TENTH EDITION

FINANCIAL ACCOUNTING

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Mc Graw Hill Education

To: Herman and Doris Hargenrater
Oscar and Selma Libby
Laura Libby, Brian Plummer, and Bennett Plummer
Abby, Grace, Claire, Joanne, and Richard Hodge
Dan Short—Mentor, trusted advisor, and former coauthor

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ABOUT THE AUTHORS

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©Robert Libby

Robert Libby is the David A. Thomas Professor of Accounting and Accounting Area Coordinator at Cornell University, where he teaches the introductory financial accounting course. He previously taught at the University of Illinois, Pennsylvania State University, the University of Texas at Austin, the University of Chicago, and the University of Michigan. He received his BS from Pennsylvania State University, where he was selected as the 2018 Outstanding Accounting Alumnus, and his MAS and PhD from the University of Illinois; he also completed the CPA exam (Illinois).

Bob was selected as the AAA Outstanding Educator in 2000 and received the AAA Outstanding Service Award in 2006 and the AAA Notable Contributions to the Literature Award in 1985 and 1996. He has received the Core Faculty Teaching Award multiple times at Cornell. Bob is a widely published author and researcher specializing in behavioral accounting. He has published numerous articles in *The Accounting Review; Journal of Accounting Research; Accounting, Organizations, and Society;* and other accounting journals. He has held a variety of offices, including vice president, in the American Accounting Association, and he is a member of the American Institute of CPAs.

PATRICIA A. LIBBY

©Patricia Libby

Patricia Libby is a retired associate professor of accounting at Ithaca College, where she taught the undergraduate and graduate financial accounting courses. She previously taught graduate and undergraduate financial accounting at Eastern Michigan University and the University of Texas. Before entering academia, she was an auditor with Price Waterhouse (now PricewaterhouseCoopers) and a financial administrator at the University of Chicago. She was also faculty advisor to Beta Alpha Psi (Mu Alpha chapter), the National Association of Black Accountants (Ithaca College chapter), and Ithaca College Accounting Association.

Patricia received her BS from Pennsylvania State University, her MBA from DePaul University, and her PhD from the University of Michigan; she also successfully completed the CPA exam (Illinois). She has published articles in *The Accounting Review, Issues in Accounting Education,* and *The Michigan CPA*.

FRANK HODGE

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Frank Hodge is the chair of the Accounting Department and the Michael G. Foster Endowed Professor at the University of Washington's Foster School of Business. He also serves in the President's Office as the University of Washington's Faculty Athletics Representative to the PAC-12 Conference and the National Collegiate Athletic Association.

Frank joined the faculty at the University of Washington in 2000. He earned his MBA and PhD degrees from Indiana University. He has won over 30 teaching awards at the University of Washington teaching financial accounting and financial statement analysis to undergraduate students, full-time MBA students, executive MBA students, and intercollegiate athletic administrators. Frank's research focuses on how individuals use accounting information to make investment decisions and how technology influences their information choices. Frank was one of six members of the Financial Accounting Standards Research Initiative team and has presented his research at the Securities and Exchange Commission. He has published articles in *The Accounting Review; Journal of Accounting Research; Contemporary Accounting Research; Accounting, Organizations, and Society;* and several other journals. Frank lives in Seattle with his wife and two daughters.

A TRUSTED LEADER FOR

The award-winning author team of Bob Libby, Pat Libby, and Frank Hodge continue *Financial Accounting*'s best-selling tradition of helping the instructor and student become partners in learning. Libby/Libby/Hodge uses a remarkable learning approach that keeps students engaged and involved in the material from the first day of class.

Libby/Libby/Hodge's *Financial Accounting* maintains its leadership by focusing on three key attributes:

THE PIONEERING FOCUS COMPANY APPROACH

The Libby/Libby/Hodge authors' trademark focus company approach is the best method for helping students understand financial statements and the real-world implications of financial accounting for future managers. **This approach shows that accounting is relevant and motivates students by explaining accounting in a real-world context.** Throughout each chapter, the material is integrated around a familiar focus company, its decisions, and its financial statements. This provides the perfect setting for discussing the importance of accounting and how businesses use accounting information.

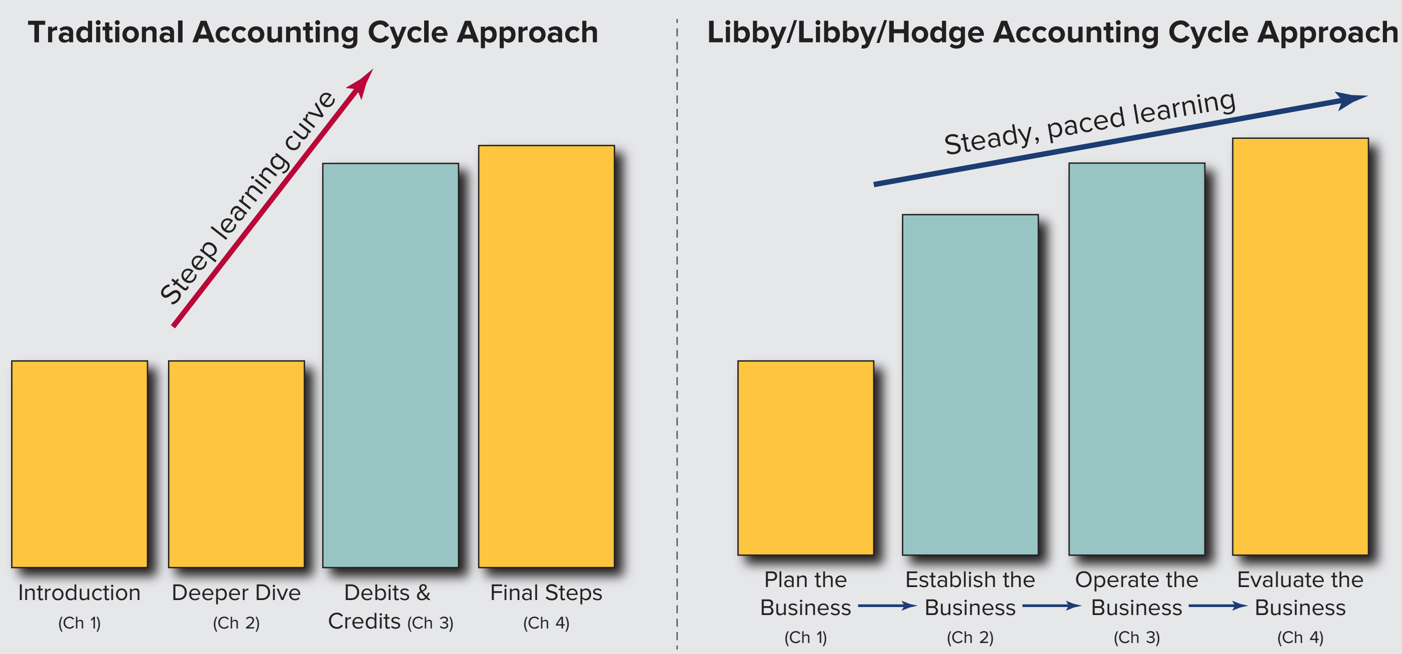
A BUILDING-BLOCK APPROACH TO TEACHING TRANSACTION ANALYSIS

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

The market-leading Libby/Libby/Hodge approach spreads transaction analysis coverage over two chapters so that students have the time to master the material. In Chapter 2 of *Financial Accounting,* students are exposed to the accounting equation and transaction analysis for investing and financing transactions that affect only balance sheet accounts. This provides students with the opportunity to learn the basic structure and tools used in accounting in a simpler setting. In Chapter 3, students are exposed to more complex operating transactions that also affect income statement accounts. **By slowing down the introduction of transactions and giving students time to practice and gain mastery, this building-block approach leads to**

STUDENTS AND INSTRUCTORS

greater student success in their study of later topics in financial accounting such as adjusting entries. After the students have developed an understanding of the complete accounting cycle and the resulting statements, Chapter 5 takes students through the corporate reporting and analysis process.



