# Financial Accounting
## for Undergraduates

Fourth Edition

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FINANCIAL ACCOUNTING FOR UNDERGRADUATES, Fourth Edition, by James Wallace, Karen Nelson, and Theodore Christensen.



**ISBN 978-1-61853-308-1**

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Printed in the United States of America.
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# Preface

## "THE MOST COMPELLING VALUE PROPOSITION OFFERED IN THE FINANCIAL ACCOUNTING MARKET!"

That has been our goal since this product's inception, and we have made that value proposition even more compelling with the Fourth Edition of Financial Accounting for Undergraduates. We created this product to satisfy the needs of students taking their first financial accounting course by providing a **high-quality**, **contemporary**, and **engaging** textbook and online learning system at an **affordable** price. With a suggested retail price of **$80** for the hardbound, full-color textbook with **free access** to myBusinessCourse, we challenge faculty to find a better overall value for their students.

Read on to learn why Financial Accounting for Undergraduates has become a best-seller, and why you should use it in your introductory financial accounting class.

## PEDAGOGY THAT ENCOURAGES STUDENT SUCCESS

Financial accounting can be challenging—especially for students lacking business experience or previous exposure to business courses. To help students succeed in the course, we use a number of pedagogical devices throughout the textbook, and we provide a wealth of resources through our online learning and homework system, **myBusinessCourse** (MBC).

**The Past/Present/Future feature puts each chapter in context.**

**PAST**

Chapter 2 explained how we analyze and record transactions (the first two steps in the *accounting cycle*), including the system of debits

**PRESENT**

This chapter completes our examination of the final three steps in the five-step accounting cycle: adjust, report, and close.

**FUTURE**

Chapter 4 examines the balance sheet and income statement more closely and introduces techniques for analyzing and interpreting

**Road Maps outline each chapter and provide a quick reference table that summarizes the print and digital resources for that chapter.**

**Road Map**

| LO | Learning Objective | Page | eLecture | Guided Example | Assignments |
|---|---|---|---|---|---|
| LO1 | Describe the nature of liabilities and discuss various current liabilities. | 464 | E10-1 | YT10.1 | SS1, SS2, SS4, E1A, E2A, E3A, E4A, E5A, E6A, E7A, E1B, E2B, E3B, E4B, E5B, E6B, E7B, P1A, P2A, P3A, P4A, P5A, P6A, P1B, P2B, P3B, P4B, P5B, P6B |
| LO2 | Illustrate the accounting for long-term liabilities. | 470 | E10-2 | YT10.2 | SS8, SE2, SE8, SE9, SE10, E8A, E9A, E10A, E11A, E14A, E15A, E16A, E17A, E18A, E19A, E21A, E8B, E9B, E10B, E11B, E14B, E15B, E16B, E17B, E18B, E19B, E21B, P7A, P7B |
| LO3 | Define contingent liabilities and explain the rules for their accounting and disclosure in the financial statements. | 480 | E10-3 | YT10.3 | SS3, SS5, SE1, SE3, E1A, E7A, E7B E12A, E12B, P6A, P6B |

**Your Turns provide hands-on practice after each major concept to ensure mastery of a topic before proceeding to the next concept.**

**YOUR TURN! 6.2**

The following inventory information is gathered from the accounting records of Tucker Enterprises:

| | |
|---|---|
| Beginning inventory | 4,000 units at $5 each |
| Purchases | 6,000 units at $7 each |
| Sales | 9,000 units at $10 each |

Calculate (a) ending inventory, (b) cost of goods sold, and (c) the gross profit using each of the following methods (i) FIFO, (ii) LIFO, and (iii) weighted-average cost.

The solution is on page 320.

On December 3, WebWork used cash to purchase $32,400 of office equipment.

| Assets | | = | Liabilities | + | Stockholders' Equity |
|---|---|---|---|---|---|
| −32,400 Cash | +32,400 Office Equipment | = | | | |

| | | | |
|---|---|---|---|
| Dec. 3 | Office equipment (+A)<br>Cash (−A)<br>*To record purchase of office equipment.* | 32,400 | 32,400 |

| + Office Equipment (A) − | | + Cash (A) − | | | |
|---|---|---|---|---|---|
| (5) | 32,400 | (1) | 30,000 | 10,800 | (2) |
| | | (4) | 36,000 | 32,400 | (5) |

We use color and other visual cues pedagogically to help students learn and retain important concepts.

*Hint: In contrast to the percentage of net sales method, the accounts receivable aging method takes into account the beginning balance of the Allowance for Doubtful Accounts.*

**A.K.A.** The Allowance for Doubtful Accounts is also often referred to as the Allowance for Uncollectible Accounts.

Margin notes provide hints and identify commonly used alternative terms.

# CURRENT DEVELOPMENTS AND ENGAGING EXAMPLES

The basics of accounting haven't changed much in hundreds of years, but the world in which we live has changed dramatically. Technology is rapidly altering how accounting is performed and what can be done with the data once they are collected. In this edition, we introduce students to Data Analytics and Blockchain Technology in **Chapter 1**.

## Data Analytics and Blockchain Technology

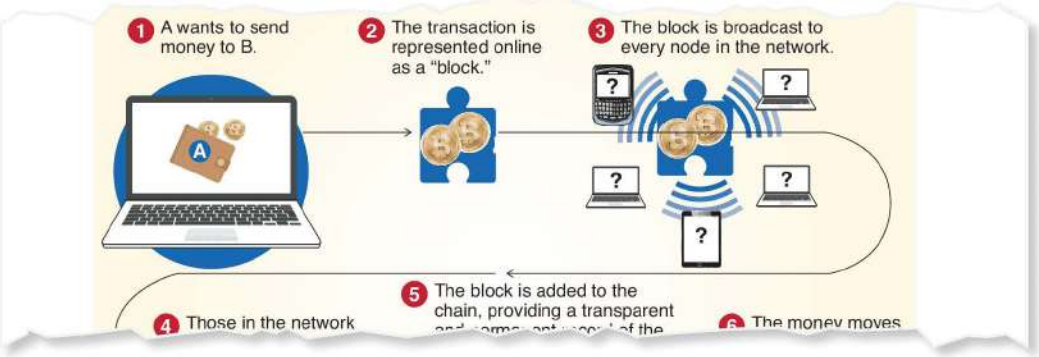
Accounting skills are not stagnant; rather they are constantly evolving. What was once done by hand is now done with the aid of specialized software. Programs like **QuickBooks** from **Intuit** have automated the basic accounting job of transaction recording, and programs like **Microsoft Excel** have greatly aided in the analysis of accounting data. While some industry observers had predicted these technological advances would replace the need for accountants, these applications have simply changed the way accountants perform their jobs. Newer technologies such as data analytics and blockchain are further

Where appropriate, we include boxed features highlighting new technologies.

### Blockchain and the Future of Accounting

When most people hear the word *blockchain*, they likely think of Bitcoin. What makes blockchain so important for cybercurrencies like Bitcoin also makes it likely to revolutionize the future of accounting. Blockchain technology, which is also known as distributed ledger technology, allows multiple parties to a transaction to securely share a database. Blockchain has the potential to create a completely traceable audit trail, and could potentially automate the entire financial audit. While the future possibilities appear endless, current applications in addition to auditing include cybersecurity and financial planning and analysis.

For an expanded introduction to Data Analytics and Blockchain Technology, we added a new **Appendix F** that provides more detail and assignments that require the use of Excel and Tableau.




In addition to the changes brought about by technology, several new accounting standards have gone into effect since the last edition of this book, including standards on revenue recognition, inventory measurement methods (lower-of-cost-or-net realizable value), leases, and investments. The Fourth Edition has been updated to incorporate the new standards. However, we recognize that the goal of the introductory course is to expose students to the general principles and processes of accounting without overwhelming them with the details that are more appropriately covered in intermediate accounting courses. Consequently, we utilize examples and applications that avoid the technical detail students will learn in future courses.

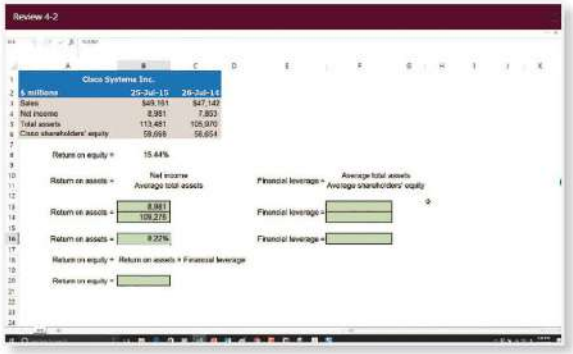
**Revenue Recognition**

Applying the revenue recognition principle can be quite straightforward for simple situations such as the sale of a dozen donuts at a Krispy Kreme store. More complex situations, however, can lead to more difficulty in applying the five-step revenue recognition process. For example, when Xerox Corp. sells a photocopy machine along with a three-year maintenance agreement as part of a packaged deal, the five-step process would be applied as follows:

Step 1: Identify the contract with the customer. The revenue recognition standard treats every revenue transaction as a contract between the seller to provide goods or services and the buyer to provide payment to the seller. Contracts may be informal and implicit such as the contract to purchase a dozen donuts from Krispy Kreme, or formal and explicit such as a written contract to purchase a photocopier with a maintenance agreement from Xerox.

# TECHNOLOGY THAT IMPROVES LEARNING AND COMPLEMENTS FACULTY INSTRUCTION

myBusinessCourse is an online learning and assessment program intended to complement your textbook and faculty instruction. Access to **myBusinessCourse** is FREE ONLY with the purchase of a new textbook, but can be purchased separately.



MBC is ideal for faculty seeking opportunities to augment their course with an online component. MBC is also a turnkey solution for online courses. The following are some of the features of MBC.

## Increase Student Readiness

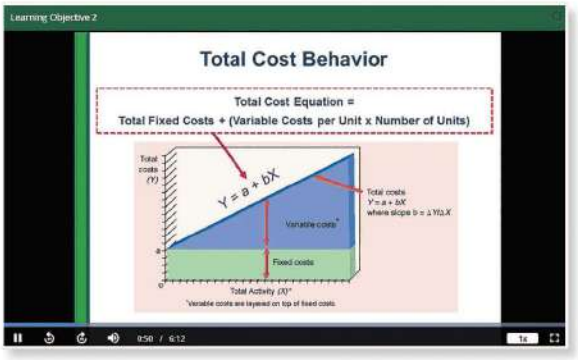
- **eLectures** cover each chapter's learning objectives and concepts. Consistent with the text and created by the authors, these videos are ideal for remediation and online instruction.

- **Guided Examples** are narrated video demonstrations created by the authors that show students how to solve select problems from the textbook.
- Immediate feedback with **auto-graded homework**.
- **Test Bank** questions that can be incorporated into your assignments.
- Instructor **gradebook** with immediate grade results.

In two recent surveys of students who used MBC, **95%** responded that MBC helped them learn accounting.*

## Make Instruction Needs-Based

- Identify where your students are struggling and customize your instruction to address their needs.
- Gauge how your entire class or individual students are performing by viewing the easy-to-use gradebook.
- Ensure your students are getting the additional reinforcement and direction they need between class meetings.




## Provide Instruction and Practice 24/7

- Assign homework from your Cambridge Business Publishers' textbook and have MBC grade it for you automatically.
- With our eLectures, your students can revisit accounting topics as often as they like or until they master the topic.
- Guided Examples show students how to solve select problems.
- Make homework due before class to ensure students enter your classroom prepared.
- For an additional fee, upgrade MBC to include the eBook and you have all the tools needed for an online course.

In the same two surveys, over **86%** of the students who responded said they would encourage their professor to continue using MBC in future terms.*

## Integrate with LMS

myBusinessCourse integrates with many learning management systems, including **Canvas**, **Blackboard**, **Moodle**, **D2L**, **Schoology**, and **Sakai**. Your gradebooks sync automatically.

# NEW TO THIS EDITION

- **Road Map:** Each chapter opens with a quick reference grid that identifies each learning objective for the chapter, the related pages, eLecture and Guided Example videos, and end of chapter assignments. This allows students and faculty to quickly identify the chapter content and to efficiently navigate to the desired resource.
- Added discussions of **Data Analytics** and **Blockchain Technology** where appropriate, and added **Appendix F**, which provides a more in-depth exploration of Data Analytics and Blockchain Technology.
- New **pedagogical use of color** in Chapter 3 to help students differentiate between the 4 types of end-of-period adjustments (accruals and deferrals).
- Added **visual cues** to journal entries and T-accounts to help students understand the type of account being affected by transactions (A, L, SE, R, E, D) and the impact the transaction has on the account (+/–).
- Updated **revenue recognition** coverage for the standard change.
- Chapter 6: Updated the inventory coverage to reflect the new standard on **lower-of-cost-or-net realizable** value.
- Chapter 9: Added coverage on **natural resources** and depletion.

* These statistics are based on the results of two surveys in which 2,330 students participated.

- Chapter 10: Updated the appendix on **leases** to reflect the new standard.
- Updated Appendix D on **Investments** to reflect the new standard.
- Updated **real financial data** throughout the text and assignments.
- Expanded the number of **Guided Example videos** and assignments included in MBC.

# SUPPLEMENT PACKAGE

## For Instructors

myBusinessCourse: A web-based learning and assessment program intended to complement your textbook and classroom instruction.

**Solutions Manual:** Created by the authors, the *Solutions Manual* contains complete solutions to all the assignment material in the text.

**PowerPoint:** The PowerPoint slides outline key elements of each chapter.

**Test Bank:** The Test Bank includes multiple-choice items, matching questions, short essay questions, and problems.

**Excel Templates**: We provide Excel spreadsheets for select assignments. These spreadsheets will save time in data entry and allow students to dedicate additional time to learning the material. The assignments accompanied by Excel spreadsheets are identified by the Excel icon.

**Website:** All instructor materials are accessible via the book's Website (password protected) along with other useful links and marketing information: www.cambridgepub.com

## For Students

myBusinessCourse: A web-based learning and assessment program intended to complement your textbook and faculty instruction. This easy-to-use program grades homework automatically and provides you with additional help when your instructor is not available. Assignments with the MBC in the margin are available in myBusinessCourse. Access is free with new copies of this textbook (look for page containing the access code towards the front of the book). If you buy a used copy of the book, you can purchase access at www.mybusinesscourse.com.

**Excel Templates**: We provide Excel spreadsheets for select assignments. These spreadsheets will save time in data entry and allow students to dedicate additional time to learning the material. The assignments accompanied by Excel spreadsheets are identified by the Excel icon.

**Website:** Updates and other useful links are available to students free of charge on the book's Website.

# ACKNOWLEDGEMENTS

All four editions of this book benefited greatly from the valuable feedback of focus group attendees, reviewers, students, and colleagues. We are extremely grateful to them for their help in making this project a success.

Markus Ahrens
James Aitken
Dave Alldredge
Bam Alling
David Ambrosini
Matthew Anderson
Adam Baker
Felicia Baldwin
James Bannister
Richard Barnhart
Gerhard Barone
Robyn Barrett
Sara Barritt
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Idalene Williams
Paula Wilson
Michele Wiltsie
Douglas Woods
Maef Woods
Daryl Woolley
Susan Wright
Rong Yang
Kathryn Yarbrough
Robert Yu
Amy Yurko
Judith Zander
Jian Zhou

In addition, we are extremely grateful to George Werthman, Lorraine Gleeson, Jill Sternard, Marnee Fieldman, Jocelyn Mousel, Katie Jones-Aiello, Beth Gilgen Nodus, Debbie McQuade, Terry McQuade, and the entire team at Cambridge Business Publishers for their encouragement, enthusiasm, and guidance. Feedback is always welcome. Please feel free contact us with your suggestions or questions.

*Jim Wallace* *Karen Nelson* *Ted Christensen*

January 2019

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# Chapter 1

# Financial Accounting and Business Decisions

*A* **Focus Company** *introduces each chapter and illustrates the relevance of accounting in everyday business.*

**PRESENT**

This chapter explains business formation, the uses and users of accounting information, the types of activities companies pursue, and financial statements that report on business.

**FUTURE**

The next chapters more fully explain financial statements, including how they are prepared, constructed, analyzed, and interpreted.

**Past/Present/Future** *provides an overview of where the chapter fits within the context of the whole book.*

It is often said that accounting is the language of business. Like all companies, **Columbia Sportswear Company** (Columbia.com), a maker of clothing for dedicated lovers of the greater outdoors, relies upon accounting for its success. It uses financial reports to judge its performance and that of its managers. It uses accounting controls to monitor its inventory. It uses accounting data to assess the amount and timing of dividend payments to shareholders.

This first chapter introduces many basic relations and principles underlying financial statements. It also identifies many key users of accounting information and discusses how that information is useful in businesses globally.


## Road Map

**Road Maps** *summarize each chapter's resources and categorize them by learning objective.*

**eLectures** *are videos available in MBC that provide 3-5 minute reviews of each learning objective.*

**Assignments** *reinforce learning and can be completed by hand or within MBC.*

| LO | Learning Objective | Page | eLecture | Guided Example | Assignments |
|---|---|---|---|---|---|
| LO1 | Explain the three forms of business organizations. | 4 | E1-1 | YT1.1 | SE1, E1A, E1B, P1A, P1B |
| LO2 | Describe business activities. | 5 | E1-2 | YT1.2 | SE5, SE10, E6A, E6B |
| LO3 | Indicate who uses accounting information. | 6 | E1-3 | YT1.3<br>YT1.4 | SE3, SE8, E3A, E14A, E3B, P8A, P8B |
| LO4 | Explain the accounting process and generally accepted accounting principles. | 10 | E1-4 | YT1.5 | SE2, SE4, SE9, SE15, SE19, E2A, E5A, E15A, E2B, E5B, E15B |
| LO5 | Describe the accounting equation and each financial statement. | 12 | E1-5 | YT1.6 | SE6, SE11, SE12, SE13, SE14, E4A, E7A, E9A, E10A, E11A, E12A, E19A, E4B, E7B, E8B, E9B, E10B, E11B, E12B, 19B, P2A, P3A, P4A, P5A, P6A, P7A, P9A, P10A, P2B, P3B, P4B, P5B, P6B, P7B, P9B, P10B |
| LO6 | Explain additional disclosures that accompany financial statements. | 19 | E1-6 | YT1.7 | SE7, E13A, E13B, P9A, P9B |
| LO7 | Describe careers in accounting. | 20 | E1-7 | | |
| LO8 | Appendix 1A: Discuss FASB's conceptual framework. | 23 | E1-8 | | SE16, SE17, SE18, SE20, SE21, E16A, E17A, E18A, E19A, E20A, E16B, E17B, E18B, E19B, E20B, P11A, P11B |

**Learning Objectives** *identify the key learning goals of the chapter.*

**Guided Examples** *are videos that demonstrate how to solve various types of problems and are available in MBC.*

**Chapter Organization charts** *visually depict the key topics and their sequence within the chapter.*

**FINANCIAL ACCOUNTING AND BUSINESS DECISIONS**

| Forms of Business Organizations | Business Activities | Accounting Information and Its Use | Information Dissemination | Other Annual Report Components | FASB Conceptual Framework (Appendix 1A) |
|---|---|---|---|---|---|
| • Sole proprietorship<br>• Partnership<br>• Corporation | • Financing<br>• Investing<br>• Operating | • External users<br>• Internal users<br>• Ethics and accounting | • Accounting process<br>• Generally Accepted Accounting Principles<br>• International Financial Reporting Standards<br>• Financial statements | • Notes to financial statements<br>• Independent auditor's report<br>• Management's Discussion and Analysis | • Objectives<br>• Elements<br>• Characteristics<br>• Recognition and Measurement |

**eLecture** *icons denote the availability of an instructional video in* **myBusinessCourse** *(MBC). See the Preface for more information on MBC.*

eLectures MBC

# BUSINESS ORGANIZATION

**LO1** **Explain** the three forms of business organizations.

**Learning Objectives** *are repeated at the start of the section covering that topic.*

The first decision every business faces is deciding what form of organization it will take. The three principal forms of business organization are the sole proprietorship, the partnership, and the corporation. Although each of these organizational forms is treated as an accounting entity, only the corporation is viewed under the law as a legal entity separate and distinct from its owners. A corporation has an unlimited life, which means that it will continue to exist indefinitely unless it is formally dissolved. The life of a sole proprietorship or partnership is limited by the participation of the existing owners. If an owner dies or withdraws, the business typically ends as well.

A **sole proprietorship** is a business owned by one person; it is the most common of the three forms of business organization. The primary advantage of the sole proprietorship is its ease of formation. As the only owner, the sole proprietor makes all of the decisions affecting the business. This organizational form also enjoys certain income tax advantages relative to a corporation in that the income of that business is not taxed; instead, its income is included as part of the owner's income that is reported to the taxation authorities.

**Key Terms** *are highlighted in bold, red font.*

A **partnership** is a voluntary association of two or more persons for the purpose of conducting a business. Partnerships and sole proprietorships differ principally with respect to the number of owners. Partnerships can be as small as two people or as large as the biggest accounting or legal firms, which have hundreds or even thousands of partners. Partnerships are also easy to establish. Because a partnership involves multiple owners, the partners should establish the rights and obligations of each partner to avoid any misunderstandings that might lead to disputes and lawsuits. An advantage of the partnership form over the sole proprietorship is the broader skill set that multiple partners can bring to a business. Partnerships also enjoy the same income tax advantage as sole proprietorships.

A **corporation** is a legal entity created under the laws of a state or the federal government. A corporation can have as few as one owner but most have many owners. The owners of a corporation receive shares of stock as evidence of their ownership interest in the business, and consequently, they are referred to as **stockholders** (or *shareholders*). Since corporations are a separate legal entity, they must pay income taxes on their profits. This leads to a situation of double taxation because the income of the corporation is taxed and stockholders also pay taxes on dividends they receive from the corporation. The corporation is the dominant organizational form in terms of the volume of business activity conducted in the United States and worldwide.

While most businesses start off as either a sole proprietorship or as a partnership, some outgrow these organizational forms and convert to the corporate form. For example, **Columbia Sportswear Company** was incorporated in 1961 after beginning as a sole proprietorship in 1938. Two primary reasons for converting a sole proprietorship or a partnership to the corporate form of business are the relative ease of raising capital to grow the business and the protection afforded to stockholders against personal liability. A third advantage of the corporate form is the relative ease of selling ownership shares. For example, stock exchanges, such as the **New York Stock Exchange (NYSE)**, exist to enable stockholders to readily buy and sell their ownership shares. No such exchanges exist for sole proprietors or partners, and thus, selling an ownership interest in a sole proprietorship or a partnership is a more difficult, time-consuming event.

| Proprietorship | Partnership | Corporation |
|---|---|---|
|  |  |  |
| • One owner control<br>• Business not taxed, but owner taxed<br>• Not legal entity<br>• Limited life | • Shared owner control<br>• Business not taxed, but owners taxed<br>• Not legal entity<br>• Limited life | • All types of owner control<br>• Business taxed and owners taxed<br>• Separate legal entity<br>• Unlimited life |



*Your Turn! boxes reinforce the material just presented with self-study questions. To aid learning, solutions are provided at the end of the chapter.*

**YOUR TURN! 1.1**

The solution is on page 53.

Identify three characteristics for each of the principal forms of business organizations.

1. sole proprietorship
2. partnership
3. corporation

# ACTIVITIES OF A BUSINESS

eLectures MBC

**LO2** **Describe** business activities.

Every business, regardless of its organizational form, its industry, or its size, is involved in three types of business activities—financing, investing, and operating.

## Financing Activities

Before a company can begin operations, it must acquire money to support its operations. Employees need to be hired, buildings constructed, raw materials purchased, and machinery put in place. Companies can obtain the necessary funds to undertake these activities in several ways. These **financing activities** are generally categorized as either debt financing or equity financing.

**Debt financing** involves borrowing money from sources such as a bank by signing a note payable or directly from investors by issuing bonds payable. The individuals or financial institutions that lend money to companies are called their **creditors**. Debt financing involves an obligation to repay a creditor both the amount initially borrowed, called the **principal**, and an interest fee for the use of the funds.

**Equity financing** involves selling shares of stock to investors. In contrast to creditors who lend money to a business and expect to receive that money back with interest, investors that purchase shares of stock are buying an ownership interest in the company. Investors hope that their stock will increase in value so that they can earn a profit when

they sell their shares. The owners of a company's stock may also receive dividend payments when the company decides to distribute some of its profits.

## Investing Activities

**A.K.A.** Land, buildings, and equipment is often referred to as property, plant, and equipment, or simply PP&E.

**A.K.A.** *(Also Known As) identify commonly used alternative terms.*

Before a company can begin operations, it must purchase the long-term resources necessary to conduct its business, such as land, buildings and equipment. **Investing activities** involve the acquisition and disposition of factories, office furniture, computer and data systems, delivery vehicles, and other items that will be used to carry out the company's business plans. These items are referred to as assets.

Companies can obtain the money needed to make these investments from either the financing activities discussed previously or from any excess cash accumulated from operating the business profitably.

## Operating Activities

The day-to-day activities of producing and selling a product or providing a service are referred to as **operating activities**. Operating activities are critical for a business because if a company is unable to generate income from its operations it is very likely that the business will fail. If creditors and stockholders do not believe that a company will be able to generate a profit, they are unlikely to provide the financing needed to start, or maintain, its operations.

**Exhibit 1-1** provides a summary of the three types of business activities. Arrows are pointing both toward, and away from, operating activities. This is because financing and investing activities are necessary to carry out a company's operating activities; however, if a company's operating activities generate excess cash, then the excess cash can be used to either finance additional investments, repay the company's creditors, or pay dividends to shareholders.

**Exhibit 1-1** Business Activities




**YOUR TURN! 1.2**

The solution is on page 53.

Classify each of the following activities as a financing, investing, or operating activity.

1. Receiving a loan from a bank.
2. Selling merchandise online.
3. Purchasing a delivery truck.
4. Purchasing merchandise for resale to customers.
5. Issuing shares of stock in exchange for cash.
6. Paying employee salaries.

# ACCOUNTING INFORMATION AND ITS USE

**LO3** **Indicate** who uses accounting information.

In today's society, many individuals and agencies are involved in the economic life of a business. The information needs of these parties are fulfilled, in part, by accounting information. The users of accounting information are classified by their relation to a business as either *external users* or *internal users*.

## External Users of Accounting

An important function of the accounting process is to accumulate and report accounting information that details a business's results of operations, cash flows, and financial position. By U.S. law, publicly owned businesses must publish financial statements annually and quarterly. The subset of accounting that produces these publicly available financial statements is referred to as **financial accounting**.

Financial accounting information serves a variety of users. Potential investors and investment professionals need financial data to compare prospective investments to determine which, if any, they should invest in, and at what price. Creditors must consider the financial strength of a business before lending it funds, and stockholders must evaluate whether to remain invested in a business, buy more shares, or sell their existing shares of stock.

