies with basic operations will report a simpler income statement, as shown in Exhibit 1.3.

The body of an income statement has three major captions—revenues, expenses, and net income—corresponding to the equation for the income statement (Revenues − Expenses = Net Income). Individual types of revenues and expenses are reported under the revenue and expense headings. These **accounts**, as they are called, are typical for most businesses, whether small or big. Notice each major caption has an underlined subtotal, and the "bottom line" amount for net income has a double underline to highlight it. Finally, a dollar sign appears (only) at the top and bottom of the column of numbers.

YOU SHOULD KNOW

Income Statement (Statement of Income, Statement of Profit and Loss, Statement of Operations): Reports the revenues less the expenses of the accounting period.

Unit of Measure Assumption: The financial results of a company's worldwide business activities should be measured and reported using a single monetary unit, such as the U.S. dollar.

Accounts: A standardized format that organizations use to accumulate the dollar effects of transactions on each financial statement item.

EXHIBIT 1.3 Income Statement

NOODLECAKE STUDIOS, INC.
Income Statement (Projected)
For the Month Ended September 30, 2018

Explanation
Who: Name of the business
What: Title of the statement
When: Accounting period

Revenues		
Sales Revenue	$ 9,000	Revenue from selling apps to customers in September
Service Revenue	3,000	Revenue from providing consulting services to others
Total Revenues	12,000	**Total revenues generated during September**
Expenses		
Salaries and Wages Expense	5,000	Cost of salaries and wages for work done in September
Rent Expense	2,500	Cost of rent for the month of September
Utilities Expense	1,600	Cost of utilities used in September
Insurance Expense	300	Cost of insurance coverage for September
Advertising Expense	100	Cost of advertising done in September
Income Tax Expense	500	Cost of taxes on September's income
Total Expenses	10,000	**Total expenses incurred during September**
Net Income	$ 2,000	**Difference between total revenues and total expenses**

When listing the accounts on the income statement, revenues are on top, usually with the largest, most relevant revenue listed first. Then expenses are subtracted, again from largest to smallest, except that Income Tax Expense is the last expense listed. Net Income is the difference between total revenues and total expenses. This format, which groups revenues separately from expenses and reports a single measure of income, is called a **"single-step income statement."** Other income statement formats are possible, as explained in Chapter 6.

"So, does the $2,000 of Net Income mean I'll have that much more cash?"

"No. Net income is a measure of how much better off your business is, not how much cash you made."

Laurie's point is one of the key ideas of the income statement. It's quite common for a business to provide goods or services to customers in one month but not collect cash from them until a later month. Similarly, expenses for the current month's activities may actually be paid in a different month. You'll have a chance to learn this in more detail later, but it's worth trying to understand from the beginning that the month's revenues don't necessarily equal cash coming in during the month and expenses don't always equal cash going out during the month.

Jordan seemed disappointed to see only $2,000 of projected net income for the first month. Laurie reassured him it's typical for new businesses like Noodlecake to initially struggle to generate a profit because the company has lots of expenses related to employee wages but relatively little revenues because it hasn't yet built a reputation that attracts customers. Noodlecake's net income will likely increase in the future as its apps gain in popularity. By selling more apps, revenues will increase without a major increase in expenses.

"I guess that's not so bad. It does make me want to watch my expenses and try to boost my sales quickly. What about the amount Noodlecake owes to the bank? Should we talk about the balance sheet?"

"Before we look at that, I want to show you the next statement that connects the income statement to the balance sheet, so you'll understand the relationships between the reports."

YOU SHOULD KNOW

Statement of Retained Earnings: Reports the way that net income and the distribution of dividends affected the financial position of the company during the accounting period.

The Statement of Retained Earnings

Noodlecake will report a **statement of retained earnings**, as shown in Exhibit 1.4. A more comprehensive statement of stockholders' equity that explains changes in all stockholders' equity accounts is provided by large corporations. But for Noodlecake, most changes in stockholders' equity relate to generating and distributing earnings, so a statement of retained earnings is just as good as a full-blown statement of stockholders' equity. The heading in Exhibit 1.4 identifies the name of the company, the title of the report, and the accounting period. The statement starts with the Retained Earnings balance at the beginning of the period. Remember that retained earnings are the profits that have accumulated in the company over time. Because this is a new business, there aren't any accumulated profits yet, so the beginning balance is $0. Next, the statement adds Net Income and subtracts any Dividends for the current period to arrive at Retained Earnings at the end of the period.[1] Again, a dollar sign is used at the top and bottom of the column of numbers and a double underline appears at the bottom.

EXHIBIT 1.4 Statement of Retained Earnings

NOODLECAKE STUDIOS, INC.
Statement of Retained Earnings (Projected)
For the Month Ended September 30, 2018

		Explanation
		Who: Name of the business **What: Title of the statement** **When: Accounting period**
Retained Earnings, September 1, 2018	$ 0	**Last period's ending Retained Earnings balance**
Add: Net Income	2,000	Reported on the income statement (Exhibit 1.3)
Subtract: Dividends	(1,000)	Distributions to stockholders in the current period
Retained Earnings, September 30, 2018	$1,000	**This period's ending Retained Earnings balance**

YOU SHOULD KNOW

Balance Sheet: Reports the amount of assets, liabilities, and stockholders' equity of an accounting entity at a point in time.

The Balance Sheet

The next financial report is the **balance sheet**. It is also known as the statement of financial position. The balance sheet's purpose is to report the amount of a business's assets, liabilities, and stockholders' equity at a specific point in time. Exhibit 1.5 presents Noodlecake's projected balance sheet. Think of the balance sheet as a picture or screen capture of Noodlecake's resources and claims on those resources at the end of a particular day (in this case, September 30, 2018).

Notice again the heading specifically identifies the name of the company and title of the statement. Unlike the other financial reports, the balance sheet is presented for a point in time (at September 30, 2018, in this case). Assets are listed in order of how soon they are to be used or turned into cash. Likewise, liabilities are listed in order of how soon each is to be paid or settled.

The balance sheet first lists the assets of the business, which for Noodlecake total $36,000. The second section lists the business's liabilities and stockholders' equity balances, also totaling $36,000. The balance sheet "balances" because the resources equal the claims on

[1]For companies that have a net loss (expenses exceed revenues), the statement of retained earnings would subtract the net loss rather than add net income.

EXHIBIT 1.5 Balance Sheet

NOODLECAKE STUDIOS, INC.
Balance Sheet (Projected)
At September 30, 2018

Explanation
Who: Name of the business
What: Title of the statement
When: Point in time

Assets		**Resources controlled by the company**
Cash	$13,000	Amount of cash on hand and in the business's bank account
Accounts Receivable	2,500	Noodlecake's right to collect for sales/services provided on account
Supplies	500	Cost of paper and other supplies on hand
Equipment	14,000	Cost of computers, desks, etc.
Software	6,000	Cost of software and programming code purchased from others
Total Assets	$36,000	**Total amount of the company's resources**
Liabilities and Stockholders' Equity		**Claims on the company's resources**
Liabilities		*Creditors'* claims on the company's resources
Accounts Payable	$ 5,000	Amount owed to suppliers for prior credit purchases (on account)
Note Payable	20,000	Amount of loan owed to the bank (for promissory note)
Total Liabilities	25,000	Total claims on the resources by creditors
Stockholders' Equity		*Stockholders'* claims on the company's resources
Common Stock	10,000	Amount stockholders contributed for the company's common stock
Retained Earnings	1,000	Total earnings retained in the business (Exhibit 1.4)
Total Stockholders' Equity	11,000	Total claims on the company's resources by stockholders
Total Liabilities and Stockholders' Equity	$36,000	**Total claims on the company's resources**

the resources. The basic accounting equation (also called the balance sheet equation) reflects the business's financial position at September 30, 2018:

Assets	=	Liabilities	+	Stockholders' Equity
$36,000	=	$25,000	+	$11,000

Cash is the first asset reported on the balance sheet. The $13,000 would represent the total amount of cash on hand and in Noodlecake's bank account. The $2,500 reported as Accounts Receivable would represent Noodlecake's right to collect from customers for sales and services provided on credit. Noodlecake intends to sell consulting services to other companies on account. The $500 reported for Supplies indicates the cost of office supplies on hand at the balance sheet date. Likewise, the $14,000 for Equipment and $6,000 for Software represent Noodlecake's cost of buying these assets. According to the **cost principle** of accounting, assets are initially reported on the balance sheet based on their original cost to the company.

Under liabilities, Laurie includes $5,000 of Accounts Payable as the amount Noodlecake owes suppliers for equipment, supplies, and other items purchased on account. The Note Payable is the written promise to repay the loan from the bank. As with all liabilities, these are financial obligations of the business arising from past business activities.

Finally, within stockholders' equity, Common Stock reflects the dollar amount of the company's stock given when Jordan and Ty contribute $10,000 to the company. Retained Earnings reports the earnings expected to be retained in the company as of September 30, 2018. It matches the ending amount of Retained Earnings on the statement of retained earnings (Exhibit 1.4).

"Besides monitoring my revenues and expenses, it looks like I need to make sure I have enough assets to pay my liabilities."

COACH'S TIP

Any account name containing "receivable" is an asset and any containing "payable" is a liability.

"Sharp observation! Your creditors are most interested in your ability to pay cash to them in the future. However, not all assets can be easily turned into cash and not all revenues and expenses are received or paid in cash. So, there is one more important financial statement."

The Statement of Cash Flows

YOU SHOULD KNOW

Statement of Cash Flows: Reports inflows and outflows of cash during the accounting period in the categories of operating, investing, and financing.

Noodlecake's projected income statement (back in Exhibit 1.3) shows a positive net income of $2,000. However, net income is not necessarily equal to cash because revenues and expenses are reported when generated or incurred regardless of when cash is received or paid. The fourth financial report of interest to external users, then, is the **statement of cash flows**. It includes only those activities that result in cash changing hands. Exhibit 1.6 shows Noodlecake's projected statement of cash flows for the month ended September 30, 2018.

The statement of cash flows is divided into three types of activities:

1. **Operating:** These cash flows arise directly from running the business to earn profit. They include cash received from selling apps and services, and cash paid for wages, advertising, rent, insurance, supplies, and so on.
2. **Investing:** These cash flows arise from buying and selling productive resources with long lives (such as buildings, land, equipment, and software), purchasing investments, and lending to others. As Exhibit 1.6 shows, Noodlecake expects to spend $20,000 cash to purchase equipment and software.
3. **Financing:** These cash flows include borrowing from banks, repaying bank loans, receiving cash from stockholders for company stock, or paying dividends to stockholders.

The bank will assess Noodlecake's ability to make cash payments on its loan by watching how the cash flows reported on this statement change in the future.

EXHIBIT 1.6 Statement of Cash Flows

NOODLECAKE STUDIOS, INC. Statement of Cash Flows (Projected) For the Month Ended September 30, 2018		Explanation Who: Name of the entity What: Title of the statement When: Accounting period
Cash Flows from Operating Activities		**Activities directly related to earning income**
Cash received from customers	$ 9,500	Cash received from customers
Cash paid to employees and suppliers	(5,500)	Cash paid to employees and suppliers of goods/services
Cash Provided by Operating Activities	4,000	Cash inflows minus outflows ($9,500 – $5,500)
Cash Flows from (used in) Investing Activities		**Activities related to the sale/purchase of productive assets**
Cash used to buy equipment and software	(20,000)	Cash spent on equipment/software
Cash from (used in) Investing Activities	(20,000)	
Cash Flows from Financing Activities		**Activities involving investors and banks**
Cash received for stock issuance	10,000	Cash received from owners for company stock
Cash dividends paid to stockholders	(1,000)	Cash paid to distribute profit to owners
Cash borrowed from the bank	20,000	Cash received on loan from the bank
Cash Provided by Financing Activities	29,000	Cash inflows minus outflows ($10,000 – $1,000 + $20,000)
Change in Cash	13,000	Sum of the three cash flow categories ($4,000 – $20,000 + $29,000)
Beginning Cash, September 1, 2018	0	Cash balance at the beginning of the accounting period
Ending Cash, September 30, 2018	$13,000	Cash balance reported on the balance sheet (Exhibit 1.5)

COACH'S TIP

Parentheses are used on the statement of cash flows to indicate negative cash flows (outflows rather than inflows).

Notes to the Financial Statements

The four basic financial statements are not complete without notes to help financial statement users understand how the amounts were derived and what other information may affect their decisions. We'll talk about notes in more detail in later chapters.

Relationships among the Financial Statements

Exhibit 1.7 shows how the four basic financial statements connect to one another:

1. Net Income, from the income statement, is a component in determining ending Retained Earnings on the statement of retained earnings.
2. Ending Retained Earnings from the statement of retained earnings is then reported on the balance sheet.
3. Cash on the balance sheet is equal to the ending Cash on the statement of cash flows.