This graphic shows a detailed comparison of the Libby/Libby/Hodge approach to the accounting cycle chapters compared to the approach taken by other financial accounting texts.

The authors' approach to introducing the accounting cycle has been tested in peer-reviewed, published research studies. One of these award-winning studies has shown that the accounting cycle approach used in this textbook yields learning gains that out-pace approaches used in other textbooks by a significant margin.

POWERFUL TECHNOLOGY FOR TEACHING AND STUDY

Students have different learning styles and conflicting time commitments, so they want technology tools that will help them study more efficiently and effectively. The tenth edition includes the best technology available with Connect's latest features—Concept Overview Videos, Excel Simulations, General Ledger problems, and other new study, practice, and assessment materials.

MARKET-LEADING PEDAGOGY

Financial Accounting, 10e, offers a host of pedagogical tools that complement the different ways you like to teach and the ways your students like to learn. Some offer information and tips that help you present a complex subject; others highlight issues relevant to what your students read online or see on television. Either way, *Financial Accounting*'s pedagogical support will make a real difference in your course and in your students' learning.

FINANCIAL ANALYSIS

Interpreting Assets, Liabilities, and Stockholders' Equity on the Balance Sheet

Assessment of **Le-Nature's** assets is important to its creditors, **Wells Fargo Bank** and others, and its stock-

DATA ANALYTICS

How Data Analytics Are Affecting What Auditors Do

Modern data analytics are changing the world of auditing. The availability of more data from clients' enterprisewide accounting systems, which combine the various record-keeping functions within an organization, has allowed access now to entire populations of transactions instead of smaller statistical samples as

A QUESTION OF ETHICS

Ethics and the Need for Internal Control

Some people are bothered by the recommendation that all well-run companies should have strong internal

KEY RATIO ANALYSIS

Net Profit Margin

FOCUS ON CASH FLOWS

Working Capital and Cash Flows

Many working capital accounts have a direct relationship to income-producing activities. Accounts receiv-

INTERNATIONAL PERSPECTIVE

The International Accounting Standards Board and Global Accounting Standards

Financial accounting standards and disclosure requirements are adopted by national regulatory agencies. Since 2002, there has been substantial movement toward the adoption of **International Financial Reporting**

FINANCIAL ANALYSIS BOXES—These features tie important chapter concepts to real-world decision-making examples. They also highlight alternative viewpoints and add to the critical-thinking and decision-making focus of the text.

DATA ANALYTICS BOXES—This feature introduces students to how companies analyze and use data for both business decisions and accounting applications.

AND CONTENT

A QUESTION OF ETHICS BOXES—These boxes appear throughout the text, conveying the importance and the consequences of acting responsibly in business practice.

> "Ethics and financial analysis boxes are excellent. Examples with real companies that students have heard of or even been to are key to their learning and understanding."
>
> —Laurie Dahlin, Worcester State University

FOCUS ON CASH FLOWS BOXES—Each of the first 11 chapters includes a discussion and analysis of changes in the cash flows of the focus company and explores the decisions that caused those changes.

> **FOCUS ON CASH FLOWS**
>
> **Working Capital and Cash Flows**
>
> Many working capital accounts have a direct relationship to income-producing activities. Accounts receivable, for example, are related to sales revenue: Accounts receivable increase when sales are made on credit. Cash is collected when customers pay their bills. Similarly, accounts payable increase when inventory is purchased on credit. A cash outflow occurs when the account is paid. We discuss how to use changes in working capital accounts to create the operating section of the statement of cash flows in Chapter 12.

KEY RATIO ANALYSIS BOXES—Each box presents ratio analysis for the focus company in the chapter as well as for comparative companies. Cautions also are provided to help students understand the limitations of certain ratios.

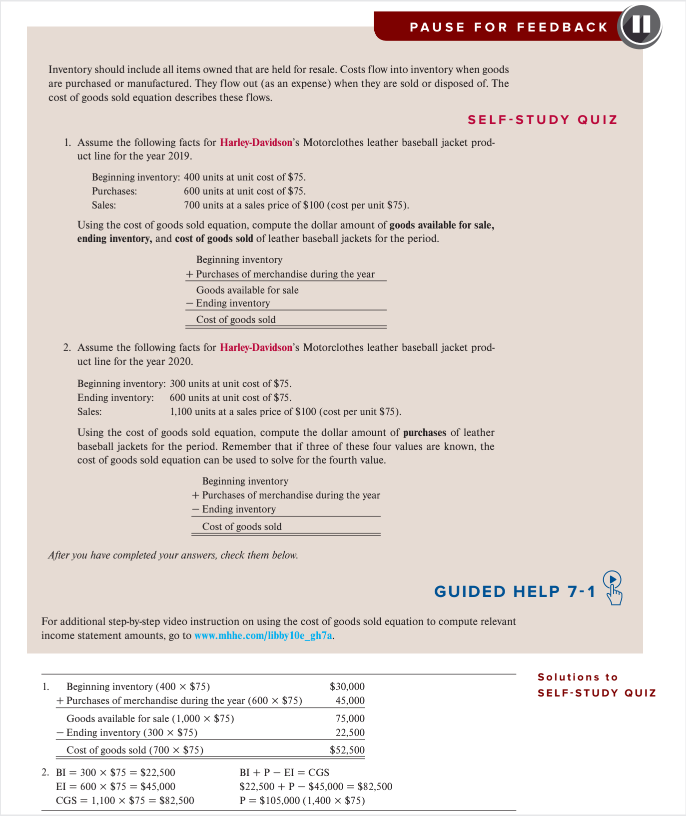
INTERNATIONAL PERSPECTIVE BOXES—These boxes highlight the emergence of global accounting standards (IFRS) at a level appropriate for the introductory student.

> "An excellent introduction to financial accounting that flows in a more logical manner than most texts. The extensive variety and amount of supporting materials allows for customization of the course, and the integration of key concepts such as ethics and cash flows enhance student understanding of the topics."
>
> —Joy Gray, Bentley University

PRACTICE IS KEY TO SUCCESS

PAUSE FOR FEEDBACK AND SELF-STUDY QUIZ

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



PAUSE FOR FEEDBACK

Inventory should include all items owned that are held for resale. Costs flow into inventory when goods are purchased or manufactured. They flow out (as an expense) when they are sold or disposed of. The cost of goods sold equation describes these flows.

SELF-STUDY QUIZ

1. Assume the following facts for **Harley-Davidson**'s Motorclothes leather baseball jacket product line for the year 2019.

   Beginning inventory: 400 units at unit cost of $75.
   Purchases: 600 units at unit cost of $75.
   Sales: 700 units at a sales price of $100 (cost per unit $75).