The financial statements issued by a company are the main source of financial information for these external users. Because financial statements are often used to evaluate the management team running the business, their objectivity is sometimes called into question because the reports are prepared by the management team itself. To establish the validity of financial statements, most businesses have their financial data audited by an independent public accountant. Publicly owned businesses are required to have their financial statements audited. The independent public accountant, or independent auditor, examines the financial statements and recommends any changes or improvements that are warranted. The independent auditor then expresses a professional opinion as to whether the financial statements are fairly presented "in conformity with generally accepted accounting principles." External users have greater confidence in financial statements that have been audited by an independent, certified public accountant.

**ACCOUNTING IN PRACTICE**

**The Big Four**

Independent auditors are licensed by the state in which they do their auditing work and are identified as **certified public accountants (CPAs)**. To qualify as a CPA, an individual must pass a rigorous examination that is administered nationally and must meet the educational and work experience requirements set by each state to ensure high standards of accounting and auditing performance. The four largest U.S. public accounting firms, referred to as the *Big Four*, have offices located throughout the world and employ thousands of auditors. These firms are **Deloitte & Touche**, **Ernst & Young**, **KPMG, LLP**, and **PricewaterhouseCoopers**.

**Accounting In Practice** *boxes describe how accounting is used in real companies.*

There are many other external users of a company's accounting information. For example, a business's customers may want information to help them determine if a company like **Whirlpool** will be able to honor its product warranties. Labor unions require information to determine the level of pay raises that they can demand from companies like **United Parcel Service**. **Exhibit 1-2** illustrates the kind of accounting information that is required by a company's external users.

**Real Companies** *and* **Institutions** *are highlighted in bold, blue font.*

**Exhibit 1-2 Accounting Information Needs of External Users**

| User Group | | Accounting Information Used to Answer Questions such as: |
|---|---|---|
| Potential investors and current stockholders |   | How does the profitability of **Target** compare to that of **WalMart**? How does **Bank of America Corporation** compare with **Wells Fargo & Company** in terms of firm size? |
| Creditors and lenders |   | Will **Delta Airlines** be able to repay its creditors in a timely fashion? Is it safe to provide a bank loan to the **Federal Express Corporation**? |
| Taxation authorities and regulators |   | Is **Tesla Motors, Inc.** reporting the proper amount of taxable income? Is **Duke Energy**'s rate hike justified by its operating costs? |

## Internal Users of Accounting

A major function of accounting is to provide the internal management of a company with the data needed for decision making and the efficient management of the business. While managers have an interest in the information reported to external users, managers also require various other types of information, such as the cost of its products, estimates of the income to be earned from a sales campaign, cost comparisons of alternative courses of action, and long-range budgets. Because of the strategic nature of much of this information, it is usually only available to a company's top-level management. The process of generating and analyzing such data is referred to as **managerial accounting**. **Exhibit 1-3** illustrates the various types of accounting information that are required by a company's internal users.

**Exhibit 1-3 Accounting Information Needs of Internal Users**

| User Group | | Accounting Information Used to Answer Questions such as: |
|---|---|---|
| Marketing Department |  | What is the optimal price to sell the **Samsung** Galaxy phone to maximize the company's sales revenue?<br>Was the promotional campaign by **Netflix** successful in promoting the company's *Stranger Things* series? |
| Management Team |  | How much is the Olive Garden restaurant chain contributing to the overall profitability of its parent company, the **Darden Restaurant Group**?<br>What is the projected profitability of the **General Motors**' Chevrolet brand for the coming year? |
| Finance Department |  | Is there sufficient cash available for **Hewlett Packard** to buy back a large amount of its outstanding common stock?<br>Will **General Electric** have sufficient cash flow to pay its short-term expenses? |



**YOUR TURN! 1.3**

The solution is on page 53.

1. Are financial statements the primary output of managerial or financial accounting? Explain.
2. Identify at least two internal users and explain why they need accounting information.
3. Identify at least two external users and explain why they need accounting information.

## Ethics and Accounting

**Ethics** deals with the values, rules, and justifications that govern one's way of life. Although fundamental ethical concepts such as right and wrong, good and evil, justice and morality are abstract, many issues in our daily lives have ethical dimensions. The way that we respond to these issues defines our ethical profile. In both our personal and professional lives, our goal is to act ethically and responsibly.

Ethical behavior has not always been the rule in business. Business history reveals unethical activities such as price gouging of customers, using inside information for personal gain, paying bribes to government officials for favors, ignoring health and safety regulations, selling arms and military equipment to aggressor governments, polluting the environment, and issuing misleading financial information. Well-known accounting scandals at such companies as **Enron**, **WorldCom**, and **Lehman Brothers** have again brought ethics to the forefront.

Increasingly, business managers recognize the importance and value of ethical behavior by their employees. It is now commonplace for businesses to develop a written code

of ethics to help guide the behavior of employees. Similarly, professional organizations of accountants have written ethics codes. The **American Institute of Certified Public Accountants (AICPA)**, for example, has a professional code of ethics to guide the conduct of its member CPAs. Similarly, the **Institute of Management Accountants (IMA)** has written standards of ethical conduct for accountants employed in the private sector.

Unethical behavior that results in misleading financial statements has the potential to erode public confidence and trust in accounting information. In response to this decline in public confidence, the U.S. Congress passed the **Sarbanes-Oxley Act** in 2002 with the goal of restoring investor trust by reducing the likelihood of future accounting scandals. Among the many changes required by this legislation is that a company's top management must certify in writing the accuracy of its reported financial statement information, and these executives risk criminal prosecution for fraudulent certification. In addition, companies must now report on the internal controls put into place to help deter errors in the financial reporting process and to detect them should they occur.

**A.K.A.** The Sarbanes-Oxley Act of 2002 is often referred to as SarBox or SOX.

**Accountant as Detective—CSI in Real Life**

**FORENSIC ACCOUNTING**

Law enforcement personnel are not the only people who perform criminal investigations. A branch of accounting known as **forensic accounting** is vitally important in many types of criminal investigations, from financial statement fraud, to money laundering, to massive investment frauds such as the one perpetrated by Bernard Madoff (who is currently serving a 150-year prison sentence). Unlike law enforcement personnel, forensic accountants are involved both before and after the commission of a crime.

**Forensic Accounting** *boxes highlight how financial accounting knowledge can help aid in the prevention of errors and fraud.*

Accountants face several unique ethical dilemmas, such as:

1. The output produced by accountants has financial implications for individuals, as well as businesses. These situations generate considerable pressure on the accountant to "improve" the reported results. The amount of income taxes to be paid by an individual or business, the amount of a bonus to be received by an employee, the price to be paid by a customer, and the amount of money to be distributed to a business's owners are examples of situations in which the financial implications can lead to efforts to influence the outcome. *Ethical behavior mandates that accountants ignore these pressures.*
2. Accountants have access to confidential, sensitive information. Tax returns, salary data, details of financial arrangements, planned acquisitions, and proposed price changes are examples of this type of information. *Ethical behavior mandates that accountants respect the confidentiality of information.*
3. A criticism of U.S. business practices is that they are too "bottom-line" (that is, short-term profit) oriented. This orientation can lead to unethical actions by management to increase reported short-term profits. Because accountants measure and report a firm's profit, they must be particularly concerned about these ethical breakdowns. *Both accountants and management must recognize the importance of a long-run perspective.* Studies indicate that, over the long term, successful companies and ethical practices go hand in hand.

**YOUR TURN! 1.4**

As an accountant for the Madoff Corporation, you are responsible for measuring and reporting the company's net income. It appears that actual results are going to be less than was expected by Wall Street analysts. Your supervisor has asked that you report some of next period's sales revenue early so that the current period's net income will be in line with analyst expectations. You know that reporting revenue like this represents a violation of generally accepted accounting principles. Your supervisor states that you will not really be doing anything wrong because the sales revenues are real—the company will just be reporting the revenue earlier than accounting guidelines allow. What should you do?

The solution is on page 54.

# THE ACCOUNTING PROCESS

**LO4** **Explain** the accounting process and generally accepted accounting principles.

**Accounting** is *the process of measuring economic activity of an entity in monetary terms and communicating results to users.* The accounting process consists of two principal activities—measurement and communication.

The measurement process must (1) identify the relevant economic activities of a business, (2) quantify these economic activities, and (3) record the resulting measures in a systematic manner. Measurement is done in monetary terms. In the United States, measurements are stated in U.S. dollars. In other countries, measurements are expressed in the local currency.

Because the purpose of accounting is to provide useful financial information, the communication process is extremely important. Accordingly, the accounting process (1) prepares financial reports to meet the needs of the user and (2) helps interpret the financial results for that user. To provide reports that serve users effectively, managers must be aware of how these users are likely to apply the reports. The needs of the various users differ; as such, there are different types of accounting reports. Managers employ various techniques to help users interpret the content of reports. These techniques include the way the report is formatted, the use of charts and graphs to highlight trends, and the calculation of ratios to emphasize important financial relations.

**Thinking Globally** *boxes emphasize the similarities and differences in business practices between companies in the U.S. and companies in other countries.*

**THINKING GLOBALLY**

Companies measure their operating performance using the currency of their principal place of business. The **Johnson & Johnson Company**, a well-known maker of baby shampoo and Band-Aids, is headquartered in New Jersey, and reports its financial results using the U.S. dollar. On the other hand, **Moet Hennessy Louis Vuitton**, the luxury goods manufacturer, is headquartered in Paris, France, and reports its financial results using the euro. Some companies prepare "convenience translations" of their financial statements in the currency and language of other countries so that potential foreign investors can more readily understand the company's financial performance and condition.

## Generally Accepted Accounting Principles

It is important that financial statements be prepared under a set of rules that is understood by the users of those reports. Imagine if every business were free to determine exactly how it measured and communicated its financial health and operating performance. How would a user of this information be able to compare one company's results to another if each played by a different set of rules? Financial statement users who rely on accounting data expect that all companies will follow the same standards and procedures when preparing their statements. In the United States these standards and procedures are called **generally accepted accounting principles (GAAP)**.

**A.K.A.** Generally accepted accounting principles are often referred to as GAAP (pronounced like the clothing store "Gap").

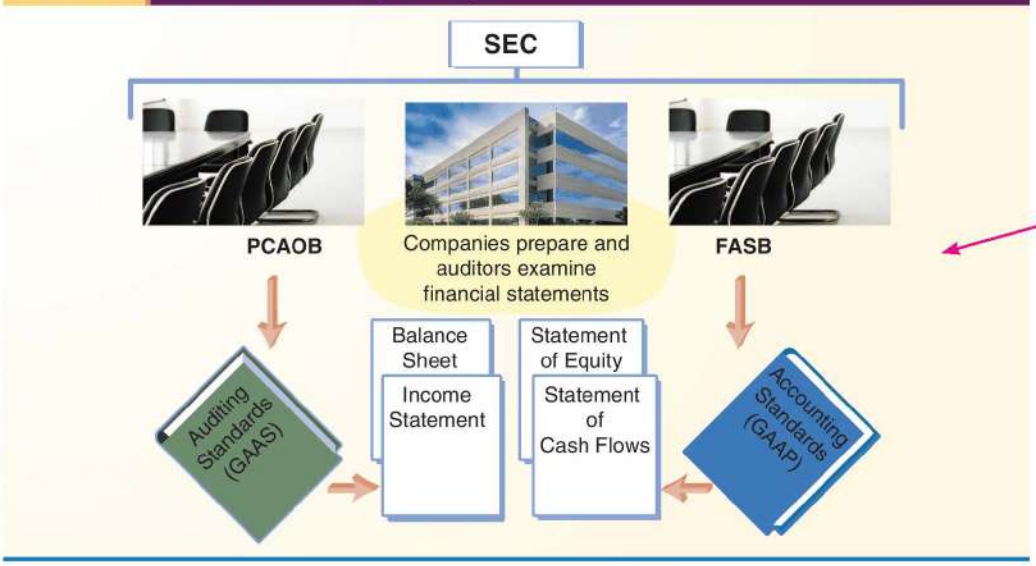
Generally accepted accounting principles are guides to action that can (and do) change over time. Sometimes specific accounting principles must be altered or new principles formulated to fit a changing set of economic circumstances or changes in business practices.

### Financial Accounting Oversight

The **Financial Accounting Standards Board (FASB)**, the American Institute of Certified Public Accountants (AICPA), and the **U.S. Securities and Exchange Commission (SEC)** are instrumental in the development of generally accepted accounting principles in the United States. As a federal agency, the SEC's primary focus is to regulate the interstate sale of stocks and bonds. The SEC requires companies under its jurisdiction to submit audited annual financial statements to the agency which it then makes available to the general public. The SEC has the power to set the accounting principles used by these companies, but the agency has largely delegated that principle-setting responsibility to the FASB.

The FASB is a nongovernmental entity whose pronouncements establish U.S. GAAP.[1] The FASB consists of a seven-member board and follows a process that allows for input from interested parties as it considers a new or changed accounting principle (see the appendix to this chapter for additional information on the conceptual framework the FASB has developed to formulate accounting standards). A new or changed principle requires the support of at least a majority of the board members. More recently, the **Public Company Accounting Oversight Board (PCAOB)** was established. The PCAOB approves auditing standards, known as **generally accepted auditing standards (GAAS)**, and monitors the quality of financial statements and audits. **Exhibit 1-4** illustrates the structure of financial accounting oversight in the United States.

**Exhibit 1-4** **Financial Accounting Oversight**

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**Infographics** *illustrate difficult concepts and procedures.*

The FASB completed the Accounting Standards Codification in 2009 concerning how GAAP is organized and communicated. This codification represents the authoritative U.S. GAAP for non-governmental entities and is easily researched through an online database maintained by the FASB. A major justification for the codification project was to ease the convergence of U.S. GAAP and international standards.

## International Financial Reporting Standards

The past few decades have witnessed a steady acceptance of international financial reporting standards. This acceptance coincides with the increasing globalization of business. Although several organizations are working to increase international harmonization in accounting, the organization that has taken the lead in formulating international accounting principles is the **International Accounting Standards Board (IASB)**. The accounting standards formulated by the IASB are referred to as the **International Financial Reporting Standards (IFRS)**. Approximately 120 nations or reporting jurisdictions either require or permit the use of IFRS. This includes the European Union, Australia, New Zealand, Israel, and Canada.

**A.K.A.** International financial reporting standards are often referred to as IFRS (pronounced "eye furs").

U.S. companies are not currently allowed to report their financial statements using IFRS. However, the FASB and IASB coordinate their standard-setting activities in an effort to reduce or eliminate as many differences as possible.

[1] Paralleling the FASB structure, the **Governmental Accounting Standards Board (GASB)** was organized in 1984 to formulate generally accepted accounting principles for state and local governments.

**YOUR TURN! 1.5**

The solution is on page 54.

Match the items from column 1 with the correct item in column 2.

1. Accounting
2. Generally Accepted Accounting Principles (GAAP)
3. Public Company Accounting Oversight Board (PCAOB)
4. International Accounting Standards Board (IASB)

*a.* Guides to action for financial reporting
*b.* Responsible for formulating international accounting standards
*c.* The process of measuring economic activity of an entity in monetary terms and communicating the results to users
*d.* The organization empowered to approve auditing standards

# FINANCIAL STATEMENTS

**LO5** **Describe** the accounting equation and each financial statement.

There are four basic financial statements: the balance sheet, the income statement, the statement of stockholders' equity, and the statement of cash flows. Each financial statement begins with a heading. The heading provides the name of the company, the name of the financial statement, and the date or time period of the statement.

## Balance Sheet

**A.K.A.** The balance sheet is also referred to as the statement of financial position.

**A.K.A.** The accounting equation is also called the balance sheet equation.

The **balance sheet** is a listing of a firm's assets, liabilities, and stockholders' equity as of a given date, usually the end of an accounting period. The balance sheet depicts a framework called the **accounting equation**. The accounting equation states that the sum of a business's economic resources must equal the sum of any claims on those resources. That is, a business obtains resources that it utilizes in its operations from outside sources, principally creditors and stockholders, who maintain claims on those resources. Consequently, the accounting equation can be written as:

**Resources of a company = Claims on resources**

Assets refer to a company's resources, liabilities refer to creditor claims on those resources, and stockholders' equity refers to owner claims on those resources. Using these terms, the accounting equation can be reformulated as:

**Assets = Liabilities + Stockholders' equity**

**Hints** *help explain difficult concepts.*

***Hint:*** *Only resources that can be expressed in monetary terms are included among the assets reported on the balance sheet. There exist some assets that cannot be expressed in monetary terms, such as the value of a company's workforce, and, therefore, are not reported on a balance sheet.*

This equation states that the firm's assets equals the sum of its liabilities plus its stockholders' equity—see **Exhibit 1-5**. Throughout the accounting process, the accounting equation must always remain in balance.

**Exhibit 1-5 Accounting Equation for a Business**

| | | | | | |
|---|---|---|---|---|---|
| **Economic Terms** | Resources | = | Creditor claims on resources | + | Stockholder (owner) claims on resources |
| **Business Terms** | Assets | = | Liabilities | + | Stockholders' equity |

**Assets** are the economic resources of a business that can be expressed in monetary terms. Assets take many forms. Cash is an asset, as are claims to receive cash payments from customers for goods or services provided, called accounts receivable. Other types of assets include inventory, supplies, land, buildings, and equipment. The key characteristic of any asset is that it represents a probable future economic benefit to a business.

**Liabilities** are the obligations or debts that a business must pay in cash or in goods and services at some future time as a consequence of past transactions or events. For example, a business can borrow money and sign a promissory note agreeing to repay the borrowed amount in six months. The business reports this obligation as a liability called notes payable. Similarly, if a business owes money to various suppliers for goods or services already provided, it is called accounts payable, or if it owes wages to its employees for work already performed, it is called wages payable. The business reports these obligations as liabilities on its balance sheet.

**Stockholders' equity** refers to the ownership (stockholder) claims on the assets of the business. Stockholders' equity represents a *residual claim* on a business's assets; that is, it is a claim on the assets of a business that remain after all liabilities to creditors have been satisfied. For this reason, stockholders' equity is sometimes referred to as a business's **net assets**, where net assets equal the difference between total assets and total liabilities. In equation format,

$$\text{Assets} - \text{Liabilities} = \text{Stockholders' equity}$$

and,

$$\text{Net assets} = \text{Stockholders' equity}$$

Columbia's balance sheet is shown in **Exhibit 1-6** and reports the company's assets, liabilities, and stockholders' equity. (All Columbia Sportswear amounts are in thousands of dollars.) Columbia's assets totaled $2,212,902 at year-end 2017, with the largest asset being cash of $673,166 followed by inventories of $457,927. Total assets ($2,212,902) are equal to the sum of liabilities ($560,643) and stockholders' equity ($1,652,259). This equality must always exist as required by the accounting equation.

**Exhibit 1-6** Columbia Sportswear Balance Sheet

**COLUMBIA SPORTSWEAR COMPANY**
**Balance Sheet**
**December 31, 2017**
**(In thousands)**

| | |
|---|---|
| **Assets** | |
| Cash | $ 673,166 |
| Investments | 94,983 |
| Accounts receivable | 364,862 |
| Inventories | 457,927 |
| Prepaid expenses and other current assets | 58,559 |
| Property, plant, and equipment, net | 281,394 |
| Other assets | 282,011 |
| Total assets | $2,212,902 |
| **Liabilities and Stockholders' Equity** | |
| Liabilities | |
| Accounts payable | $ 252,301 |
| Income taxes payable | 77,211 |
| Other liabilities | 231,131 |
| Total liabilities | 560,643 |
| Stockholders' Equity | |
| Common stock | 45,829 |
| Retained earnings | 1,606,430 |
| Total stockholders' equity | 1,652,259 |
| Total liabilities and stockholders' equity | $2,212,902 |

**Real financial data** *for focus companies illustrate key concepts of each chapter.*

***Hint:*** *Final totals in the financial statements are double underlined. Follow this format whenever asked to prepare a financial statement.*

Columbia's balance sheet indicates that the company principally depends on stockholders' equity to finance its operations since liabilities totaled only $560,643 at 2017 year-end, or approximately 25 percent of total assets.

**Takeaways** *summarize the key concepts before proceeding to the next topic.*

| TAKEAWAY 1.1 | Concept → | Method → | Assessment |
|---|---|---|---|
| | What mix of financing does a company use? | The balance sheet provides information regarding the various forms of financing, both debt financing and equity financing.<br>Compare the amount of liabilities appearing on the balance sheet to the amount of equity appearing on the balance sheet. | A higher ratio of liabilities to equity implies a higher use of creditor financing, and vice versa. Creditor financing is viewed by users as more risky. |

## Income Statement

**A.K.A.** The income statement is also called the statement of operations, the statement of income, and the earnings statement.

**A.K.A.** Sales revenue is also referred to as revenue, sales, net sales, or net revenue.

**A.K.A.** Net income is also referred to as net earnings or net profit.

The **income statement** reports the results of operations for a business for a given time period, usually a quarter or a year. The income statement lists the revenues and expenses of the business. **Sales revenue** are increases to a company's resources that result when goods or services are provided to customers. The amount of sales revenue earned is measured by the value of the assets received in exchange for the goods or services delivered.

**Expenses** are decreases in a company's resources from generating revenue. Expenses are generally measured by the value of the assets used up or exchanged as a result of a business's operating activities. Common examples of expenses include the cost of the items sold, referred to as cost of goods sold, selling expense, marketing expense, administrative expense, interest expense, and income tax. When total revenue exceeds total expenses, the resulting amount is called **net income**; when total expenses exceed sales revenue, the resulting amount is called a **net loss**.

Columbia's income statement is presented in **Exhibit 1-7**. The statement begins with the business's name, statement title, and time period covered. For Columbia, total revenue in 2017 is reported to be $2,477,329 (remember amounts are rounded to the nearest $1,000). Next, Columbia subtracts a series of expenses totaling $2,372,206, yielding net income of $105,123.

**Exhibit 1-7** Columbia Sportswear Income Statement

**COLUMBIA SPORTSWEAR COMPANY**
**Income Statement**
**For Year Ended December 31, 2017**
**(In thousands)**

| | |
|---|---|
| Revenue | |
| Sales | $2,466,105 |
| Other revenue | 11,224 |
| Total revenue | 2,477,329 |
| Expenses | |
| Cost of goods sold | 1,306,143 |
| Selling, general, and administrative expense | 910,894 |
| Income tax expense | 154,419 |
| Other expenses | 750 |
| Total expenses | 2,372,206 |
| Net income | $ 105,123 |

| Concept → | Method → | Assessment | TAKEAWAY 1.2 |
|---|---|---|---|
| Is a company profitable? | The income statement reports a company's performance for a given period of time.<br><br>Compare reported sales revenue to reported expenses. | Sales revenue in excess of expenses yields net income, implying a profitable company. If expenses exceed revenue, the company has a net loss. | |

## Statement of Stockholders' Equity

The **statement of stockholders' equity** reports the events causing an increase or decrease in stockholders' equity during a given time period. The statement of stockholders' equity consists of two parts—contributed capital and earned capital. **Contributed capital** is a measure of the capital contributed by the stockholders of a company when they purchase ownership shares in the company. Ownership shares are called *common shares* or *common stock*. **Earned capital** is a measure of the capital that is earned by the company, reinvested in the business, and not distributed to its stockholders—that is, its *retained earnings*.

**Retained earnings** are increased when operations produce net income and decreased when operations produce a net loss. Retained earnings also decrease when a company pays a dividend to its stockholders.

A company's retained earnings for a period is determined as follows (sometimes called *statement of retained earnings*):

| | |
|---|---|
| Retained earnings, beginning of period | $1,527,710 |
| **Add:** Net income (loss) | 105,123 |
| **Less:** Dividends and other | (26,403) |
| Retained earnings, end of period | $1,606,430 |

*Note: According to a 2011 survey of 500 companies, nearly 98% (489 out of 500) of the companies surveyed issue a Statement of Stockholders' Equity, while only 1% issue a separate Statement of Retained Earnings. Source: Accounting Trends & Techniques, 2011.*

Columbia's statement of stockholders' equity appears in **Exhibit 1-8**. We focus here on Columbia's retained earnings from its statement of stockholders' equity to emphasize two important concepts: (1) the relation between the income statement and the balance sheet and (2) the components of retained earnings. Columbia's statement of stockholders' equity in **Exhibit 1-8** begins with its ending retained earnings from 2016 of $1,527,710. The beginning balance of retained earnings is then increased by its net income of $105,123 from 2017. (Can you find this amount on Columbia's income statement in **Exhibit 1-7**?) Next, earnings that were distributed as a dividend to Columbia's stockholders in 2017 ($26,403) are subtracted to yield an ending retained earnings balance of $1,606,430 as of December 31, 2017. (Can you find this amount on Columbia's balance sheet in **Exhibit 1-6**?)

**Exhibit 1-8** Columbia Sportswear Statement of Stockholders' Equity

**COLUMBIA SPORTSWEAR COMPANY**
**Statement of Stockholders' Equity**
**For Year Ended December 31, 2017**

| (In thousands) | Common Stock | Retained Earnings | Total |
|---|---|---|---|
| Balance, December 31, 2016 | $53,801 | $1,527,710 | $1,581,511 |
| **Add:** Common stock issued | 27,570 | | 27,570 |
| Net income | | 105,123 | 105,123 |
| **Less:** Common stock repurchased | (35,542) | | (35,542) |
| Dividends and other | | (26,403) | (26,403) |
| Balance, December 31, 2017 | $45,829 | $1,606,430 | $1,652,259 |

| TAKEAWAY 1.3 | Concept → | Method → | Assessment |
|---|---|---|---|
| | What portion of a company's current period net income is distributed to its stockholders, and what portion is retained? | The statement of stockholders' equity reports both a company's net income and the amount of dividends distributed to stockholders.<br><br>Compare the company's dividends to its net income. | A higher ratio of dividends to net income implies that a company is distributing more of its net income to its stockholders, whereas a lower ratio implies it is retaining more of its income for purposes such as growing its business. |

**CORPORATE SOCIAL RESPONSIBILITY**

**Corporate Social Responsibility** *boxes showcase how forward-thinking companies are embracing CSR as part of their long-term business models.*

**Reporting on Triple Bottom Line**

Companies worldwide are focused on more than just the bottom line. Research shows that financial responsibility goes hand in hand with social responsibility. This is labeled a "virtuous cycle" because financial success provides the means to act in a socially responsible manner, and acting socially responsible increases a company's financial performance. Financial statements are not well suited for measuring social performance. To aid in the pursuit of socially responsible behavior, accountants have developed a **triple bottom line** framework in which the single bottom line of financial performance on the income statement is supplemented with a social bottom line and an environmental bottom line. The triple bottom line standard for urban and community accounting has been ratified by the United Nations and has become widely used in public sector accounting.