EXHIBIT 1.7 Relationships among the Financial Statements

NOODLECAKE STUDIOS, INC.
Income Statement
For the Month Ended September 30, 2018

Revenues	
Sales Revenue	$ 9,000
Service Revenue	3,000
Total Revenues	12,000
Expenses	
Salaries and Wages Expense	5,000
Rent Expense	2,500
Utilities Expense	1,600
Insurance Expense	300
Advertising Expense	100
Income Tax Expense	500
Total Expenses	10,000
Net Income	$ 2,000

NOODLECAKE STUDIOS, INC.
Statement of Retained Earnings
For the Month Ended September 30, 2018

Retained Earnings, September 1, 2018	$ 0
Add: Net Income	2,000
Subtract: Dividends	(1,000)
Retained Earnings, September 30, 2018	$1,000

1

NOODLECAKE STUDIOS, INC.
Balance Sheet
At September 30, 2018

Assets	
Cash	$13,000
Accounts Receivable	2,500
Supplies	500
Equipment	14,000
Software	6,000
Total Assets	$36,000
Liabilities and Stockholders' Equity	
Liabilities	
Accounts Payable	$ 5,000
Note Payable	20,000
Total Liabilities	25,000
Stockholders' Equity	
Common Stock	10,000
Retained Earnings	1,000
Total Stockholders' Equity	11,000
Total Liabilities and Stockholders' Equity	$36,000

2

3

NOODLECAKE STUDIOS, INC.
Statement of Cash Flows
For the Month Ended September 30, 2018

Cash Flows from Operating Activities	$ 4,000
Cash Flows from (Used in) Investing Activities	(20,000)
Cash Flows from Financing Activities	29,000
Change in Cash	13,000
Beginning Cash, September 1, 2018	0
Ending Cash, September 30, 2018	$13,000

A summary of the four basic financial statements is presented in Exhibit 1.8.

EXHIBIT 1.8 Summary of the Four Basic Financial Statements

Financial Statement	Purpose: To report . . .	Structure	Examples of Content
Income Statement	The financial performance of the business *during the current accounting period.*	Revenues – Expenses = Net Income (Loss)	Sales revenue, wages expense, supplies expense, rent expense
Statement of Retained Earnings	The accumulation of earnings retained in the business *during the current accounting period* with that of prior periods.	Beginning Retained Earnings + Net Income (this period) – Dividends (this period) = Ending Retained Earnings	Net income is from the income statement. Dividends are amounts distributed this period.
Balance Sheet	The financial position of a business *at a point in time.*	Assets = Liabilities + Stockholders' Equity	Cash, receivables, supplies, equipment, accounts payable, notes payable, common stock, retained earnings
Statement of Cash Flows	Activities that caused increases and decreases in cash *during the current accounting period.*	+/– Operating Cash Flows +/– Investing Cash Flows +/– Financing Cash Flows = Change in Cash + Beginning Cash = Ending Cash	Cash collected from customers, cash paid to suppliers, cash paid for equipment, cash borrowed from banks, cash received from issuing stock

You have seen lots of new and important material in this section. Before moving on, take a moment to complete the self-study practice. This is the best way to make sure you've paid enough attention when reading about how business activities are reported in financial statements.

How's it going? Self-Study Practice

For each account, indicate (1) the type of account (A = asset, L = liability, SE = stockholders' equity, R = revenue, E = expense) and (2) whether it is reported on the income statement (I/S), statement of retained earnings (SRE), balance sheet (B/S), or statement of cash flows (SCF).

Account Title	Type	Statement
1. Land	_____	_____
2. Advertising Expense	_____	_____
3. Accounts Receivable	_____	_____
4. Service Revenue	_____	_____
5. Common Stock	_____	_____
6. Note Payable	_____	_____

After you have finished, check your answers with the solution.

Solution to Self-Study Practice

	Type	Statement
1.	A	B/S
2.	E	I/S
3.	A	B/S
4.	R	I/S
5.	SE	B/S
6.	L	B/S

"So, you've just seen how your financial statements should look in one month and how they relate. Are you feeling okay with all this?"

"It actually makes me anxious to get started. What will my external users look for?"

Evaluate the Results

USING FINANCIAL STATEMENTS

Learning Objective 1-3
Explain how financial statements are used by decision makers.

The financial statements are a key source of information when external users, like creditors and investors, make decisions concerning a company. As you will see throughout this course, the amounts reported in the financial statements can be used to calculate percentages and ratios that reveal important insights about a company's performance. For now, however, let's consider how creditors and investors might gain valuable information simply by reading the dollar amounts reported in each financial statement.

- **Creditors are mainly interested in assessing:**
  1. **Is the company generating enough cash to pay what it owes?** The statement of cash flows helps answer this question. In particular, creditors would be interested in seeing whether operating activities are producing positive cash flows. Noodlecake's expected net inflow of $4,000 cash from operating activities is very good for a new business. Find it in Exhibit 1.6.
  2. **Does the company have enough assets to cover its liabilities?** Answers to this question come from comparing assets and liabilities reported on the balance sheet. Noodlecake is expected to own more than it owes at September 30 (total assets of $36,000 versus total liabilities of $25,000). With $13,000 in Cash, Noodlecake would be able to immediately pay all of its Accounts Payable and part of its Note Payable if needed.
- **Investors expect a return on their contributions to a company.** The return may be immediate (through dividends) or long term (through selling their stock certificates at a price higher than their original cost). Dividends and higher stock prices are more likely if a company is profitable. As a result, investors look closely at the income statement (and statement of retained earnings) for information about the company's ability to generate profits (and distribute dividends).

"I've heard a lot about fraud and 'cooking the books.' How do users know the information they're getting is useful and can be trusted?"

USEFUL FINANCIAL INFORMATION

Learning Objective 1-4
Describe factors that contribute to useful financial information.

Laurie indicated that useful financial information arises when businesses apply generally accepted accounting principles in an ethical business environment.

Generally Accepted Accounting Principles

The system of financial statement reporting used today has a long history—all the way back to a publication in 1494 by Italian monk and mathematician Luca Pacioli. Currently, the Financial Accounting Standards Board (FASB) has the primary responsibility for setting the underlying rules of accounting in the United States. As a group, these rules are called **generally accepted accounting principles, or GAAP** for short (pronounced like the name of the clothing store).

The accounting rules in the United States are similar, for the most part, to those used elsewhere in the world, but some important differences exist. The FASB has been working with the International Accounting Standards Board (IASB) to eliminate differences so that investors can more easily compare the financial statements of companies from different countries. Throughout this course, we'll use a pullout feature called Spotlight on the World to alert you to important differences.

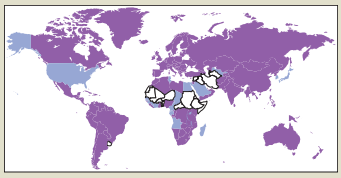
YOU SHOULD KNOW

Generally Accepted Accounting Principles (GAAP): The rules used in the United States to calculate and report information in the financial statements.

International Financial Reporting Standards (IFRS): The rules used internationally to calculate and report information in the financial statements.

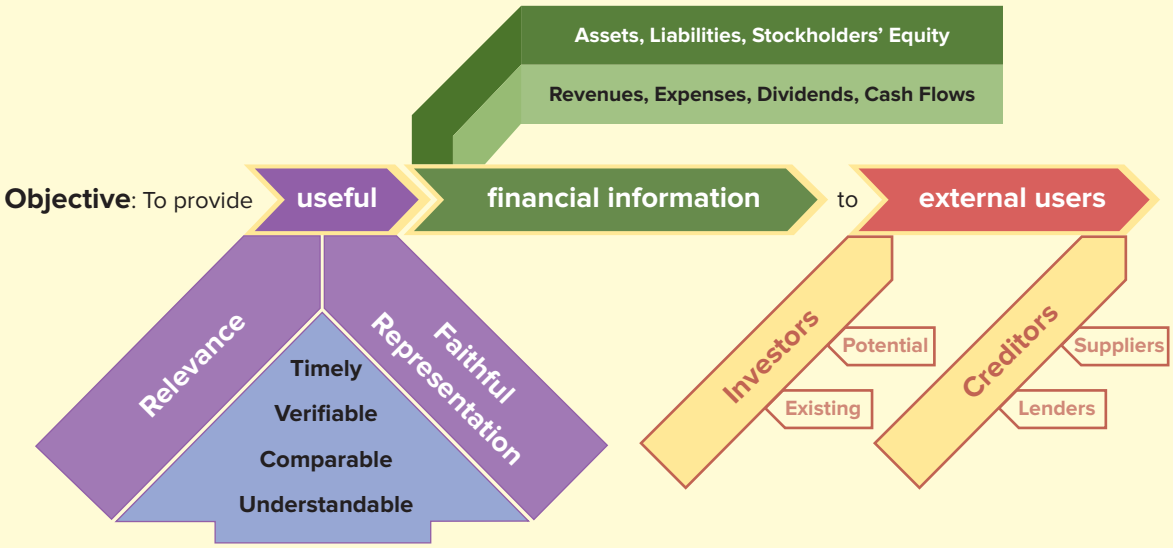
SPOTLIGHT ON The World

The accounting rules developed by the IASB are called **International Financial Reporting Standards, or IFRS** for short. As the map indicates, many countries already require or permit the use of IFRS (purple), or have expressed an acceptance of IFRS in other ways (blue). For example, foreign companies whose stock is traded in the U.S. use IFRS.



The main goal of GAAP and IFRS is to ensure companies produce financial information that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the companies. As shown in Exhibit 1.9, for financial information to be judged useful, it must possess two fundamental characteristics: **relevance** and **faithful representation.** Information is relevant if it makes a difference in

EXHIBIT 1.9 Key Concepts for External Financial Reporting



decision making and it is a faithful representation if it fully depicts the economic substance of business activities. The usefulness of financial information is enhanced when it is (i) timely, (ii) verifiable, (iii) comparable, and (iv) understandable. Information is *timely* if it is available in time to influence decision makers. That's why large public companies in the U.S. must issue annual financial statements within 60 days of year-end. Information is *verifiable* if others, such as external auditors, reach similar values using similar methods. It is *comparable* if the same accounting principles are used over time and across companies. It is *understandable* if reasonably informed users can comprehend and interpret it. To achieve these objectives, the FASB and IASB have developed a framework that outlines the financial elements to be measured (shown in green in Exhibit 1.9) and the main external users for whom the financial information is intended (shown in beige in Exhibit 1.9).

"Who is responsible for ensuring that businesses follow GAAP?"

Laurie told Jordan that a company's managers have primary responsibility for following GAAP. To provide additional assurance, some private companies and all public companies hire independent auditors to scrutinize their financial records. Following rules approved by the Public Company Accounting Oversight Board (PCAOB) and other accounting bodies, these auditors report whether, beyond reasonable doubt, the financial statements represent what they claim to represent and whether they comply with GAAP. In a sense, GAAP is to auditors and accountants what the criminal code is to lawyers and the public. The Securities and Exchange Commission (SEC) is the government agency that oversees stock exchanges and financial reporting by public companies in the United States. More information about public company reporting is presented in Chapter Supplement 1B.

"Overall, users expect information that is truthful, and this assumes that the company is following strong ethical business and accounting practices."

Ethical Conduct

Ethics refers to the standards of conduct for judging right from wrong, honest from dishonest, and fair from unfair. Intentional misreporting is both unethical and illegal. As you will see throughout this course, some accounting and business issues have clear answers that are either right or wrong. However, many situations require accountants, auditors, and managers to weigh the pros and cons of alternatives before making final decisions. To help ensure these decisions are made in a professional and ethical manner, the American Institute of Certified Public Accountants (AICPA) requires that all its members adhere to a **Code of Professional Conduct.** Yet, despite this code of conduct, some individuals have been involved in accounting scandals and fraud.

In response to frauds, the government introduced laws through the **Sarbanes-Oxley Act (SOX)**. SOX requires top managers of public companies to sign a report certifying their responsibilities for the financial statements, maintain an audited system of **internal controls** to ensure accuracy in the accounting reports, and maintain an independent committee to oversee top management and ensure they cooperate with auditors. SOX ensures corporate executives face severe consequences—20 years in prison and $5 million in fines—if found guilty of committing accounting fraud.

Ethical conduct is just as important for small private businesses as it is for large public companies. Laurie's advice to Jordan and to all managers is to create an ethical environment and establish a strong system of checks and controls inside the company. Do not tolerate blatant acts of fraud, such as employees making up false expenses for reimbursement, punching in a time card belonging to a fellow employee late for work, or copying someone's

YOU SHOULD KNOW

Sarbanes-Oxley Act (SOX): A set of laws established to strengthen corporate reporting in the United States.