   Using the cost of goods sold equation, compute the dollar amount of **goods available for sale, ending inventory,** and **cost of goods sold** of leather baseball jackets for the period.

   Beginning inventory
   \+ Purchases of merchandise during the year
   Goods available for sale
   − Ending inventory
   Cost of goods sold

2. Assume the following facts for **Harley-Davidson**'s Motorclothes leather baseball jacket product line for the year 2020.

   Beginning inventory: 300 units at unit cost of $75.
   Ending inventory: 600 units at unit cost of $75.
   Sales: 1,100 units at a sales price of $100 (cost per unit $75).

   Using the cost of goods sold equation, compute the dollar amount of **purchases** of leather baseball jackets for the period. Remember that if three of these four values are known, the cost of goods sold equation can be used to solve for the fourth value.

   Beginning inventory
   \+ Purchases of merchandise during the year
   − Ending inventory
   Cost of goods sold

After you have completed your answers, check them below.

GUIDED HELP 7-1

For additional step-by-step video instruction on using the cost of goods sold equation to compute relevant income statement amounts, go to www.mhhe.com/libby10e_gh7a.

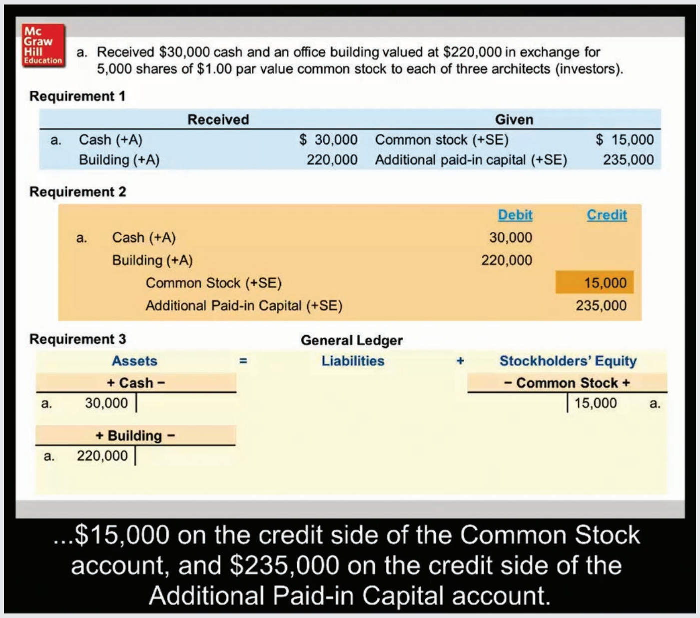
Solutions to SELF-STUDY QUIZ

1.	Beginning inventory (400 × $75)	$30,000
	+ Purchases of merchandise during the year (600 × $75)	45,000
	Goods available for sale (1,000 × $75)	75,000
	− Ending inventory (300 × $75)	22,500
	Cost of goods sold (700 × $75)	$52,500

2. BI = 300 × $75 = $22,500 — BI + P − EI = CGS
   EI = 600 × $75 = $45,000 — $22,500 + P − $45,000 = $82,500
   CGS = 1,100 × $75 = $82,500 — P = $105,000 (1,400 × $75)

GUIDED HELP VIDEOS

Research shows that when students have difficulty understanding a key concept, they benefit most when help is available immediately. Our unique Guided Help videos provide narrated, animated, step-by-step walk-throughs of select topics covered in the Self-Study Quiz that students can view at any time through their mobile device or online. These videos also save office hour time!



SMARTBOOK

Within Connect, SmartBook brings these features to life by interleaving reading with active practice. As students read, SmartBook encourages them to answer questions to demonstrate their knowledge—then, based on their answers, highlights those areas where students need more practice.

IN FINANCIAL ACCOUNTING

COMPREHENSIVE PROBLEMS

Selected chapters include problems that cover topics from earlier chapters to refresh, reinforce, and build an integrative understanding of the course material. The comprehensive problems are complemented in Connect by General Ledger questions that help students see how transactions flow from the general journal through to the financial statements—and allow students to correct misconceptions.

COMPREHENSIVE PROBLEMS (CHAPTERS 6–8) connect

COMP8-1
LO6-2, 7-2, 7-4, 8-3, 8-4, 8-5, 8-6

Complete the requirements for each of the following independent cases:

Case A. **Keurig Dr Pepper**, is a leading worldwide integrated brand owner, bottler, and distributor of nonalcoholic beverages. Key brands include Dr Pepper, Snapple, 7-UP, Mott's juices, A&W root beer, Canada Dry ginger ale, Schweppes ginger ale, and Hawaiian Punch, and Green Mountain coffee among others, and the innovative Keurig singleserve coffee system.

The following represents selected data from recent financial statements of Keurig Dr Pepper (dollars in millions):

KEURIG DR PEPPER
Consolidated Balance Sheets (partial)

(in millions)	December 31, 20x3	December 31, 20x2
Assets		
Current assets:		
Cash and cash equivalents	$ 61	$1,787
Accounts receivable (net of allowances of $2 and $3, respectively)	668	595

CASES AND PROJECTS

This section includes annual report cases, financial reporting and analysis cases, critical thinking cases, and financial reporting and analysis team projects. The real-world company analysis theme is continued in this section, giving students practice comparing American Eagle and Express among other relevant companies. Several of these cases and projects are now assignable in Connect.

CASES AND PROJECTS connect

Annual Report Cases

CP7-1
LO7-1, 7-2, 7-4,7-5

Finding Financial Information

Refer to the financial statements of **American Eagle Outfitters** given in Appendix B at the end of this book.

Required:
1. How much inventory does the company hold at the end of the most recent year?
2. Estimate the amount of merchandise that the company purchased during the current year. (**Hint:** Use the cost of goods sold equation and ignore "certain buying, occupancy, and warehousing expenses.")
3. What method does the company use to determine the cost of its inventory?
4. Compute the inventory turnover ratio for the current year. What does an inventory turnover ratio tell you?

CP7-2
LO7-2, 7-4, 7-5, 7-7

Finding Financial Information

Refer to the financial statements of **Express, Inc.**, given in Appendix C at the end of this book.

Required:
1. The company uses lower of cost or net realizable value to account for its inventory. At the end of the year, do you expect the company to write its inventory down to net realizable value? Explain your answer. What was the amount of the write-down for the latest year reported? How did you know?
2. What method does the company use to determine the cost of its inventory?
3. If the company overstated ending inventory by $10 million for the year ended February 3, 2018, what would be the corrected value for Income before Income Taxes?
4. Compute the inventory turnover ratio for the current year. What does an inventory turnover ratio tell you?

CP7-3
LO7-5

Comparing Companies within an Industry

Refer to the financial statements of **American Eagle Outfitters** (Appendix B) and **Express, Inc.** (Appendix C) and the Industry Ratio Report (Appendix D) at the end of this book.

Required:
1. Compute the inventory turnover ratio for both companies for the current year. What do you infer from the difference?
2. Compare the inventory turnover ratio for both companies to the industry average. Are these two companies doing better or worse than the industry average in turning over their inventory?

CONTINUING PROBLEM

The continuing case revolves around Penny's Pool Service & Supply, Inc., and its largest supplier, Pool Corporation, Inc. In the first five chapters, the continuing case follows the establishment, operations, and financial reporting for Penny's. In Chapter 5, Pool Corporation, a real publicly traded corporation, is introduced in more detail. The Pool Corporation example is then extended to encompass each new topic in the remaining chapters.