## Statement of Cash Flows

The **statement of cash flows** reports a business's cash inflows and cash outflows during a given period of time. The cash flows are grouped into the three business activities of operating, investing, and financing. Cash flow from operating activities includes the cash received from the sale of goods and services and the cash spent on operating expenses. Cash flow from investing activities includes cash payments and receipts from the business buying and selling certain assets that it uses in its operations. Cash flow from financing activities includes the issuance and repurchase of the business's own shares and the amounts borrowed and repaid to creditors.

Columbia's statement of cash flows is in **Exhibit 1-9**. This statement shows that Columbia's cash balance increased during 2017 by $121,777 from $551,389 on December 31, 2016, to $673,166 on December 31, 2017. Columbia's operating activities provided $341,128 in cash while Columbia's investing activities used $147,784 and Columbia's financing activities used $71,567. Adding the changes in cash for the three types of activities produces the increase of $121,777. The statement of cash flows always concludes with this reconciliation of the cash balance from the beginning of the year to the end of the year. (Can you find the ending cash balance on Columbia's balance sheet in **Exhibit 1-6**?)

**Exhibit 1-9** Columbia Sportswear Statement of Cash Flows

**COLUMBIA SPORTSWEAR COMPANY**
**Statement of Cash Flows**
**For Year Ended December 31, 2017**
**(In thousands)**

| | |
|---|---|
| Cash flows from operating activities | $341,128 |
| Cash flows from investing activities | (147,784) |
| Cash flows from financing activities | (71,567) |
| Net increase (decrease) in cash | 121,777 |
| Cash at beginning of year | 551,389 |
| Cash at end of year | $673,166 |

| Concept → | Method → | Assessment | TAKEAWAY 1.4 |
|---|---|---|---|
| What are the major sources and uses of a company's cash? | The statement of cash flows reports a company's sources and uses of cash separated into three activities: operating, investing, and financing.<br>Identify a company's sources and uses of cash as reported in the statement of cash flows. | Sources of cash are reported as positive numbers and uses of cash as negative numbers. Larger positive numbers represent major cash sources and larger negative numbers represent major cash uses. | |

## Relations Among the Financial Statements

The income statement, the statement of stockholders' equity, the balance sheet, and the statement of cash flows are linked to one another. That is, the financial statements *articulate*. To illustrate the linkages, refer to the financial statements of Columbia Sportswear in **Exhibit 1-10**. Observe that Ⓐ, the company's net income (or net loss) for a period is an input to the statement of stockholders' equity, and that Ⓑ, the ending common stock, retained earnings, and total equity are inputs to the balance sheet. The statement of cash flows Ⓒ explains the change in the cash balance on the balance sheet for a period.

**Exhibit 1-10** Financial Statements for Columbia Sportswear Company

**Columbia Sportswear Company**
**Income Statement**
**For Year Ended December 31, 2017**

| | |
|---|---|
| **Revenue** | |
| Sales | $2,466,105 |
| Other revenue | 11,224 |
| Total revenue | 2,477,329 |
| **Expenses** | |
| Cost of sales | 1,306,143 |
| Selling, general, and administrative | 910,894 |
| Income tax expense | 154,419 |
| Other expenses | 750 |
| Total expenses | 2,372,206 |
| Net income | $ 105,123 |

**Columbia Sportswear Company**
**Statement of Stockholders' Equity**
**For Year Ended December 31, 2017**

| | Common Stock | Retained Earnings | Total |
|---|---|---|---|
| Balance, December 31, 2016 | $53,801 | $1,527,710 | $1,581,511 |
| **Add:** Common stock issued | 27,570 | | 27,570 |
| Net income | | 105,123 | 105,123 |
| **Less:** Common stock repurchased | (35,542) | | (35,542) |
| Dividends and other | | (26,403) | (26,403) |
| Balance, December 31, 2017 | $45,829 | $1,606,430 | $1,652,259 |

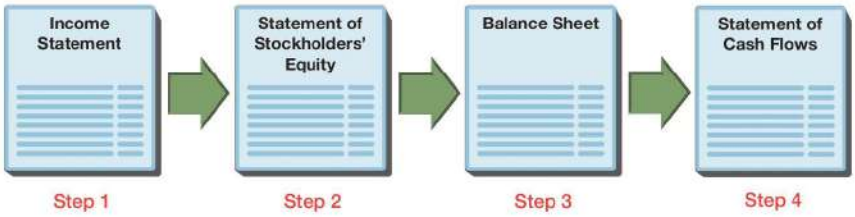
**Columbia Sportswear Company**
**Balance Sheet**
**December 31, 2017**

| | | | |
|---|---|---|---|
| **Assets** | | **Liabilities** | |
| Cash | $ 673,166 | Accounts payable | $ 252,301 |
| Investments | 94,983 | Income taxes payable | 77,211 |
| Accounts receivable | 364,862 | Other liabilities | 231,131 |
| Inventories | 457,927 | Total liabilities | 560,643 |
| Prepaid expenses and other current assets | 58,559 | **Stockholders' Equity** | |
| Property, plant, and equipment, net | 281,394 | Common stock | 45,829 |
| Other assets | 282,011 | Retained earnings | 1,606,430 |
| | | Total stockholders' equity | 1,652,259 |
| Total assets | $2,212,902 | Total liabilities and stockholders' equity | $2,212,902 |

**Columbia Sportswear Company**
**Statement of Cash Flows**
**For Year Ended December 31, 2017**

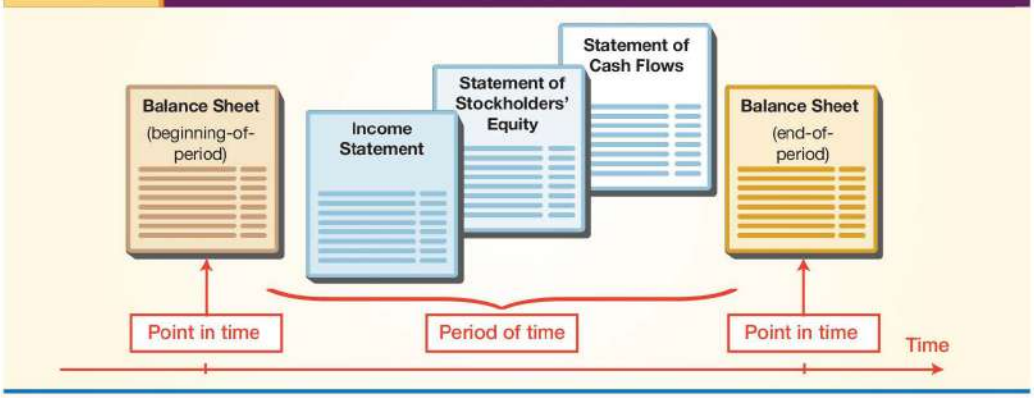
| | |
|---|---|
| **Cash flows from operating activities** | $341,128 |
| **Cash flows from investing activities** | (147,784) |
| **Cash flows from financing activities** | (71,567) |
| Net increase in cash | 121,777 |
| Cash at beginning of year | 551,389 |
| Cash at end of year | $673,166 |

When financial statements are prepared, the sequence suggested by these relations is customarily followed; that is, (1) the income statement is prepared first, followed by (2) the statement of stockholders' equity, then (3) the balance sheet, and finally (4) the statement of cash flows.




Three of these financial statements present information covering a specific period of time: the income statement, the statement of stockholders' equity, and the statement of cash flows. For this reason, these financial statements are referred to as **period-of-time statements**. In contrast, the balance sheet reports information as of a specific date. The balance sheet, therefore, is referred to as a **point-in-time statement**. (Illustrated in **Exhibit 1-11**.)

**Exhibit 1-11 Financial Statement Links Across Time**




**YOUR TURN! 1.6**

The solution is on pages 54–55.

Kanzu Corporation started business on January 1. The following information was compiled by Kanzu as of December 31.

| | | | |
|---|---|---|---|
| Sales revenue | $20,000 | Accounts payable | $ 4,000 |
| Expenses | 12,000 | Notes payable | 33,000 |
| Dividends | 3,000 | Common stock | 20,000 |
| Cash | 1,500 | Retained earnings | ? |
| Accounts receivable | 2,500 | Cash flow from operating activities | 6,500 |
| Inventory | 3,000 | Cash flow from investing activities | (55,000) |
| Equipment | 15,000 | Cash flow from financing activities | 50,000 |
| Building | 40,000 | | |

Prepare the company's year-end financial statements: an income statement, a statement of stockholders' equity, a balance sheet, and a statement of cash flows.

**Guided Example** *icons denote the availability of a demonstration video in* **myBusinessCourse** *(MBC). See the Preface for more on MBC.*

# OTHER ANNUAL REPORT COMPONENTS

Columbia Sportswear Company, like all publicly traded companies in the United States, must file an **annual report** called a **Form 10-K** with the U.S. Securities and Exchange Commission (SEC). Some companies also send a less detailed version of their annual report to their stockholders. The four financial statements explained in this chapter are essential

components of this report. Additional components of the annual report are the notes to the financial statements, the auditor's report, and the Management's Discussion and Analysis.

## Notes to Financial Statements

**LO6** **Explain** additional disclosures that accompany financial statements.

A skilled financial statement user wants to know more than just the numbers reported in the financial statements. That user also wants to know assumptions and estimates that were used in preparing the statements, the measurement procedures that were followed, and the details behind certain summary numbers. The **notes to the financial statements**, which are quantitative as well as qualitative, provide a great deal more information than just the numbers alone. For example, notes usually contain a description regarding how the company determined the value of its inventory, a detailed chart to explain the property, plant, and equipment account, and a description of any pending lawsuits. No analysis of the annual report is complete without a careful reading of the notes to the financial statements. The following is a short excerpt from Columbia's notes:

> **Accounts receivable** Accounts receivable have been reduced by an allowance for doubtful accounts. The Company makes ongoing estimates of the collectability of accounts receivable and maintains an allowance for estimated losses resulting from the inability of the Company's customers to make required payments.

**Excerpts** *from recent financial statements and notes are used to illustrate and reinforce concepts.*

The notes are considered a key part of the financial statements and, with the four basic financial statements, are audited by the company's independent auditor.

## Independent Auditor's Report

The report of the independent auditor, commonly referred to as the **auditor's report**, describes the activities undertaken by a company's independent auditor and provides that auditor's opinion regarding whether the financial statements fairly present the results of the company's operations and financial health. A short excerpt from the auditor's report included with Columbia Sportswear's annual report follows. **Deloitte & Touche**, which is Columbia's independent auditor, reports that the financial statements of Columbia are, in its opinion, fairly presented. The independent auditor has intentionally avoided using language such as the statements are "correctly presented" or are "exactly correct." As we will see in subsequent chapters, the financial statements are prepared only after the management team makes a number of assumptions, estimates, and accounting policy decisions. As a consequence, it is inappropriate to describe the statements as being right or wrong since the reported numbers are dependent on the accounting policies selected and the assumptions and estimates made by management.

> **Report of Independent Registered Public Accounting Firm**
> In our opinion, such financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America.
>
> ***DELOITTE & TOUCHE LLP***

## Management's Discussion and Analysis

In addition to the financial statements and notes, the SEC requires companies to provide other information, such as a description of its business, the properties it owns, and the risks it faces. Unlike the financial statements and notes, however, this information is not audited by the company's independent auditor. An important component of this other information is the **Management's Discussion and Analysis**, or MD&A, which contains management's interpretation of the company's recent performance and financial condition. This

interpretation helps financial statement users gain context to help frame their own analysis and interpretation of the numbers that appear in the financial statements.

The MD&A is also where a company's management provides its view regarding what the future holds for its business. Discussions of future opportunities and risks are called "forward-looking" and are helpful to any financial statement user interested in learning about such things as potential new markets for the company's products or potential new competitors. Obviously these forward-looking statements are subjective in nature, and the financial statement user must do his or her own independent analysis.

The following is a short excerpt from Columbia's MD&A.

**Business Outlook**

The global business climate continues to present us with a great deal of uncertainty, making it difficult to predict future results. Consistent with the historical seasonality of the business, we anticipate 2018 profitability to be heavily concentrated in the second half of the year. Factors that could significantly affect our full year 2018 financial results include:

- Performance and profitability of our global direct-to-consumer operations;
- Unseasonable weather conditions or other unforeseen factors affecting consumer demand and the resulting effect on cancellations of advance wholesale orders, sales returns, wholesale customer accommodations, replenishment orders and reorders, direct-to-consumer sales, changes in mix and volume of full price sales in relation to promotional and closeout product sales, and suppressed wholesale and end-consumer demand in subsequent seasons;
- Industry trends affecting consumer traffic and spending in brick and mortar retail channels, which are creating uncertainty regarding the long-term financial health of several of our U.S. wholesale customers;
- The effects of changes in foreign currency exchange rates on sales, gross margin, operating income, and net income;
- Difficult economic and competitive environments in certain key markets within our Latin America and Asia Pacific ("LAAP") region, in particular, Korea;
- Continued sales growth and profitability contributed by our Europe, Middle East and Africa ("EMEA") region;
- Performance of our Mountain Hardwear business as we work to re-invigorate that brand in the marketplace;
- The financial impact of activities associated with and resulting from Project CONNECT;
- Further refinement of our 2017 TCJA provisional income tax estimates; and
- The financial impact of executing our Consumer-First platform.

These factors and others may have a material effect on our financial condition, results of operations or cash flows, particularly with respect to quarterly comparisons.

**YOUR TURN! 1.7**

The solution is on page 55.

Match each of the items in the left column with the appropriate annual report component where we would find that item, from the right column.

1. An opinion regarding the fair presentation of financial statements.
2. Information regarding the procedures followed to value a company's assets.
3. A discussion of new markets that a company plans to enter.

*a.* Management Discussion and Analysis
*b.* Notes to the Financial Statements
*c.* Auditor's report


## CAREERS IN ACCOUNTING

**LO7** **Describe** careers in accounting.

Job prospects after graduation are one of the primary considerations students have when selecting a major. The good news for accounting majors is that the present is very good and the future looks even brighter. According to the

Bureau of Labor Statistics, accounting jobs are expected to grow by 13 percent annually through 2022, assuring accounting majors will be in demand for the foreseeable future.

Accounting opportunities are present in multiple areas. **Exhibit 1-12** lists some typical job titles in (1) private accounting; (2) public accounting; and (3) government. Accountants working in the private sector work for a particular company, whereas accountants working in public accounting spend most of their time working for clients of their employer.

Accounting professionals are not just in high demand, they are also held in high regard by the public. Accounting professionals often earn various certificates in order to further distinguish themselves. The most sought after certification is the Certified Public Accountant (CPA) certificate. This certification requires both education and professional experience, passing an examination, and the highest ethical standards. Three other important certifications are the Certified Management Accountant (CMA), the Certified Internal Auditor (CIA), and the Certified Fraud Examiner (CFE) certificates.

**Exhibit 1-12 Careers in Accounting**

| | Private Accounting | Public Accounting | Government Accounting |
|---|---|---|---|
| Typical Positions | Internal audit<br>Tax<br>Financial reporting<br>Analyst<br>Budgeting<br>Cost accounting | Auditor<br>Tax<br>Consulting<br>Strategy | Auditor<br>Tax<br>Budgeting<br>Criminal investigation |

One of the reasons that accounting graduates find great opportunities upon graduation is because their accounting courses provide specific skills that can be applied immediately on the job. It is therefore quite apparent that when one compares the advantages and disadvantages of an accounting career, the positive job outlook and the high salaries are often listed. Accountants also have a great deal of mobility and upward advancement potential.

According to the U.S. Bureau of Labor Statistics, the 2017 median pay for the 1.4 million accounting jobs in their database was $69,350. **Exhibit 1-13** compares the 2018 salaries of starting accountants, accountants with a couple years of experience, and more senior accountants in both public accounting and in large corporations.

**Exhibit 1-13 Accounting Salaries**

| Area of Employment | Position and Experience | Midpoint of Salary Range |
|---|---|---|
| Private Accounting | Bookkeeper | $ 37,500 |
| | Financial Analyst < 1 year | $ 50,000 |
| | Financial Analyst 1–3 years | $ 65,000 |
| | Financial Analyst Manager | $100,000 |
| | Corporate Controller | $170,000 |
| | Chief Financial Officer | $192,000 |
| Public Accounting | Junior Accountant < 1 year | $ 46,000 |
| | Senior Accountant | $ 70,000 |
| | Senior Manager | $132,000 |

Source: Robert Half 2018 Salary Guide

## Data Analytics and Blockchain Technology

Accounting skills are not stagnant; rather they are constantly evolving. What was once done by hand is now done with the aid of specialized software. Programs like **QuickBooks** from **Intuit** have automated the basic accounting job of transaction recording, and programs like **Microsoft Excel** have greatly aided in the analysis of accounting data. While some industry observers had predicted these technological advances would replace the need for accountants, these applications have simply changed the way accountants perform their jobs. Newer technologies such as data analytics and blockchain are further

changing the way accountants do their jobs. However, knowledge of these technologies and the related skills needed to use them are often lacking among current accountants. That was the key finding in a recently released joint report, *Building a Team to Capitalize on the Promise of Big Data*, by the human resource consulting firm Robert Half and the Institute of Management Accountants (IMA).

**Data analytics** (DA) can broadly be defined as the process of examining sets of data with the goal of discovering useful information from patterns found in the data. Accountants employing data analytics can glean important insights from a company's financial data and identify areas where improvements can be made.

Blockchain was made famous as the underpinning technology used for digital currencies, such as **Bitcoin** and **Ethereum**. **Blockchain** is a distributed digital ledger that provides a secure means, for those that have permission, to view recorded transactions. This technology has wide-ranging implications for business and is expected to greatly affect the way accountants perform audits.

Understanding what data analytics and blockchain technology are and how they are used is the first step towards developing marketable skills in each area, so we have included examples of each at various points in the book. In addition, **Appendix F** at the end of this book provides a more detailed discussion of both topics.

## COMPREHENSIVE PROBLEM

GuidedExamples MBC

You have been approached by Janet Jones about helping her assemble a set of December 31 financial statements for her new business. Janet began the operations of her bakery shop on January 1, 2019. Janet decided that she did not want to risk any personal liability resulting from operating the business; consequently, she organized the bakery, called Sweet Pleasures, as a corporation.

***Required***

Use the format of **Exhibits 1-6** through **1-9** to prepare an income statement, statement of stockholders' equity, balance sheet, and statement of cash flows for Sweet Pleasures as of December 31, 2019. Use the account titles and balances provided below. Be sure to use proper underlining and double underlining.

| | | | |
|---|---|---|---|
| Sales of goods | $200,000 | Dividends | $ 10,000 |
| Cash | 99,000 | Bank loan payable | 20,000 |
| Rent expense | 16,000 | Accounts receivable | 40,000 |
| Interest payable | 1,600 | Cash received from operating activities | 160,000 |
| Cash received from issuance of common stock | 50,000 | Cash payments for operating activities | 94,000 |
| Insurance expense | 20,000 | Salary expense | 40,000 |
| Purchase of equipment | 27,000 | Cash received from borrowing from bank | 20,000 |
| Equipment | 27,000 | Interest expense | 1,600 |
| Common stock | 50,000 | Administrative expense | 18,000 |
| Cash dividends paid | 10,000 | | |

***Solution***

**SWEET PLEASURES CORPORATION**
**Income Statement**
**For Year Ended December 31, 2019**

| | | |
|---|---|---|
| Revenue | | |
| Sales of goods | | $200,000 |
| Expenses | | |
| Rent expense | $16,000 | |
| Insurance expense | 20,000 | |
| Salary expense | 40,000 | |
| Administrative expense | 18,000 | |
| Interest expense | 1,600 | |
| Total expenses | | 95,600 |
| Net income | | $104,400 |

**SWEET PLEASURES CORPORATION**
**Statement of Stockholders' Equity**
**For Year Ended December 31, 2019**

| | Common Stock | Retained Earnings | Total |
|---|---|---|---|
| Balance, January 1 | $ 0 | $ 0 | $ 0 |
| Add: Common stock issued | 50,000 | | 50,000 |
| Net income | | 104,400 | 104,400 |
| Less: Dividends | | (10,000) | (10,000) |
| Balance, December 31 | $50,000 | $ 94,400 | $144,400 |

**SWEET PLEASURES CORPORATION**
**Balance Sheet**
**December 31, 2019**

| | | | |
|---|---|---|---|
| **Assets** | | **Liabilities** | |
| Cash | $ 99,000 | Bank loan payable | $ 20,000 |
| Accounts receivable | 40,000 | Interest payable | 1,600 |
| Equipment | 27,000 | Total liabilities | 21,600 |
| | | **Stockholders' Equity** | |
| | | Common stock | 50,000 |
| | | Retained earnings | 94,400 |
| | | Total stockholders' equity | 144,400 |
| Total assets | $166,000 | Total liabilities and stockholders' equity | $166,000 |

**SWEET PLEASURES CORPORATION**
**Statement of Cash Flows**
**For Year Ended December 31, 2019**

| | | |
|---|---|---|
| Cash flow from operating activities | | |
| Cash received from operating activities | $160,000 | |
| Cash payments for operating activities | (94,000) | |
| Cash provided by operating activities | | $66,000 |
| Cash flow from investing activities | | |
| Purchase of equipment | (27,000) | |
| Cash used by investing activities | | (27,000) |
| Cash flow from financing activities | | |
| Borrowing from bank | 20,000 | |
| Issuance of common stock | 50,000 | |
| Cash dividends paid | (10,000) | |
| Cash provided by financing activities | | 60,000 |
| Net increase of cash | | 99,000 |
| Cash at January 1 | | 0 |
| Cash at December 31 | | $99,000 |

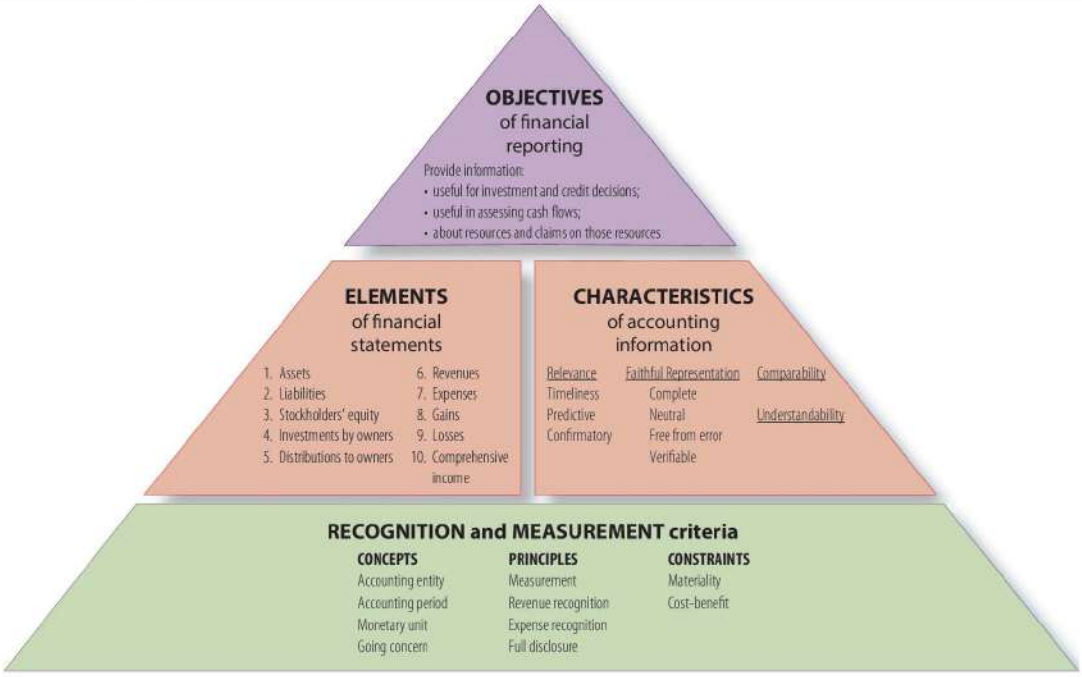
## APPENDIX 1A: FASB's Conceptual Framework

The FASB has developed a conceptual framework, in coordination with the International Accounting Standards Board. The **conceptual framework** is a cohesive set of interrelated objectives and fundamentals for external financial reporting whose purpose is to guide the formulation of specific U.S. accounting principles. This framework, outlined in **Exhibit 1A-1**, consists of (1) financial reporting objectives, (2) financial statement elements,

**LO8** Appendix 1A: **Discuss** FASB's conceptual framework.

(3) qualitative characteristics of accounting information, and (4) recognition and measurement criteria for financial statements. A recurrent theme in the conceptual framework is the importance of providing information that is useful to financial statement users.

**Exhibit 1A-1** **Summary of Conceptual Framework**




## Financial Reporting Objectives

The **financial reporting objectives** focus on information useful to investors and creditors. Accordingly, financial statements have the principal objective of providing information that is (1) useful in making investment, credit, and similar decisions and (2) helpful in assessing the ability of enterprises to generate future cash flows. Financial statements should also (3) contain information about a company's economic resources, the claims on those resources, and the effects of events that change those resources and claims. This helps to identify a company's financial strengths and weaknesses, predict future performance, and evaluate earlier expectations.

## Financial Statement Elements

The **financial statement elements** are the components of financial statements. These elements include assets, liabilities, stockholders' equity, investments by owners, distributions to owners, revenues, expenses, gains, losses, and comprehensive income.

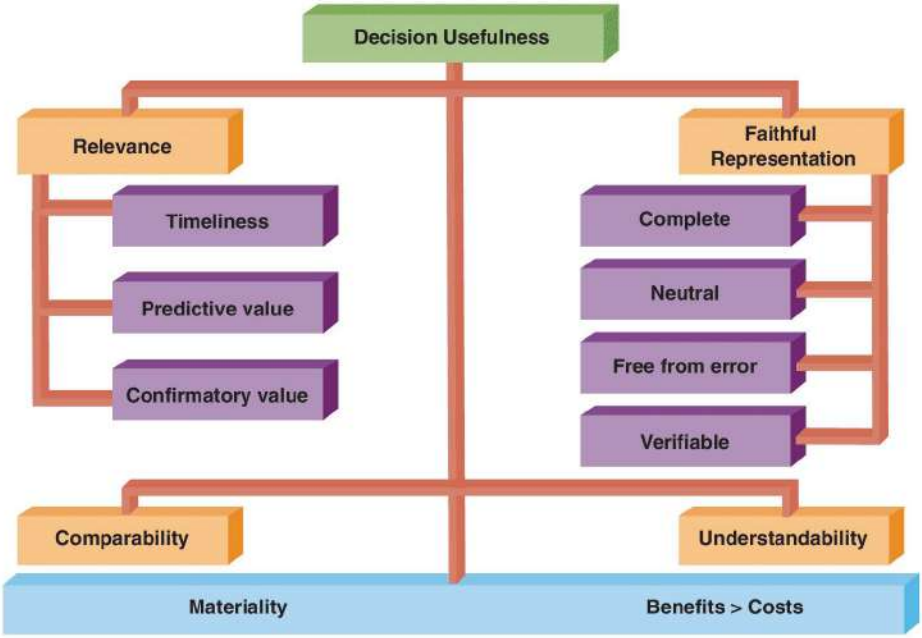
## Qualitative Characteristics

The **qualitative characteristics of accounting information** are depicted in **Exhibit 1A-2**. These qualities are intended to contribute to decision usefulness. The two primary qualities are **relevance** and **faithful representation**. To be relevant, accounting information must make a difference in a user's decisions. Relevant information must be timely and contribute to the predictive and evaluative decisions made by investors and creditors. Faithful representation has the characteristics of being complete, neutral, free from error, and verifiable.