SPOTLIGHT ON Ethics

Accounting Scandals

Accounting scandals are often driven by greed and the fear of personal or business failure. Initially, some people may appear to benefit from fraudulent reporting. In the long run, however, fraud harms most individuals and organizations. When it is uncovered, the corporation's stock price drops dramatically. For example, Valeant Pharmaceuticals' stock price dropped 51 percent on March 15, 2016, leading its biggest investor to lose $1.3 billion in a single day. Creditors are also harmed by fraud. WorldCom's creditors recovered only 42 percent of what they were owed. They lost $36 billion. Innocent employees also are harmed by fraud. At Enron, 5,600 employees lost their jobs and many lost all of their retirement savings. The auditing firm Arthur Andersen, which once employed 28,000, disbanded after becoming entangled in the WorldCom and Enron frauds.

ideas and claiming them as his or her own. Also be aware that not all ethical dilemmas are clear-cut. Some situations will require you to weigh one moral principle (e.g., honesty) against another (e.g., loyalty). When faced with an ethical dilemma, you should follow a three-step process:

1. **Identify who will be affected by the situation**—both those who will appear to benefit (often the manager or employee) and those who will be harmed (other employees, the company's reputation, owners, creditors, and the public in general).
2. **Identify and evaluate the alternative courses of action.**
3. **Choose the alternative that is the most ethical**—and that you would be proud to have reported in the news.

Often, there is no one right answer to ethical dilemmas and hard choices will need to be made. In the end, however, following strong ethical practices is a key factor in business success and in ensuring good financial reporting.

Epilogue and What's Coming Up

Jordan got going quickly and, in August, created a corporation called Noodlecake Studios, Inc. Things didn't turn out exactly as he had planned, but the business has been successful. Noodlecake started developing apps only for the iPhone but then created software to port these apps to Android devices for sale on Google Play. Noodlecake also provides software consulting services to other companies, and is now looking to publish games for Sony and other gaming consoles.

The next three chapters will take you step by step through some of the financing, investing, and operating decisions during Noodlecake's first month of business. We will look at the way accountants collect data about business activities and process them to construct the financial statements. The key to success in this course is to regularly **practice** the skills presented in this textbook. It is very difficult to learn accounting without doing the assignments and keeping up with the reading.

SUPPLEMENT 1A CAREERS THAT DEPEND ON ACCOUNTING KNOWLEDGE

Learning Objective 1-S1
Describe examples where accounting helps in pursuing other business careers.

Accounting knowledge can make the difference in your ability to land a dream job, whether you hope to work in production and operations management, human resources, finance, or marketing. Exhibit 1A.1 displays nonaccounting jobs that could be available to you at the world's leading companies and explains how accounting knowledge can be vital to these positions. If, instead, you have your eyes set on an accounting career, see Supplement 2A in Chapter 2 for further information.

EXHIBIT 1A.1 Accounting Knowledge Can Benefit All Majors

Production and Operations Management

Production Manager, Nintendo: Figure out how to make a $250 3DS for $100.71.

Outsourcing Specialist, Apple: Coordinate more than 20 suppliers of parts for the next iPad, at the same total cost as legacy iPads.

Human Resources

Compensation Analyst, Google: Develop affordable, attractive global pay programs.

Labor Relations Manager, National Basketball Players Association union: Assist in salary renegotiations involving the $99 million salary cap and 50% revenue sharing–guarantee.

Accounting

Finance

Investment Analyst, Goldman Sachs: Assess value of investing $50 million in Quirky Incorporated.

Financial Analyst, Amazon Web Services: Build financial models to forecast revenue and other key business measures.

Marketing

Brand Manager, Kraft Heinz Company: Set prices to achieve 5% annual sales growth.

Customer Business Developer, Procter & Gamble: Collaborate with accounting to enhance customer profits and cash flows.

Sources: http://techland.time.com/2011/03/29/the-incredibly-cheap-100-nintendo-3ds, http://blogs.forbes.com/johnray/2011/03/11/isuppli-teardown-of-the-ipad-2-investor-edition/, http://www.isuppli.com/Teardowns/News/Pages/iPad-2-Carries-Bill-of-Materials-of-$326-60-IHS-iSuppli-Teardown-Analysis-Shows.aspx, https://amazon.jobs/en/jobs/483415.

Photo: ©Rubberball/Getty Images RF

SUPPLEMENT 1B PUBLIC COMPANIES

Learning Objective 1-S2
Describe the decision to become a public company and explain the implications for accounting.

When a company needs more financing than it can access privately, it may choose to issue shares to investors through a public stock exchange. This process—referred to as *going public*—offers many positive outcomes. A public company (1) keeps the money it raises when issuing shares, (2) can more easily raise money in the future by issuing additional shares, (3) can pay employees using company shares not just cash, (4) gives founders and other stockholders a way to sell their shares, and (5) can buy other companies by paying with shares rather than cash. However, there are downsides to going public: (1) greater public reporting of significant events affecting the company, (2) increased accounting disclosures, and (3) greater risk of litigation for misstatements in and omissions from these reports.

The first step in going public is to register with the Securities and Exchange Commission (SEC) for an initial public offering (IPO). This registration and the ensuing IPO process is time-consuming. A typical IPO takes about 90 to 180 days to complete. It also is expensive. The company's top executives will need the help of lawyers, accountants, and other business advisers to prepare the documents required by the SEC. For example, the company will provide detailed information about the shares it will be issuing, its business plan and risks, management experience, executive pay, at least two years of audited financial statements, and analyses of these prior financial results.

Public Company Financial Reporting

After completing the IPO, a public company is required to provide frequent updates about its business. It gives these updates through press releases, financial statement reports, and various filings with the SEC.

Press Releases To keep external financial statement users informed, a public company will announce annual (and quarterly) results through a press release sent to news agencies. The press release typically includes highlights of key financial results for the period, management's discussion of these results, and attachments containing a condensed income statement and balance sheet. The press release is issued three to five weeks after the accounting period ends to give the company's accountants time to make final adjustments to the accounting records, to allow time for the company's management to prepare a written analysis of the results, and in the case of annual results, to enable external auditors to complete most of their work.

Many companies follow up the press release with a conference call broadcast on the Internet, which allows analysts to ask questions of the company's senior executives. By listening to these calls (or later reading their transcripts), you can learn a lot about the company's business strategy, its expectations for the future, and the key factors analysts consider when they evaluate the company. Archived conference calls are available at the company's website or conferencecalltranscripts.org.

Financial Statement Reports Several weeks after the preliminary press release, a public company will release its complete financial statements as part of an annual (or quarterly) report posted at its investor relations website. A typical annual report contains two parts. The first part usually begins with a letter to investors from the company's Chief Executive Officer (CEO), followed by glossy pictures and comments about the company's business. The second part presents the financial section. The typical elements of the financial section are listed and described in Exhibit 1B.1. The comparative financial statements (list item 5) are similar to the financial statements in the body of this chapter, except they cover multiple years by including a column of numbers for each year.

A company's quarterly report is a highly condensed version of its annual report. Following a short letter to stockholders and abbreviated discussion of the financial results, a quarterly report presents a condensed income statement for the quarter, a condensed balance sheet dated at the end of the quarter, and a condensed statement of cash flows. This condensed report typically shows less detail than the annual report, often omitting items 3, 4, 7, 8, and 9 in Exhibit 1B.1. Quarterly financial statements are not audited, so they are labeled as unaudited. Obviously, with all these limitations, the quarterly reports aren't as informative as the annual report, but at least they are released on a timelier basis (every three months rather than every year).

Securities and Exchange Commission (SEC) Filings To ensure sufficient, relevant information is available to investors, the SEC requires each public company to file certain

EXHIBIT 1B.1 Typical Elements of an Annual Report's Financial Section

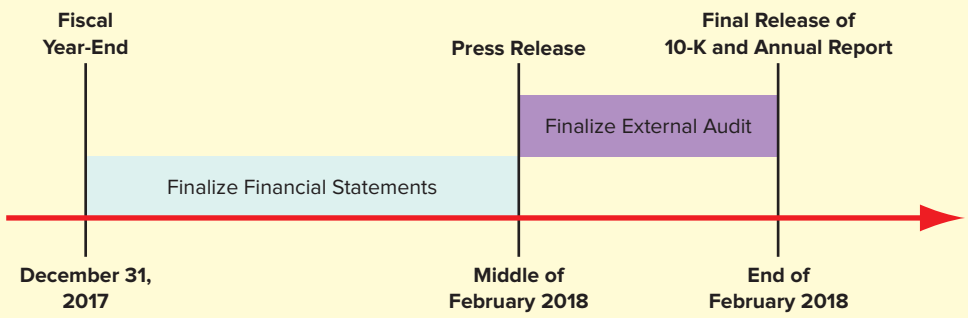
Section Name	Information Presented
1. Summarized financial data	• key figures covering a 5- or 10-year period
2. Management's discussion and analysis (MD&A)	• detailed analysis of the company's financial condition and operating results; a must-read
3. Management's report on internal control	• statements that describe management's responsibility for ensuring effective control over the financial reporting
4. Auditor's report	• the auditor's conclusion about whether GAAP was followed and whether the company's controls were effective
5. Comparative financial statements	• multi-year presentation of the four basic financial statements
6. Financial statement notes	• further information crucial for interpreting the financial statements
7. Recent stock price data	• brief summary of highs and lows during the year
8. Unaudited quarterly data	• condensed summary of results by quarter
9. Directors and officers	• list of those overseeing and running the company

reports with the SEC, including an **annual report on Form 10-K, quarterly reports on Form 10-Q, and current event reports on Form 8-K.** (We wouldn't burden you with the details of the form numbers except that most people refer to them by number.) Form 10-K requires disclosure of information beyond that listed in Exhibit 1B.1 (e.g., description of properties owned, legal proceedings, executive pay), so often companies will use the 10-K in place of a glossy annual report. The 8-K is prepared any time a significant business event occurs between financial statement dates. The 8-K could report a change in the company's top management, its acquisition of another company, the filing of a press release, or the release of new financial data.

To find a public company's SEC filings, click on "Company Filings Search" in the Filings tab at www.sec.gov. These filings are available soon after the SEC's Electronic Data Gathering and Retrieval service (EDGAR) receives them. The typical timing of these releases and filings for a company with a December 31 year-end is shown in Exhibit 1B.2.

Throughout the remaining chapters of this book, you will learn how to evaluate the results reported in financial statements, using ratios and other measures commonly considered by analysts.

EXHIBIT 1B.2 Timing of Significant Financial Reporting Events



REVIEW THE CHAPTER

DEMONSTRATION CASE

The introductory case presented here reviews the items reported on the income statement, statement of retained earnings, and balance sheet, using the financial statements of **Under Armour, Inc.**—a public company founded in 1996 by a former University of Maryland football player to develop, market, and distribute athletic apparel and gear. Following is a list of items and amounts (in thousands of U.S. dollars) adapted from Under Armour, Inc.'s financial statements for the quarter ended September 30, 2016.

Under Armour, Inc.

Accounts Payable	$ 857,300	Office Expenses	$ 508,300
Accounts Receivable	876,000	Operating Expenses	773,000
Cash	180,000	Retained Earnings, July 1, 2016	1,031,500
Common Stock	776,300	Retained Earnings, September 30, 2016	1,156,700
Dividends	3,000	Sales Revenues	1,471,600
Equipment	1,658,000	Total Assets	3,685,000
Income Tax Expense	62,100	Total Expenses	1,343,400
Inventory	971,000	Total Liabilities	1,762,000
Net Income	128,200	Total Liabilities and Stockholders' Equity	3,685,000
Notes Payable	904,700	Total Revenues	1,471,600
		Total Stockholders' Equity	1,923,000

Required:

1. Prepare an income statement, a statement of retained earnings, and a balance sheet for the quarter, following the formats in Exhibits 1.3, 1.4, and 1.5.
2. Describe the content of these three statements.
3. Name the other statement Under Armour would include in its financial statements.
4. Did more of the financing for Under Armour's assets come from liabilities or stockholders' equity?
5. Explain why Under Armour would subject its statements to an independent audit.

Suggested Solution

1. The first step to reach a solution is to distinguish accounts as belonging to the income statement (revenues and expenses), statement of retained earnings (retained earnings and dividends), and balance sheet (assets, liabilities, and stockholders' equity). Organize the accounts in proper format and follow the flow from one to another (as shown by the following arrows).