CONTINUING PROBLEM connect

CON8-1

Asset Acquisition, Depreciation, and Disposal

Pool Corporation, Inc., is the world's largest wholesale distributor of swimming pool supplies and equipment. Assume Pool Corporation purchased for cash new loading equipment for the warehouse on January 1 of Year 1, at an invoice price of $72,000. It also paid $2,000 for freight on the equipment, $1,300 to prepare the equipment for use in the warehouse, and $800 for insurance to cover the equipment during operation in Year 1. The equipment was estimated to have a residual value of $3,300 and be used over three years or 24,000 hours.

Required:
1. Record the purchase of the equipment, freight, preparation costs, and insurance on January 1 of Year 1.
2. Create a depreciation schedule assuming Pool Corporation uses the straight-line method.

WHAT'S NEW IN THE 10th EDITION?

In response to feedback and guidance from numerous financial accounting faculty and new accounting rules, the authors have made many important changes to the tenth edition of *Financial Accounting,* including:

- ***New* focus companies** including **IBM**, a leading tech company focusing on data analytics, artificial intelligence, and quantum computing; **Skechers USA**, a fast-growing casual and athletic footwear company; and **The Walt Disney Company**, a diversified worldwide entertainment company with significant investments in other companies.
- **New Annual Report Cases** using financial statements from **American Eagle Outfitters** and **Express Inc.** assignable in Connect.
- **Additional emphasis on the new revenue recognition standard** through detailed edits of Chapters 3 and 6.
- Clear and concise discussion of the **new leasing standard** in Chapter 9.
- Discussion of **new passive investments standard** in Appendix A.
- ***New* format for journal entries** to be consistent with what students see in Connect.
- ***New* Data Analytics features,** added where appropriate to introduce students to business and accounting applications they may study in later courses.
- **Highlighted Guided Help features** in the text to provide students with narrated, animated, step-by-step **videos** on select topics in the Self-Study Quizzes in each chapter.
- ***New*** and Expanded **McGraw-Hill Connect®** content includes new **General Ledger Problems** that auto-post from journal entries to T-accounts to trial balances, **Excel Simulations,** and new **Concept Overview Videos**.
- **Reviewed, updated, and introduced new end-of-chapter material** in each chapter to support new topics and learning objectives.
- **MBA Companion,** available in Create, has been updated to incorporate the new leasing standard and tax law.

Chapter 1 Financial Statements and Business Decisions

Focus Company: Le-Nature's Inc.

- Chapter 1 is written around a recent accounting fraud that is exciting, yet simple. Students are introduced to the structure, content, and use of the four basic financial statements through the story of two brothers who founded **Le-Nature's Inc.,** a natural beverage company. Le-Nature's financial statements are used to support increases in borrowing for expansion. When actual sales do not live up to expectations, the brothers turn to financial statement fraud to cover up their failure, which emphasizes the importance of controls, responsible ethical conduct, and accurate financial reporting.
- **GUIDED HELP** feature provides all users of the text access to step-by-step video instruction on preparing a simple balance sheet, income statement, and statement of stockholders' equity for **LaCrosse Footwear**, a leading outdoor footwear company.
- More algorithmic exercises included in Connect®.
- ***New* CONTINUING PROBLEM** added to the end-of-chapter problems based on the activities of Penny's Pool Service & Supply and its supplier, **Pool Corporation**. These companies provide a consistent context for summarizing the key points emphasized in each chapter. In Chapter 1, students prepare a basic income statement, statement of stockholders' equity, and balance sheet based on Penny's estimates for the first year.
- Revised Annual Report Cases can be graded through Connect.
- New and updated real companies in end-of-chapter exercises, problems, and cases.

Chapter 2 Investing and Financing Decisions and the Accounting System

Focus Company: Chipotle Mexican Grill

- Chapter 2 introduces the accounting cycle for **Chipotle Mexican Grill,** a relatively simple company facing mounting competition. The chapter integrates typical financial information for investing and financing activities for the first quarter, resulting in a quarterly balance sheet (with a few simplifications). This fast-casual restaurant does not utilize franchising, thus reducing the complexities found with most other competitors and allowing focused emphasis on transaction analysis, journal entries, T-accounts, and the structure of the balance sheet.
- **Simplified illustration numbers** (now dollars in millions).

- Modified the **format of journal entries** to be consistent with what students will see in Connect.
- Added **DATA ANALYTICS** feature that introduces students to the concept, how Chipotle Mexican Grill utilizes data analytics in decision making, and provides information on what a data-driven focus means to future employment opportunities.
- Focus and contrast company data updated.
- Highlighted **GUIDED HELP** features provide access to step-by-step video instruction applying transaction analysis to identify accounts and effects on the accounting equation and another Guided Help for recording, posting, and classifying accounts for financing and investing activities.
- ***New*** **General Ledger Problem** designations for a few exercises and problems that also may be completed manually.
- ***New*** **General Ledger Problem** designation for the **CONTINUING PROBLEM** in the end-of-chapter problems based on the activities of Penny's Pool Service & Supply and its supplier, **Pool Corporation**. In Chapter 2, students prepare journal entries, post to T-accounts, prepare a trial balance and classified balance sheet, identify investing and financing activities affecting cash flows, and compute and interpret the current ratio based on the balance sheet for Penny's Pool Service & Supply.
- ***New and updated real company information*** in end-of-chapter exercises, problems, and cases.
- Revised Annual Report Cases that can be graded through Connect.

Chapter 3 Operating Decisions and the Accounting System

Focus Company: Chipotle Mexican Grill

- Chapter 3 builds on Chapter 2 by explaining and illustrating transaction analysis for operating activities for the first quarter for **Chipotle Mexican Grill.** Using journal entry and T-account tools learned in Chapter 2, students apply their expanded knowledge of accounting concepts and transaction analysis to prepare journal entries and T-accounts for typical transactions involving revenues and expenses, and the structure of the income statement.
- **Simplified illustration numbers** (now dollars in millions).
- Added **DATA ANALYTICS** feature on examples of use of Big Data in the restaurant industry.
- Added **FINANCIAL ANALYSIS** feature on the 2017 **corporate tax rate changes** and the resulting activities of a few corporations including Chipotle Mexican Grill.
- Focus and contrast company data updated.
- Enhanced concepts based on the FASB's Accounting Standards update for **revenue recognition.**
- Highlighted **GUIDED HELP** feature provides access to step-by-step video instruction applying transaction analysis to identify accounts and effects on the accounting equation, as well as for identifying revenue and expense account titles and amounts for a given period.
- ***New*** **General Ledger Problem** designations for a few exercises and problems that also may be completed manually.
- **CONTINUING PROBLEM** in end-of-chapter problems based on the activities of Penny's Pool Service & Supply and its supplier, **Pool Corporation**. In Chapter 3, students prepare journal entries, create a classified income statement, and calculate and analyze the net profit margin for Penny's Pool Service & Supply.
- ***New*** **COMPREHENSIVE PROBLEM** covering Chapters 1, 2, and 3 that can be completed manually or as a **General Ledger Problem.**
- ***New and updated real company information*** in end-of-chapter exercises, problems, and cases.
- Revised Annual Report Cases that can be graded through Connect.