Additional enhancing qualitative characteristics of accounting information are comparability and understandability. In order to enable users to most effectively compare financial results across companies, U.S. GAAP requires that companies disclose in the notes to financial statements the accounting policy choices they elected to use in the preparation of their financial statements. **Comparability** aids users to understand similarities and differences among items. Related to comparability is **consistency**, although they are not the same. Comparability relates to making comparisons among more than one item, whereas consistency relates to a single item and means the same accounting methods are used from one accounting period to the next. U.S. GAAP requires that

when a firm changes a method of reporting its financial results that the financial impact of the method change be revealed in its notes to financial statements. **Understandability** is enhanced if information is classified, characterized, and presented clearly and concisely.

**Exhibit 1A-2 Qualitative Characteristics of Accounting Information**




## Recognition and Measurement Criteria

The **recognition and measurement criteria** specify the conditions that must be satisfied before a particular asset, liability, revenue, or expense can be recorded in the financial records. An item under consideration must meet the definition of an element and be measurable, and information about the item must achieve the primary qualitative characteristics of accounting information. The recognition and measurement criteria consist of four concepts, four principles, and two constraints.

## Concepts

A fundamental concept in accounting is the entity. An **accounting entity** is an economic unit with identifiable boundaries for which we accumulate and report financial information. Before we can analyze and report activities, we must identify the particular entity. Each sole proprietorship, partnership, and corporation is an entity, and separate accounting records must be maintained for each unit. In accumulating financial information, we maintain a record of the activities of the accounting entity separately from the economic and personal activities of its owners. The operations of most businesses are virtually continuous. Yet, the economic life of a company can be divided into specific periods of time, known as the **accounting period**, which is typically one year for purposes of preparing financial statements. Although the division of the total life of a business into segments based on annual periods is artificial, the concept of the accounting period is useful for financial reporting. The **monetary unit concept** specifies that a monetary unit (for example, the dollar in the United States and the euro in the European Union) is to be used to measure and record an entity's economic activity. Only items that can be expressed in these monetary units are included in the financial statements. When all assets, liabilities, and stockholders' equity are stated in monetary terms, they can be added or subtracted to prepare financial statements. Also, relations among financial statement components can be calculated and presented to help interpret the statements. In the absence of evidence to the contrary, a business is assumed to have an indefinite life. The **going concern concept** presumes that an enterprise will continue to operate indefinitely and will not be sold or otherwise liquidated.

## Principles

Four principles frame financial accounting information: measurement, revenue recognition, expense recognition, and full disclosure. U.S. GAAP is a mixed measurement system. It is primarily founded on the **cost principle**, meaning assets and liabilities are initially recorded at the amount paid or obligated to pay. Historical acquisition cost is considered the proper initial measurement because, for example, at the time an asset is acquired, it represents the fair value of the asset as agreed upon by both the buyer and seller. However, the fair value principle is sometimes applied after acquisition, which is a "market-based" measurement system for assets and liabilities. In 2014, the FASB and IASB issued a joint **revenue recognition** standard with the intention of improving financial reporting by providing consistent principles for recognizing revenue regardless of the company's industry or geography. The rule replaces a patchwork of previous standards and is based on a five-step process that broadly considers when a performance obligation has been satisfied. This generally occurs when goods or services are transferred from the seller to the buyer. The amount of revenue recognized is the amount that reflects the consideration to which the seller expects to be entitled in exchange for those goods or services. The **expense recognition principle** states that net income is determined by linking any expenses incurred with the related earned sales revenues. Thus, expenses are recorded in the period that they help to generate the revenues.

Together, the revenue recognition principle and the expense recognition principle define the **accrual basis of accounting**. It is important to observe that recording revenues and expenses do not depend upon the receipt or payment of cash. The accrual basis of accounting is widely used. Under the **cash basis of accounting**, revenues are recorded when cash is received from operating activities and expenses are recorded when cash payments are made for operating activities. Net income, therefore, becomes the difference between operating cash receipts and operating cash payments. The cash basis is not considered generally accepted.

All information necessary for a user's understanding of financial statements should be disclosed in a company's annual report. The purpose of accounting is to provide useful information to those parties interested in a firm's financial health. Sometimes, facts or conditions exist that, although not specifically part of the data in the accounting system, have considerable influence on a full understanding and interpretation of financial statements. To properly inform financial statement users, the **full disclosure principle** requires that a business disclose all significant financial facts and circumstances.

## Constraints

Two factors constrain the qualitative characteristics of accounting information: materiality and cost-benefit. Applying accounting procedures requires effort and costs money. When amounts involved are too small to affect the financial picture, the application of theoretically correct accounting procedures is hardly worth its cost. The concept of **materiality** permits a firm to expense the cost of such assets as small tools, office equipment, and furniture when acquired because their cost is "immaterial" in amount. The **cost-benefit constraint** requires that the benefit derived from the information outweighs the cost of providing it.

**Summaries** *review key bullet points for each Learning Objective and summarize each section's Takeaway.*

## SUMMARY OF LEARNING OBJECTIVES

**LO1 Explain the three forms of business organizations. (p. 4)**

- There are three primary organizational forms that a business can take: proprietorship, partnership, and corporation.
- A sole proprietorship consists of a single owner. It is the most common form of business and the easiest to establish.
- A partnership is similar to a sole proprietorship except that there is more than one owner. Partnerships are also relatively easy to establish. An advantage of the partnership form over the sole proprietorship is the broader set of skills and resources that multiple partners can bring to an enterprise.
- A corporation is the most complex of the three organizational forms. The advantages of the corporate form of business include the ease of transferring ownership interests and the ease of raising funds. Another advantage is the limited liability protection it offers its owners. A disadvantage of the corporate form is the possibility of double taxation of the company's net income.

**LO2 Describe business activities. (p. 5)**

- Companies engage in three types of business activities: operating, investing, and financing.
- Operating activities consist of selling products or providing services to generate sales revenue and using economic resources to manufacture goods or provide services.

- Investing activities consist of those activities needed to provide the infrastructure to run a company's operations. Also included in this activity category are investments of excess cash.
- Financing activities consist of both debt financing and equity financing. Debt financing involves the procurement of a bank loan, whereas equity financing involves the sale of shares of stock to investors.

**Indicate who uses accounting information. (p. 6)** **LO3**

- Accounting information is important to both internal and external users.
- Financial accounting produces publicly available financial statements for external users including investors, creditors, taxation authorities, regulatory agencies, labor unions, and customers.
- The process of generating and analyzing data for internal management use is referred to as managerial accounting.
- Business leaders recognize the importance of ethical behavior.

**Explain the accounting process and generally accepted accounting principles. (p. 10)** **LO4**

- Accounting is the process of measuring the economic activities of an enterprise in monetary terms and communicating the results to interested parties.
- The basic purpose of accounting is to provide financial information that is useful in making economic decisions.
- The Financial Accounting Standards Board (FASB) is a private sector organization that has responsibility for formulating generally accepted accounting principles in the United States.
- Generally accepted accounting principles (GAAP) are the standards and procedures that guide the preparation of financial statements.
- The International Accounting Standards Board (IASB) has taken the lead role in formulating International Accounting Reporting Standards (IFRS).

**Describe the accounting equation and each financial statement. (p. 12)** **LO5**

- The accounting equation, Assets = Liabilities + Stockholders' Equity, is the fundamental framework within which accounting analysis takes place.
  - Assets are the economic resources of a business that can be expressed in monetary terms.
  - Liabilities are the obligations that a business must pay in money or services in the future as a consequence of past transactions or events.
  - Stockholders' equity is the residual interest of the owners in the assets of a business.
- The *income statement* presents a company's sales revenues and expenses for a period of time.
- The *statement of stockholders' equity* reports the financial events causing a change in stockholders' equity during a period of time, and includes retained earnings and common stock.
- The *balance sheet* presents a company's assets, liabilities, and stockholders' equity as of a given date.
- The *statement of cash flows* reports a company's cash inflows and outflows during a period of time.

**Explain additional disclosures that accompany financial statements. (p. 19)** **LO6**

In addition to the basic financial statements, the annual report includes notes to the financial statements, an independent auditor's report, and Management's Discussion and Analysis.

- The notes to the financial statements provide both a quantitative and a qualitative description of a company's financial statements and explain the numbers reported in those financial statements.
- The independent auditor's report provides a degree of assurance that a company's financial statements are presented fairly and can be relied upon for decision-making purposes.
- The Management's Discussion and Analysis (MD&A) provides management with an opportunity to both analyze past performance and discuss future opportunities and concerns involving a company.

**Describe careers in accounting. (p. 20)** **LO7**

- Accounting graduates are in high demand and can anticipate bright employment prospects.
- Accountants can find jobs in public accounting, private corporations, or the government.

**Appendix 1A: Discuss FASB's conceptual framework. (p. 23)** **LO8**

- The conceptual framework provides a guide to the formulation of U.S. generally accepted accounting principles.
- The framework consists of interrelated objectives, elements, characteristics, and recognition and measurement criteria.
- The financial reporting objectives focus on information useful to investors and creditors.

- The financial statement elements are the components of financial statements.
- The qualitative characteristics of accounting information are intended to contribute to decision usefulness.
- The recognition and measurement criteria specify the conditions that must be satisfied before a particular asset, liability, revenue, or expense can be recorded in the financial records.

| SUMMARY | Concept → | Method → | Assessment |
|---|---|---|---|
| **TAKEAWAY 1.1** | What mix of financing does a company use? | The balance sheet provides information regarding the various forms of financing, both debt financing and equity financing.<br><br>Compare the amount of liabilities appearing on the balance sheet to the amount of equity appearing on the balance sheet. | A higher ratio of liabilities to equity implies a higher use of creditor financing, and vice versa. Creditor financing is viewed by users as more risky. |
| **TAKEAWAY 1.2** | Is a company profitable? | The income statement reports a company's performance for a given period of time.<br><br>Compare reported sales revenue to reported expenses. | Sales revenue in excess of expenses yields net income, implying a profitable company. If expenses exceed revenue, the company has a net loss. |
| **TAKEAWAY 1.3** | What portion of a company's current period net income is distributed to its stockholders, and what portion is retained? | The statement of stockholders' equity reports both a company's net income and the amount of dividends distributed to stockholders.<br><br>Compare the company's dividends to its net income. | A higher ratio of dividends to net income implies that a company is distributing more of its net income to its stockholders, whereas a lower ratio implies that it is retaining more of its income for purposes such as growing its business. |
| **TAKEAWAY 1.4** | What are the major sources and uses of a company's cash? | The statement of cash flows reports a company's sources and uses of cash separated into three activities: operating, investing, and financing.<br><br>Identify a company's sources and uses of cash as reported in the statement of cash flows. | Sources of cash are reported as positive numbers and uses of cash as negative numbers. Larger positive numbers represent major cash sources and larger negative numbers represent major cash uses. |

## KEY TERMS

*Key Terms are listed for each chapter with references to page numbers within the chapter.*

**Accounting** (p. 10)
**Accounting entity** (p. 25)
**Accounting equation** (p. 12)
**Accounting period** (p. 25)
**Accrual basis of accounting** (p. 26)
**American Institute of Certified Public Accountants (AICPA)** (p. 9)
**Annual report** (p. 18)
**Assets** (p. 12)
**Auditor's report** (p. 19)
**Balance sheet** (p. 12)
**Blockchain** (p. 22)
**Cash basis of accounting** (p. 26)
**Certified public accountants (CPAs)** (p. 7)
**Comparability** (p. 24)
**Conceptual framework** (p. 23)
**Consistency** (p. 24)
**Contributed capital** (p. 15)
**Corporation** (p. 4)
**Cost-benefit constraint** (p. 26)
**Cost principle** (p. 26)
**Creditors** (p. 5)
**Data analytics** (p. 22)

**Debt financing** (p. 5)
**Earned capital** (p. 15)
**Equity financing** (p. 5)
**Ethics** (p. 8)
**Expense recognition (matching) principle** (p. 26)
**Expenses** (p. 14)
**Faithful representation** (p. 24)
**Financial accounting** (p. 7)
**Financial Accounting Standards Board (FASB)** (p. 10)
**Financial reporting objectives** (p. 24)
**Financial statement elements** (p. 24)
**Financing activities** (p. 5)
**Forensic accounting** (p. 9)
**Form 10-K** (p. 18)
**Full disclosure principle** (p. 26)
**Generally accepted accounting principles (GAAP)** (p. 10)
**Generally accepted auditing standards (GAAS)** (p. 11)
**Going concern concept** (p. 25)
**Governmental Accounting Standards Board (GASB)** (p. 11)
**Income statement** (p. 14)
**Institute of Management Accountants (IMA)** (p. 9)
**International Accounting Standards Board (IASB)** (p. 11)
**International Financial Reporting Standards (IFRS)** (p. 11)
**Investing activities** (p. 6)
**Liabilities** (p. 13)
**Management's Discussion and Analysis** (p. 19)
**Managerial accounting** (p. 8)
**Materiality** (p. 26)
**Monetary unit concept** (p. 25)
**Net assets** (p. 13)
**Net income** (p. 14)
**Net loss** (p. 14)
**New York Stock Exchange (NYSE)** (p. 5)
**Notes to the financial statements** (p. 19)
**Operating activities** (p. 6)
**Partnership** (p. 4)
**Period-of-time statements** (p. 18)
**Point-in-time statement** (p. 18)
**Principal** (p. 5)
**Public Company Accounting Oversight Board (PCAOB)** (p. 11)
**Qualitative characteristics of accounting information** (p. 24)
**Recognition and measurement criteria** (p. 25)
**Relevance** (p. 24)
**Retained earnings** (p. 15)
**Revenue recognition principle** (p. 26)
**Sales revenue** (p. 14)
**Sarbanes-Oxley Act** (p. 9)
**Sole proprietorship** (p. 4)
**Statement of cash flows** (p. 16)
**Statement of stockholders' equity** (p. 15)
**Stockholders** (p. 4)
**Stockholders' equity** (p. 13)
**Triple bottom line** (p. 16)
**Understandability** (p. 25)
**U.S. Securities and Exchange Commission (SEC)** (p. 10)

**Homework** *icons indicate which assignments are available in* **myBusinessCourse** *(MBC). This feature is only available when the instructor incorporates MBC in the course.*

**Self-Study Questions** *in multiple-choice format with answers provided at the end of each chapter.*

**Assignments with the MBC logo in the margin are available in myBusinessCourse. See the Preface of the book for details.**

## SELF-STUDY QUESTIONS

*(Answers to Self-Study Questions are at the end of this chapter.)*

**1. Which form of business organization is characterized by limited liability?** **LO1**
*a.* Sole proprietorship
*b.* Partnership
*c.* Corporation
*d.* Both sole proprietorship and partnership

**2. Which of the following processes best defines accounting?** **LO4**
*a.* Measuring economic activities
*b.* Communicating results to interested parties
*c.* Preventing fraud
*d.* Both a and b.

**3. Generally accepted accounting principles are:** **LO4**
*a.* A set of guidelines to aid in the financial reporting process
*b.* A set of laws to prevent financial fraud
*c.* A set of standards for ethical conduct
*d.* A set of voluntary "best business practices"

**4. To which area of accounting are generally accepted accounting principles primarily relevant?** **LO3**
*a.* Managerial accounting
*b.* Financial accounting
*c.* Tax accounting
*d.* Financial reporting to all regulatory agencies

**LO2** **5. Which of the following is not one of the three types of business activities?**

*a.* Investing
*b.* Financing
*c.* Marketing
*d.* Operating

**LO5** **6. If assets total $140,000 and liabilities total $50,000, how much are net assets?**

*a.* $40,000
*b.* $90,000
*c.* $140,000
*d.* $50,000

**LO5** **7. What are increases in resources that a firm earns by providing goods or services to its customers?**

*a.* Assets
*b.* Revenues
*c.* Expenses
*d.* Liabilities

**LO6** **8. Which of the following items is not required to be included as part of a company's annual report?**

*a.* Notes to the financial statements
*b.* Management discussion and analysis
*c.* Detailed history of the company
*d.* Auditor's report

**LO3** **9. Which of the following situations presents ethical challenges to accountants?**

*a.* Pressure by superiors to produce a "good" number
*b.* Avoiding the disclosure of confidential information
*c.* An emphasis on short-term results
*d.* All the above present ethical challenges to accountants

**LO1** **10. Match the following organizational attributes in the left column with the organizational form in the right column that the attribute is most often associated with.**

1. Tax advantages
2. Unlimited liability
3. Shared control
4. Most complex to set up
5. Easiest to raise a large amount of funds
6. Single owner

*a.* Sole proprietorship
*b.* Partnership
*c.* Corporation

**LO5** **11. The financial statements of People Company contain the following. How much is net income?**

| | |
|---|---|
| Accounts payable | $12,000 |
| Revenues | 27,000 |
| Accounts receivable | 10,000 |
| Expenses | 8,000 |
| Cash | 7,000 |

*a.* $6,000
*b.* $11,000
*c.* $19,000
*d.* $17,000

**LO5** **12. If Bing Company reports its year-end total liabilities to be $40,000, and its year-end stockholders' equity to be $60,000, how much are Bing Company's year-end total assets?**

*a.* $15,000
*b.* $185,000
*c.* $100,000
*d.* Cannot be determined from the given information

**LO5** **13. Puff Company began the year with a retained earnings balance of $50,000, reported net income for the year of $45,000, and reported ending retained earnings of $60,000. How much dividends did Puff Company report for the year?**

*a.* $135,000
*b.* $35,000
*c.* $15,000
*d.* $30,000

## QUESTIONS

1. Define *accounting*. What is the basic purpose of accounting?
2. What is the distinction between *financial* accounting and *managerial* accounting?
3. Who are some of the outside groups that may be interested in a company's financial data and what are their particular interests?
4. What are *generally accepted accounting principles* and what organization has primary responsibility for their formulation in the United States?
5. What are the main advantages and disadvantages of the corporate form of business?
6. What role does financial accounting play in the allocation of society's financial resources?
7. What is the accounting equation? Define *assets, liabilities,* and *stockholders' equity.*
8. What are the three principal business activities and how do they differ?
9. What is meant by corporate social responsibility?
10. What is the difference between generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS)?
11. What are *revenues* and *expenses*?
12. What is the purpose of an income statement? The statement of stockholders' equity? The balance sheet? The statement of cash flows?
13. What is a *period-of-time statement*? Give three examples.
14. What is a *point-in-time statement*? Give one example.
15. On December 31, the Hill Company had $800,000 in total assets and owed $230,000 to creditors. If the corporation's common stock amounted to $400,000, what amount of retained earnings should appear on its December 31 balance sheet?
16. What are three aspects of the accounting environment that may create ethical pressure on an accountant?
17. What type of information might you find in the Management's Discussion and Analysis (MD&A) section of the annual report?
18. What is the purpose of having the financial statements audited by an independent auditor?
19. Determine whether the following statements are true or false and explain why:
    *a.* The accounting process is only interested in communicating economic activity.
    *b.* There are few potential users of financial accounting information.
    *c.* Financial accounting is primarily used to communicate to outside users.
    *d.* Auditors ensure the validity of a company's financial statements.
20. Why did the FASB develop a conceptual framework?
21. What are two primary qualities of accounting information that contribute to decision usefulness?
22. How would you describe, in one sentence, each of the following accounting principles, concepts and constraints?

| | |
|---|---|
| Accounting entity | Consistency |
| Accounting period | Revenue recognition |
| Monetary unit | Expense recognition (matching) |
| Cost-benefit | Materiality |
| Going concern | Full disclosure |

23. Which of the following is a primary qualitative characteristic of accounting information?
    *a.* Relevance
    *b.* Faithful representation
    *c.* Comparability
    *d.* All of the above are important characteristics.

## SHORT EXERCISES

LOs *link assignments to the Learning Objectives of each chapter.*

**LO1** **SE1-1. Forms of Business Organization** Match the following forms of business organization with the set of attributes that best describes that form of business: sole proprietorship, partnership, or corporation.

*a.* Shared control, unlimited liability, tax advantages, increased skills and resources
*b.* Best for raising large amounts of funds, double taxation, limited liability, easiest to transfer ownership interests
*c.* Sole ownership, easiest to establish, tax advantages, unlimited liability

**LO4** **SE1-2. Accounting Processes** Identify the following processes as either measuring or communicating.

*a.* Prepare financial statements for the entity
*b.* Identify relevant economic activities of the entity
*c.* Record relevant economic activities of the entity
*d.* Interpret financial results of the entity
*e.* Quantify relevant economic activities of the entity

**LO3** **SE1-3. Types of Statements** Match the following type of report with the most likely statement user: management, taxation authority, regulatory agency, or investor.

*a.* Financial statements
*b.* Tax return
*c.* Annual budget
*d.* Special report on a bank's financial health

**LO4** **SE1-4. Accounting Organizations** Match the following organizations with the set of accounting guidelines: Financial Accounting Standards Board (FASB), International Accounting Standards Board (IASB).

*a.* Generally accepted accounting principles (GAAP)
*b.* International financial reporting standards (IFRS)

**LO2** **SE1-5. Business Activities** Match the following activities with the type of activity: Operating, Investing, Financing.

*a.* Day-to-day business activities
*b.* Purchase of land for a new warehouse
*c.* Sale of merchandise inventory
*d.* Obtain a new bank loan
*e.* Payment of dividends
*f.* Invest excess cash
*g.* Purchase office supplies
*h.* Sell old equipment that is no longer needed

**LO5** **SE1-6. Financial Statement Items** Identify the financial statement (or statements) in which each of the following items would appear: income statement (IS), statement of stockholders' equity (SSE), balance sheet (BS), or statement of cash flows (SCF).

*a.* Assets
*b.* Revenues
*c.* Cash flow from investing activities
*d.* Stockholders' equity
*e.* Expenses
*f.* Net change in cash
*g.* Net income
*h.* Liabilities

**LO6** **SE1-7. Annual Report Components** Which of the following would not be part of the notes to the financial statements in a company's annual report?

*a.* Qualitative information about potential lawsuits
*b.* Additional information about the reported total of notes payable
*c.* Details about potential new products to be introduced during the next year
*d.* Details of estimates used to compute the expected amount of warranty expense

**SE1-8. Sarbanes-Oxley Act** The Sarbanes-Oxley Act of 2002 was enacted to help restore confidence in financial reporting. Which of the following was **not** part of the legislation? **LO3**

*a.* Severe penalties for fraudulent reporting
*b.* A requirement for certification of the financial statements by top management
*c.* A new statement of social responsibility
*d.* A report on internal controls to help prevent and detect errors in the reporting process

**SE1-9. Financial Accounting and Generally Accepted Accounting Principles** Answer the following multiple-choice questions: **LO4**

1. What is not a primary function of financial accounting in society?
   *a.* Provide comedy material for late-night talk shows.
   *b.* Aid in the proper allocation of financial resources in a free enterprise economic system.
   *c.* Aid users to make better investing decisions.
2. IFRS refers to:
   *a.* A random set of letters.
   *b.* A set of standards and procedures that form guidelines for international financial accounting.
   *c.* A set of standards and procedures that form guidelines for international managerial accounting.
3. GAAP:
   *a.* Is the distance between two objects.
   *b.* Is a set of guidelines for preparing managerial reports in the United States.
   *c.* Is a set of guidelines for preparing financial reports in the United States.

**SE1-10. Cash Flow Activity Classification** Classify each activity as financing, investing, or operating: **LO2**

1. Repay a loan from a bank.
2. Sell merchandise from a storefront operation.
3. Dispose of an old delivery truck.
4. Pay rent on a company warehouse.
5. Repurchase shares of stock from stockholders.
6. Pay utilities.

**SE1-11. Using the Basic Accounting Equation** Use the basic accounting equation to answer the following: **LO5**

*a.* Hawkins Company has total assets of $150,000 and total liabilities of $110,000. How much is the company's total stockholders' equity?
*b.* Paul Company has total liabilities of $170,000 and total stockholders' equity of $105,000. How much total assets does the company have?
*c.* If Black Company's total assets increased by $35,000 during the year, and its total liabilities decreased during the same year by $20,000, what was the change in the company's total stockholders' equity?

**SE1-12. Using the Basic Accounting Equation** Floyd Company had beginning-of-the-year total assets of $320,000 and total liabilities of $180,000. **LO5**

*a.* If during the year total assets increased by $15,000 and total liabilities increased by $40,000, what is the end-of-year total stockholders' equity?
*b.* If during the year total assets increased by $60,000 and total liabilities decreased by $5,000, what is the end-of-year total stockholders' equity?
*c.* If during the year total liabilities increased by $40,000 and total stockholders' equity increased by $35,000, what are the end-of-year total assets?

**SE1-13. Financial Statements** Indicate which statement (or statements) you would examine to locate the following items: balance sheet (BS), income statement (IS), statement of stockholders' equity (SSE), or statement of cash flows (SCF). **LO5**

*a.* Expenses for the period
*b.* Cash at year-end
*c.* Cash used to purchase new equipment
*d.* Dividends for the period

LO5 **SE1-14. Financial Statements** Indicate which statement (or statements) you would examine to locate the following items: balance sheet (BS), income statement (IS), statement of stockholders' equity (SSE), or statement of cash flows (SCF).

*a.* Revenues for the period
*b.* Cash at year-end
*c.* Cash used to pay back borrowings
*d.* Dividends for the period

LO4 **SE1-15. International Accounting Principles** The worldwide acceptance of a global set of international accounting principles will provide certain benefits.

*a.* Which group has taken the lead in developing a set of international accounting principles?
*b.* Identify and briefly discuss a benefit that would result from the adoption of a global set of international accounting principles.

LO8 (Appendix 1A) **SE1-16. Principles of Accounting** Which of the following accounting principles applies to the statement of cash flows?

*a.* Materiality
*b.* Conservatism
*c.* Accrual basis of accounting
*d.* Cash basis of accounting

LO8 (Appendix 1A) **SE1-17. Generally Accepted Accounting Principles** Select the best answer to each of the following questions:

1. Accounting rules are developed to provide:
   *a.* Simplicity
   *b.* Useful information
   *c.* Complexity
   *d.* Ability to change over time
2. The conceptual framework consists of each of the following except:
   *a.* Financial reporting objectives
   *b.* Financial statement elements
   *c.* Ratio analysis guidelines for analysts
   *d.* Recognition criteria for financial statement items
3. Which of the following is a financial statement element?
   *a.* Income statement
   *b.* Liabilities
   *c.* Balance sheet
   *d.* Statement of cash flows

LO8 (Appendix 1A) **SE1-18. Basic Accounting Principles** Match the following list of accounting concepts, principles, and assumptions with the definitions below:

| | | |
|---|---|---|
| Accounting period concept | Consistency | Cost principle |
| Going concern concept | Materiality constraint | Full disclosure principle |
| | Comparability | |

1. Ability to compare the financial performance of different companies.
2. Assumption that a company will continue to operate beyond the current period.
3. Only items large enough to make a difference to a user must be disclosed in the financial statements.
4. Prepare financial statements at set time intervals.
5. Record assets on the balance sheet at an amount equal to what was paid for them.
6. A company prepares its financial statements using the same methods used in prior periods.
7. All items of importance to the users of financial statements should be disclosed in the annual report.