UNDER ARMOUR, INC.
Income Statement
For the Quarter Ended September 30, 2016
(in thousands of dollars)

Revenues	
Sales Revenues	$1,471,600
Total Revenues	1,471,600
Expenses	
Operating Expenses	773,000
Office Expenses	508,300
Income Tax Expense	62,100
Total Expenses	1,343,400
Net Income	$ 128,200

UNDER ARMOUR, INC.
Statement of Retained Earnings
For the Quarter Ended September 30, 2016
(in thousands of dollars)

Retained Earnings, July 1, 2016	$1,031,500
Add: Net Income	128,200
Subtract: Dividends	(3,000)
Retained Earnings, September 30, 2016	$1,156,700

To the balance sheet

UNDER ARMOUR, INC.
Balance Sheet
At September 30, 2016
(in thousands of dollars)

From the statement of retained earnings

Assets	
Cash	$ 180,000
Accounts Receivable	876,000
Inventory	971,000
Equipment	1,658,000
Total Assets	$3,685,000
Liabilities	
Accounts Payable	$ 857,300
Notes Payable	904,700
Total Liabilities	1,762,000
Stockholders' Equity	
Common Stock	766,300
Retained Earnings	1,156,700
Total Stockholders' Equity	1,923,000
Total Liabilities and Stockholders' Equity	$3,685,000

2. The income statement reports the most common measure of financial performance for a business: net income (revenues minus expenses during the accounting period). The statement of retained earnings links the net income number from the income statement to the end-of-period retained earnings balance on the balance sheet. The balance sheet reports the amount of assets, liabilities, and stockholders' equity of a business at a point in time.
3. Under Armour would also present a statement of cash flows.
4. The balance sheet indicates more financing for Under Armour's assets is provided from stockholders' equity ($1,923,000) than liabilities ($1,762,000).
5. Like all public companies, Under Armour will subject its financial statements to an audit because it is required by the SEC to have an independent audit. Also, an audit will give users greater confidence in the accuracy of financial statement information because the people who audited the statements are required to meet professional standards of ethics and competence.

CHAPTER SUMMARY

Describe various organizational forms and business decision makers. **LO 1-1**

- Sole proprietorships are owned by one individual, are relatively inexpensive to form, and are not treated legally as separate from their owners. Thus, all profits or losses become part of the taxable income to the owner, who is also responsible personally for all debts of the business.
- Partnerships are businesses legally similar to proprietorships, but with two or more owners.
- Corporations are separate legal entities (thus, corporations pay taxes) that issue shares of stock to investors (stockholders) and are more costly to establish. Stockholders cannot be held liable for more than their investment in the corporation. Private corporations issue stock to a few individuals while public corporations issue stock in the stock market.
- Business decision makers include creditors (banks, suppliers), investors (stockholders), customers, governments, and other external users.

LO 1-2 **Describe the purpose, structure, and content of the four basic financial statements.**

- The *income statement* reports the net amount that a business earned (net income) over a period of time by subtracting the costs of running the business (expenses) from the total amount generated by selling its goods and services (revenues).
- The *statement of retained earnings* explains changes in the Retained Earnings account over a period of time by considering increases (from net income) and decreases (from dividends to stockholders).
- The *balance sheet* reports what the business owns (reported as assets) at a particular point in time and how much of the financing for these assets came from creditors (reported as liabilities) and stockholders (reported as stockholders' equity).
- The *statement of cash flows* explains changes in the cash account over a period of time by reporting inflows and outflows of cash from the business's operating, investing, and financing activities.

LO 1-3 **Explain how financial statements are used by decision makers.**

- Creditors are mainly interested in assessing whether the company (1) is generating enough cash to make payments on its loan and (2) has enough assets to cover its liabilities. Answers to these questions are indicated by the statement of cash flows and the balance sheet.
- Investors look closely at the income statement for information about a company's ability to generate profits, and at the statement of retained earnings for information about a company's dividend distributions.

LO 1-4 **Describe factors that contribute to useful financial information.**

- Companies generate useful financial information by applying Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS) in an ethical business environment.
- To be useful, information must be relevant and a faithful representation of reality. Information is more useful when it is timely, verifiable, comparable, and understandable.

KEY TERMS

Accounting p. 5
Accounts p. 10
Balance Sheet p. 12
Basic Accounting Equation p. 8
Financial Statements p. 6
Generally Accepted Accounting Principles (GAAP) p. 18
Income Statement p. 10
International Financial Reporting Standards (IFRS) p. 18
Sarbanes-Oxley Act (SOX) p. 19
Separate Entity Assumption p. 8
Statement of Cash Flows p. 14
Statement of Retained Earnings p. 12
Unit of Measure Assumption p. 10

See complete definitions in the glossary in the back of this text.

HOMEWORK HELPER

Alternative terms

- The balance sheet also can be called the statement of financial position.
- The income statement also can be called the statement of operations.
- Net Income also can be called Net Earnings.

Helpful reminders

- The balance in each account is reported once and only once in either the balance sheet, income statement, or statement of retained earnings.

Frequent mistakes

- Dividends are not expenses. Dividends relate to distributing (not generating) earnings. Consequently, a company's dividends are reported on its statement of retained earnings (not its income statement).

PRACTICE MATERIAL

QUESTIONS (Symbol indicates questions that require analysis from more than one perspective.)

1. Define *accounting*.
2. Val is opening a hair salon, but she does not know what business form it should take. Tell her about the advantages and disadvantages of operating as a sole proprietorship versus a corporation.
3. Briefly distinguish financial accounting from managerial accounting.
4. The accounting process generates financial reports for both internal and external users. Describe some of the specific groups of internal and external users.
5. Explain what the separate entity assumption means when it says a business is treated as separate from its owners for accounting purposes.
6. List the three main types of business activities on the statement of cash flows and give an example of each.
7. What information should be included in the heading of each of the four primary financial statements?
8. What are the purposes of (*a*) the balance sheet, (*b*) the income statement, (*c*) the statement of retained earnings, and (*d*) the statement of cash flows?
9. Explain why the income statement, statement of retained earnings, and statement of cash flows would be dated "For the Year Ended December 31, 2018," whereas the balance sheet would be dated "At December 31, 2018."
10. Briefly explain the difference between *net income* and *net loss*.
11. Describe the basic accounting equation that provides the structure for the balance sheet. Define the three major components reported on the balance sheet.
12. Describe the equation that provides the structure for the income statement. Explain the three major items reported on the income statement.
13. Describe the equation that provides the structure for the statement of retained earnings. Explain the four major items reported on the statement of retained earnings.
14. Describe the equation that provides the structure for the statement of cash flows. Explain the three major types of activities reported on the statement.
15. Briefly describe the organization responsible for developing accounting measurement rules (generally accepted accounting principles) in the United States.
16. What is the main goal for accounting rules in the United States and around the world? What characteristics must financial information possess to reach that goal?
17. Briefly define what an ethical dilemma is and describe the steps to consider when evaluating ethical dilemmas.
18. In what ways might accounting frauds be similar to cases of academic dishonesty?

MULTIPLE CHOICE

1. Which of the following is *not* one of the four basic financial statements?
   - **a.** The balance sheet
   - **b.** The audit report
   - **c.** The income statement
   - **d.** The statement of cash flows
2. Which of the following is true regarding the income statement?
   - **a.** The income statement is sometimes called the statement of operations.
   - **b.** The income statement reports revenues, expenses, and liabilities.
   - **c.** The income statement only reports revenue for which cash was received at the point of sale.
   - **d.** The income statement reports the financial position of a business at a particular point in time.
3. Which of the following is false regarding the balance sheet?
   - **a.** The accounts shown on a balance sheet represent the basic accounting equation for a particular business.
   - **b.** The retained earnings balance shown on the balance sheet must agree with the ending retained earnings balance shown on the statement of retained earnings.
   - **c.** The balance sheet summarizes the net changes in specific account balances over a period of time.
   - **d.** The balance sheet reports the amount of assets, liabilities, and stockholders' equity of a business at a point in time.
4. Which of the following regarding retained earnings is false?
   - **a.** Retained earnings is increased by net income.
   - **b.** Retained earnings is a component of stockholders' equity on the balance sheet.
   - **c.** Retained earnings is an asset on the balance sheet.
   - **d.** Retained earnings represents earnings not yet distributed to stockholders in the form of dividends.
5. Which of the following is *not* one of the items required to be shown in the heading of a financial statement?
   - **a.** The financial statement preparer's name
   - **b.** The title of the financial statement
   - **c.** The financial reporting date or period
   - **d.** The name of the business entity
6. Which of the following statements regarding the statement of cash flows is false?
   - **a.** The statement of cash flows separates cash inflows and outflows into three major categories: operating, investing, and financing.

b. The ending cash balance shown on the statement of cash flows must agree with the amount shown on the balance sheet at the end of the same period.
c. The total increase or decrease in cash shown on the statement of cash flows must agree with the "bottom line" (net income or net loss) reported on the income statement.
d. The statement of cash flows covers a period of time.

7. Which of the following regarding GAAP is true?

a. GAAP is an abbreviation for generally applied accounting principles.
b. Changes in GAAP always affect the amount of income reported by a company.
c. GAAP is the abbreviation for generally accepted accounting principles.
d. Changes to GAAP must be approved by the Senate Finance Committee.

8. Which of the following is true?

a. FASB creates SEC.
b. GAAP creates FASB.
c. SEC creates CPA.
d. FASB creates GAAP.

9. Which of the following would *not* be a goal of external users reading a company's financial statements?

a. Understanding the current financial state of the company
b. Assessing the company's contribution to social and environmental policies
c. Predicting the company's future financial performance
d. Evaluating the company's ability to generate cash from sales

10. Which of the following is *not* required by the Sarbanes-Oxley Act?

a. Top managers of public companies must sign a report certifying their responsibilities for the financial statements.
b. Public companies must maintain an audited system of internal control to ensure accuracy in accounting reports.
c. Public companies must maintain an independent committee to meet with the company's independent auditors.
d. Top managers of public companies must be members of the American Institute of Certified Public Accountants.

For answers to the Multiple-Choice Questions **see page Q1** located in the last section of the book.

MINI-EXERCISES

connect

LO 1-4

M1-1 Identifying Definitions with Abbreviations

The following is a list of important abbreviations used in the chapter. These abbreviations also are used widely in business. For each abbreviation, give the full designation. The first one is an example.

Abbreviation	Full Designation
1. CPA	Certified Public Accountant
2. GAAP	_____
3. FASB	_____
4. SEC	_____
5. IFRS	_____

LO 1-1, 1-2, 1-4

M1-2 Matching Definitions with Terms or Abbreviations

Match each definition with its related term or abbreviation by entering the appropriate letter in the space provided.

Term or Abbreviation	Definition
____ 1. SEC	A. A system that collects and processes financial information about an organization and reports that information to decision makers.
____ 2. Investing activities	B. Measurement of information about a business in the monetary unit (dollars or other national currency).
____ 3. Private company	C. An unincorporated business owned by two or more persons.
____ 4. Corporation	D. A company that sells shares of its stock privately and is not required to release its financial statements to the public.
____ 5. Accounting	
____ 6. Partnership	
____ 7. FASB	
____ 8. Financing activities	
____ 9. Unit of measure	

____ 10. GAAP
____ 11. Public company
____ 12. Operating activities

E. An incorporated business that issues shares of stock as evidence of ownership.
F. Buying and selling productive resources with long lives.
G. Transactions with lenders (borrowing and repaying cash) and stockholders (selling company stock and paying dividends).
H. Activities directly related to running the business to earn profit.
I. Securities and Exchange Commission.
J. Financial Accounting Standards Board.
K. A company that has its stock bought and sold on stock exchanges and is required to publicly release its financial statements.
L. Generally accepted accounting principles.

M1-3 Matching Definitions with Terms LO 1-2, 1-4

Match each definition with its related term by entering the appropriate letter in the space provided.

Term	Definition
____ 1. Relevance	A. The financial reports of a business are assumed to include the results of only that business's activities.
____ 2. Faithful representation	B. The resources owned by a business.
____ 3. Expenses	C. Financial information that depicts the economic substance of business activities.
____ 4. Separate entity	D. The total amounts invested and reinvested in the business by its owners.
____ 5. Assets	E. The costs of business necessary to earn revenues.
____ 6. Liabilities	F. A feature of financial information that allows it to influence a decision.
____ 7. Stockholders' equity	G. Earned by selling goods or services to customers.
____ 8. Revenues	H. The amounts owed by the business.

M1-4 Matching Financial Statement Items to Balance Sheet and Income Statement Categories LO 1-2

For each of the following items in Procter & Gamble's financial statements, indicate (1) whether it is reported in the income statement (I/S) or balance sheet (B/S) and (2) whether it is an asset (A), liability (L), stockholders' equity (SE), revenue (R), or expense (E) account. The first item is given as an example. Procter & Gamble

Item	(1) Statement	(2) Account Type
(Example) Cash	B/S	A
1. Accounts Payable		
2. Accounts Receivable		
3. Income Tax Expense		
4. Sales Revenue		
5. Notes Payable		
6. Retained Earnings		

LO 1-2

M1-5 Matching Financial Statement Items to Balance Sheet and Income Statement Categories

For each item, indicate (1) whether it is reported on the income statement (I/S) or balance sheet (B/S) and (2) the type of account (A = asset, L = liability, SE = stockholders' equity, R = revenue, E = expense).