Chapter 4 Adjustments, Financial Statements, and the Quality of Earnings

Focus Company: Chipotle Mexican Grill

- Chapter 4 builds on Chapters 2 and 3 by explaining and illustrating end-of-period adjustments, financial statements, and closing the records for the first quarter for **Chipotle Mexican Grill.**
- Focus and contrast company data updated.
- Added a **DATA ANALYTICS** feature on the use of data analytics by the Securities and Exchange Commission's Fraud Group, which concentrates on detecting fraud and prosecuting corporations and individuals for violations involving false or misleading financial statements and disclosures.
- Highlighted **GUIDED HELP** feature provides access to step-by-step video instruction on recording adjusting entries, as well as a Guided Help on recording a closing entry.
- ***New*** **General Ledger Problem** designations for a few exercises and problems that also may be completed manually.
- **CONTINUING PROBLEM** in end-of-chapter problems based on the activities of Penny's Pool Service & Supply and its supplier, **Pool Corporation**. In Chapter 4, students prepare adjusting journal entries for Penny's Pool Service & Supply.
- **Two COMPREHENSIVE PROBLEMS** covering the accounting cycle (Chapters 1 through 4) that can be completed manually or as a **General Ledger Problem.**
- ***New and updated real company information*** in end-of-chapter exercises, problems, and cases.
- Revised Annual Report Cases that can be graded through Connect.

Chapter 5 Communicating and Interpreting Accounting Information

Focus Company: Apple Inc.

- Chapter 5 has been rewritten around the most recent financial statements and corporate governance and disclosure processes of **Apple Inc.,** students' favorite technology company.
- Focus and contrast company data updated.
- Focus of the chapter has been narrowed to three topics: details of the corporate governance and disclosure process; financial statement formats and important subtotals, totals, and additional disclosures; and the analysis of financial statements through gross profit, net profit, total asset turnover, and return on assets analysis.
- Updated coverage of the changing world of web-based information services used by analysts.
- Section on the effects of transactions on key ratios ties the chapter to material in Chapters 2, 3, and 4.
- ***New*** **DATA ANALYTICS** feature that introduces students to how data analytics are changing the nature of auditing.
- Highlighted **GUIDED HELP** feature provides access to step-by-step video instruction on preparing a detailed classified income statement and balance sheet from a trial balance for **Amazon. com**, the world's largest online retailer.
- More algorithmic exercises included in Connect.
- Two **CONTINUING PROBLEMS** in end-of-chapter problems. The first asks students to evaluate the effects of key transactions on important statement subtotals and

financial ratios for Penny's Pool Service & Supply. The second introduces Penny's supplier, **Pool Corporation**, a public company, and asks students to prepare a detailed classified income statement and balance sheet and compute the gross profit percentage and return on assets ratios.

- Revised Annual Report Cases can be graded through Connect.
- ***New and updated real company information*** in the demonstration case, end-of-chapter exercises, problems, and cases.

Chapter 6 Reporting and Interpreting Sales, Revenue, Receivables, and Cash

Focus Company: Skechers U.S.A.

- ***New Focus Company:*** The chapter material is rewritten around the financial statements of **Skechers U.S.A.,** a fast-growing leader in the casual and athletic footwear market.
- Content narrowed to three related topics: revenue recognition and determinants of net sales, receivables valuation, and control of cash.
- ***New*** coverage of five-step revenue recognition process for bundled sales added at a level appropriate for the introductory student.
- Coverage of electronic banking increased.
- Two **GUIDED HELP** features provide access to step-by-step video instruction on (1) preparing entries related to bad debts and determining their financial statement effects and (2) using aging to estimate bad debt expense.
- More algorithmic exercises included in Connect.
- **CONTINUING PROBLEM** asks students to make summary entries for bad debts and compute the amount to be reported as net sales for **Pool Corporation**, a public company.
- Revised Annual Report Cases can be graded through Connect.
- ***New and updated real company information*** in end-of-chapter exercises, problems, and cases.

Chapter 7 Reporting and Interpreting Cost of Goods Sold and Inventory

Focus Company: Harley-Davidson, Inc.

- Focus and contrast company data updated.
- ***New*** FASB's Accounting Standards update for applying lower of cost or net realizable value to inventories covered at an appropriate level for the introductory course.
- Two **GUIDED HELP** features provide access to step-by-step video instruction on (1) computation of goods available for sale and cost of goods sold and (2) computing cost of goods sold and ending inventory under FIFO and LIFO costing methods.
- ***New*** **COMPREHENSIVE PROBLEM** added that covers key revenue recognition, receivables, and inventory learning objectives from Chapters 6 and 7.
- More algorithmic exercises included in Connect.
- **CONTINUING PROBLEM** included in end-of-chapter problems. Students are asked to compute the effects of the LIFO/FIFO choice for inventory items with increasing and decreasing costs for **Pool Corporation**, a public company.
- Revised Annual Report Cases can be graded through Connect.
- ***New and updated real company information*** in end-of-chapter exercises, problems, and cases.

Chapter 8 Reporting and Interpreting Property, Plant, and Equipment; Intangibles; and Natural Resources

Focus Company: Southwest Airlines

- Chapter 8 illustrates the acquisition, use, repair and improvement, and disposal of property, plant, and equipment, followed by an illustration of accounting and reporting for intangible assets and natural resources at several companies including **Amazon.com** (goodwill from purchase of Whole Foods Market), **Cisco Systems** (goodwill), **IBM** (technology), **Gilead Sciences** (research and development), **Yum! Brands** and **Papa John's International** (franchises), and **International Paper** (natural resources), among others.
- Enhanced discussion of accounting for **technology.**
- Focus and contrast company data updated.
- ***New*** **General Ledger Problem** designations for a few exercises and problems that also may be completed manually.
- Highlighted **GUIDED HELP** features provide access to step-by-step video instruction on determining cost and creating depreciation schedules under straight-line, units-of-production, and declining-balance methods, as well as a Guided Help on recording a disposal of an asset.
- **CONTINUING PROBLEM** in end-of-chapter problems. Based on the activities of **Pool Corporation**, students are asked to determine cost; create depreciation schedules under straight-line, units-of-production, and declining-balance methods; and dispose of an asset.
- New **COMPREHENSIVE PROBLEMS** covering sales and receivables, inventory, and productive assets (Chapters 6 through 8), with one that can be completed manually or as a **General Ledger Problem.**
- ***New and updated real company information*** in end-of-chapter exercises, problems, and cases.
- Revised Annual Report Case that can be graded through Connect.

Chapter 9 Reporting and Interpreting Liabilities

Focus Company: Starbucks

- Focus company data updated. New contrast companies added.
- Incorporated easy-to-follow discussion of the **new leasing standard.**
- Updated descriptions of how to calculate present values using tables, three different financial calculators, and Excel.
- **GUIDED HELP** features teach students the steps required to compute present values using three popular calculator models (TI BAII+, HP 10BII+, and HP 12C) and Excel.
- **Supplement A** compliments the Guided Help tutorials with vivid graphics displaying the steps required to compute present values using all three calculator models (TI BAII+, HP 10BII+, and HP 12C) and Excel.
- **CONTINUING PROBLEM** asks students to record transactions that affect the liabilities section of the balance sheet for **Pool Corporation**, a public company.
- Updated Annual Report Case that can be graded through Connect.
- Updated end-of-chapter exercises, problems, and cases.