**SE1-19. FASB Codification** A major reason for the codification project completed by the FASB in 2009 was to: **LO4**

*a.* ease the convergence between financial and managerial accounting
*b.* ease the convergence between U.S. GAAP and IFRS
*c.* ease the convergence between financial and tax accounting
*d.* ease the convergence between U.S. GAAP and GASB

**SE1-20. Basic Accounting Principles** Which of the following is not considered a qualitative characteristic of accounting information? **LO8 (Appendix 1A)**

*a.* faithful representation
*b.* comparability
*c.* assets must equal liabilities and stockholders' equity
*d.* relevance

**SE1-21. Basic Accounting Principles** Identify whether the following statements are true or false. **LO8 (Appendix 1A)**

1. Together the revenue recognition principle and the expense recognition (matching) principle define the accrual basis of accounting.
2. The cash basis of accounting is only used in the preparation of the statement of cash flows.
3. The accrual basis of accounting is used in the preparation of the income statement and the balance sheet.

## EXERCISES—SET A

**E1-1A. Forms of Business Organization** Match the following organizational attributes in the left column with the organizational form in the right column. More than one organizational form may be associated with a given attribute. **LO1**

1. Unlimited liability
2. Full control
3. Business income combined with owner(s) income for income tax purposes
4. Relatively more difficult to establish
5. Easier to raise funds

*a.* Sole proprietorship
*b.* Partnership
*c.* Corporation

**E1-2A. Accounting Process** Establish the correct sequence of steps in the accounting measurement process. **LO4**

*a.* Record in a systematic fashion
*b.* Identify relevant economic activity
*c.* Quantify economic activity

**E1-3A. Types of Accounting** Identify the type of accounting associated with each type of report: Managerial, Financial, Tax, or some combination as needed. **LO3**

*a.* Budget for internal use by management
*b.* Tax return for state income taxes
*c.* Audited financial statements
*d.* Special reports for regulators of a public utility

**E1-4A. Corporate Social Responsibility** Which of the following is not part of the triple bottom line reporting framework? **LO5**

*a.* Economic bottom line
*b.* Social bottom line
*c.* Competitive bottom line
*d.* Environmental bottom line

**E1-5A. Generally Accepted Accounting Principles** Identify whether the following statements are true or false: **LO4**

*a.* U.S. GAAP is universally accepted in all countries in the world.
*b.* U.S. GAAP is established by the IASB.
*c.* Once established, U.S. GAAP is rarely, if ever, modified.
*d.* The international counterpart to the FASB is the IASB.

**LO2** **E1-6A. Business Activities** Identify each of the following activities as operating (O), investing (I), or financing (F):

*a.* Payment of employee salaries
*b.* Repayment of a loan
*c.* Issuance of common stock
*d.* Purchase of equipment to manufacture a company's products
*e.* Sale of merchandise inventory
*f.* Investment of excess cash in the shares of another company

**LO5** **E1-7A. The Accounting Equation** Determine the missing amount in each of the following cases:

| Assets | Liabilities | Stockholders' Equity |
|---|---|---|
| $190,000 | $62,000 | ? |
| ? | $53,000 | $31,000 |
| $115,000 | ? | $61,000 |

**LO5** **E1-8A. Determining Net Income** The beginning and ending balances of retained earnings for the year were $50,000 and $65,000, respectively. If dividend payments during the year were $0, determine the net income or net loss for the year.

*a.* $19,000 net loss
*b.* $19,000 net income
*c.* $15,000 net income
*d.* $11,000 net income

**LO5** **E1-9A. Determining Retained Earnings and Net Income** The following information appears in the records of Becker Corporation at year-end:

| | | | |
|---|---|---|---|
| Accounts receivable | $ 32,000 | Retained earnings | $ ? |
| Accounts payable | 12,000 | Supplies | 8,000 |
| Cash | 7,000 | Equipment, net | 145,000 |
| Common stock | 115,000 | | |

*a.* Calculate the balance in retained earnings at year-end.
*b.* If the amount of the retained earnings at the beginning of the year was $38,000, and $13,000 in dividends is paid during the year, calculate net income for the year.

**LO5** **E1-10A. Determining Stockholders' Equity and Assets** Determine the following:

*a.* The stockholders' equity of a corporation that has assets of $600,000 and liabilities of $306,000.
*b.* The assets of a corporation that has liabilities of $250,000, common stock of $125,000, and retained earnings of $85,000.

**LO5** **E1-11A. Financial Statements** Fred Flores operates a golf driving range. For each of the following financial items related to his business, indicate the financial statement (or statements) in which the item would be reported: balance sheet (BS), income statement (IS), statement of stockholders' equity (SSE) or statement of cash flows (SCF).

*a.* Accounts receivable
*b.* Cash received from the sale of land
*c.* Net income
*d.* Cash invested in the business by Flores
*e.* Notes payable
*f.* Supplies expense
*g.* Land
*h.* Supplies

**E1-12A. Omitted Financial Statement Data** For the following four unrelated situations, A through D, calculate the unknown amounts appearing in each column: **LO5**

| | A | B | C | D |
|---|---|---|---|---|
| Beginning | | | | |
| Assets | $45,000 | $32,000 | $53,000 | ? |
| Liabilities | 32,000 | 15,000 | 49,000 | 19,000 |
| Ending | | | | |
| Assets | 50,000 | 30,000 | 41,000 | 52,000 |
| Liabilities | 22,000 | ? | 20,000 | 24,000 |
| During Year | | | | |
| Sales revenue | ? | 30,000 | 31,000 | 27,000 |
| Expenses | 12,000 | 22,000 | 12,000 | 19,000 |
| Dividends | 2,000 | 3,000 | ? | 8,000 |

**E1-13A. Other Components of the Annual Report** Identify where the following items will appear in a company's annual report: Management's Discussion and Analysis (MD&A), notes to the financial statements, or the auditor's report, or indicate that the item is not disclosed. **LO6**

*a.* A comment that the financial statements appear to be fairly presented
*b.* A discussion about new competition likely to occur next year
*c.* A quantitative summary of notes payable appearing on the balance sheet
*d.* The "secret" ingredients in the company's special sauce

**E1-14A. Ethics** In each of the following cases, (a) identify the aspect of the accounting environment primarily responsible for the ethical pressure on the accountant as pressure to achieve a favorable outcome, to disclose confidential information, or to report good short-term results, and (b) indicate the appropriate behavioral response for the accountant. **LO3**

1. James Jehring, a tax accountant, is preparing an income tax return for a client. The client asks Jehring to take a sizable deduction on the tax return for business-related travel even though the client states that he has no documentation to support the deduction. "I don't think the IRS will audit my return," declares the client.
2. Willa English, an accountant for Dome Construction Company, has just finished putting the numbers together for a construction project on which the firm is going to submit a bid next month. At a social gathering that evening, a friend casually asks English what Dome's bid is going to be. Ms. English knows that the friend's brother works for a competitor of Dome.
3. The manager of Cross Department Store is ending his first year with the firm. December's business was slower than expected, and the firm's annual results are trailing last year's results. The manager instructs Kyle Tarpley, the store accountant, to include sales revenues from the first week of January in the December data. "This way, we'll show an increase over last year," declares the manager.

**Ethics** *assignments are denoted by this icon.*

**E1-15A. International Accounting Principles** Identify whether the following statements are true or false. **LO4**

1. One argument for IFRS is that there is less globalization in the world.
2. IFRS is accepted as GAAP in every country of the world.
3. The United States is working to converge its standards with IFRS.

**E1-16A. The Conceptual Accounting Framework** The Financial Accounting Standards Board worked many years to develop a conceptual framework for U.S. GAAP. **LO8 (Appendix 1A)**

*a.* What is the purpose of a conceptual framework?
*b.* Identify the financial reporting objectives that are specified in the conceptual framework.

**E1-17A. Recognition and Measurement Criteria** Indicate the accounting concepts, principles, or constraints that underlie each of the following independent situations: accounting entity concept, going concern concept, cost-benefit constraint, expense recognition (matching principle), materiality constraint, revenue recognition principle, full disclosure principle, cost principle. **LO8 (Appendix 1A)**

*a.* Dr. Lynn is a practicing pediatrician. Over the years, she has accumulated a personal investment portfolio of securities, virtually all of which have been purchased from her earnings as a pediatrician. The investment portfolio is not reflected in the accounting records of her medical practice.

*b.* A company purchases a desk tape dispenser for use by the office secretary. The tape dispenser cost $25 and has an estimated useful life of 15 years. The purchase is immediately expensed on the company's income statement.

*c.* A company sells a product that has a two-year warranty covering parts and labor. In the same period that revenues from product sales are recorded, an estimate of future warranty costs is recorded on the company's income statement.

*d.* A company is sued for $1.5 million by a customer claiming that a defective product caused an accident. The company believes that the lawsuit is without merit. Although the case will not be tried for a year, the company adds a note describing the lawsuit to its current financial statements.

**LO8 (Appendix 1A)** **E1-18A. Revenue Recognition Principle** For each of the following situations, determine whether the criteria for revenue recognition have been met by December 31, 2018.

*a.* A manufacturing company received $60,000 cash on December 31, 2018, as an advance payment on a special order for a piece of equipment. The equipment will be manufactured by March 31, 2019.

*b.* A television dealer acquired six new high-definition television sets for $7,800 cash on December 31, 2018, and advertised their availability, at $2,000 each, in that evening's newspaper.

*c.* A snow removal service signed a contract on November 15, 2018, with a shopping mall to clear its parking lot of all snowfalls over 1 inch during the months of December 2018 through March 2019. The cost is $900 per month and payment is due in two $1,800 installments: January 2, 2019, and February 1, 2019. By December 31, 2018, no snowfall over 1 inch had occurred.

**LO5, 8 (Appendix 1A)** **E1-19A. Accrual Basis of Accounting versus Cash Basis of Accounting** On December 31, Greg Jones completed his first year as a financial planner. The following data are available from his accounting records:

| | | | |
|---|---|---|---|
| Fees billed to clients for services rendered | $131,000 | Rent expense for year just ended | $12,000 |
| Cash received from clients | 119,000 | Utility expenses incurred | 4,500 |
| Supplies purchased for cash | 7,100 | Utility bills paid | 3,300 |
| Supplies used during the year | 6,100 | Salary earned by assistant | 39,400 |
| Cash paid for rent (rent is paid through Mar. of next year) | 15,000 | Salary paid to assistant | 35,100 |

*a.* Compute Greg's net income for the year just ended using the accrual basis of accounting.

*b.* Compute Greg's net income for the year just ended using the cash basis of accounting.

*c.* Which net income amount is computed in accordance with generally accepted accounting principles?

**LO8 (Appendix 1A)** **E1-20A. Recognition and Measurement Criteria** The following are unrelated accounting practices:

1. Pine Company purchased a new $30 snow shovel that is expected to last six years. The shovel is used to clear the firm's front steps during the winter months. The shovel's cost is recorded on the company's balance sheet as an asset.
2. Penny Corporation has been named as the defendant in a $50 million pollution lawsuit. Because the lawsuit will take several years to resolve and the outcome is uncertain, Penny's management decides not to mention the lawsuit in the current year financial statements.

***Required***

For each of the given practices, indicate which accounting concepts, principles, or constraints apply and whether they have been applied appropriately. For each inappropriate accounting practice, indicate the proper accounting procedure.

## EXERCISES—SET B

**LO1** **E1-1B. Forms of Business Organization** Match the following organizational attributes in the left column with the organizational form in the right column. More than one organizational form may be associated with a given attribute.

1. Limited liability
2. Shared control
3. Double taxation
4. Easiest to form
5. Easier to transfer ownership

*a.* Sole proprietorship
*b.* Partnership
*c.* Corporation

**E1-2B. The Accounting Process** Establish the correct sequence of steps in the accounting measurement process. **LO4**

*a.* Quantify economic activity
*b.* Identify relevant economic activity
*c.* Record in a systematic fashion

**E1-3B. Types of Accounting** Identify the type of accounting associated with each type of report: Managerial, Financial, Tax, or some combination as needed. **LO3**

*a.* Cost report for a new product
*b.* Tax return for federal income taxes
*c.* Unaudited financial statements requested for a bank loan
*d.* Special report for banking regulators

**E1-4B. Corporate Social Responsibility** Which of the following is not part of the triple bottom line reporting framework? **LO5**

*a.* Social bottom line
*b.* Environmental bottom line
*c.* Economic bottom line
*d.* Efficiency bottom line

**E1-5B. Generally Accepted Accounting Principles** Identify whether the following statements are true or false. **LO4**

*a.* GAAP can differ from one country to another.
*b.* U.S. GAAP is established by the FASB.
*c.* U.S. GAAP is a guide to action that may change over time.
*d.* At this time there is no international counterpart to the FASB.

**E1-6B. Business Activities** Identify each of the following activities as operating (O), investing (I), or financing (F). **LO2**

*a.* Payment of rent on the company headquarters
*b.* Repurchase of the company's common stock
*c.* Obtain a long-term bank loan
*d.* Sale of an empty warehouse
*e.* Delivery of consulting service
*f.* Sale of short-term investments

**E1-7B. The Accounting Equation** Determine the missing amount in each of the following cases: **LO5**

| Assets | Liabilities | Stockholders' Equity |
|---|---|---|
| $350,000 | ? | $225,000 |
| $155,000 | $95,000 | ? |
| ? | $40,000 | $ 59,000 |

**E1-8B. Determining Net Income** The beginning and ending balances of retained earnings for the year were $63,000 and $82,000, respectively. If dividend payments during the year were $8,000, determine the net income or net loss for the year. **LO5**

*a.* $14,000 net loss
*b.* $27,000 net income
*c.* $35,000 net income
*d.* $14,000 net income

**LO5** **E1-9B. Determining Retained Earnings and Net Income** The following information appears in the records of Poco Corporation at year-end:

| | | | |
|---|---|---|---|
| Accounts receivable | $ 42,000 | Retained earnings | $ ? |
| Accounts payable | 21,000 | Supplies | 30,000 |
| Cash | 18,000 | Equipment, net | 105,000 |
| Common stock | 139,000 | | |

*a.* Calculate the amount of retained earnings at year-end.
*b.* If the amount of the retained earnings at the beginning of the year was $25,000, and $10,000 in dividends is paid during the year, calculate net income for the year.

**LO5** **E1-10B. Determining Stockholders' Equity and Assets** Determine the following:

*a.* The stockholders' equity of a corporation that has assets of $850,000 and liabilities of $190,000.
*b.* The assets of a corporation that has liabilities of $195,000, common stock of $90,000, and retained earnings of $80,000.

**LO5** **E1-11B. Financial Statements** Julie Jason operates a bakery. For each of the following financial statement items related to her business, indicate the financial statement (or statements) in which the item would be reported: balance sheet (BS), income statement (IS), statement of stockholders' equity (SSE) or statement of cash flows (SCF).

*a.* Accounts payable
*b.* Cash received from the sale of equipment
*c.* Net loss
*d.* Cash invested in the business by Jason
*e.* Notes receivable
*f.* Rent expense
*g.* Building
*h.* Inventory

**LO5** **E1-12B. Omitted Financial Statement Data** For the following four unrelated situations, A through D, calculate the unknown amounts appearing in each column:

| | A | B | C | D |
|---|---|---|---|---|
| Beginning | | | | |
| Assets | $38,000 | $22,000 | $38,000 | ? |
| Liabilities | 22,000 | 15,000 | 29,000 | 19,000 |
| Ending | | | | |
| Assets | 40,000 | 36,000 | 44,000 | 65,000 |
| Liabilities | 22,000 | ? | 27,000 | 24,000 |
| During Year | | | | |
| Sales revenue | ? | 26,000 | 31,000 | 27,000 |
| Expense | 12,000 | 22,000 | 12,000 | 19,000 |
| Dividends | 2,000 | 5,500 | ? | 4,000 |

**LO6** **E1-13B. Other Components of the Annual Report** Identify where the following items will appear in a company's annual report: Management's Discussion and Analysis (MD&A), notes to the financial statements, or the auditor's report, or indicate that the item is not disclosed.

*a.* A comment that the statements are presented in conformity with generally accepted accounting principles
*b.* A discussion about new products to be introduced next year
*c.* A quantitative summary of property, plant, and equipment appearing on the balance sheet
*d.* The salaries of every employee

**LO3** **E1-14B. Ethics** In each of the following cases, (a) identify the aspect of the accounting environment primarily responsible for the ethical pressure on the accountant as pressure to achieve a favorable outcome, to disclose confidential information, or to report good short-term results, and (b) indicate the appropriate behavioral response for the accountant.

1. Jenny Jones, a tax accountant, is preparing an income tax return for a client. The client asks Jones to omit some income she received for consulting services because the amount was paid in cash. "I don't think the IRS will audit my return," declares the client. "And even if they do, what are the chances they would catch this?"
2. Fred French, an accountant for Top Electronics Company, has just finished estimating the cost for a new iPod device that the company plans to introduce. Cost estimates help the company to determine the price it can charge for new products. At a social gathering that evening, a friend casually asks Fred what Top's cost for the iPod device came out to be. Fred knows that the friend's brother works for a competitor of Top Electronics.
3. The manager of Jazz Department Store is ending his first year with the firm. December's business was slower than expected, and the firm's annual results are below Wall Street's expectations. The manager instructs Chris Green, store accountant, to record some of December's expenses in the following year. "This way, we'll meet Wall Street's expectations," declares the manager.

**E1-15B. International Accounting Principles** Although there are obstacles to the worldwide acceptance of a global set of international accounting principles, the potential benefits appear significant. **LO4**

Identify and briefly discuss three potential benefits to the worldwide acceptance of a global set of international accounting principles.

**E1-16B. The Conceptual Framework** The Financial Accounting Standards Board worked many years to develop a conceptual framework for U.S. GAAP. **LO8 (Appendix 1A)**

*a.* Identify the financial statement elements that are specified in the conceptual framework.
*b.* Before a financial statement element may be recorded in the accounts, certain recognition criteria must be met. What are those recognition criteria?

**E1-17B. Recognition and Measurement Criteria** Indicate the accounting concepts, principles, or constraints that underlie each of the following independent situations: accounting entity concept, going concern concept, cost-benefit constraint, expense recognition (matching principle), materiality constraint, revenue recognition principle, full disclosure principle, cost principle. **LO8 (Appendix 1A)**

*a.* General Motors reports in its annual report to stockholders that revenues from automotive sales "are recorded by the company when products are shipped to dealers."
*b.* The annual financial report of Fiat Chrysler Corporation and subsidiaries includes the financial data of its significant subsidiaries, including Chrysler Financial Corporation (which provides financing for dealers and customers), Chrysler Technologies Corporation (which manufactures high-technology electronic products), and Pentastar Transportation Group, Inc. (which includes Thrifty Rent-A-Car System, Inc., and Dollar Rent A Car Systems, Inc.).
*c.* A company purchased a parcel of land several years ago for $70,000. The land's estimated current market value is $80,000. The Land account balance is not increased but remains at $70,000.
*d.* A company has a calendar-year fiscal year-end. On January 8, 2019, a tornado destroyed its largest warehouse, causing a $2,000,000 loss. This information is reported in a footnote to the 2018 financial statements.

**E1-18B. Revenue Recognition Principle** For each of the following situations, determine whether the criteria for revenue recognition have been met by December 31, 2018. **LO8 (Appendix 1A)**

*a.* A manufacturing company received $85,000 cash on December 31, 2018, as an advance payment on a special order for a piece of equipment. The equipment will be manufactured by March 31, 2019.
*b.* An appliance dealer acquired ten new washer/dryer sets for $6,800 cash on December 31, 2018, and advertised their availability, at $1,000 for each set, in that evening's newspaper.
*c.* A yard maintenance service signed a contract on October 15, 2018, with an apartment complex to maintain its grounds during the months of November 2018 through June 2019. The cost is $750 per month and payment is due in two $3,000 installments: December 15, 2018 and March 15, 2019.

**E1-19B. Accrual Basis of Accounting versus Cash Basis of Accounting** On December 31, John Bush completed his first year as a financial planner. The following data are available from his accounting records: **LO5, 8 (Appendix 1A)**

| | | | |
|---|---|---|---|
| Fees billed to clients for services rendered | $137,000 | Rent expense for year just ended | $12,000 |
| Cash received from clients | 115,000 | Utility expense incurred | 3,100 |
| Supplies purchased for cash | 9,000 | Utility bills paid | 3,200 |
| Supplies used during the year | 6,800 | Salary earned by assistant | 39,000 |
| Cash paid for rent (rent is paid through Feb. of next year) | 14,000 | Salary paid to assistant | 35,000 |

*a.* Compute John's net income for the year just ended using the accrual basis of accounting.
*b.* Compute John's net income for the year just ended using the cash basis of accounting.
*c.* Which net income amount is computed in accordance with generally accepted accounting principles?

LO8 (Appendix 1A)

**E1-20B. Recognition and Measurement Criteria** The following are unrelated accounting practices:

1. A recession has caused a slowing of business activity and lower profits for Penn Company. Consequently, the firm delays making its payments for December's rent and utilities until January and does not record either of these expenses in December.
2. Joan Jeffrey, a consultant operating as a sole proprietorship, used her business car for a personal, month-long vacation. A full year's gas and oil expenditures on the car are charged to the firm's gas and oil expense account.

***Required***

For each of the given practices, indicate which accounting concepts, principles, or constraints apply and whether they have been applied appropriately. For each inappropriate accounting practice, indicate the proper accounting procedure.

## PROBLEMS—SET A

LO1

**P1-1A. Forms of Business Organization** Presented below are four independent situations:

*a.* Kent Jones, a senior in college looking for summer employment, decided to start a dog-walking business. Each morning and evening he picks up a group of dogs and walks them around the city park.
*b.* Brothers Jack and Jim Stevens each owned a separate electronics repair shop. They decided to combine their talents and resources in order to expand the amount of business they could undertake.
*c.* Three chemists at a large engineering company decided to start their own business based on an experimental chemical process they had developed outside the company. The process had the potential to be very successful; however, it was quite dangerous and could result in large legal problems.
*d.* Jason King ran a small, but successful holistic healing spa. The spa has gained a strong reputation beyond the community where it is located. Jason decided to open a chain of similar spas across the state to capitalize on his reputation. This will require a substantial investment in supplies and employee training. In addition, since Jason will not be able to closely supervise each location, he is worried about potential liability.

***Required***

Explain the form of organization that would be best in each situation—sole proprietorship, partnership, or corporation. Explain what factors you considered important in each situation.

LO5

**P1-2A. Financial Statements** While each of the financial statements is likely to aid in any business decision, it is often the case that a particular financial statement may be best suited to help in a particular decision. Consider each decision below independently:

*a.* You are trying to determine whether a particular firm is a good investment. You understand that share price increases are impacted heavily by a company's earnings potential.
*b.* You are employed in the lending department of a large bank. You are trying to determine if you should lend to a potential customer. If you do make the loan you are especially concerned that the company will have sufficient collateral in the event that it is unable to repay the loan.
*c.* You wish to invest in a firm that provides you with a steady source of income. You especially want a firm that pays out a large part of its net income as dividends.

*d.* You are trying to determine if a particular firm will have sufficient cash flow in order to keep expanding without relying too heavily on external sources of financing.

***Required***

Determine which of the financial statements contains the most useful information to help in your decision. Explain what information you used from each statement to help you make your decision.

**P1-3A. Balance Sheet** The following balance sheet data are for Brintany Coastal Catering Service, a corporation, at May 31, 2019: **LO5**

| | | | |
|---|---|---|---|
| Accounts receivable | $27,300 | Accounts payable | 10,200 |
| Notes payable | 29,000 | Cash | 16,300 |
| Equipment, net | 61,000 | Common stock | 41,500 |
| Supplies | 15,400 | Retained earnings | ? |

***Required***

Prepare a balance sheet for Brintany as of May 31, 2019.

**P1-4A. Statement of Stockholders' Equity and Balance Sheet** The following is balance sheet information for Tuttle Janitorial Service, Inc., at the end of 2019 and 2018: **LO5**

| | December 31, 2019 | December 31, 2018 |
|---|---|---|
| Accounts payable | $ 6,000 | $ 9,000 |
| Cash | 25,000 | 22,000 |
| Accounts receivable | 39,000 | 31,000 |
| Land | 56,000 | 46,000 |
| Building, net | 250,000 | 260,000 |
| Equipment, net | 44,000 | 46,000 |
| Mortgage payable | 93,000 | 88,000 |
| Supplies | 18,000 | 16,000 |
| Common stock | 225,000 | 225,000 |
| Dividends | 12,000 | 0 |
| Retained earnings | ? | ? |

***Required***

*a.* Prepare a balance sheet as of December 31 of each year.

*b.* Prepare a statement of stockholders' equity for 2019. (*Hint:* The increase in retained earnings is equal to the net income less the dividend.)

**P1-5A. Statement of Stockholders' Equity and Balance Sheet** The following is balance sheet information for Flush Janitorial Service, Inc., at the end of 2019 and 2018: **LO5**

| | December 31, 2019 | December 31, 2018 |
|---|---|---|
| Accounts payable | $ 17,000 | $ 18,000 |
| Cash | 50,000 | 44,000 |
| Accounts receivable | 78,000 | 62,000 |
| Land | 92,000 | 92,000 |
| Building, net | 500,000 | 520,000 |
| Equipment, net | 75,000 | 77,000 |
| Mortgage payable | 175,000 | 205,000 |
| Supplies | 27,000 | 22,000 |
| Common stock | 420,000 | 420,000 |
| Dividends | 20,000 | 0 |
| Retained earnings | ? | ? |

***Required***

*a.* Prepare a balance sheet as of December 31 of each year.

*b.* Prepare a statement of stockholders' equity for 2019. (*Hint:* The increase in retained earnings is equal to the net income less the dividend.)