Item	(1) Statement	(2) Account Type
1. Accounts Receivable		
2. Sales Revenue		
3. Equipment		
4. Supplies Expense		
5. Cash		
6. Advertising Expense		
7. Accounts Payable		
8. Retained Earnings		

LO 1-2

M1-6 Matching Financial Statement Items to Balance Sheet and Income Statement Categories

Tootsie Roll Industries

Tootsie Roll Industries manufactures and sells more than 64 million Tootsie Rolls each day. The following items were listed on Tootsie Roll's recent income statement and balance sheet. For each item, indicate (1) the type of account (A = asset, L = liability, SE = stockholders' equity, R = revenue, E = expense) and (2) whether it is reported on the income statement (I/S) or balance sheet (B/S).

1. Accounts Receivable
2. Office Expenses
3. Cash
4. Equipment
5. Advertising Expense
6. Sales Revenue
7. Notes Payable
8. Retained Earnings
9. Accounts Payable

LO 1-2

M1-7 Matching Financial Statement Items to Balance Sheet and Income Statement Categories

General Mills

General Mills is a manufacturer of food products, such as Lucky Charms cereal, Pillsbury crescent rolls, and Green Giant vegetables. The following items were presented in the company's financial statements. For each item, indicate (1) the type of account (A = asset, L = liability, SE = stockholders' equity, R = revenue, E = expense) and (2) whether it is reported on the income statement (I/S) or balance sheet (B/S).

1. Accounts Payable
2. Common Stock
3. Equipment
4. Accounts Receivable
5. Notes Payable
6. Cash
7. Retained Earnings
8. Office Expenses
9. Sales Revenue
10. Supplies

LO 1-2

M1-8 Matching Financial Statement Items to the Basic Financial Statements

Oakley, Inc.

Oakley, Inc., reported the following items in its financial statements. For each item, indicate (1) the type of account (A = asset, L = liability, SE = stockholders' equity, R = revenue, E = expense, D = dividend) and (2) whether it is reported on the income statement (I/S), statement of retained earnings (SRE), and/or balance sheet (B/S).

1. Dividends
2. Common Stock
3. Sales Revenue
4. Equipment
5. Cash
6. Notes Payable
7. Accounts Payable
8. Retained Earnings, Beginning of Year

LO 1-2

M1-9 Matching Financial Statement Items to the Four Basic Financial Statements

Match each element with its financial statement by entering the appropriate letter in the space provided.

Element	Financial Statement
____ 1. Cash Flows from Financing Activities	A. Balance Sheet
____ 2. Expenses	B. Income Statement
____ 3. Cash Flows from Investing Activities	C. Statement of Retained Earnings
____ 4. Assets	D. Statement of Cash Flows
____ 5. Dividends	
____ 6. Revenues	
____ 7. Cash Flows from Operating Activities	
____ 8. Liabilities	

M1-10 Reporting Amounts on the Statement of Cash Flows LO 1-2

Learning which items belong in each cash flow statement category is an important first step in understanding their meaning. Use a letter to mark each item in the following list as a cash flow from Operating, Investing, or Financing activities. **Put parentheses around the letter if it is a cash *outflow* and use no parentheses if it's an *inflow*.**

____ **1.** Cash paid for dividends
____ **2.** Cash collected from customers
____ **3.** Cash received when signing a note payable
____ **4.** Cash paid to employees
____ **5.** Cash paid to purchase equipment
____ **6.** Cash received from issuing stock

M1-11 Reporting Amounts on the Statement of Cash Flows LO 1-2

Learning which items belong in each category of the statement of cash flows is an important first step in understanding their meaning. Use a letter to mark each item in the following list as a cash flow from Operating, Investing, or Financing activities. **Put parentheses around the letter if it is a cash *outflow* and use no parentheses if it's an *inflow*.**

____ **1.** Cash paid to purchase land
____ **2.** Cash collected from clients
____ **3.** Cash received from selling equipment
____ **4.** Cash paid for dividends
____ **5.** Cash paid to suppliers
____ **6.** Cash received from issuing stock

M1-12 Preparing a Statement of Retained Earnings LO 1-2

Stone Culture Corporation was organized on January 1, 2017. For its first two years of operations, it reported the following:

Net Income for 2017	$40,000	Dividends for 2018	$ 20,000
Net Income for 2018	45,000	Total assets at the end of 2017	125,000
Dividends for 2017	15,000	Total assets at the end of 2018	242,000

On the basis of the data given, prepare a statement of retained earnings for both 2017 (its first year of operations) and 2018.

M1-13 Relationships among Financial Statements LO 1-2

Apple, Inc.
Google, Inc.
Intel Corp.

Items from the income statement, statement of retained earnings, and balance sheet are listed below in alphabetical order. For the companies shown in each column, solve for the missing amounts.

TIP: Use Exhibit 1.7 to identify relations among the items, then solve for amounts.

	Apple, Inc.	Google, Inc.	Intel Corp.
Common Stock	$20	$23	$22
Dividends	0	0	5
Net Income	(a)	(d)	(g)
Retained Earnings, Beginning of Year	104	38	33
Retained Earnings, End of Year	(b)	(e)	(h)
Total Assets	(c)	(f)	(i)
Total Expenses	122	34	44
Total Liabilities	83	22	42
Total Revenues	171	50	55

LO 1-2

M1-14 Relationships among Financial Statements

Items from the income statement, statement of retained earnings, and balance sheet are listed below in alphabetical order. For the companies shown in each column, solve for the missing amounts.

	Amazin' Corp.	Best Tech, Inc.	Colossal Corp.
Common Stock	$ 5	$15	$100
Dividends	10	5	50
Net Income	(a)	(d)	(g)
Retained Earnings, Beginning of Year	30	0	200
Retained Earnings, End of Year	(b)	(e)	(h)
Total Assets	(c)	(f)	(i)
Total Expenses	75	30	200
Total Liabilities	30	30	350
Total Revenues	100	50	300

LO 1-2

Activision Blizzard, Inc.

LEVEL UP

M1-15 Relationships among Financial Statements

Items from the 2015 income statement, statement of retained earnings, and balance sheet of Activision Blizzard, Inc., are listed below in alphabetical order. Solve for the missing amounts, and explain whether the company was profitable.

TIP: Use Exhibit 1.7 to identify relations among the items, then work backward to solve for amounts.

	Activision Blizzard, Inc.
Common Stock	$ 3,972
Dividends	170
Net Income (Loss)	(a)
Retained Earnings, Beginning of Year	3,374
Retained Earnings, End of Year	(b)
Total Assets	15,251
Total Expenses	(c)
Total Liabilities	7,183
Total Revenues	4,664

LO 1-2, 1-3

M1-16 Preparing an Income Statement, Statement of Retained Earnings, and Balance Sheet

The following information was reported in the December 31, 2017, financial statements of National Airways, Inc. (listed alphabetically, amounts in millions).

Accounts Payable	$ 4,650	Interest Expense	$ 130
Accounts Receivable	580	Landing Fees Expense	3,100
Aircraft Fuel Expense	8,700	Notes Payable	6,950
Cash	2,970	Repairs and Maintenance Expense	1,200
Common Stock	1,220	Retained Earnings (as of December 31, 2017)	5,780
Dividends	20	Salaries and Wages Expense	3,280
Equipment	14,370	Supplies	680
Income Tax Expense	260	Ticket Revenues	17,100

1. Prepare an income statement for the year ended December 31, 2017.
2. Prepare a statement of retained earnings for the year ended December 31, 2017.
   TIP: Assume the balance in Retained Earnings was $5,370 (million) at January 1, 2017.
3. Prepare a balance sheet at December 31, 2017.
4. Using the balance sheet, indicate whether the total assets of National Airways at the end of the year were financed primarily by liabilities or stockholders' equity.

EXERCISES

connect

E1-1 Reporting Amounts on the Four Basic Financial Statements

LO 1-2

Using the following table and the equations underlying each of the four basic financial statements, show (*a*) that the balance sheet is in balance, (*b*) that net income is properly calculated, (*c*) what caused changes in the retained earnings account, and (*d*) what caused changes in the cash account.

Assets	$18,200	Beginning Retained Earnings	$3,500
Liabilities	13,750	Ending Retained Earnings	4,300
Stockholders' Equity	4,450	Cash Flows from Operating Activities	1,600
Revenue	10,500	Cash Flows from Investing Activities	(1,000)
Expenses	9,200	Cash Flows from Financing Activities	(900)
Net Income	1,300	Beginning Cash	1,000
Dividends	500	Ending Cash	700

E1-2 Reporting Amounts on the Four Basic Financial Statements

LO 1-2

Using the following table and the equations underlying each of the four basic financial statements, show (*a*) that the balance sheet is in balance, (*b*) that net income is properly calculated, (*c*) what caused changes in the retained earnings account, and (*d*) what caused changes in the cash account.

Assets	$79,500	Beginning Retained Earnings	$20,500
Liabilities	18,500	Ending Retained Earnings	28,750
Stockholders' Equity	61,000	Cash Flows from Operating Activities	15,700
Revenue	32,100	Cash Flows from Investing Activities	(7,200)
Expenses	18,950	Cash Flows from Financing Activities	(5,300)
Net Income	13,150	Beginning Cash	3,200
Dividends	4,900	Ending Cash	6,400

E1-3 Preparing a Balance Sheet

LO 1-2, 1-3

DSW, Inc.

DSW, Inc., is a designer shoe warehouse, selling luxurious and fashionable shoes. Its balance sheet, at July 30, 2016 (the last Saturday of the month), contained the following (listed alphabetically, amounts in thousands).

Accounts Payable	$314,400	Inventory	$ 556,100
Accounts Receivable	49,000	Notes Payable	203,200
Cash	165,800	Retained Earnings	310,000
Common Stock	631,400	Total Assets	1,459,000
Equipment	688,100	Total Liabilities and Stockholders' Equity	?

Required:

1. Prepare the balance sheet as of July 30, 2016, solving for the missing amount.
2. As of July 30, did most of the financing for assets come from creditors or stockholders?

LO 1-2, 1-3

E1-4 Completing a Balance Sheet and Inferring Net Income

Ken Young and Kim Sherwood organized Reader Direct as a corporation; each contributed $49,000 cash to start the business and received 4,000 shares of stock. The store completed its first year of operations on December 31, 2017. On that date, the following financial items for the year were determined: cash on hand and in the bank, $47,500; amounts due from customers from sales of books, $26,900; equipment, $48,000; amounts owed to publishers for books purchased, $8,000; one-year notes payable to a local bank for $2,850. No dividends were declared or paid to the stockholders during the year.

Required:

1. Complete the following balance sheet at December 31, 2017.

_____
_____
_____

Assets		Liabilities and Stockholders' Equity	
Cash	$_____	**Liabilities**	
Accounts Receivable	_____	Accounts Payable	$_____
Equipment	_____	Notes Payable	_____
		Total Liabilities	_____
		Stockholders' Equity	
		Common Stock	_____
		Retained Earnings	13,550
		Total Stockholders' Equity	_____
Total Assets	$_____	Total Liabilities and Stockholders' Equity	$_____

2. Using the retained earnings equation and an opening balance of $0, work backwards to compute the amount of net income for the year ended December 31, 2017.
3. As of December 31, 2017, did most of the financing for assets come from creditors or stockholders?
4. Assuming that Reader Direct generates net income of $3,000 and pays dividends of $2,000 in 2018, what would be the ending Retained Earnings balance at December 31, 2018?

LO 1-2

E1-5 Labeling and Classifying Business Transactions

K·Swiss Inc.

The following items relate to business transactions involving K·Swiss Inc.

a. Coins and currency
b. Amounts K·Swiss owes to suppliers of shoes
c. Amounts K·Swiss can collect from customers
d. Amounts owed to bank for loan to buy building
e. Property on which buildings will be built
f. Amounts distributed from profits to stockholders
g. Amounts earned by K·Swiss by selling shoes
h. Unused paper in K·Swiss head office
i. Cost of paper used up during month
j. Amounts contributed by stockholders for K·Swiss stock

Required:

1. Identify an appropriate label (account name) for each item as it would be reported in the company's financial statements. Choose from the following: Accounts Payable, Accounts Receivable, Cash, Common Stock, Dividends, Land, Notes Payable, Sales Revenue, Supplies, and Supplies Expense.
2. Classify each item (*a* through *j*) as an asset (A), liability (L), stockholders' equity (SE), revenue (R), or expense (E).

E1-6 Preparing an Income Statement and Inferring Missing Values

LO 1-2, 1-3

Cinemark Holdings, Inc.

Cinemark Holdings, Inc., operates movies and food concession counters throughout the United States. Its income statement for the quarter ended September 30, 2016, reported the following (accounts are listed alphabetically in thousands):

Admissions Revenue	$472,800	Office Expenses	$202,900
Concessions Expenses	41,900	Rent Expense	82,800
Concessions Revenue	295,700	Salaries and Wages Expense	84,500
Film Rental Expenses	249,800	Net Income	?
Income Tax Expense	40,900		

Required:

1. Solve for the missing amount by preparing an income statement for the quarter ended September 30, 2016.
2. What are Cinemark's main source of revenue and two biggest expenses?