Chapter 10 Reporting and Interpreting Bond Securities

Focus Company: Amazon

- Focus company data updated.
- Updated graphics that visually help students understand the timing of bond payments and the accounting for bonds.

- **FINANCIAL ANALYSIS** feature describes bond ratings and bond rating agencies.
- Revised structure allows instructors to seamlessly assign accounting for bonds with or without the use of discount and premium accounts.
- Updated **GUIDED HELP** tutorials walk students through (1) how to calculate the present value of a bond issued at a premium and (2) how to account for the bond over its life.
- Simplified discussion of how the issuance of bonds affects the statement of cash flows.
- **CONTINUING PROBLEM** at end of chapter asks students to record bond transactions for **Pool Corporation**, a public company.
- Updated Annual Report Case that can be graded through Connect.
- Updated end-of-chapter exercises, problems, and cases.

Chapter 11 Reporting and Interpreting Stockholders' Equity

Focus Company: International Business Machines (IBM)

- ***New Focus Company:*** The chapter material is rewritten around the financial statements of **IBM,** a company that focuses on data analytics, artificial intelligence, and quantum computing.
- ***New*** contrast companies: **Microsoft Corporation** and **Intel Corporation**.
- ***New*** learning objective focused on the Statement of Stockholders' Equity.
- **FINANCIAL ANALYSIS** feature on preferred stock.
- **CONTINUING PROBLEM** at end of chapter that asks students to record transactions that affect the equity section of the balance sheet for **Pool Corporation**, a public company.
- Updated Annual Report Case that can be graded through Connect.
- Updated end-of-chapter exercises, problems, and cases.

Chapter 12 Statement of Cash Flows

Focus Company: National Beverage Corporation

- **Chapter can be used any time after Chapter 4.**
- Focus company information updated and new contrast companies are included to reflect changes in the beverage industry.
- Two **GUIDED HELP** features provide access to step-by-step video instruction on (1) preparing the operating section of the statement of cash flows using the indirect method and (2) preparing the investing and financing sections of the statement of cash flows.
- **Supplement C** and related problem material illustrate preparation of the complete statement of cash flows using the T-account approach.
- More algorithmic exercises included in Connect.
- **CONTINUING PROBLEM** included in end-of-chapter problems that asks students to prepare a complete statement of cash flows for **Pool Corporation**, a public company.
- Updated Annual Report Case that can be graded through Connect.
- ***New and updated real company information*** in end-of-chapter exercises, problems, and cases.

Chapter 13 Analyzing Financial Statements

Focus Company: The Home Depot

- Focus company data updated.
- ***New*** analyst reports highlighting professional analysts' assessment of The Home Depot.
- ***New*** **DATA ANALYTICS** feature that introduces students to graphical analysis of a company's profitability ratios.
- ***New*** discussion of ROA profit driver analysis.
- Ratio formulas in chapter updated to be consistent with formulas provided in previous chapters.
- **CONTINUING PROBLEM** at end of chapter asks students to download the latest financial statements for **Pool Corporation**, a public company, and compute various ratios discussed in the chapter.
- Updated Annual Report Case that can be graded through Connect.
- Updated end-of-chapter exercises, problems, and cases.

Appendix A Reporting and Interpreting Investments in Other Corporations

Focus Company: The Walt Disney Company

- ***New focus company,*** **The Walt Disney Company,** a recognizable global company that builds and expands its brands through investing in other companies. Accounting and reporting are discussed and illustrated for (1) debt securities held to maturity, actively traded, and available for sale; (2) passive equity investments; (3) investments involving significant influence; and (4) investments in controlling interests.
- Focus and contrast company data updated.
- **GUIDED HELP** feature provides access to step-by-step video instruction on accounting for and reporting available-for-sale securities as investments at fair value.
- **CONTINUING PROBLEM** in end-of-chapter problems. Using the activities of the **Pool Corporation**, a public company, students are asked to record passive investments as trading securities and as available-for-sale securities over a three-year period.
- ***New and updated real company information*** in end-of-chapter exercises, problems, and cases.
- End-of-chapter material substantially updated to match the revised content of the chapter for passive investments.
- Revised Annual Report Cases that can be graded through Connect.

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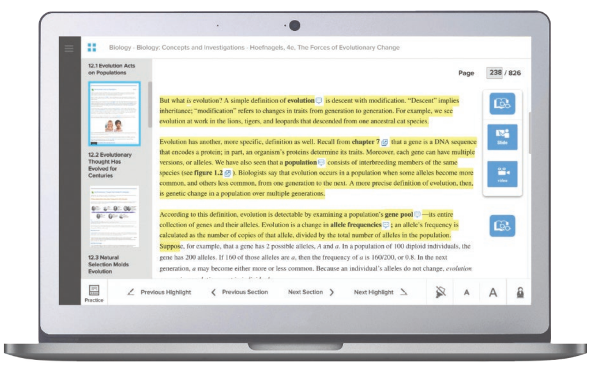

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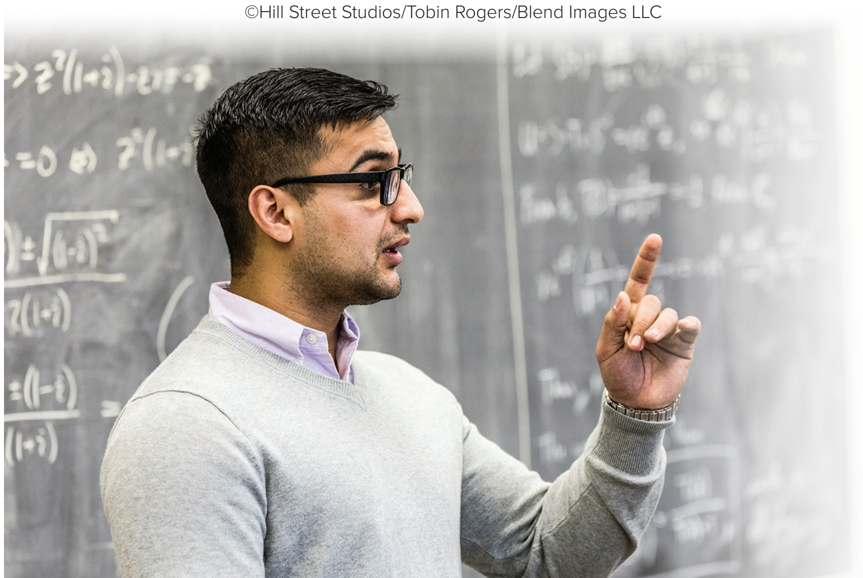

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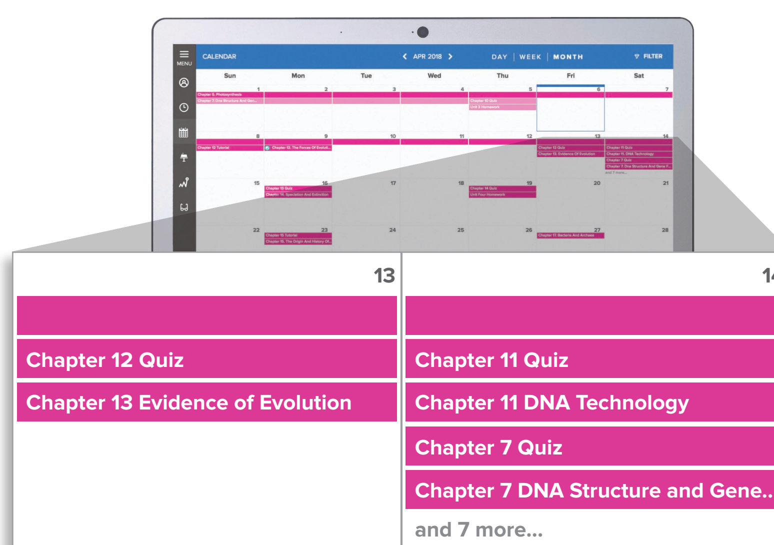