LO5 **P1-6A. Income Statement and Balance Sheet** On March 1, 2019, Janet Dodge began Dodge Delivery Service, which provides delivery of bulk mailings to the post office, neighborhood delivery of weekly newspapers, data delivery to computer service centers, and various other delivery services using leased vans. On February 28, Dodge invested $20,000 of her own funds in the firm and borrowed $8,000 from her father on a six-month, non-interest-bearing note payable. The following information is available at March 31:

**Excel icons** *denote assignments with Excel templates available.*

| | | | |
|---|---|---|---|
| Accounts receivable | $10,700 | Delivery fees earned | $23,300 |
| Rent expense | 2,500 | Cash | 12,700 |
| Advertising expense | 1,100 | Supplies inventory | 14,800 |
| Supplies expense | 2,500 | Notes payable | 8,000 |
| Accounts payable | 1,400 | Insurance expense | 900 |
| Salaries expense | 6,200 | Common stock | 20,000 |
| Miscellaneous expense | 1,300 | Retained earnings | ? |

***Required***

*a.* Prepare an income statement for the month of March.
*b.* Prepare a balance sheet as of March 31, 2019.

LO5 **P1-7A. Statement of Cash Flows** Shown below is selected information from the financial records of Merris Corporation as of December 31:

| | | | |
|---|---|---|---|
| Inventory | $165,000 | Cash purchase of equipment | $ 29,000 |
| Cash collected from customers | 350,000 | Buildings, net | 810,000 |
| Equipment, net | 355,000 | Sales revenue | 910,000 |
| Retained earnings | 480,000 | Cash paid for operating activities | 225,000 |
| Cash dividends paid | 38,000 | Principal payments on existing note payable | 41,000 |
| Salary expense | 215,000 | Common stock | 529,000 |

***Required***

*a.* Determine which of the above items will appear on the statement of cash flows and then prepare the statement for Merris Corporation for the year ended December 31, 2019.
*b.* Comment on the adequacy of Merris's operations to provide cash for its investing and financing activities.

LO3 **P1-8A. Ethics** In each of the following cases, (a) identify the aspect of the accounting environment primarily responsible for the ethical pressure on the accountant as pressure to achieve a favorable outcome, to disclose confidential information, or to report good short-term results, and (b) indicate the appropriate behavioral response that the accountant should take.

1. Patricia Kelly, an accountant for Wooden Company, is reviewing the costs charged to a government contract that Wooden worked on this year. Wooden is manufacturing special parts for the government and is allowed to charge the government for its actual manufacturing costs plus a fixed fee. Kelly notes that $75,000 worth of art objects purchased for the president's office is buried among the miscellaneous costs charged to the contract. Upon inquiry, the firm's vice president replies, "This sort of thing is done all the time."
2. Barry Marklin, accountant for Smith & Wesson partnership, is working on the 2016 year-end financial data. The partnership agreement calls for Smith and Wesson to share the firm's 2016 net income equally. In 2017, the partners will share the net income 60 percent to Smith and 40 percent to Wesson. Wesson plans to cut back his involvement in the firm. Smith wants Marklin to delay recording sales revenue from work done at the end of 2016 until January 2017. "We haven't received the cash yet from those services," declares Smith.
3. The St. Louis Wheelers, a professional football franchise, just signed its first-round draft pick to a multiyear contract that is reported in the newspapers as a four-year, $20 million contract. Johanna Factor, the Wheelers' accountant, receives a call from an agent of another team's first-round pick. "Just calling to confirm the contract terms reported in the papers," states the agent. "My client should receive a similar contract, and I'm sure you don't want him to get shortchanged."

**P1-9A. Financial Statements and Other Components** Match each of the items in the left column with the appropriate annual report component from the right column: **LO5, 6**

| | |
|---|---|
| 1. The company's total liabilities | a. Income Statement |
| 2. The sources of cash during the period | b. Balance Sheet |
| 3. An opinion about whether the financial statements are fairly stated | c. Statement of Cash Flows |
| 4. The amount of dividends that are distributed to the company's stockholders | d. Statement of Stockholders' Equity |
| 5. A discussion of potential new products to be introduced the next year | e. Notes to the Financial Statements |
| 6. Information regarding accounting methods used | f. Management's Discussion and Analysis (MD&A) |
| 7. The company's total revenue for the period | g. Auditor's report |

**P1-10A. Income Statement, Statement of Stockholders' Equity, and Balance Sheet** Petty Corporation started business on January 1, 2019. The following information was compiled by Petty's accountant on December 31, 2019: **LO5**

| | | | |
|---|---|---|---|
| Sales revenue | $32,000 | Equipment, net | $25,000 |
| Expenses | 20,000 | Building, net | 59,000 |
| Dividends | 8,000 | Accounts payable | 7,000 |
| Cash | 3,250 | Notes payable | 50,500 |
| Accounts receivable | 2,750 | Common stock | 33,000 |
| Inventory | 4,500 | Retained earnings | ? |

***Required***

*a.* You have been asked to assist the accountant for the Petty Corporation in preparing year-end financial statements. Use the above information to prepare an income statement, statement of stockholders' equity, and a balance sheet as of December 31, 2019.

*b.* Comment on the decision to pay an $8,000 dividend.

**P1-11A. Recognition and Measurement Criteria** The following are unrelated accounting situations and the accounting treatment that was followed in each firm's records: **LO8 (Appendix 1A)**

1. John Company mounts an $800,000 year-long advertising campaign on a national cable television network. The firm's annual accounting period is the calendar year. The television network required full payment in December at the beginning of the campaign. Accounting treatment is
   Increase Advertising Expense, $800,000
   Decrease Cash, $800,000
2. Because of a local bankruptcy, machinery worth $225,000 was acquired at a "bargain" purchase price of $170,000. Accounting treatment is
   Increase Machinery, $170,000
   Decrease Cash, $170,000
3. Tony Voes, a consultant operating a sole proprietorship, withdrew $30,000 from the business and purchased stocks as an investment gift to his wife. Accounting treatment is
   Increase Investments, $30,000
   Decrease Cash, $30,000
4. Channy Company received a firm offer of $96,000 for a parcel of land it owns that cost $50,000 two years ago. The offer was refused, but the indicated gain was recorded in the accounts. Accounting treatment is
   Increase Land, $46,000
   Increase Revenue from Change in Land Value, $46,000

***Required***

In each of the given situations, indicate which accounting concepts, principles or constraints apply and whether they have been applied appropriately. If you decide the accounting treatment is not generally accepted, discuss the effect of the departure on the balance sheet.

## PROBLEMS—SET B

**LO1** **P1-1B. Forms of Business Organization**

Presented below are four independent situations:

*a.* Larry Jordon, a photography major in college, decided to start a photography business specializing in weddings and similar occasions. Larry is still able to go to school full-time as all of his jobs are on weekends or holidays.

*b.* Joe Friday and Jay Holmes each owned a separate detective agency. They decided to combine their talents and resources in order to expand the amount of business they could undertake.

*c.* Three business school professors at a large university decided to start their own consulting business based on their combined talents. They feel that the insurance they can obtain will satisfy any possible legal issues they may face. They plan to use one professor's home office to meet clients, so start-up costs should be minimal.

*d.* Verna Zilver runs a small, but successful beauty salon. The salon has gained a strong reputation beyond the community where it is located. Verna has decided to open a chain of similar salons across the state to capitalize on her reputation. This will require a substantial investment in facilities and supplies. In addition, since Verna will not be able to closely supervise each location, she is worried about potential liability.

***Required***

Explain the form of organization that would be best in each situation—sole proprietorship, partnership, or corporation. Explain what factors you considered important in each situation.

**LO5** **P1-2B. Financial Statements** While each of the financial statements is likely to aid in any business decision, it is often the case that a particular financial statement may be best suited to help in a particular decision. Consider each decision below independently:

*a.* You are trying to determine whether a particular firm is a good investment. You want to invest in a firm that has strong revenue growth.

*b.* You are employed as a financial analyst for a large investment firm. You are trying to assess the riskiness of a particular investment opportunity. You understand that the more debt a firm has relative to its stockholders' equity, the riskier the firm is.

*c.* You are trying to determine how much of a firm's net income it distributes to its stockholders.

*d.* You are trying to determine how a particular firm was able to finance its large expansion during the year.

***Required***

Determine which of the financial statements contains the most useful information to help in your decision. Explain what information you used from each statement to help you make your decision.

**LO5** **P1-3B. Balance Sheet** The following balance sheet data are for Better Plumbing Contractors, Inc., a corporation, at May 31, 2019:

| | | | |
|---|---|---|---|
| Accounts payable | $ 9,900 | Common stock | $101,000 |
| Cash | 15,700 | Retained earnings | ? |
| Equipment, net | 100,000 | Notes payable | 31,000 |
| Supplies | 28,500 | Accounts receivable | 9,200 |
| Land | 31,000 | | |

***Required***

Prepare a balance sheet for Better as of May 31, 2019.

**LO5** **P1-4B. Statement of Stockholders' Equity and Balance Sheet** The following is balance sheet information for Bryant Packaging Service at the end of 2019 and 2018:

| | December 31, 2019 | December 31, 2018 |
|---|---|---|
| Accounts payable | $ 2,800 | $ 2,600 |
| Cash | 11,000 | 12,000 |
| Accounts receivable | 23,800 | 19,500 |
| Equipment, net | 33,000 | 31,000 |
| Notes payable | 21,000 | 21,000 |
| Supplies | 5,700 | 5,200 |
| Common stock | 6,000 | 6,000 |
| Dividends | 13,000 | 0 |
| Retained earnings | ? | ? |

***Required***

*a.* Prepare a balance sheet as of December 31 of each year.

*b.* Prepare a statement of stockholders' equity for 2019. (*Hint:* The increase in retained earnings is equal to the net income less the dividend.)

**P1-5B. Statement of Stockholders' Equity and Balance Sheet** The following is balance sheet information for Philip Packaging Service at the end of 2019 and 2018: **LO5**

| | December 31, 2019 | December 31, 2018 |
|---|---|---|
| Accounts payable | $ 16,000 | $ 14,000 |
| Cash | 53,000 | 49,000 |
| Accounts receivable | 80,000 | 64,000 |
| Equipment, net | 76,000 | 78,000 |
| Notes payable | 175,000 | 175,000 |
| Supplies | 29,000 | 31,000 |
| Common stock | 30,000 | 30,000 |
| Dividends | 15,000 | 0 |
| Retained earnings | ? | ? |

***Required***

*a.* Prepare a balance sheet as of December 31 of each year.

*b.* Prepare a statement of stockholders' equity for 2019. (*Hint:* The increase in retained earnings is equal to the net income less the dividend.)

**P1-6B. Income Statement and Balance Sheet** The first year records of R. Levitt, Interior Decorator, show the following information for the year-end December 31, 2019: **LO5**

| | | | |
|---|---|---|---|
| Notes payable | $ 6,000 | Supplies | $ 6,500 |
| Decorating fees earned | 57,600 | Cash | 6,200 |
| Insurance expense | 1,600 | Accounts receivable | 8,600 |
| Supplies expense | 8,100 | Advertising expense | 700 |
| Miscellaneous expense | 1,200 | Salaries expense | 36,000 |
| Common stock | 7,000 | Rent expense | 4,500 |
| Retained earnings | ? | Accounts payable | 2,800 |

***Required***

*a.* Prepare an income statement for the year.

*b.* Prepare a balance sheet as of December 31, 2019.

**P1-7B. Statement of Cash Flows** Shown below is selected information from the financial records of Willy Corporation as of December 31, 2019: **LO5**

| | | | |
|---|---|---|---|
| Inventory | $155,000 | Cash purchase of equipment | $129,000 |
| Cash collected from customers | 670,000 | Buildings, net | 860,000 |
| Equipment, net | 255,000 | Sales revenue | 940,000 |
| Retained earnings | 580,000 | Cash paid for operating activities | 425,000 |
| Cash dividends paid | 90,000 | Principal payments on existing note payable | 128,000 |
| Salary expense | 226,000 | Common stock | 329,000 |

***Required***

*a.* Determine which of the above items will appear on the statement of cash flows and then prepare the statement for Willy Corporation for the year ended December 31, 2019.

*b.* Comment on the adequacy of Willy's operations to provide cash for its investing and financing activities.

**LO3** **P1-8B. Ethics** In each of the following cases, (a) identify the aspect of the accounting environment primarily responsible for the ethical pressure on the accountant as pressure to achieve a favorable outcome, to disclose confidential information, or to report good short-term results, and (b) indicate the appropriate behavioral response that the accountant should take:

1. Jim Miller, an accountant for the Geary Company, is reviewing costs charged to a big government contract to supply logistical support. The contract specifies that Geary is entitled to its cost plus 10 percent extra for profit. Jim notices that gardening services at the home of the company president, Stuart Geary, are included under miscellaneous expenses. The company's vice president, Slick Herve, tells you not to worry about this since the government expects a little bit of fancy accounting to be included in all of its contracts.
2. Juan Salles, an accountant for the law partnership Dewy and Suem, is working on the year-end financial statements. Currently the two partners, Dewy and Suem, each receive one-half of the firm's net income. Next year the allocation will change to a two-thirds, one-third split since Suem will be taking considerable time off to do pro bono work, something Dewy never does. Dewy suggested to Salles that he delay booking a large partial settlement the partnership received in December until January of next year when they will receive the final cash payment. Dewy commented that it would be "cleaner" to keep it all together.
3. Pete Jackson is the accountant for a large professional services firm. Part of his responsibility is to complete payroll tax reports based on the salaries paid to all the employees. Pete received a call from a friend at a search firm that specializes in personnel such as those employed at Pete's place of employment. Pete's friend casually asked how much certain employees were making, explaining he wanted to be able to calibrate market wages for work he was doing.

**LO5, 6** **P1-9B. Financial Statements and Other Components** Match each of the items in the left column with the appropriate annual report component from the right column:

1. The company's total assets
2. An opinion regarding whether the financial statements followed GAAP
3. Information regarding the estimates used in the financial statements
4. The use of cash during the period
5. The company's total expenses for the period
6. A discussion of potential risks that a company may encounter in the future
7. The amount of a company's earnings that are distributed to the company's stockholders

*a.* Income Statement
*b.* Statement of Stockholders' Equity
*c.* Balance Sheet
*d.* Statement of Cash Flows
*e.* Management's Discussion and Analysis (MD&A)
*f.* Notes to the Financial Statements
*g.* Auditor's report

**LO5** **P1-10B. Income Statement, Statement of Stockholders' Equity, and Balance Sheet** Pick Corporation started business on January 1, 2019. The following information was compiled by Pick's accountant on December 31, 2019:

| | | | |
|---|---|---|---|
| Sales revenue | $52,000 | Equipment, net | $31,000 |
| Expenses | 41,000 | Building, net | 49,000 |
| Dividends | 4,000 | Accounts payable | 8,000 |
| Cash | 5,250 | Notes payable | 49,500 |
| Accounts receivable | 6,750 | Common stock | 33,000 |
| Inventory | 5,500 | Retained earnings | ? |

***Required***

*a.* You have been asked to assist the accountant for the Pick Corporation in preparing year-end financial statements. Use the above information to prepare an income statement, statement of stockholders' equity, and a balance sheet as of December 31, 2019.

*b.* Comment on the decision to pay a $4,000 dividend.

**P1-11B. Recognition and Measurement Criteria** The following are unrelated accounting situations and the accounting treatment that was followed in each firm's records:

**LO8 (Appendix 1A)**

1. The Buchanan Company mounts a $900,000 year-long advertising campaign on a new national cable television network. The firm's annual accounting period is the calendar year. The television network required full payment in December at the beginning of the campaign. Accounting treatment is
   Increase Advertising Expense, $900,000
   Decrease Cash, $900,000
2. Because of a local bankruptcy, machinery worth $320,000 was acquired at a "bargain" purchase price of $150,000. Accounting treatment is
   Increase Machinery, $150,000
   Decrease Cash, $150,000
3. J.R. Brown, a consultant operating a sole proprietorship, withdrew $50,000 from the business and purchased stocks as an investment gift to his wife. Accounting treatment is
   Increase Investments, $50,000
   Decrease Cash, $50,000
4. Puite Company received a firm offer of $106,000 for a parcel of land it owns that cost $56,000 two years ago. The offer was refused, but the indicated gain was recorded in the accounts. Accounting treatment is
   Increase Land, $50,000
   Increase Revenue from Change in Land Value, $50,000

***Required***

In each of the given situations, indicate which accounting concepts, principles or constraints apply and whether they have been applied appropriately. If you decide the accounting treatment is not generally accepted, discuss the effect of the departure on the balance sheet.

## SERIAL PROBLEM: KATE'S CARDS

**SP1.** Kate Collins has always been good at putting together rhymes for any occasion. Kate is a recent college graduate with a double major in business and art. Kate has always had a bit of an entrepreneurial streak and has decided to open her own business designing and selling greeting cards.

Kate decided that she would rent a small studio where she would design the cards on a new Apple iMac that she is planning to purchase. Kate also decided to offer classes in greeting card design to other aspiring greeting card producers. After much thought, Kate decided to name her business "Kate's Cards."


***Required***

*a.* What form of business—sole proprietorship, partnership, or corporation—should Kate choose? Discuss why the organizational form that you selected is most appropriate for Kate.

*b.* What accounting information will Kate need to run her business?

*c.* What balance sheet accounts—assets, liabilities, and stockholders' equity—and income statement accounts—revenues and expenses—will Kate likely need to use?

*d.* Should Kate use her personal bank account or open a separate business bank account?

**Kate's Cards** *is a continuous problem that requires students to apply the concepts from the current chapter. There is a Kate's Cards assignment in each chapter.*

## EXTENDING YOUR KNOWLEDGE

### REPORTING AND ANALYSIS

**EYK1-1. Financial Reporting Problem: Columbia Sportswear Company** Financial statements for the **Columbia Sportswear Company** are reported in **Appendix A** at the end of the textbook.

COLUMBIA SPORTSWEAR COMPANY

***Required***

Refer to Columbia Sportswear's financial statements to answer the following questions:

*a.* How much did Columbia's total assets increase or decrease from December 31, 2016, to December 31, 2017?

**Extending Your Knowledge** *assignments require use of real world financial statements and critical thinking skills.*

*b.* How much did Columbia's cash and cash equivalents increase or decrease from December 31, 2016, to December 31, 2017, and how much cash did Columbia report on its December 31, 2017, balance sheet?

*c.* How much accounts receivable and accounts payable did Columbia report on December 31, 2017?

*d.* Did Columbia experience sales growth in 2017?

*e.* Was Columbia profitable in 2017? How does the company's 2017 net income compare to 2016?

COLUMBIA SPORTSWEAR COMPANY

UNDER ARMOUR

**Financial Statements** *for Columbia Sportswear and Under Armour are located at the end of the book in Appendix A and Appendix B.*

**EYK1-2. Comparative Analysis Problem: Columbia Sportswear Company vs. Under Armour, Inc.** Simplified financial statements for the **Columbia Sportswear Company** are reported in **Exhibit 1-10** and **Under Armour**'s financial statements are presented in **Appendix B** at the end of this book.

***Required***

1. Based on the information in these financial statements, compare the following for each company as of December 31, 2017:
   *a.* Total assets
   *b.* Sales
   *c.* Net income
   *d.* Cash flow from operations
2. From this information, what can you conclude about the relative size and operating performance of each company?

**EYK1-3. Business Decision Problem** Paul Seger, a friend of yours, is negotiating the purchase of an exterminating company called Complete Pest Control. Seger has been employed by a national pest control service and knows the technical side of the business. However, he knows little about accounting, so he asks for your assistance. The owner of Complete Pest Control, Greg Krum, provided Seger with income statements for the past three years, which showed an average net income of $75,000 per year. The latest balance sheet shows total assets of $360,000 and liabilities of $60,000. Seger brings the following matters to your attention:

1. Krum is asking $375,000 for the firm. He told Seger that because the firm has been earning a 20 percent return on stockholders' equity, the price should be higher than the net assets reported on the balance sheet. (Note: The return on stockholders' equity is calculated as net income divided by total stockholders' equity.)
2. Seger noticed that there was no salary expense reported for Krum on the income statements, even though he worked half-time in the business. Krum explained that, because he had other income, he withdrew only $15,000 each year from the firm for personal use. If he purchases the firm, Seger will hire a full-time manager to run the firm at an annual salary of $30,000.
3. Krum's tax returns for the past three years report a lower net income for the firm than the amounts shown in the financial statements. Seger is skeptical about the accounting principles used in preparing the company's financial statements.

***Required***

*a.* If Seger accepts Krum's average annual income figure of $75,000, what would Seger's return on stockholders' equity be, assuming that the net income remained at the same level and that the firm was purchased for $375,000?

*b.* Should Krum's withdrawals of $15,000 per year affect the net income reported in the financial statements? What will Seger's percentage return be if he takes into consideration the $30,000 salary he plans to pay a full-time manager?

*c.* Could there be legitimate reasons for the difference between net income as shown in the financial statements and net income as reported on the tax returns, as mentioned in point 3? How might Seger obtain additional assurances about the propriety of the company's financial statements?

**EYK1-4. Financial Analysis Problem** Todd Jansen is deciding among several job offers. One job offer he is considering is in the marketing department at Columbia Sportswear. Before he makes his decision, he decides to review the financial reports of the company.

***Required***

Use the Columbia Sportswear annual report located in Appendix A at the end of this book to answer the following questions:

*a.* Were the financial statements of Columbia audited? If so, what firm performed the audit?
*b.* What was the amount of Columbia's 2017 net income? How does this compare with 2016 net income?
*c.* How much cash was provided or used for investing activities? What were the major sources and uses of cash from investing activities?
*d.* How much were accrued liabilities in 2017? What makes up this balance?
*e.* What are some of the more significant estimates used in the preparation of the company's financial statements?
*f.* To what amount are the financial statements rounded?

## CRITICAL THINKING

**EYK1-5. Accounting Research Problem** Go to this book's Website and locate the annual report of **General Mills, Inc.** for the year ending May 28, 2017 (fiscal year 2017).

GENERAL MILLS, INC.

***Required***

*a.* Refer to the company's balance sheet.
  *1.* What form of business organization does General Mills use? What evidence supports your answer?
  *2.* What is the date of the most recent balance sheet?
  *3.* For the most recent balance sheet, what is the largest asset reported? The largest liability?
*b.* Refer to the company's income statement.
  *1.* What time period is covered by the fiscal year 2017 statement of earnings?
  *2.* What total amount of sales revenue did General Mills generate in the most recent period? What is the change in sales revenues from last year to the current report year?
  *3.* What is the net income (i.e., net earnings, including earnings attributable to noncontrolling interests) for the most recent period?
*c.* Refer to the company's statement of cash flows.
  *1.* For the most recent period, what is the amount and trend of the cash flow from operating activities?
  *2.* For the most recent period, what is the amount and trend of the cash flow from investing activities?
  *3.* For the most recent period, what is the amount and trend of the cash flow from financing activities?

**EYK1-6. Accounting Communication Activity** Bruce Smith is an intern for the Start Company. He knows the company's balance sheet is supposed to balance, but he is not having much luck getting it to balance. Bruce knows that you are taking a course in accounting so he asks for your help. Bruce provides you with the following balance sheet that is currently out of balance:

**Writing** *assignments are denoted by this icon.*

**START COMPANY**
**Balance Sheet**
**December 31, 2019**

| Assets | | Liabilities | |
|---|---|---|---|
| Cash | 15,000 | Inventory | 20,000 |
| Accounts receivable | 30,000 | Notes payable | 34,000 |
| Equipment, net | 28,000 | **Stockholders' Equity** | |
| Accounts payable | (22,000) | Dividends | (11,000) |
| | | Common stock | 10,000 |
| | | Retained earnings, beginning of year | 10,000 |
| Total | 51,000 | Total | 67,000 |

In addition, Bruce provides you with a correct income statement that reports a net income for 2019 of $28,000.

***Required***

*a.* Prepare a corrected balance sheet for the Start Company.
*b.* Write a memo to Bruce explaining what he did wrong.
*c.* In the memo explain the purpose of the balance sheet.

**EYK1-7. Accounting Ethics Case** Jack Hardy, CPA, has a brother, Ted, in the retail clothing business. Ted ran the business as a sole proprietor for 10 years. During this 10-year period, Jack helped Ted with various accounting matters. For example, Jack designed the accounting system for the company, prepared Ted's personal income tax returns (which included financial data about the clothing business), and recommended various cost control procedures. Ted paid Jack for all of these services. A year ago, Ted expanded the business and incorporated. Ted is president of the corporation and also chairs the corporation's board of directors. The board of directors has overall responsibility for corporate affairs. When the corporation was formed, Ted asked Jack to serve on its board of directors. Jack accepted. In addition, Jack now prepares the corporation's income tax returns and continues to advise his brother on accounting matters.

Recently, the corporation applied for a large bank loan. The bank wants audited financial statements for the corporation before it will decide on the loan request. Ted asked Jack to perform the audit. Jack replied that he cannot do the audit because the code of ethics for CPAs requires that he be independent when providing audit services.

***Required***

Why is it important that a CPA be independent when providing audit services? Which of Jack's activities or relationships impair his independence?

**EYK1-8. Ethics** As the accountant for Minkow Corporation, you are responsible for reporting the company's profit. It appears that the company's actual results are much better than was expected by Wall Street analysts. Your supervisor has requested that you report some of next period's expenses now so that this period's profits will be in line with analyst expectations. He states that you are not really doing anything wrong since the reported results will be more conservative. In addition, this will make it easier to make next year's numbers. What should you do?

COLUMBIA SPORTSWEAR COMPANY

**EYK1-9. Corporate Social Responsibility Problem** Go to the **Columbia Sportswear Company** Website and find the section on their commitment to corporate and environmental responsibility. These sections can be found near the bottom of their home page under the section "About Us."

***Required***

Answer the following questions.

*a.* How does Columbia describe the company's efforts at corporate responsibility?
*b.* How is the Higg Index used by Columbia's environmental responsibility efforts?
*c.* What featured initiative has Columbia embarked upon?
*d.* Why do you think that Columbia makes these efforts to be a good corporate citizen? Why do you think they devote so much space on their Website to promote these efforts?

**EYK1-10. Forensic Accounting Problem** Go to the Association of Certified Fraud Examiners Website and find their description of a forensic accountant. This can be found under the Career tab, Career Paths, then click on Accounting followed by Forensic Accountant (www.acfe.com/career-path-forensic-accountant.aspx).

**Forensic Accounting** *assignments are denoted by this icon.*

***Required***

Answer the following questions.

*a.* What do forensic accountants do?
*b.* What knowledge, skills, and abilities should a forensic accountant possess?
*c.* How might the knowledge learned from this course help you to become a forensic accountant?

LVMH MOET HENNESSEY-LOUIS VUITTON S.A.

**EYK1-11. Analyzing IFRS Financial Statements** The 2017 financial statements of **LVMH Moet Hennessey-Louis Vuitton S.A.** are presented in **Appendix C** at the end of this book. LVMH is a Paris-based holding company and one of the world's largest and best-known luxury goods companies. As a member of the European Union, French companies are required to prepare their consolidated (group) financial statements using International Financial Reporting Standards (IFRS). After reviewing LVMH's consolidated financial statements, consider the following questions:

*a.* What is LVMH's second largest asset account on its 2017 balance sheet? What percentage of total assets does this asset represent?
*b.* Is LVMH principally debt financed or equity financed in 2017? What percentage of LVMH's assets is financed with debt?