E1-7 Preparing an Income Statement

LO 1-2

Home Realty, Incorporated, has been operating for three years and is owned by three investors. J. Doe owns 60 percent of the total outstanding stock of 9,000 shares and is the managing executive in charge. On December 31, the following financial items for the entire year were determined: sales revenue, $166,000; salaries and wages expense, $97,000; interest expense, $6,300; advertising expenses, $9,025; and income tax expense, $18,500. Also during the year, the company declared and paid the owners dividends amounting to $12,000. Prepare the company's income statement.

E1-8 Inferring Values Using the Income Statement and Balance Sheet Equations

LO 1-2

Review the chapter explanations of the income statement and the balance sheet equations. Apply these equations in each of the following independent cases to compute the two missing amounts for each case. Assume that it is the end of the first full year of operations for the company.

TIP: First identify the numerical relations among the columns using the balance sheet and income statement equations. Then compute the missing amounts.

Independent Cases	Total Revenues	Total Expenses	Net Income (Loss)	Total Assets	Total Liabilities	Stockholders' Equity
A	$110,000	$82,000	$	$150,000	$70,000	$
B		80,000	12,000	112,000		70,000
C	80,000	86,000		104,000	26,000	
D	50,000		20,000		22,000	77,000
E		81,000	(6,000)		73,000	28,000

LO 1-2, 1-3

E1-9 Preparing an Income Statement and Balance Sheet

Five individuals organized Miami Music Corporation on January 1. At the end of January 31, the following monthly financial data are available:

Total Revenues	$131,000
Operating Expenses	90,500
Cash	30,800
Accounts Receivable	25,300
Supplies	40,700
Accounts Payable	25,700
Common Stock	30,600

No dividends were declared or paid during January.

Required:

1. Complete the following income statement and balance sheet for the month of January.

MIAMI MUSIC CORPORATION
Income Statement
For the Month Ended January 31

Total Revenues	$_____
Operating Expenses	_____
Net Income	$_____

MIAMI MUSIC CORPORATION
Balance Sheet
At January 31

Assets	
Cash	$_____
Accounts Receivable	_____
Supplies	_____
Total Assets	$_____
Liabilities	
Accounts Payable	$_____
Total Liabilities	_____
Stockholders' Equity	
Common Stock	_____
Retained Earnings	_____
Total Stockholders' Equity	_____
Total Liabilities and Stockholders' Equity	$_____

2. Did Miami Music Corporation generate a profit? Which financial statement indicates this?
3. Does Miami Music Corporation have sufficient resources to pay its liabilities? Which financial statement indicates this?

E1-10 Analyzing and Interpreting an Income Statement LO 1-2, 1-3

Three individuals organized Pest Away Corporation on January 1 to provide insect extermination services. The company paid dividends of $10,000 during the year. At the end of the first year of operations, the following income statement was prepared:

PEST AWAY CORPORATION
Income Statement
For the Year Ended December 31

Revenues	
Service Revenue	$192,000
Sales Revenue	24,000
Total Revenues	216,000
Expenses	
Supplies Expense	76,000
Salaries and Wages Expense	33,000
Advertising Expense	22,000
Office Expenses	46,000
Total Expenses	177,000
Net Income	$ 39,000

Required:

1. Did the company generate more revenue from selling goods or providing services to customers?
2. If salaries and wages were to double, how much net income would the company report?
3. If the company paid $20,000 of its advertising expense during the current year, what amount is owed for advertising at the end of the year? In what account would the amount still owing be reported?
4. Would the $10,000 of dividends be reported on the balance sheet or statement of retained earnings?

E1-11 Matching Cash Flow Statement Items to Business Activity Categories LO 1-2

Tech Data Corporation

Tech Data Corporation is a leading distributor of computer peripherals and network solutions. The following items were taken from its recent cash flow statement. Mark each item in the following list with a letter to indicate whether it is a cash flow from Operating, Investing, or Financing activities. **Put parentheses around the letter if it is a cash *outflow* and use no parentheses if it's an *inflow*.**

____ **1.** Cash paid to suppliers and employees
____ **2.** Cash received from customers
____ **3.** Cash received from borrowing using a long-term note
____ **4.** Cash received from issuing stock
____ **5.** Cash paid to purchase equipment

E1-12 Matching Cash Flow Statement Items to Business Activity Categories LO 1-2

Coca-Cola Company

The Coca-Cola Company is one of the world's leading manufacturers, marketers, and distributors of nonalcoholic beverage concentrates and syrups, producing more than 500 beverage brands. Mark each item in the following list with a letter to indicate whether it is a cash flow from Operating, Investing, or Financing activities. **Put parentheses around the letter if it is a cash *outflow* and use no parentheses if it's an *inflow*.**

____ **1.** Purchases of equipment
____ **2.** Cash received from customers

____ 3. Cash received from issuing stock
____ 4. Cash paid to suppliers and employees
____ 5. Cash paid on notes payable
____ 6. Cash received from selling equipment

COACHED PROBLEMS

connect

LO 1-2

CP1-1 Preparing an Income Statement, Statement of Retained Earnings, and Balance Sheet

Assume you are the president of Nuclear Company. At the end of the first year of operations (December 31), the following financial data for the company are available:

Accounts Payable	$30,000
Accounts Receivable	59,500
Cash	12,000
Common Stock	62,280
Dividends	200
Equipment	36,000
Notes Payable	1,470
Operating Expenses	57,200
Other Expenses	8,850
Sales Revenue	88,000
Supplies	8,000

Required:

1. Prepare an income statement for the year ended December 31.
   TIP: Begin by classifying each account as asset, liability, stockholders' equity, revenue, or expense. Each account is reported on only one financial statement.
2. Prepare a statement of retained earnings for the year ended December 31.
   TIP: Because this is the first year of operations, the beginning balance in Retained Earnings will be zero.
3. Prepare a balance sheet at December 31.
   TIP: The balance sheet includes the ending balance from the statement of retained earnings.

LO 1-3

CP1-2 Interpreting the Financial Statements

Refer to CP1-1.

Required:

1. Was the company profitable? Which financial statement provides the information to answer this question?
2. Did the company's dividends exceed its net income? Which financial statement provides the information to answer this question?
3. Is the company financed mainly by creditors or stockholders? Which financial statement provides the information to answer this question?
4. By how much did cash increase (decrease)? Which financial statement would report the business activities responsible for this change in cash?

LO 1-2

CP1-3 Reporting Amounts on the Four Basic Financial Statements

Fitbit, Inc.

Fitbit, Inc., reported the following information for the nine-month period ended October 1, 2016. Items are listed alphabetically and are in thousands of dollars.

Accounts Payable	$ 519,400	Income Tax Expense	$ 18,300
Accounts Receivable	461,300	Interest Expense	2,600
Advertising Expense	79,800	Inventories	215,000
Cash (January 1, 2016)	664,400	Notes Payable	53,700
Cash (October 1, 2016)	672,100	Operating Expenses	263,100
Common Stock	830,700	Retained Earnings (January 1, 2016)	260,300
Equipment	255,400	Sales Revenue	503,800
Office Expenses	113,900	Supplies	86,400

Other cash flow information:

Cash received from issuing common stock	$ 39,400
Cash paid to purchase equipment	66,800
Cash paid to suppliers and employees	488,700
Cash received from customers	523,700
Cash received from sale of long-term assets	100
Dividends paid to stockholders	0

Required:

Prepare the four basic financial statements for the nine months ended October 1, 2016.

TIP: Prepare the four statements in the following order: (1) income statement, (2) statement of retained earnings, (3) balance sheet, (4) statement of cash flows.

CP1-4 Evaluating Financial Statements LO 1-3

Refer to CP1-3. Fitbit, Inc.

Required:

1. Did Fitbit rely more on creditors or stockholders for its financing at October 1, 2016? What is your information source?
2. Was the stockholders' equity at October 1, 2016, comprised more of contributions made by stockholders directly to the company or amounts earned and retained through profitable business operations? What is your information source?

GROUP A PROBLEMS

connect

PA1-1 Preparing an Income Statement, Statement of Retained Earnings, and Balance Sheet LO 1-2

Assume you are the president of High Power Corporation. At the end of the first year of operations (December 31), the following financial data for the company are available:

Accounts Payable	$32,100
Accounts Receivable	9,550
Cash	13,300
Common Stock	59,090
Dividends	1,950
Equipment	86,000
Notes Payable	1,160
Operating Expenses	58,700
Other Expenses	7,850
Sales Revenue	90,000
Supplies	5,000

Required:

1. Prepare an income statement for the year ended December 31.
2. Prepare a statement of retained earnings for the year ended December 31.
3. Prepare a balance sheet at December 31.

LO 1-3

PA1-2 Interpreting the Financial Statements

Refer to PA1-1.

Required:

1. Is the company financed mainly by creditors or stockholders? Which financial statement provides the information to answer this question?
2. By how much did cash increase (decrease)? Which financial statement would report the business activities responsible for this change in cash?
3. Was the company profitable? Which financial statement provides the information to answer this question?
4. Did the company's dividends exceed its net income? Which financial statement provides the information to answer this question?

LO 1-2

PA1-3 Reporting Amounts on the Four Basic Financial Statements

The following information for the year ended December 31, 2016, was reported by Nice Bite, Inc.

Accounts Payable	$ 45,000	Inventory	$ 17,200
Accounts Receivable	22,800	Notes Payable	23,600
Cash (balance on January 1, 2016)	103,500	Office Expense	14,300
Cash (balance on December 31, 2016)	102,800	Prepaid Rent	7,000
Common Stock	180,500	Retained Earnings (beginning)	6,300
Dividends	0	Salaries and Wages Expenses	35,700
Equipment	136,700	Service Revenue	137,800
Income Tax Expense	10,100	Utilities Expense	25,100
Interest Expense	29,500	Wages Payable	8,000

Other cash flow information:

Cash from issuing common stock	$ 21,000
Cash paid to reacquire common stock	23,500
Cash paid for income taxes	11,000
Cash paid to purchase long-term assets	41,000
Cash paid to suppliers and employees	83,200
Cash received from customers	137,000

Required:

Prepare the four basic financial statements for 2016.

LO 1-3

PA1-4 Evaluating Financial Statements

Refer to PA1-3.

Required:

1. Did Nice Bite rely more on creditors or stockholders for its financing at December 31, 2016? What is your information source?
2. Did the retained earnings at December 31, 2016, arise primarily from current year earnings or earnings retained from prior years? What is your information source?

GROUP B PROBLEMS

connect

PB1-1 Preparing an Income Statement and Balance Sheet LO 1-2

Assume you are the president of APEC Aerospace Corporation. At the end of the first year of operations (December 31), the following financial data for the company are available:

Accounts Payable	$33,130
Accounts Receivable	9,500
Cash	13,900
Common Stock	10,000
Dividends	1,100
Equipment	86,000
Notes Payable	51,220
Operating Expenses	60,000
Other Expenses	8,850
Sales Revenue	94,000
Supplies	9,000

Required:

1. Prepare an income statement for the year ended December 31.
2. Prepare a statement of retained earnings for the year ended December 31.
3. Prepare a balance sheet at December 31.

PB1-2 Interpreting the Financial Statements LO 1-3

Refer to PB1-1.

Required:

1. Is the company financed mainly by creditors or stockholders? Which financial statement provides the information to answer this question?
2. Was the company profitable? Which financial statement provides the information to answer this question?
3. By how much did cash increase (decrease)? Which financial statement would report the business activities responsible for this change in cash?
4. Did the company's dividends exceed its net income? Which financial statement provides the information to answer this question?

PB1-3 Reporting Amounts on the Four Basic Financial Statements LO 1-2

Cheese Factory Incorporated reported the following information for the fiscal year ended August 31, 2018.

Accounts Payable	$145,000	Office Expenses	$ 95,000
Accounts Receivable	15,000	Prepaid Rent	50,000
Cash (balance on September 1, 2017)	75,000	Retained Earnings (beginning)	410,000
Cash (balance on August 31, 2018)	80,000	Salaries and Wages Expense	955,000
Common Stock	100,000	Salaries and Wages Payable	170,000
Dividends	10,000	Sales Revenue	1,660,000
Equipment	755,000	Supplies	25,000
Notes Payable	30,000	Utilities Expense	530,000

Other cash flow information:

Additional investments by stockholders	$ 34,000
Cash paid to purchase equipment	40,000
Cash paid to suppliers and employees	1,490,000
Repayments of borrowings	155,000
Cash received from customers	1,661,000
Cash received from borrowings	5,000
Dividends paid in cash	10,000

Required:

Prepare the four basic financial statements for the fiscal year ended August 31, 2018.