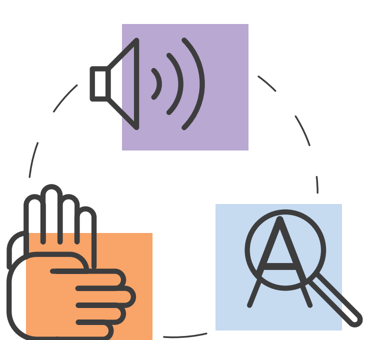

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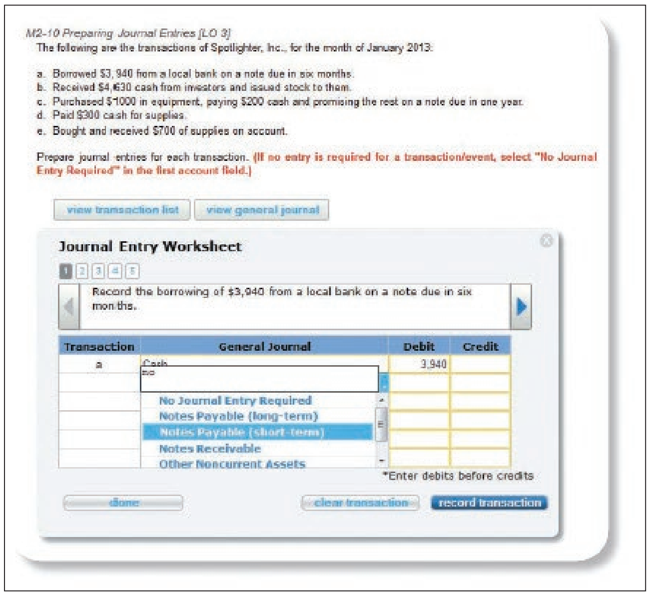

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- Cases and Projects
- General Ledger Problems

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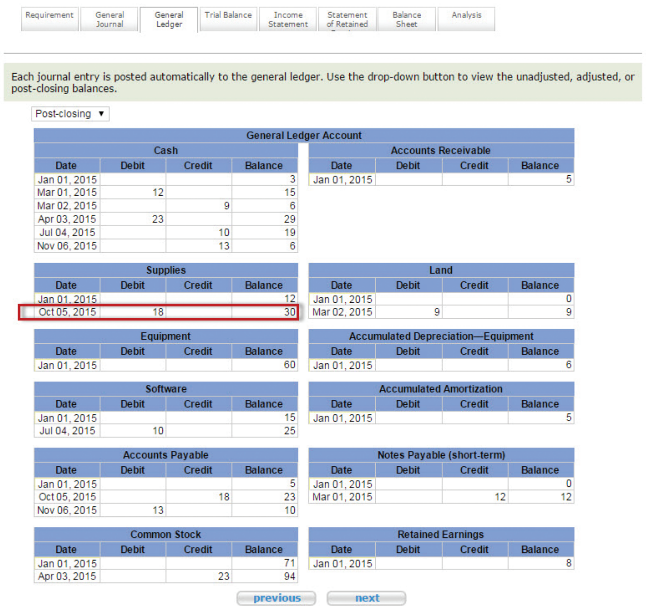

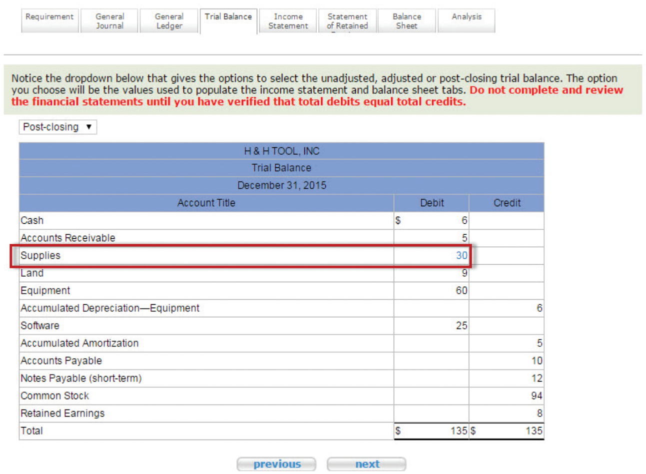

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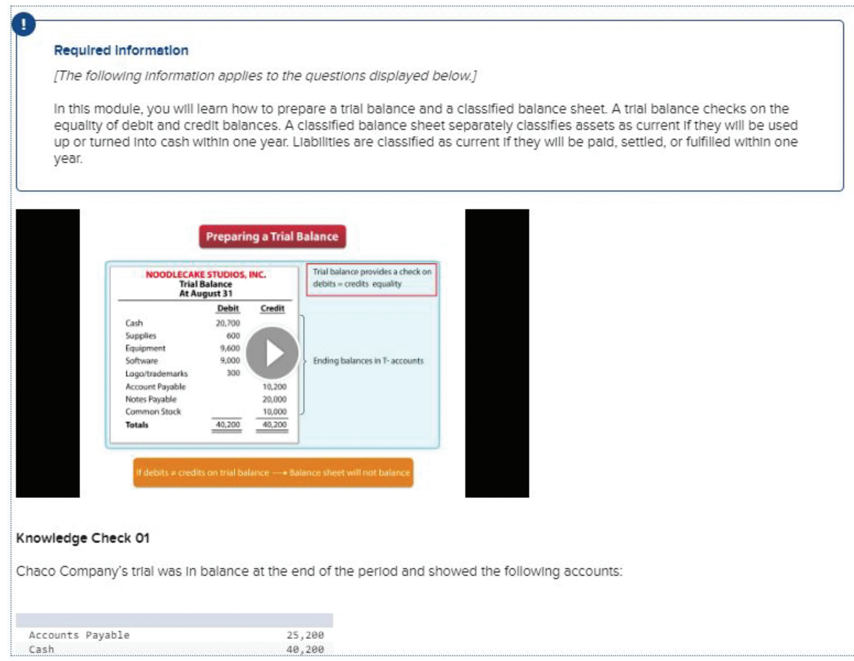
The **Concept Overview Videos** provide engaging narratives of all chapter learning objectives in an assignable and interactive online format. They follow the structure of the text and are organized to match the specific learning objectives within each chapter of *Financial Accounting*. These short presentations provide additional explanation and enhancement of material from the text chapter, allowing students to learn, study, and practice with instant feedback, at their own pace.