*c.* Is LVMH profitable in 2017? What percentage of the company's sales revenue in 2017 is represented by its "profit for the year," or its net income?

*d.* How much is LVMH's cash flow from operating activities in 2017? How does LVMH's profit for the year (net income) compare with its cash flow from operating activities?

**EYK1-12. Working with the Takeaways** You have just learned that you inherited a large sum of money. You know that it is important to invest this money wisely, and you have decided to invest in the shares of several different companies. One of those companies is the Columbia Sportswear Company.

***Required***

Answer the following questions regarding your potential investment in Columbia Sportswear shares:

*a.* Should you request financial statements from the company, and if so, which ones?

*b.* Is it important that the financial statements be audited by an independent auditor? Explain.

*c.* What does each of the four financial statements tell you about Columbia's financial health or operating performance?

## ANSWERS TO SELF-STUDY QUESTIONS:

1. c, (p. 4) 2. d, (p. 10) 3. a, (p. 10) 4. b, (pp. 10–11) 5. c, (pp. 5–6) 6. b, (p. 13) 7. b, (p. 14) 8. c, (pp. 19–21) 9. d, (pp. 8–9) 10. (pp. 4–5)

*1.* Sole proprietorship and partnership
*2.* Sole proprietorship and partnership
*3.* Partnership
*4.* Corporation
*5.* Corporation
*6.* Sole proprietorship

11. c, (p. 14) 12. c, (pp. 12–13) 13. b, (pp. 15–16)

## YOUR TURN! SOLUTIONS

### Solution 1.1

Sole proprietorship: Easiest to set up, owner controlled, and tax advantages.

Partnership: Relatively easy to establish, larger skill set, and tax advantages.

Corporations: Easiest to raise capital, easiest to transfer ownership, and protection against personal liability.

### Solution 1.2

1. Financing
2. Operating
3. Investing
4. Operating
5. Financing
6. Operating

### Solution 1.3

1. The financial statements are the primary output of financial accounting. External users require information on a business's performance and financial position. This is the type of information provided by the financial statements. Managerial accounting involves the process of generating and analyzing financial data to use for internal decision making and management of the business.
2. Internal users include management, the marketing department, and the finance department, among others. Each of these groups require data to help them run their departments and make good business decisions.

3. External users include, among others, investors, lenders, and regulators. These external groups require accounting information to help them make decisions regarding a company's performance and financial position.

## Solution 1.4

Your supervisor is asking you to participate in the preparation of fraudulent financial statements. This is not only unethical it is also illegal and could subject you to criminal prosecution. By reporting the sales revenue early, the financial statements will mislead users into thinking the company is doing better than it actually is. This in turn may lead them to make erroneous investment decisions. You should not follow your supervisor's request. Instead you should explain to your supervisor why reporting sales revenue prior to when it is earned is unethical. If your supervisor continues to pressure you, you should report your supervisor's request to a higher level of management in the company.

## Solution 1.5

1. c
2. a
3. d
4. b

## Solution 1.6

**KANZU CORPORATION**
**Income Statement**
**For Year Ended December 31, 2019**

| | |
|---|---|
| Sales revenue | $20,000 |
| Expenses | 12,000 |
| Net income | $ 8,000 |

**KANZU CORPORATION**
**Statement of Stockholders' Equity**
**For Year Ended December 31, 2019**

| | Common Stock | Retained Earnings | Total |
|---|---|---|---|
| Balance, January 1 | $ 0 | $ 0 | $ 0 |
| Add: Common stock issued | 20,000 | | 20,000 |
| Net income | | 8,000 | 8,000 |
| Less: Dividends | | (3,000) | (3,000) |
| Balance, December 31 | $20,000 | $5,000 | $25,000 |

**KANZU CORPORATION**
**Balance Sheet**
**December 31, 2019**

| | | | | |
|---|---|---|---|---|
| **Assets** | | **Liabilities** | | |
| Cash | $ 1,500 | Accounts payable | $ 4,000 | |
| Accounts receivable | 2,500 | Notes payable | 33,000 | |
| Inventory | 3,000 | Total liabilities | | $37,000 |
| Building | 40,000 | **Stockholders' Equity** | | |
| Equipment | 15,000 | Common stock | 20,000 | |
| Total assets | $62,000 | Retained earnings | 5,000 | |
| | | Total stockholders' equity | | 25,000 |
| | | Total liabilities and stockholders' equity | | $62,000 |

| KANZU CORPORATION<br>Statement of Cash Flows<br>For Year Ended December 31, 2019 | |
|---|---|
| Cash flow from operating activities | $ 6,500 |
| Cash flow from investing activities | (55,000) |
| Cash flow from financing activities | 50,000 |
| Net increase in cash | 1,500 |
| Cash at January 1, 2019 | 0 |
| Cash at December 31, 2019 | $ 1,500 |

## Solution 1.7

1. c
2. b
3. a

# Chapter 2

# Processing Accounting Information

**PAST**

Chapter 1 described the environment of financial accounting. It also introduced the financial statements and how they are related.

**PRESENT**

This chapter explains the accounting system, including transaction analysis, the system of debits and credits, and the journalizing of transactions.

**FUTURE**

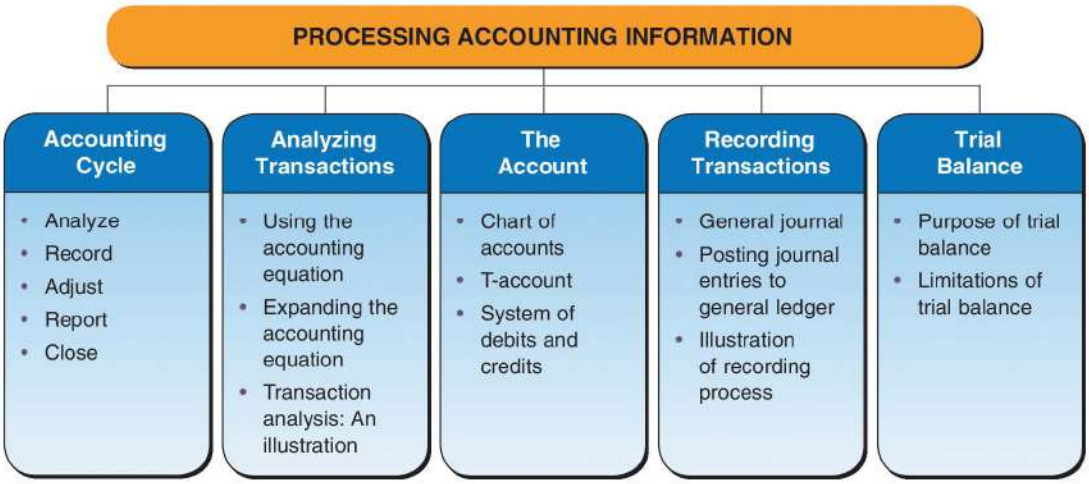
Chapter 3 describes accounting adjustments, the construction of financial statements, and the period-end closing process.

While not everyone is familiar with the company **Intuit Inc.**, nearly everyone that works in the business world is familiar with some of its products. Intuit is a software company based in Mountain View, California, that develops the popular financial and tax preparation software QuickBooks, Mint, and TurboTax.

This chapter describes the details of the accounting system of debits and credits that is applied throughout the world and is the foundation for all accounting software. This chapter also explains the process of journalizing and posting transactions so that financial statements can be prepared for both internal and external users of accounting.


## Road Map

| LO | Learning Objective | Page | eLecture | Guided Example | Assignments |
|---|---|---|---|---|---|
| LO1 | Identify the five major steps in the accounting cycle. | 58 | E2-1 | YT2.1 | SS15, SS17, SE10 |
| LO2 | Analyze and record transactions using the accounting equation. | 59 | E2-2 | YT2.2 | SS1, SS2, SS3, SS16, SE6, E1A, E2A, E3A, E4A, E11A, E15A, E1B, E2B, E3B, E4B, E11B, E15B, P1A, P2A, P3A, P4A, P5A, P6A, P7A, P8A, P9A, P10A, P11A, P1B, P2B, P3B, P4B, P5B, P6B, P7B, P8B, P9B, P10B, P11B |
| LO3 | Explain the nature, format, and purpose of an account. | 66 | E2-3 | | SS4, SE11, E14A, E14B |
| LO4 | Describe the system of debits and credits and its use in recording transactions. | 66 | E2-4 | YT2.3, YT2.4 | SS5, SS6, SS7, SS8, SS9, SS10, SE1, SE2, SE3, SE4, SE5, E5A, E8A, E9A, E10A, E11A, E5B, E8B, E9B, E10B, E11B, P12A, P13A, P14A, P15A, P16A, P12B, P13B, P14B, P15B, P16B |
| LO5 | Explain the process of journalizing and posting transactions. | 69 | E2-5 | YT2.5 | SS11, SS13, SS14, SE7, E4A, E6A, E7A, E8A, E9A, E10A, E12A, E13A, E16A, E4B, E6B, E7B, E8B, E9B, E10B, E12B, E13B, E16B, P12A, P13A, P14A, P15A, P16A, P17A, P12B, P13B, P14B, P15B, P16B, P17B |
| LO6 | Describe the trial balance. | 77 | E2-6 | YT2.6 | SS12, SE8, SE9, E12A, E13A, E12B, E13B, P12A, P13A, P14A, P15A, P16A, P17A, P12B, P13B, P14B, P15B, P16B, P17B |

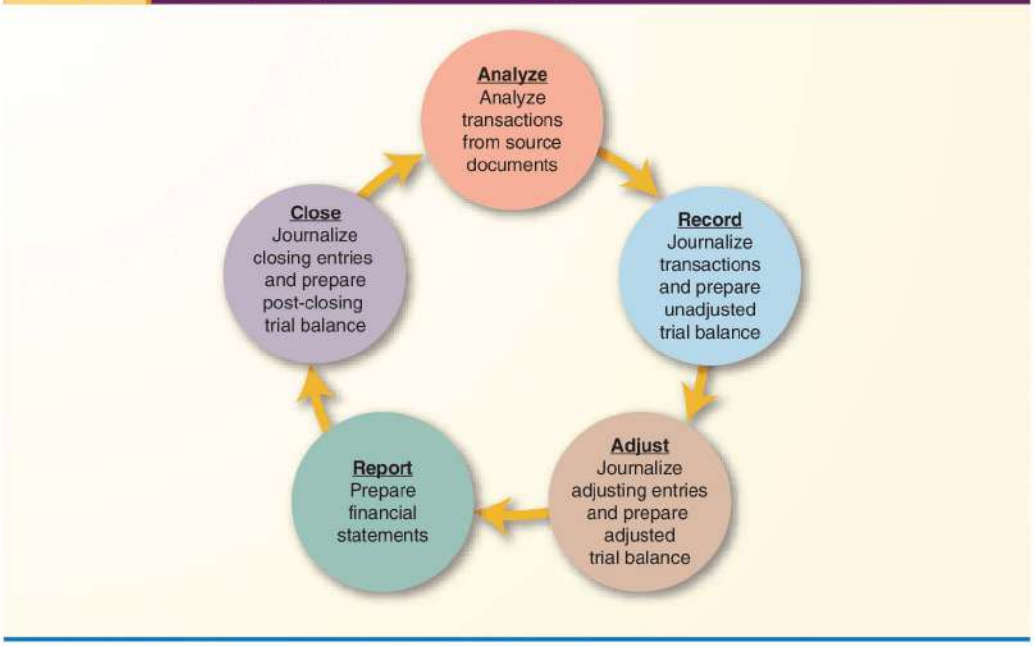



# ACCOUNTING CYCLE

**LO1** **Identify** the five major steps in the accounting cycle.

Businesses engage in economic activities. The role of accounting is to analyze these activities for their impact on a company's accounting equation, and then enter the results of that analysis in the company's accounting system. When a company's management team needs financial data for decision-making purposes and for reports to external parties, the company's financial statements are prepared and communicated. At the end of the accounting period, the "books are closed," a process that prepares the accounting records for the next accounting period. These accounting activities constitute the major steps in the **accounting cycle**—a sequence of activities undertaken by accountants to accumulate and report the financial information of a business. Stated succinctly, these steps are analyze, record, adjust, report, and close. **Exhibit 2-1** shows the sequence of the major steps in the accounting cycle.

**Exhibit 2-1** **Five Major Steps in the Accounting Cycle**




The five steps in the accounting cycle do not occur with equal frequency. A business analyzes and records financial transactions daily during the accounting period. It adjusts and

reports accumulated financial data whenever management needs financial information, usually at weekly, monthly, or quarterly intervals, but at least annually. Closing the books occurs just once, at the end of the accounting period. This chapter focuses on the first two steps of the accounting cycle—analyze and record. In Chapter 3, we examine the final three steps of the cycle.

This chapter explains the accounting cycle using WebWork, a Website development and consulting business launched on December 1, 2019.

**ACCOUNTING IN PRACTICE**

**Accounting Periods**

The annual accounting period is known as a **fiscal year**. Businesses with fiscal year-ends on December 31 are said to be on a **calendar year**. About 60 percent of U.S. businesses are on a calendar year. Many companies prefer to have their accounting year coincide with their "natural" year—that is, at a point in time when business activity is at a low point. For example, many retailers conclude their fiscal year when inventory quantities are low and easier to count, as year-end accounting procedures are more efficiently accomplished when there is less inventory. The "natural" year does not necessarily coincide with the calendar year. For example, **Gap**, a retailer, ends its fiscal year on the Friday nearest January 31. The company's busiest period is November through January, when its customers are holiday shopping. Similarly, the **Boston Celtics**, a professional basketball team, concludes its fiscal year on June 30, following completion of the NBA finals.

**YOUR TURN! 2.1**

Place the following five major steps in the accounting cycle in the proper order:

*a)* Report
*b)* Record
*c)* Close
*d)* Analyze
*e)* Adjust

The solution is on page 116.

# ANALYZING TRANSACTIONS

**LO2** **Analyze** and **record** transactions using the accounting equation.

Many companies utilize a computer-based accounting system to record their financial transactions. You may have some personal experience using accounting software programs like QuickBooks by **Intuit**. While these computer-based accounting systems are not as sophisticated as the systems used by major corporations, they work in much the same way. Similarly, manual systems might lack the sophistication of large accounting systems utilized by companies like **Ford Motor Company**, but the basic process remains the same.

As we saw in Chapter 1, the accounting equation is written as:

**Assets (A) = Liabilities (L) + Stockholders' equity (SE)**

The accounting equation provides a convenient way to analyze and summarize a company's financial transactions and data. The first step in the accounting cycle—analyze—is to determine what information (if any) must be recorded in a company's accounting records. Only items that can be expressed in monetary terms are recorded in financial statements. (The monetary unit concept was discussed in Appendix 1A.) For example, the payment of salary to Jeff Bezos, the CEO of **Amazon**, is recorded because it can be expressed in monetary terms.

An **accounting transaction** is an economic event that must be recorded in the company's accounting records. In general, an event that affects any of the elements of the accounting equation—assets, liabilities, or stockholders' equity—must be recorded in a company's accounting records. Some activities—for example, ordering supplies, bidding on a contract, or negotiating the purchase of an asset—may represent a business activity, but an accounting transaction does not occur until such activities result in a change in an asset, liability, or stockholders' equity account.

An accounting transaction affects at least two elements of the accounting equation, so that the equation always remains in balance. This is where the term **double-entry accounting** comes from. For example, if an asset account such as Cash is increased, one of the following financial events must also occur to keep the accounting equation in balance:

*a.* Another asset, such as Accounts Receivable, must decrease; or

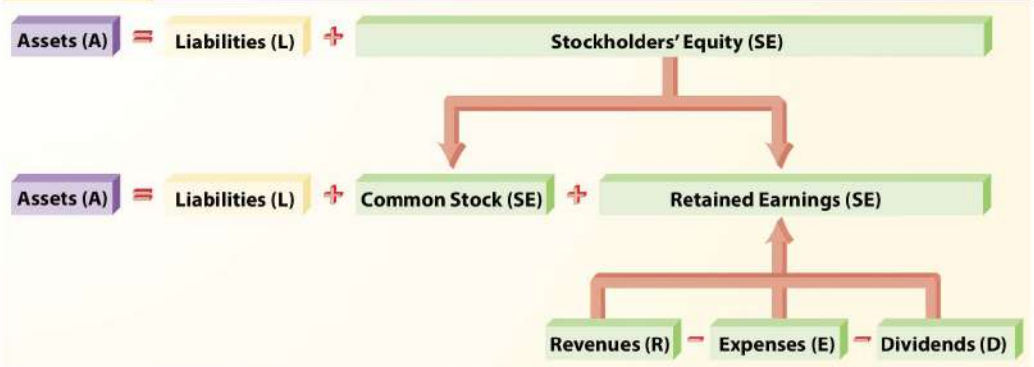
*b.* A liability, such as Notes Payable, must increase; or

*c.* Stockholders' equity, such as Common Stock, must increase.

## Accounting Equation Expanded

Stockholders' equity has two primary components—the amount invested by stockholders (common stock) and the cumulative net income of the business that has not been distributed to stockholders as a dividend (retained earnings). Common stock is increased when the company issues shares of stock. Retained earnings is increased by revenues and decreased by expenses (revenues and expenses are the elements of a company's net income or net loss). Retained earnings is also decreased by a company's payment of dividends. Incorporating these components into stockholders' equity, the *expanded accounting equation* is illustrated in **Exhibit 2-2**.

**Exhibit 2-2** The Accounting Equation Expanded






## Transactions and the Accounting Equation: An Illustration

We now consider the transactions of WebWork, Inc., a developer of web-based applications, to illustrate how various economic activities and events lead to financial statements.

Steve Gates first established WebWork on December 2, 2019. The company's transactions for December, the first month of operations, are analyzed on the following pages. The accounting equation for WebWork is shown after each transaction so that the financial effects of each transaction can be examined. The accounting equation remains in balance following each transaction. This is not a coincidence; it is the result of the fundamental structure of the accounting system.

The following pages illustrate eleven transactions that occurred at WebWork during December 2019. Avoid the temptation to skip any of these transactions because each transaction is included to illustrate a particular concept or approach to recording an economic event utilizing the accounting equation.

### Transaction 1. Issued Stock

On December 2, 2019, Steve Gates invested $30,000 cash in exchange for all of the company's common stock. This transaction increased the company's assets, Cash, by $30,000 and increased its stockholders' equity, Common Stock, by $30,000, as illustrated below

using the accounting equation. (For each transaction that impacts stockholders' equity, we add a brief description—in this case "Issued stock.")

| | Assets | = | Liabilities | + | Stockholders' Equity | |
|---|---|---|---|---|---|---|
| | Cash | = | | | Common Stock | |
| (1) | +30,000 | = | | | +30,000 | Issued stock |
| | $30,000 | | | | $30,000 | |

It is important to verify the equality of the accounting equation following each transaction. After the above transaction is recorded, both sides of the equation total $30,000.

## Transaction 2. Paid Rent in Advance

On December 2, WebWork prepaid its office rent for the next six months, December 2019 through May 2020. WebWork's rent is $1,800 per month; meaning it paid a total of $10,800 cash (6 × $1,800). This transaction decreased Cash by $10,800 and increased Prepaid Rent by $10,800.

| | Assets | | | = | Liabilities | + | Stockholders' Equity |
|---|---|---|---|---|---|---|---|
| | Cash | + | Prepaid Rent | = | | | Common Stock |
| Balance | 30,000 | | | | | | 30,000 |
| (2) | −10,800 | | +10,800 | | | | |
| | 19,200 | + | 10,800 | | | | 30,000 |
| | $30,000 | | | = | | | $30,000 |

The expenditure for prepaid rent is recorded as an asset because the advance payment is a future economic benefit to the company. This outlay of cash has value to the business beyond the current accounting period, but any rent that is used up in the current accounting period will be recorded as an expense for the month of December.

## Transaction 3. Purchased Office Supplies on Account

On December 2, WebWork purchased office supplies on account totaling $2,850. Businesses often extend credit to their customers. Credit allows businesses to pay for goods or services at a later date. When credit is used to purchase goods or services, the purchase is said to be made *on account*. This transaction increased Office Supplies by $2,850 and increased Accounts Payable by the same amount.

| | Assets | | | | | = | Liabilities | + | Stockholders' Equity |
|---|---|---|---|---|---|---|---|---|---|
| | Cash | + | Office Supplies | + | Prepaid Rent | = | Accounts Payable | + | Common Stock |
| Balance | 19,200 | | | | 10,800 | | | | 30,000 |
| (3) | | | +2,850 | | | | +2,850 | | |
| | 19,200 | + | 2,850 | | +10,800 | = | 2,850 | + | 30,000 |
| | | | $32,850 | | | = | | | $32,850 |

Office supplies are recorded as an asset because they are expected to be used by the business in future periods beyond the current accounting period. Any supplies that are used up in the current accounting period will be recorded as an expense for the month of December. Following the purchase of office supplies, WebWork's assets total $32,850, which is equal to the sum of total liabilities of $2,850 plus stockholders' equity of $30,000.

### Transaction 4. Signed Bank Note in Exchange for Cash

On December 2, WebWork obtained a two-year bank loan in the amount of $36,000, after signing a note payable. Annual interest charges on the note amount to 10 percent and are due each November 30. As a consequence of this loan, the company's Cash account increased by $36,000 and the Notes Payable account, a liability, increased by $36,000.

| | Assets | | | | = | Liabilities | | | + | Stockholders' Equity |
|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | + | Office Supplies | + | Prepaid Rent | = | Accounts Payable | + | Notes Payable | + | Common Stock |
| Balance | 19,200 | | 2,850 | | 10,800 | | 2,850 | | | | 30,000 |
| (4) | +36,000 | | | | | | | | +36,000 | | |
| | 55,200 | + | 2,850 | + | 10,800 | = | 2,850 | + | 36,000 | + | 30,000 |
| | $68,850 | | | | | | $68,850 | | | | |

### Transaction 5. Purchased Equipment With Cash

On December 3, WebWork used cash to purchase office equipment costing $32,400. This transaction decreased Cash by $32,400 and increased Office Equipment by the same amount. The accounting equation remains in balance because an equal amount, $32,400, is added to one asset (Equipment) and subtracted from another asset (Cash).

| | Assets | | | | | | = | Liabilities | | | + | Stockholders' Equity |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | + | Office Supplies | + | Prepaid Rent | + | Equipment | = | Accounts Payable | + | Notes Payable | + | Common Stock |
| Balance | 55,200 | | 2,850 | | 10,800 | | | | 2,850 | | 36,000 | | 30,000 |
| (5) | −32,400 | | | | | | +32,400 | | | | | | |
| | 22,800 | + | 2,850 | + | 10,800 | + | 32,400 | = | 2,850 | + | 36,000 | + | 30,000 |
| | $68,850 | | | | | | | | $68,850 | | | | |

### Transaction 6. Received Customer Prepayment

**A.K.A.** Unearned revenue is also called **deferred revenue**.

On December 5, WebWork received a prepayment in the amount of $3,000 for services to be performed over the next few months. Because WebWork has not yet performed the services, it does not record the $3,000 payment as revenue. This practice follows the revenue recognition principle discussed in Appendix 1A. Instead, a liability account, **Unearned Revenue**, is increased by $3,000, and the Cash account is increased by $3,000. Unearned revenue is a liability because the company accepted payment for goods or services that have not yet been provided. Once WebWork performs the services, the unearned revenue liability will be reduced and revenue will be recognized.

| | Assets | | | | | = | Liabilities | | | | + | Stockholders' Equity |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | + | Office Supp. | + | Prepd. Rent | + | Equipment | = | Accts. Pay. | + | Unearned Revenue | + | Notes Pay. | + | Common Stock |
| Bal. | 22,800 | | 2,850 | | 10,800 | | 32,400 | | 2,850 | | | | 36,000 | | 30,000 |
| (6) | +3,000 | | | | | | | | | | +3,000 | | | | |
| | 25,800 | + | 2,850 | + | 10,800 | + | 32,400 | = | 2,850 | + | 3,000 | + | 36,000 | + | 30,000 |
| | $71,850 | | | | | | | | $71,850 | | | | | | |

## Non-Accounting Transaction. Hired an Employee

On December 6, WebWork hired an employee to provide administrative help in the office. The employee will be paid $1,620 every two weeks and begins work Monday, December 9. At the time the employee is hired there is no immediate financial effect on the assets, liabilities, or stockholders' equity of the company. There is only an employment agreement between the employee and the company. The employee has not yet performed any work, nor has the employee received any wages.

## Transaction 7. Provided Services to Customers for Cash

On December 10, WebWork performed services for several customers and was paid $13,510 cash. This transaction increased Cash by $13,510 and increased Fee Revenue by the same amount.

| | Assets | | | | = | Liabilities | | | + | Stockholders' Equity | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | + Office Supp. | + Prepd. Rent | + Equip-ment | = Accts. Pay. | + Unearned Revenue | + Notes Pay. | + Comm. Stock | + Retained Earnings Rev. | −Exp. | −Div. | |
| Bal. | 25,800 | 2,850 | 10,800 | 32,400 | 2,850 | 3,000 | 36,000 | 30,000 | | | | |
| (7) | +13,510 | | | | | | | | +13,510 | | | Fee revenue |
| | 39,310 + | 2,850 + | 10,800 + | 32,400 = | 2,850 + | 3,000 + | 36,000 + | 30,000 + | 13,510 | | | |
| | $85,360 | | | | | $85,360 | | | | | | |

This transaction is recorded as earned revenue because WebWork has performed the services for which it was paid.

## Transaction 8. Provided Services for Cash and on Account

On December 18, WebWork performed $4,740 of services and received $1,000 in cash with the remaining $3,740 to be paid to WebWork by customers within 90 days. As previously noted in transaction 3 above, businesses often extend credit to customers, allowing them to pay for goods or services at a later date. Under accrual accounting, revenue must be recorded when goods or services are transferred from the seller to the buyer, regardless of when payment is received. Consequently, this transaction increased Cash by $1,000, and Accounts Receivable by $3,740, and it increased Fee Revenue by the total amount of $4,740. The accounting equation remains in balance because both sides of the equation are increased by $4,740.