LO 1-3

PB1-4 Evaluating Financial Statements

Refer to PB1-3.

Required:

1. Did Cheese Factory's cash balance increase or decrease during the year ended August 31, 2018? Which financial statement shows the reasons for this change?
2. What would Cheese Factory's 2018 net income have been had it given a 5 percent pay increase to all employees on September 1, 2017? Which financial statement did you use to answer this?

SKILLS DEVELOPMENT CASES

connect

LO 1-1, LO 1-2, LO 1-3

S1-1 Finding Financial Information

The Home Depot

Answer the following questions by referring to the financial statements of The Home Depot in Appendix A at the end of this book. (**Note: Fiscal 2016 for The Home Depot runs from February 1, 2016, to January 29, 2017.** As with many retail companies, **The Home Depot labels the period "Fiscal 2016" even though it ends in the 2017 calendar year.** The label "Fiscal 2016" is appropriate because Fiscal 2016 includes 11 months from the 2016 calendar year. The Home Depot explains its choice of fiscal period in Note 1 to its financial statements.)

Required:

1. What amount of net income was reported (in millions) for the year ended January 29, 2017?
   a. $94,595
   b. $32,313
   c. $7,009
   d. $7,957
2. What amount of sales revenue (in millions) was earned for the year ended January 29, 2017?
   a. $32,313
   b. $94,595
   c. $7,957
   d. $7,009
3. What was the cost (in millions) of the company's inventory on January 29, 2017?
   a. $2,538
   b. $12,549
   c. $2,216
   d. $11,809
4. How much cash (in millions) does The Home Depot have on January 29, 2017?
   a. $2,538
   b. $12,549
   c. $2,216
   d. $11,809

S1-2 Comparing Financial Information

LO 1-1, LO 1-2, LO 1-3

The Home Depot
Lowe's

Refer to the financial statements of The Home Depot in Appendix A and Lowe's in Appendix B at the end of this book. (Note: Fiscal 2106 for The Home Depot runs from February 1, 2016, to January 29, 2017. Fiscal 2016 for Lowe's runs from January 30, 2016, to February 3, 2017. See S1-1 for further explanation of these fiscal periods.)

Required:

1. Was Lowe's net income for the year ended February 3, 2017, greater (or less) than The Home Depot's?
2. Was Lowe's sales revenue for the year ended February 3, 2017, greater (or less) than The Home Depot's?
3. Did Lowe's have more (or less) inventory than The Home Depot at the end of "Fiscal 2016"?
4. Did Lowe's have more (or less) cash than The Home Depot at the end of "Fiscal 2016"?
5. What reasons do The Home Depot and Lowe's give for choosing such odd dates to end their fiscal years?
6. How many weeks are included in "Fiscal 2016" for The Home Depot versus Lowe's? If the companies were identical in all other respects, which company would you expect to report a larger amount of sales revenue?

S1-3 Internet-Based Team Research: Examining an Annual Report

LO 1-1, LO 1-2, LO 1-3

Reuters

As a team, select an industry to analyze. Reuters provides lists of industries in the online stock screener at stockscreener.us.reuters.com/Stock/US. Another source is csimarket.com. Each group member should access the annual report (or Form 10-K filed with the SEC) for one publicly traded company in the industry, with each member selecting a different company. In addition to the company's own website, a great source is the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) service. This free source is available by going to the "Filings" section of www.sec.gov and clicking on "Company Filings" and then entering the "Company name."

Required:

1. On an individual basis, each team member should write a short report that lists the following information:
   a. What type of business organization is it?
   b. What types of products or services does it sell?
   c. On what day of the year does its fiscal year end?
   d. For how many years does it present complete balance sheets? Income statements? Cash flow statements?
   e. Are its financial statements audited by independent CPAs? If so, by whom?
   f. Did its total assets increase or decrease over the last year?
   g. Did its net income increase or decrease over the last year?
2. Then, as a team, write a short report comparing and contrasting your companies using these attributes. Discuss any patterns across the companies that you as a team observe. Provide potential explanations for any differences discovered.

S1-4 Ethical Decision Making: A Real-Life Example

LO 1-2, LO 1-3, LO 1-4

Adelphia Communications

Complete this case involving Adelphia Communications, which your instructor may access from and make available to you in the Connect eBook. By completing the requirements of this case, which ask you to explain how accounting concepts apply to Adelphia's business, you will learn the challenges and importance of distinguishing between personal and business activities when accounting for a family-owned business.

S1-5 Ethical Decision Making: A Mini-Case

LO 1-4

You are one of three stockholders who own and operate Mary's Maid Service. The company has been operating for seven years. One of the other stockholders has prepared the company's annual financial statements. Recently, you proposed the financial statements be audited each year because

it would benefit the stockholders. The stockholder who prepares the statements proposed that his uncle, who has a lot of financial experience, can do the job at little cost. The third stockholder remained silent.

Required:

1. What position would you take on the proposal? Justify your response in writing.
2. What would you recommend? Give the basis for your recommendation.

LO 1-2, LO 1-3, LO 1-4

S1-6 Critical Thinking: Developing a Balance Sheet and Income Statement

On September 30, Ashley and Jason started arguing about who is better off. Jason said he was better off because he owned a video game console that he bought last year for $250. He figures that, if needed, he could sell it to a friend for $180. Ashley argued she was better off because she had $1,000 cash in her bank account and a piece of art she bought two years ago for $800 but could now probably sell for $1,400. Jason countered that Ashley still owed $250 on a loan and Jason's dad promised to buy him a Porsche if he does really well in accounting. Jason said he had $6,000 cash in his bank account right now because he just received a $4,800 student loan. Ashley knows that Jason also owes a tuition installment of $800 for this term.

Ashley and Jason met again in early November. They asked how each other was doing. Ashley claimed that she'd become much more successful than Jason. She had a part-time job, where she earned $1,500 per month. Jason mocked Ashley because he had won $1,950 on a lottery ticket he bought in October, and that was merely for the "work" of standing in line for a minute. It was just what he needed because his apartment costs $800 each month. Ashley, on the other hand, pays $470 for her share of the rent. Both Ashley and Jason have other normal living costs that total $950 each month.

Required:

1. Prepare a financial report that compares what Ashley and Jason each owns and owes on September 30. Make a list of any decisions you had to make when preparing your report.
2. In a written report, identify and justify which of the two characters is better off. If you were a creditor, to whom would you rather lend money?
3. Prepare a report that compares what Ashley and Jason each earned during October. Make a list of any decisions you had to make when preparing your report.
4. In a written report, identify and justify which of the two characters is more successful. If you were a creditor considering a three-year loan to one of these characters, to whom would you rather lend money?

LO 1-2

Electronic Arts

S1-7 Preparing an Income Statement and Balance Sheet

Complete this case involving Electronic Arts, which your instructor may access from and make available to you online in the Connect eBook. By completing this case, you will learn to use a spreadsheet to prepare a balance sheet and income statement. Detailed advice is included in the case to help you set up and complete the spreadsheet.

CONTINUING CASE

connect

LO 1-2, 1-3

CC1-1 Financial Statements for a Business Plan

Nicole Mackisey is thinking of forming her own spa business, Nicole's Getaway Spa (NGS). Nicole expects that she and two family members will each contribute $10,000 to the business and receive 1,000 shares each. Nicole forecasts the following amounts for the first year of operations, ending December 31, 2018: Cash on hand and in the bank, $2,150; amounts due from customers from spa treatments, $1,780; building and equipment, $70,000; amounts owed to beauty supply outlets for spa equipment, $4,660; notes payable to a local bank for $38,870. Cash dividends of $2,000 will be paid to the stockholders during the year. Nicole also forecasts that first-year sales revenues will be

$40,000; wages will be $24,000; the cost of supplies used up will be $7,000; office expenses will be $5,000; and income taxes will be $1,600.

Required:

1. Based on Nicole's estimates, prepare a (forecasted) income statement for Nicole's Getaway Spa for the year ended December 31, 2018.
2. Prepare a (forecasted) statement of retained earnings for Nicole's Getaway Spa for the year ended December 31, 2018.
3. Prepare a (forecasted) balance sheet for Nicole's Getaway Spa at December 31, 2018.
4. Are creditors or stockholders expected to supply most of the financing for NGS's assets at December 31, 2018?

2

CHAPTER TWO

The Balance Sheet

YOUR LEARNING OBJECTIVES

LO 2-1 Identify financial effects of common business activities that affect the balance sheet.

LO 2-2 Apply transaction analysis to accounting transactions.

LO 2-3 Use journal entries and T-accounts to show how transactions affect the balance sheet.

LO 2-4 Prepare a trial balance and a classified balance sheet.

LO 2-5 Interpret the balance sheet using the current ratio and an understanding of related concepts.

LO 2-S1 Describe examples of common career paths in accounting.

THAT WAS THEN

In the previous chapter, you were introduced to the four main financial statements: the balance sheet, income statement, statement of retained earnings, and statement of cash flows.

Noodlecake Studios, Inc.

FOCUS COMPANY: NOODLECAKE STUDIOS, INC.

In Chapter 1 you heard about Jordan's plans for starting an app development company, and the initial success of its *Super Stickman Golf* series. Jordan's local CPA, Laurie, advised him all businesses, big and small, need systems for gathering and organizing financial information. Like most public accounting firms, Laurie offers professional services to help smaller companies like **Noodlecake Studios** track the financial results of their activities. With Laurie's help, Jordan will implement an accounting system to do this for Noodlecake. This system will provide the financial information he needs to manage the company and report its results to others interested in his business.[1]

The focus in this chapter is on activities that occurred during August, when Jordan was establishing Noodlecake. You will learn how these activities are captured in an accounting system, leading to the assets, liabilities, and stockholders' equity that are reported in a balance sheet. Later, in Chapter 3, you will learn about the operating activities that occur after a business is open to customers and begins generating the revenues and expenses that are reported in an income statement. Your introduction to the accounting system will conclude in Chapter 4, where you will learn about the steps needed to adjust the accounting records before finalizing and evaluating a company's financial results.

THIS IS NOW

This chapter focuses on just the balance sheet and the accounting system used to produce it.

[1]See Supplement 2A for a list of other services offered by public accounting firms, and for a summary of accounting careers available in private and public accounting.

Logo: Noodlecake Studios, Inc.

ORGANIZATION OF THE CHAPTER

Understand the business	The accounting cycle	Evaluate the results	Supplement 2A	Review the chapter
• Building a balance sheet from business activities • Transactions and other activities	• Step 1: Analyze transactions • Steps 2 and 3: Record and summarize • The debit/credit framework • Preparing a trial balance and balance sheet	• Assessing the ability to pay • Balance sheet concepts and values	• Accounting careers	• Demonstration case • Chapter summary • Key terms • Homework helper • Practice material

Understand the Business

Learning Objective 2-1
Identify financial effects of common business activities that affect the balance sheet.

YOU SHOULD KNOW

Assets: Probable future economic benefits owned by the business as a result of past transactions.
Liabilities: Probable debts or obligations of the entity that result from past transactions, which will be fulfilled by providing assets or services.
Stockholders' Equity: The financing provided by the owners and the operations of the business.

BUILDING A BALANCE SHEET FROM BUSINESS ACTIVITIES

After meeting with Laurie, Jordan understood that before he could start selling apps, he would first have to establish the business. This would involve acquiring **assets** that Noodlecake would use for many months or years to come. The assets would be owned by Noodlecake, but creditors would have a claim to those assets equal to the amount of **liabilities** the company owes. As owners of Noodlecake, Jordan and his friend Ty also would have a claim on the company's assets (**stockholders' equity**), but their claim would be secondary to creditors' claims. Jordan remembered that the balance sheet was structured like the basic accounting equation (A = L + SE), but it was only by accounting for Noodlecake's activities that he truly learned how a balance sheet was built.

A key activity for any start-up company is to obtain **financing.** Two sources of financing are available to businesses: equity and debt. Equity refers to financing a business through owners' contributions and reinvestments of profit. Debt refers to financing a business through loans and other amounts that must be repaid. A business is obligated to repay debt financing, but it is not obligated to repay its equity financing.

Like most small business owners, Jordan and Ty used their personal savings to make an initial cash contribution to the company. They decided to contribute $5,000 each ($10,000 in total). In exchange for their investment in the company, Jordan and Ty will receive common stock as evidence of their ownership.

Jordan had determined that Noodlecake would need additional money to become established, so, on behalf of the company, he applied for a loan from a bank. Soon after the loan was approved, Noodlecake received $20,000 cash in exchange for its promise to repay the loan in two years. The terms for repaying the loan were described in detail on a legal document called a promissory note. Noodlecake's initial financing activities are pictured in Exhibit 2.1.

After obtaining initial financing, a company will start **investing** in assets that will be used after the business opens. In the case of Noodlecake, Jordan felt an important first step was to develop a logo to visually represent his company's name. Using a company check, he paid

EXHIBIT 2.1 Financing Activities

Issue stock

The business receives $10,000 cash.

The business gives common stock.

Obtain loan

The business receives $20,000 cash.

The business gives a promissory note.

a graphic designer $300 cash for the logo shown in Exhibit 2.2. The company also needed equipment, such as desks and computers. This equipment could be purchased with cash, but that would be inconvenient and inefficient. Instead, businesses typically buy goods or services from others on credit, by promising to pay within 30 or 60 days of the purchase. Noodlecake bought $9,600 of equipment on credit, as indicated by the supplier's bill (or "invoice"). These examples are pictured in Exhibit 2.2.

EXHIBIT 2.2 Investing Activities

Purchase logo/trademark

The business receives a logo.

The business gives a check for $300.

Purchase equipment

The business receives equipment.

The business gives a promise to pay $9,600.

By carefully reading Exhibits 2.1 and 2.2, you will see three features that will be important for understanding how accounting works.

1. The company always **documents** its activities. Promissory notes, electronic stock certificates, checks, invoices, and other documents indicate the nature of the underlying business activity.
2. The company always **receives** something and **gives** something. This is a basic feature of all business activities. A business enters into an exchange either to earn a profit immediately or to obtain resources that will allow it to earn a profit later. This is the fundamental idea of business: to create value through exchange. Any exchange that affects the company's assets, liabilities, or stockholders' equity must be captured in and reported by the accounting system. Because the accounting system captures both what is received and what is given, it is often referred to as a "double-entry" system.
3. Each exchange is analyzed to determine a dollar amount that represents the value of items given and received. This value is called the **cost** and is used to measure the financial effects of the exchange, as required by the **cost principle**.

As illustrated in Exhibit 2.3, these three features are key inputs into the process used when accounting for business activities. After each activity is documented, accountants assign names to the items exchanged and then analyze their financial effects on the accounting equation. The ultimate goal is to capture these financial effects so that they can be reported in the financial statements for use by decision makers inside and outside the company. Take a moment right now to read Exhibit 2.3.

YOU SHOULD KNOW

Cost Principle: Requires assets to be initially recorded at the historical cash-equivalent cost, which is the amount paid or payable on the date of the transaction.

EXHIBIT 2.3 Accounting for Business Activities

Picture the documented activity

Picture what is described in words. This step is easily overlooked but is vital to succeeding in the next step.

Name what's exchanged

Building on the previous step, assign names to what your business has received and given.

Analyze the financial effects

A = L + SE

Building on the last step, show how the costs cause elements of the accounting equation to increase and/or decrease.

TRANSACTIONS AND OTHER ACTIVITIES

YOU SHOULD KNOW

Transaction: An exchange or an event that has a direct economic effect on the assets, liabilities, or stockholders' equity of a business.

Business activities that affect the basic accounting equation (A = L + SE) are called **transactions**. Transactions are of special importance because they are the only activities that enter the financial accounting system. Transactions include two types of events:

1. **External exchanges:** These are exchanges involving assets, liabilities, and/or stockholders' equity between the company and someone else. When Starbucks sells you a Frappuccino®, it is exchanging an icy taste of heaven for your cash, so Starbucks would record this in its accounting system.
2. **Internal events:** These events do not involve exchanges with others outside the business, but rather occur within the company itself. For example, when the company Red Bull combines sugar, water, taurine, and caffeine, something magical happens: These ingredients turn into Red Bull Energy Drink. This internal event is a transaction because it has a direct financial effect whereby some assets (supplies of sugar, etc.) are used up to create a different asset (an inventory of Red Bull drinks).

Some important activities that occur will not be captured by the accounting system because they are not transactions. For example, during the first month of business, Jordan signed a contract on behalf of Noodlecake to rent office space the following month. This activity was not a transaction because no assets or services were exchanged at that time. The landlord exchanged a promise to rent the building for Noodlecake's promise to pay rent, but **an exchange of only promises is not an accounting transaction.** For this same reason, Noodlecake's accounting system did not capture other activities such as placing orders with suppliers or promising to hire employees. Documents were created to indicate these activities occurred, but they were appropriately excluded from the accounting

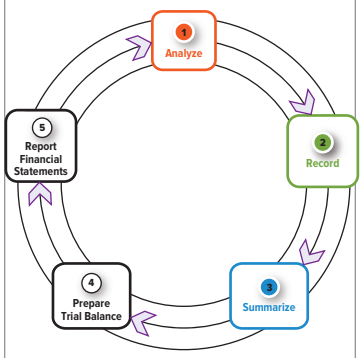
records because these were not transactions. Later, when these promises result in actually receiving or giving an asset or service, they become transactions to be captured by the accounting system.

The Accounting Cycle

Learning Objective 2-2
Apply transaction analysis to accounting transactions.

A systematic accounting process is used to capture and report the financial effects of a company's activities. This process, represented by the circular graphic below, is called the accounting cycle because it repeats itself over and over. For now, we will focus on the first three steps:

1 Analyze → 2 Record → 3 Summarize



STEP 1: ANALYZE TRANSACTIONS

The process shown earlier in Exhibit 2.3 is referred to as transaction analysis, which involves determining whether a transaction exists and, if it does, analyzing its impact on the accounting equation. Two simple ideas are used when analyzing transactions:

1. **Duality of effects.** It's a fancy name, but the idea is simple. Every transaction has at least two effects on the basic accounting equation. To remember this, just think of expressions like "give and receive" or "push and pull" or, if you're a closet scientist, Newton's third law of motion.
2. **A = L + SE.** You know this already, right? Well, just remember the dollar amount for assets must always equal the total of liabilities plus stockholders' equity for every accounting transaction. If it doesn't, you are missing something and you should go back to the first (duality of effects) idea.

As part of transaction analysis, a name is given to each item exchanged. Accountants refer to these names as account titles. To ensure account titles are used consistently, every company establishes a **chart of accounts**—a list that designates a name and reference number the company will use when accounting for each item it exchanges. A partial chart of accounts for Noodlecake is shown in Exhibit 2.4. (The chart of accounts shown in Chapter 2

YOU SHOULD KNOW

Chart of Accounts: A summary of all account names and corresponding account numbers used to record financial results in the accounting system.

EXHIBIT 2.4 Noodlecake's (Partial) Chart of Accounts

Account Number	Account Name	Description
100	Cash	– Dollar amount of coins, paper money, funds in bank
140	Supplies	– Cost of paper, pens, business forms, etc.
173	Equipment	– Cost of computers, printers, desks, etc.
181	Logo and Trademarks	– Cost of purchased logo and trademarks
186	Software	– Cost of purchased software and technology
201	Accounts Payable	– Owed to suppliers for goods or services bought on credit
220	Notes Payable (long-term)	– Owed to lenders, as per terms of promissory note
301	Common Stock	– Stock issued for contributions made to the company
305	Retained Earnings	– Accumulated earnings (not yet distributed as dividends)

includes only balance sheet accounts. Chapter 3 will expand this to include additional assets and liabilities as well as revenue and expense accounts.) **A more comprehensive chart of accounts to use when completing homework assignments is presented in the Homework Helper at the end of this chapter and a chart of accounts containing every account used in this book is shown at the end of this book and can be downloaded from the Additional Student Resources in Connect.**

The chart of accounts is tailored to each company's business, so although some account titles are common across all companies (Cash, Accounts Payable), others may be unique to a particular company (such as "Current Content Library" for Netflix's movies). Depending on the company, you may see a liability for a bank loan called a Note Payable or a Loan Payable.[2]

The best way to learn how to analyze transactions is to work through examples. So skim the names and descriptions in Exhibit 2.4 one more time and then look closely at the following business activities.

(a) Issue Stock to Owners Jordan incorporates Noodlecake Studios, Inc., on August 1. The company issues common stock to Jordan and Ty as evidence of their total contribution of $10,000 cash, which is deposited in the company's bank account.

COACH'S TIP

Analyze transactions from the standpoint of the business, not its owners.

Picture

Name

- **Noodlecake has received $10,000 cash.**
- **Noodlecake gave $10,000 of common stock.**

Analyze

	Assets		=	Liabilities	+	Stockholders' Equity	
(a)	Cash	+10,000	=			Common Stock	+10,000

In the accounting equation analysis above, we included the reference "(a)" to relate it to the original transaction.

[2] The account names you see in the financial statements of most large businesses are actually aggregations of several specific accounts. For example, Apple keeps separate accounts for land, buildings, and equipment but combines them into one title on its balance sheet called Property, Plant, and Equipment.

(b) Invest in Logo/Trademarks **Noodlecake pays $300 cash to create the company's logo.**

Picture

noodlecake games ← Receives

Gives → 

Name

- **Noodlecake has received a logo costing $300.**
- **Noodlecake gave $300 cash.**

Analyze

	Assets	=	Liabilities	+	Stockholders' Equity
(b) Cash	−300	=	No Change		
Logo/trademarks	+300				

Notice that even though transaction (b) did not affect liabilities or stockholders' equity, the accounting equation remained in balance because the decrease in one asset was offset by the increase in another asset. **The accounting equation must always "balance" (be equal) for each transaction.**

(c) Obtain Loan from Bank **Noodlecake borrows $20,000 from a bank, depositing those funds in its bank account and signing a formal agreement to repay the loan in two years** (on August 3, 2020).

Picture

← Receives

Gives →

Name

- **Noodlecake has received $20,000 cash.**
- **Noodlecake gave a note, payable to the bank for $20,000.**

Analyze

	Assets	=	Liabilities	+	Stockholders' Equity
(c) Cash	+20,000	=	Notes Payable		+20,000

COACH'S TIP

Notes payable are like accounts payable except they (a) charge interest, (b) can be outstanding for periods either shorter or longer than one year, and (c) are documented using formal documents called notes.

Logo: Noodlecake Studios Inc.; Money photo: ©Comstock/PunchStock RF
Money photo: ©Comstock/PunchStock RF

(d) Invest in Equipment **Noodlecake purchases and receives $9,600 in computers, printers, and desks, in exchange for its promise to pay $9,600 at the end of the month.**

Picture

Receives ←

Gives →

Name

- **Noodlecake has received $9,600 of equipment.**
- **Noodlecake gave a promise to pay $9,600 on account.**

Analyze

	Assets	=	Liabilities	+	Stockholders' Equity
(d)	Equipment +9,600	=	Accounts Payable +9,600		

Noodlecake would typically wait until the end of the month to pay the amount owed to the supplier in (d). But to show you how the payment is accounted for, we will present it here in (e).

(e) Pay Supplier **Noodlecake pays $5,000 to the equipment supplier in (d).**

Picture

Receives ←

Gives →

Name

- **Noodlecake has received a release from $5,000 of its promise to pay on account.**
- **Noodlecake gave $5,000 cash.**

Analyze

	Assets	=	Liabilities	+	Stockholders' Equity
(e)	Cash −5,000	=	Accounts Payable −5,000		

In (e), Noodlecake fulfills part of its liability owed to a supplier. Thus, the Accounts Payable is decreased because, in exchange for its payment to the supplier, Noodlecake receives a release from $5,000 of its promise to pay the supplier.

COACH'S TIP

Although we use the same format for all of our examples, the content in each differs. Don't skip this section with the plan of coming back to it later because the next part of this chapter builds on this part. Most students say that, of all the topics in this course, transaction analysis is the one they wished they had spent more time on when first learning it.

(f) Order Software for App **Noodlecake signs a contract with an independent developer for program code for the Tiny Warriors game app for $9,000. No code has been received yet.**

Picture

Promise of Future Delivery ← Receives / Gives → Promise to Pay for Purchase

Name

- **An exchange of only promises is not a transaction.**
- **This does not affect the accounting equation.**

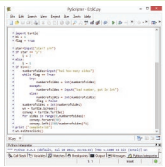
Analyze

	Assets	=	Liabilities	+	Stockholders' Equity
(f)	No Change	=	No Change		

Not all documented business activities are considered accounting transactions. As shown in (f), Noodlecake and the app programmer have documented the order, but it involves an exchange of only promises, so it is not an accounting transaction.

(g) Receive Software **Noodlecake receives the $9,000 of app game code ordered in (f), pays $4,000 cash, and promises to pay the remaining $5,000 next month.**

Picture



Receives ← / Gives →

&

Name

- **Noodlecake has received software costing $9,000.**
- **Noodlecake gave $4,000 cash and a promise to pay $5,000 on account.**

Analyze

	Assets		=	Liabilities		+	Stockholders' Equity
(g)	Cash	−4,000	=	Accounts Payable	+5,000		
	Software	+9,000					

COACH'S TIP

Not all business activities are considered accounting transactions.

Game code: ©Harrison Phillips; Money photo: ©Comstock/PunchStock RF; Invoice photo: ©Studio 101/Alamy RF