**A.K.A.** Delivering goods or services in advance of payment is referred to as providing goods or services "on account" or "on credit."

| | Assets | | | | | = | Liabilities | | | + | Stockholders' Equity | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | + Accts. Rec. | + Office Supp. | + Prepd. Rent | + Equip-ment | = Accts. Pay. | + Unearned Revenue | + Notes Pay. | + Comm. Stock | + Retained Earnings Rev. | −Exp. | −Div. | |
| Bal. | 39,310 | | 2,850 | 10,800 | 32,400 | 2,850 | 3,000 | 36,000 | 30,000 | 13,510 | | | |
| (8) | +1,000 | +3,740 | | | | | | | | +4,740 | | | Fee revenue |
| | 40,310 + | 3,740 + | 2,850 + | 10,800 + | 32,400 = | 2,850 + | 3,000 + | 36,000 + | 30,000 + | 18,250 | | | |
| | $90,100 | | | | | | $90,100 | | | | | | |

## Transaction 9. Paid Employee Wages

On December 20, WebWork paid the employee after she completed her first two weeks on the job. This transaction decreased Cash by $1,620, and increased Wage Expense by $1,620. By definition, an increase in expenses decreases stockholders' equity.

| | Assets | | | | | = | Liabilities | | | + | Stockholders' Equity | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | + Accts. Rec. | + Office Supp. | + Prepd. Rent | + Equip-ment | = Accts. Pay. | + Unearned Revenue | + Notes Pay. | + Comm. Stock | + Retained Earnings Rev. | − Exp. | −Div. | |
| Bal. | 40,310 | 3,740 | 2,850 | 10,800 | 32,400 | 2,850 | 3,000 | 36,000 | 30,000 | 18,250 | | | |
| (9) | −1,620 | | | | | | | | | | −1,620 | | Wage expense |
| | 38,690 + | 3,740 + | 2,850 + | 10,800 + | 32,400 = | 2,850 + | 3,000 + | 36,000 + | 30,000 + | 18,250 − | 1,620 | | |
| | $88,480 | | | | | $88,480 | | | | | | | |

### Transaction 10. Received Payment on Account from Customer

On December 27, WebWork received a payment of $2,400 cash from a customer that had previously received services performed on account (see Transaction 8). This transaction increased Cash by $2,400, and decreased Accounts Receivable by $2,400.

| | Assets | | | | | = | Liabilities | | | + | Stockholders' Equity | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | + Accts. Rec. | + Office Supp. | + Prepd. Rent | + Equip-ment | = Accts. Pay. | + Unearned Revenue | + Notes Pay. | + Comm. Stock | + Retained Earnings Rev. | − Exp. | − Div. |
| Bal. | 38,690 | 3,740 | 2,850 | 10,800 | 32,400 | 2,850 | 3,000 | 36,000 | 30,000 | 18,250 | 1,620 | |
| (10) | +2,400 | −2,400 | | | | | | | | | | |
| | 41,090 + | 1,340 + | 2,850 + | 10,800 + | 32,400 = | 2,850 + | 3,000 + | 36,000 + | 30,000 + | 18,250 − | 1,620 | |
| | $88,480 | | | | | $88,480 | | | | | | |

After recording this transaction, the balance in Accounts Receivable is $1,340. This represents the amount still owed to WebWork for services that were previously performed on account but remain unpaid.

### Transaction 11. Paid Cash Dividend

On December 30, WebWork paid a cash dividend. Dividends are not a business expense, and are not included in the calculation of net income. Rather, dividends are a distribution of the company's accumulated net income to its stockholders. Payment of the dividend decreased Cash by $500 and increased Dividends by $500. By definition, an increase in dividends causes a decrease in stockholders' equity.

| | Assets | | | | | = | Liabilities | | | + | Stockholders' Equity | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | + Accts. Rec. | + Office Supp. | + Prepd. Rent | + Equip-ment | = Accts. Pay. | + Unearned Revenue | + Notes Pay. | + Comm. Stock | + Retained Earnings Rev. | − Exp. | − Div. | |
| Bal. | 41,090 | 1,340 | 2,850 | 10,800 | 32,400 | 2,850 | 3,000 | 36,000 | 30,000 | 18,250 | 1,620 | | |
| (11) | −500 | | | | | | | | | | | −500 | Dividends |
| | 40,590 + | 1,340 + | 2,850 + | 10,800 + | 32,400 = | 2,850 + | 3,000 + | 36,000 + | 30,000 + | 18,250 − | 1,620 − | 500 | |
| | $87,980 | | | | | $87,980 | | | | | | | |

## Transaction Summary

**Exhibit 2-3** provides a summary of the eleven accounting transactions for WebWork, for the month of December. The exhibit illustrates the financial effect of each transaction using the accounting equation. It is important that the accounting equation remains in balance at all times, and that the equality between total assets and the sum of total liabilities and stockholders' equity is maintained following each transaction.

**Exhibit 2-3** **Summary of December Transactions and Their Effect on the Expanded Accounting Equation**

| | Assets | | | | | = | Liabilities | | | + | Stockholders' Equity | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | | Retained Earnings | | | |
| | Cash | + Accts. Rec. | + Office Supp. | + Prepd. Rent | + Equip-ment | = Accts. Pay. | + Unearned Revenue | + Notes Pay. | + Comm. Stock | | | Rev. | − Exp. | − Div. |
| (1) | +30,000 | | | | | | | | +30,000 | | | | | |
| (2) | −10,800 | | | +10,800 | | | | | | | | | | |
| (3) | | | +2,850 | | | +2,850 | | | | | | | | |
| (4) | +36,000 | | | | | | | +36,000 | | | | | | |
| (5) | −32,400 | | | | +32,400 | | | | | | | | | |
| (6) | +3,000 | | | | | | +3,000 | | | | | | | |
| (7) | +13,510 | | | | | | | | | | | +13,510 | | |
| (8) | +1,000 | +3,740 | | | | | | | | | | +4,740 | | |
| (9) | −1,620 | | | | | | | | | | | | −1,620 | |
| (10) | +2,400 | −2,400 | | | | | | | | | | | | |
| (11) | −500 | | | | | | | | | | | | | −500 |
| | 40,590 | + 1,340 | + 2,850 | + 10,800 | + 32,400 | = 2,850 | + 3,000 | + 36,000 | + 30,000 | | | + 18,250 | − 1,620 | − 500 |
| | $87,980 | | | | | $87,980 | | | | | | | | |

| Concept | Method | Assessment | TAKEAWAY 2.1 |
|---|---|---|---|
| When should an event be recorded in a company's accounting records? | Review the event details.<br><br>Does the event affect the company's assets, liabilities, or stockholders' equity? | If the event affects any of the elements of the accounting equation, it must be recorded in a company's accounting records. | |

**YOUR TURN! 2.2**

The solution is on page 116.

Ford Aerobics Studio, Inc., operates as a corporation. The firm rents studio space (including a sound system) and specializes in offering aerobics classes to individuals and groups. On January 1, the assets, liabilities, and stockholders' equity of the business were as follows: Cash, $5,000; Accounts Receivable, $5,200; Accounts Payable, $1,000; Notes Payable, $2,500; Common Stock, $5,500; and Retained Earnings, $1,200. The January business activities for the studio were as follows:

1. Paid $600 cash on accounts payable.
2. Paid January rent of $3,600 cash.
3. Billed clients for January classes in the amount of $11,500.
4. Received a $500 invoice from a supplier for T-shirts given free to January's class members as an advertising promotion.
5. Collected $10,000 cash on account from clients for prior aerobics classes.
6. Paid employee wages of $2,400 cash.
7. Received a $680 invoice for January's utilities.
8. Paid $20 cash to the bank as January interest on an outstanding note payable.
9. Paid $900 cash in dividends to stockholders.
10. Paid $4,000 cash on January 31 to purchase a sound system to replace the rented system.

**Required**

*a.* Set up an expanded accounting equation in columnar form with the following individual assets, liabilities, and stockholders' equity accounts: Cash, Accounts Receivable, Equipment, Accounts Payable, Notes Payable, Common Stock, and Retained Earnings. Enter the January 1 balances below each account. (The beginning balance in the Equipment account is $0.)

*b.* Record the financial impact (increase or decrease) of each transaction (1) through (10) on the beginning account balances. Then total the columns to demonstrate that total assets equal the sum of total liabilities plus stockholders' equity as of January 31.

# THE "ACCOUNT" SYSTEM

**LO3** **Explain** the nature, format, and purpose of an account.

The basic component of an accounting system is the **account**, which is an individual record of the increases and decreases in a specific asset, liability, or stockholders' equity item. An account is created for each individual asset, liability, and stockholders' equity item on a company's financial statements. Some common account titles are Cash, Accounts Receivable, Notes Payable, Fee Revenue, and Rent Expense.

## Chart of Accounts

Businesses maintain a chart of accounts to facilitate the analysis of a company's business activities. A **chart of accounts** is a list of the titles of all accounts in a business's accounting system. Account titles are grouped by, and in the order of, the six major components of the expanded accounting equation: assets, liabilities, stockholders' equity, revenues, expenses, and dividends. **Exhibit 2-4** shows the chart of accounts for WebWork and indicates the account numbers that will be used throughout this illustration. (Each company maintains its own unique set of accounts and its own numbering system.)

**Exhibit 2-4** **Chart of Accounts for WebWork**

| | |
|---|---|
| **Assets** | **Equity** |
| 110 Cash | 310 Common Stock |
| 120 Accounts Receivable | 320 Retained Earnings |
| 130 Office Supplies | 330 Dividends |
| 150 Prepaid Rent | |
| 170 Office Equipment | **Revenues** |
| 175 Accumulated Depreciation—Office Equipment | 410 Fee Revenue |
| | **Expenses** |
| **Liabilities** | 510 Supplies Expense |
| 210 Accounts Payable | 520 Wage Expense |
| 220 Interest Payable | 530 Rent Expense |
| 230 Wages Payable | 540 Depreciation Expense—Office Equipment |
| 250 Unearned Revenue | 550 Interest Expense |
| 260 Notes Payable | |
| | **Dividends** |
| | 610 Dividends |

## System of Debits and Credits

**LO4** **Describe** the system of debits and credits and its use in recording transactions.

One basic characteristic of all accounts is that data entries separately record the increases and decreases to an account. The method of recording data entries in the accounts is a matter of convention; that is, a simple set of rules is followed, which involves debits and credits.

A **T-account** is a simplified form of an account which is used to capture these effects. T-accounts are so named because they resemble the letter "T" as shown below:

**Account Title** (e.g., Cash)

| Debit | Credit |
|---|---|
| Always the left side | Always the right side |

The terms **debit** and **credit** refer to the left side and the right side, respectively, of an account. Regardless of what amount is recorded in an account, any entry made on the left side is a debit to the account while any entry recorded on the right side is a credit to the

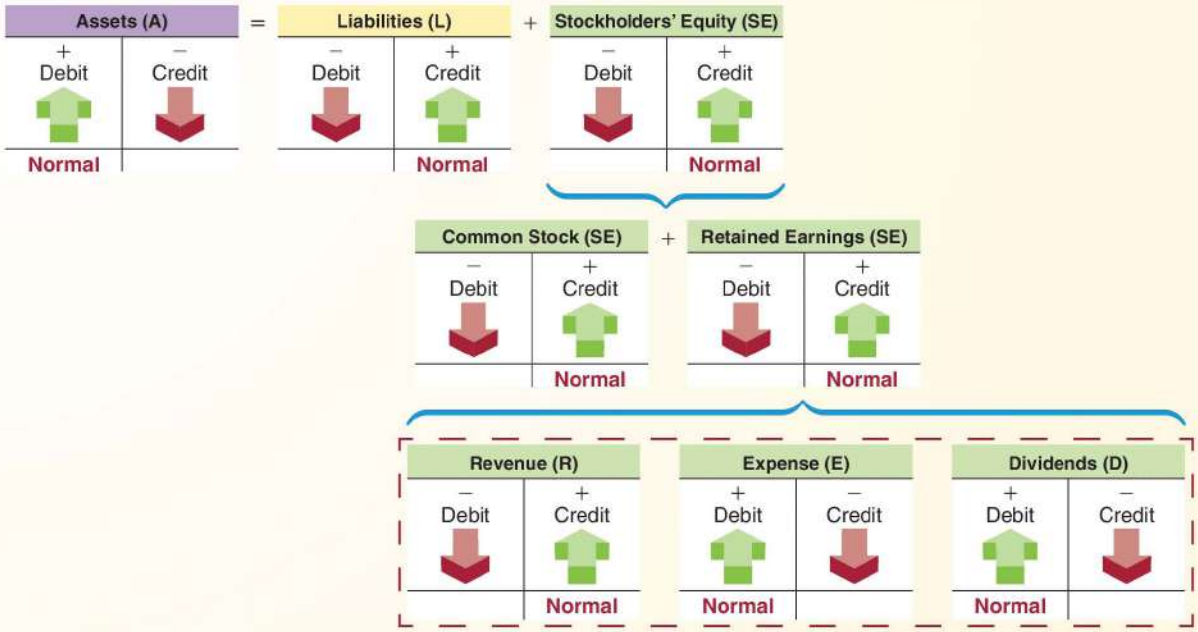
account. The words *debit* and *credit* are abbreviated *dr.* (from the Latin *debere*) and *cr.* (from the Latin *credere*), respectively.

The system of debits and credits identifies which side of the account, debit or credit, is used to increase the account and which side of the account is used to decrease the account. **Exhibit 2-5** summarizes these rules for each of the six primary categories of accounts: assets, liabilities, stockholders' equity, revenues, expenses, and dividends.

Observe the following relations in **Exhibit 2-5**:

1. Debit always refers to the left side of an account; credit always refers to the right side.
2. The pattern of increases and decreases in accounts derives from the accounting equation. Assets are on the left side of the accounting equation and increase with debit (or left side) entries. Assets decrease with credit entries.
3. Liabilities and stockholders' equity are on the right side of the accounting equation and increase with credit (or right side) entries. Liabilities and stockholders' equity decrease with debit entries.
4. The **normal balance** of an account is the side on which increases to the account are recorded. This is because increases in an account are usually greater than, or equal to, decreases in an account. Asset accounts normally have debit balances while liability and stockholders' equity accounts normally have credit balances.
5. Revenue, expense, and dividends are temporary subdivisions of retained earnings. The pattern of increases and decreases in these accounts derives from their relation to retained earnings. Revenues increase earnings, and just like the retained earnings account, revenue accounts increase with credit entries and decrease with debit entries. On the other hand, expenses decrease earnings, and so have the opposite pattern as retained earnings; expense accounts increase with debit entries and decrease with credit entries.
6. Dividends are distributions of retained earnings to shareholders, and like expense accounts have the opposite pattern as retained earnings; dividends increase with debit entries and decrease with credit entries.

**Exhibit 2-5** System of Increases and Decreases, Debits and Credits, and Normal Balances



**YOUR TURN! 2.3**

The solution is on page 116.

For each of the following accounts, identify whether the account's normal balance is a debit or a credit.

*a.* Cash
*b.* Common stock
*c.* Wage expense
*d.* Notes payable
*e.* Dividends
*f.* Sales revenue
*g.* Inventory

As an example of the system of debits and credits, the Cash T-account with the December transactions for WebWork is presented in **Exhibit 2-6**.

**Exhibit 2-6** **Cash T-account**

| + | Cash (A) | | – |
|---|---|---|---|
| **(1)** | 30,000 | 10,800 | **(2)** |
| **(4)** | 36,000 | 32,400 | **(5)** |
| **(6)** | 3,000 | 1,620 | **(9)** |
| **(7)** | 13,510 | 500 | **(11)** |
| **(8)** | 1,000 | | |
| **(10)** | 2,400 | | |
| | 85,910 | 45,320 | |
| **Bal.** | 40,590 | | |

To compute the T-account balance, sum the numbers in each column and subtract the smaller total from the larger total. In this example, subtract 45,320 from 85,910 to compute the 40,590 balance.

Note that amounts are not indicated with either a plus (+) or minus (-) sign in a T-account because, as shown in **Exhibit 2-5**, the type of the account and whether the data entry is a debit or credit to that account tell us if the amount is an increase or decrease. Because Cash is an asset, increases are always shown on the left as debits and decreases on the right as credits.

A T-account consists of: (1) the account title (such as Cash), (2) amounts reflecting increases and decreases, and (3) cross-references to other accounting records. It is customary to reference (or link) the data entries in a T-account with a number or a letter to identify the related accounting transaction that originated the data. This permits a systematic review of the data entries in the event of a recording error. It also enables a company, and its independent auditor, to review the company's set of accounts and match the account information with the related accounting transactions. The numerical references in the Cash T-account above are the ones used to identify the December transactions for WebWork from **Exhibit 2-3**.

**YOUR TURN! 2.4**

The solution is on page 116.

Using the information in **Exhibit 2-3**, construct the T-account for Accounts Receivable in proper form.

**CORPORATE SOCIAL RESPONSIBILITY**

**What to Record?**

An important element of the conceptual framework discussed in Appendix 1A in Chapter 1 is the monetary unit concept, which states that only those items that can be expressed in monetary terms are reported in financial statements. This causes many items of interest to be excluded from financial statements. Reporting of a company's social responsibility activities, for example, would be compromised if it were constrained to the activities that can be expressed in monetary terms. Reporting guidelines established by the Global Reporting Initiative, the organization that pioneered the world's most widely used sustainability reporting framework, allow for a wider range of activities to be measured and reported. For example, **Bayer Group**, a global healthcare company, reports such items as greenhouse emissions, net water usage, and employee safety records in its annual sustainable development report.

# RECORDING TRANSACTIONS

**LO5** **Explain** the process of journalizing and posting transactions.

Earlier in this chapter we analyzed the transactions of WebWork using the accounting equation. This approach enabled us to see how accounting transactions affect a company's financial position and operations. This approach is not feasible, however, for even a modest-sized business because of the large number of transactions and accounts involved. Consequently, we now explain the process of analyzing and recording accounting information in an actual accounting system.

An initial step in the analysis and recording process is to identify evidence of a business transaction. This usually comes in the form of a source document. **Source documents** are printed forms or computer records that are generated when a firm engages in a business transaction. At a minimum, a source document usually specifies the dollar amount involved, the date of the transaction, and possibly the party dealing with the firm. Some examples of source documents include (1) a supplier's invoice showing evidence of a purchase of supplies on account, (2) a bank check indicating the payment of an obligation, (3) a deposit slip showing the amount of cash deposited in a bank, and (4) a cash receipt indicating the amount of cash received from a customer for services rendered. An example of an invoice follows. Regardless of its form, the source document serves as the basis for the analysis of the underlying business event.

**WebWork, Inc.** **INVOICE**

137 Technology Lane
Irvine, CA 92614
Phone (949) 727-3555

INVOICE # [**100**]
DATE: DECEMBER 18, 2019

**TO:**
Pick Enterprises
1055 Kinrose Ave.
Los Angeles, CA 90024
(310) 208-5570

**FOR:**
Web design

| DESCRIPTION | HOURS | RATE | AMOUNT |
|---|---|---|---|
| Design work for Website, including motion graphics | 16 | $150 | $2,400 |
| | | TOTAL | $2,400 |

Make all checks payable to WebWork, Inc.
Total due in 15 days. Overdue accounts subject to a service charge of 1% per month.

**Thank you for your business!**

Once the source document has been analyzed to determine the accounts affected and the amounts involved, we then record the transaction. All accounting transactions are initially recorded in a journal. A **journal**, or *book of original entry,* is a tabular record in which a business's activities are reflected in terms of debits and credits and recorded in chronological order. A journal organizes information by date, and thus, serves as a chronological diary of a company's business activities. The word *journalize* means to record a transaction in a journal. An entry in a journal is called a **journal entry**.

**A.K.A.** A company's journals are also referred to as its "books."

**A.K.A.** Another term often used to describe the recording of a transaction is to "book" the transaction.

## General Journal

The **general journal** is a record with enough flexibility that any type of business transaction can be recorded in it. Like all journals in an accounting system, the general journal is a book

of original entry in which accounting data are entered into a company's accounting system. **Exhibit 2-7** shows the first transaction as it is recorded in WebWork's general journal. The procedure for recording entries in the general journal follows:

❶ Indicate the year, month, and date of entry. (Usually the year and month are rewritten only at the top of each page of the journal or at the point in the journal where the year and month change.)

❷ Enter the titles of accounts affected (from the chart of accounts) in the Description column. Accounts to receive debits are entered close to the left margin and are recorded first. Accounts to receive credits are recorded next and indented slightly to the right.

❸ Enter dollar amounts in the left (Debit) and right (Credit) columns.

❹ Record an explanation of the transaction below the account titles; it should be brief, disclosing information necessary to understand the event recorded.

**Exhibit 2-7 General Journal with First Entry of WebWork**

| GENERAL JOURNAL | | | |
|---|---|---|---|
| **Date** | **Description** | **Debit** | **Credit** |
| 2019 | | | |
| ❶ Dec. 2 | Cash ❷ | 30,000 ❸ | |
| | Common stock | | 30,000 |
| | *Issued stock in exchange for cash.* ❹ | | |

A journal entry that involves more than two accounts is called a **compound journal entry**. (As shown on page 73, the journal entry for Transaction 8 is an example of a compound journal entry involving three accounts.) Any number of accounts can appear in a compound entry; but, regardless of how many accounts are used, the sum of the debit amounts always equals the sum of the credit amounts. Accordingly, each transaction entered in the general journal is recorded with equal dollar amounts of debits and credits. The account titles cited in the Description column should correspond to those from the chart of accounts. (To delineate between journal entries made in the general journal, we leave a blank line between each transaction entry.)

## Posting Journal Entries to the General Ledger

After an accounting transaction is journalized in the general journal, the debits and credits in each journal entry are immediately transferred to another component of the accounting system called the general ledger. A **general ledger** is a listing of each account of a company and the amounts making up each account. While the general journal organizes transactions in chronological order, the general ledger organizes transactions by account. This makes it easier to determine the balance of each account, which in turn facilitates the preparation of the company's financial statements. Although businesses can use various ledgers to accumulate detailed accounting information, all firms have a general ledger.

The process of transferring the debit and credit information from the general journal to the general ledger is called **posting**. It is important to be able to trace each data entry appearing in a general ledger account to the general journal location from which it was posted; consequently, both the general journal and general ledger accounts have a **posting reference** code. The posting reference of the general journal indicates the account to which the related debit or credit has been posted. The posting references in the general journal and ledger accounts are entered when the journal entries are posted to the ledger accounts (automatically when computerized, or by hand for a manual system). We will use the transaction number as the posting reference in the examples that follow.

## Illustration of the Recording Process

We now apply the recording process to the transactions of WebWork, that were summarized in **Exhibit 2-3**. For each transaction, we **(1) analyze** the transaction using the accounting equation, **(2) journalize** the transaction, and **(3) post** journal entries to the general ledger (for simplicity, we use the T-account structure for each ledger account).

### Transaction 1 Issued Stock

On December 2, Steve Gates invested $30,000 in exchange for common stock of WebWork.

**ANALYZE**

| Assets | = | Liabilities | + | Stockholders' Equity |
|---|---|---|---|---|
| +30,000 Cash | = | | | +30,000 Common Stock |

**JOURNALIZE**

| | | | |
|---|---|---|---|
| Dec. 2 | Cash (+A) | 30,000 | |
| | Common stock (+SE) | | 30,000 |
| | *To record issuance of common stock for cash.* | | |

**POST**

| Cash (A) + | | Cash (A) − | Common Stock (SE) − | | Common Stock (SE) + |
|---|---|---|---|---|---|
| (1) | 30,000 | | | 30,000 | (1) |

### Transaction 2 Paid Rent in Advance

On December 2, WebWork prepaid rent for the office covering the next six months, December 2019 through May 2020. Monthly rent is $1,800; the total amount prepaid was $10,800 cash.

**ANALYZE**

| Assets | | = | Liabilities | + | Stockholders' Equity |
|---|---|---|---|---|---|
| −10,800 Cash | +10,800 Prepaid Rent | = | | | |

**JOURNALIZE**

| | | | |
|---|---|---|---|
| Dec. 2 | Prepaid rent (+A) | 10,800 | |
| | Cash (−A) | | 10,800 |
| | *To record advance payment of six months' rent.* | | |

**POST**

| Prepaid Rent (A) + | | Prepaid Rent (A) − | Cash (A) + | | Cash (A) − |
|---|---|---|---|---|---|
| (2) | 10,800 | | (1) 30,000 | 10,800 | (2) |

### Transaction 3 Purchased Office Supplies on Account

On December 2, WebWork purchased $2,850 of office supplies on account.

**ANALYZE**

| Assets | = | Liabilities | + | Stockholders' Equity |
|---|---|---|---|---|
| +2,850 Office Supplies | = | +2,850 Accounts Payable | | |

**JOURNALIZE**

| | | | |
|---|---|---|---|
| Dec. 2 | Office supplies (+A) | 2,850 | |
| | Accounts payable (+L) | | 2,850 |
| | *To record purchase of office supplies.* | | |

**POST**

| Office Supplies (A) + | | Office Supplies (A) − | Accounts Payable (L) − | | Accounts Payable (L) + |
|---|---|---|---|---|---|
| (3) | 2,850 | | | 2,850 | (3) |

## Transaction 4 Signed Bank Note in Exchange for Cash

On December 2, WebWork obtained a two-year bank loan for $36,000, signing a note payable. Annual interest of 10 percent is due each November 30.

**ANALYZE**

| Assets | = | Liabilities | + | Stockholders' Equity |
|---|---|---|---|---|
| +36,000 Cash | = | +36,000 Notes Payable | | |

**JOURNALIZE**

| | | | |
|---|---|---|---|
| Dec. 2 | Cash (+A)<br>Notes payable (+L)<br>*To record borrowing of funds.* | 36,000 | 36,000 |

**POST**

| + Cash (A) − | | | − Notes Payable (L) + | | |
|---|---|---|---|---|---|
| (1) | 30,000 | 10,800 (2) | | 36,000 | (4) |
| **(4)** | **36,000** | | | | |

## Transaction 5 Purchased Equipment with Cash

On December 3, WebWork used cash to purchase $32,400 of office equipment.

**ANALYZE**

| Assets | | = | Liabilities | + | Stockholders' Equity |
|---|---|---|---|---|---|
| −32,400 Cash | +32,400 Office Equipment | = | | | |

**JOURNALIZE**

| | | | |
|---|---|---|---|
| Dec. 3 | Office equipment (+A)<br>Cash (−A)<br>*To record purchase of office equipment.* | 32,400 | 32,400 |

**POST**

| + Office Equipment (A) − | | + Cash (A) − | | | |
|---|---|---|---|---|---|
| **(5)** | **32,400** | (1) | 30,000 | 10,800 | (2) |
| | | (4) | 36,000 | **32,400** | **(5)** |

## Transaction 6 Received Customer Prepayment

On December 5, WebWork received $3,000 cash for services to be performed in the future.

**ANALYZE**

| Assets | = | Liabilities | + | Stockholders' Equity |
|---|---|---|---|---|
| +3,000 Cash | = | +3,000 Unearned Revenue | | |

**JOURNALIZE**

| | | | |
|---|---|---|---|
| Dec. 5 | Cash (+A)<br>Unearned revenue (+L)<br>*To record advance payment from a customer.* | 3,000 | 3,000 |

**POST**

| + Cash (A) − | | | | − Unearned Revenue (L) + | | |
|---|---|---|---|---|---|---|
| (1) | 30,000 | 10,800 | (2) | | 3,000 | **(6)** |
| (4) | 36,000 | 32,400 | (5) | | | |
| **(6)** | **3,000** | | | | | |