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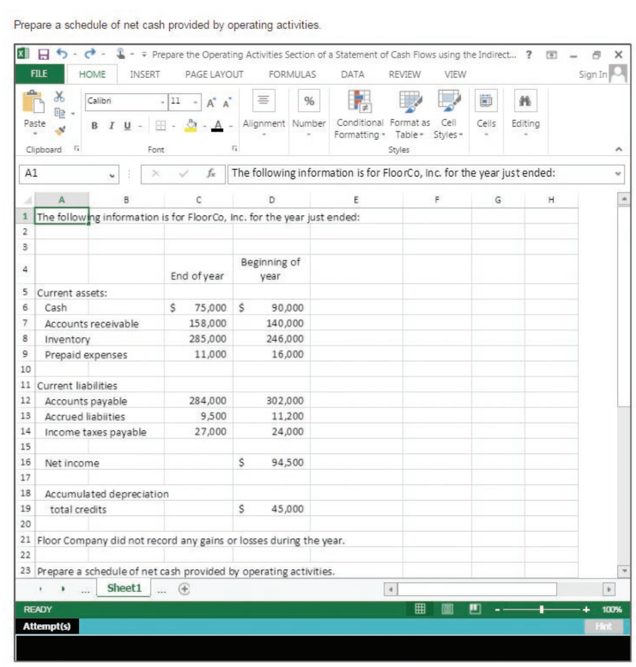

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>
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ACKNOWLEDGMENTS

Many dedicated instructors have devoted their time and effort to help us make each edition better. We would like to acknowledge and thank all of our colleagues who have helped guide our development decisions for this and previous editions. This text would not be the success it is without the help of all of you.

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MBA Companion *(Available in McGraw-Hill Education's Create)*

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Under Armour

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Income Taxes Overview
Pensions and Other Postretirement Benefits Overview

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FINANCIAL ACCOUNTING

3 Operating Decisions and the Accounting System

Chipotle Mexican Grill's brand continues to evolve. Its recent annual report states it has re-envisioned its purpose to "cultivate nourished communities where wholesome food is enjoyed every day," a philosophy that guides its operating decisions. "Wholesome food" entails finding, preparing, cooking, and serving high-quality and nutritious food made from natural ingredients and animals that are grown or raised with care and respect for the environment. The company keeps operations simple, offering a few menu items (burritos, burrito bowls, tacos, and salads). Within these items, customers can choose from meats, tofu, beans, rice, and a variety of additional items such as salsa, guacamole, cheese, lettuce, and queso—creating hundreds of options. The focused menu allows Chipotle to concentrate on the source of the food items, a challenging activity given the smaller and often costlier market for organic meats, produce, and dairy products. Anticipating changes in these food costs and sources is critical to determining menu prices and controlling costs.

To control quality and increase efficiency, the company purchases key ingredients such as meat, beans, rice, cheese, and tortillas from a small number of suppliers and other raw materials from approved sources. Twenty-four independently owned and operated regional distribution centers purchase from these suppliers and then deliver the items as needed to the Chipotle restaurants in each region.

The second highest cost for Chipotle, as with most restaurants, is hiring and developing employees. The food is prepared from scratch on stoves and grills, not with microwaves and other automated cooking techniques. Each employee is cross-trained in all aspects of preparing the food—from grilling, to making fresh salsa, to cooking rice—and creating a positive interactive experience for customers. The company has a strong culture of

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

3-1 Describe a typical business operating cycle and explain the necessity for the time period assumption.

3-2 Explain how business activities affect the elements of the income statement.

3-3 Explain the accrual basis of accounting and apply the revenue and expense recognition principles to measure income.

3-4 Apply transaction analysis to examine and record the effects of operating activities on the financial statements.

3-5 Prepare a classified income statement.

3-6 Compute and interpret the net profit margin ratio.

3-7 Identify operating transactions and demonstrate how they affect cash flows.

FOCUS COMPANY

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Chipotle Mexican Grill

IT'S MORE THAN MEAT, GUACAMOLE, AND TORTILLAS

www.chipotle.com

employee professional and personal development with numerous incentives to build strong leadership. In the past, a significant number of salaried and hourly management members were promoted from within the company. However, under the leadership of CEO Brian Niccol who was hired in March 2018 to turn around Chipotle's business after two years of weak performance, the company is now hiring new field managers from outside the company.

Chipotle also competes using marketing strategies. In the past, Chipotle spent less on expensive national advertising campaigns than larger restaurant chains and much more on strategic promotional activities to make connections with neighborhoods and explain how Chipotle is different. Most activities are innovative, such as the award-winning, two-minute animated video "Back to the Start" that aired during the 2012 Grammy Awards; the Cultivate Chicago festival featuring indie bands, artisanal food, wine producers, and high-profile chefs; and the Chipotle Truck, which travels to various locations, including new store openings, and sells almost a full menu of Chipotle items from the food trailer. In 2018, Chipotle plans to utilize more aggressive marketing efforts, including "addressable TV" ads (targeting selective segments of on-demand or live TV shows), digital marketing, online ordering, and a loyalty program.

UNDERSTANDING THE BUSINESS

Over **Chipotle**'s history since 1993, the restaurant industry has become extremely competitive with many established as well as new concept restaurants adopting service and sourcing formats similar to Chipotle's. For example, in February 2012, **McDonald's Corporation** announced a requirement that suppliers need to phase out stalls that restrict the movement of pregnant pigs, a change made in direct response to Chipotle's TV video on its ethical stance aired at the Grammy Awards. **Taco Bell** announced in

2012 the creation of a Cantina Bell™ menu featuring "gourmet" food items such as the Cantina Burrito and Cantina Bowl. **Jack in the Box, Inc.**, expanded its **Qdoba Mexican Grill** chain to compete in the fast-casual segment of the industry that is dominated by Mexican restaurants. The newer concepts feature Mediterranean, Indian, farm-to-table, fish-to-table, and vegetarian cuisine, with many more popping up every day that focus on selective food sourcing, food prepared on-site, and a service model that allows customers to choose exactly what they eat. For example, the fast-growing, fast-casual concepts include **City Barbecue** offering smoked in-house meats and sides, **Bobby's Burger Palace** by chef Bobby Flay, and **Dat Dog** hot dog joint out of New Orleans.

Restaurants have to manage economic downturns and shifts in consumer tastes for healthier food choices while facing the competition. Recent trends in mobile technology apps for ordering, customer payment, and loyalty program management; equipment improvements, such as 1,000-degree ovens for baking two-minute pizzas; and the tremendous expansion of fast-casual restaurant concepts provide challenges. Based on their projections of these forces, companies set goals for their performance. Published income statements provide the primary basis for comparing projections to the actual results of operations. To understand how business plans and the results of operations are reflected on the income statement, we need to answer the following questions:

1. How do business activities affect the income statement?
2. How are business activities measured?
3. How are business activities reported on the income statement?

In this chapter, we focus on Chipotle's operating activities that involve the sale of food to the public. The results of these activities are reported on the income statement.

ORGANIZATION OF THE CHAPTER

How Do Business Activities Affect the Income Statement?
- The Operating Cycle
- Elements of the Income Statement

How Are Operating Activities Recognized and Measured?
- Accrual Accounting
  - Revenue Recognition Principle
  - Expense Recognition Principle

The Expanded Transaction Analysis Model
- Transaction Analysis Rules
- Analyzing Chipotle's Transactions

How Is the Income Statement Prepared and Analyzed?
- Classified Income Statement
- Net Profit Margin Ratio
- Focus on Cash Flows

LEARNING OBJECTIVE 3-1

Describe a typical business operating cycle and explain the necessity for the time period assumption.

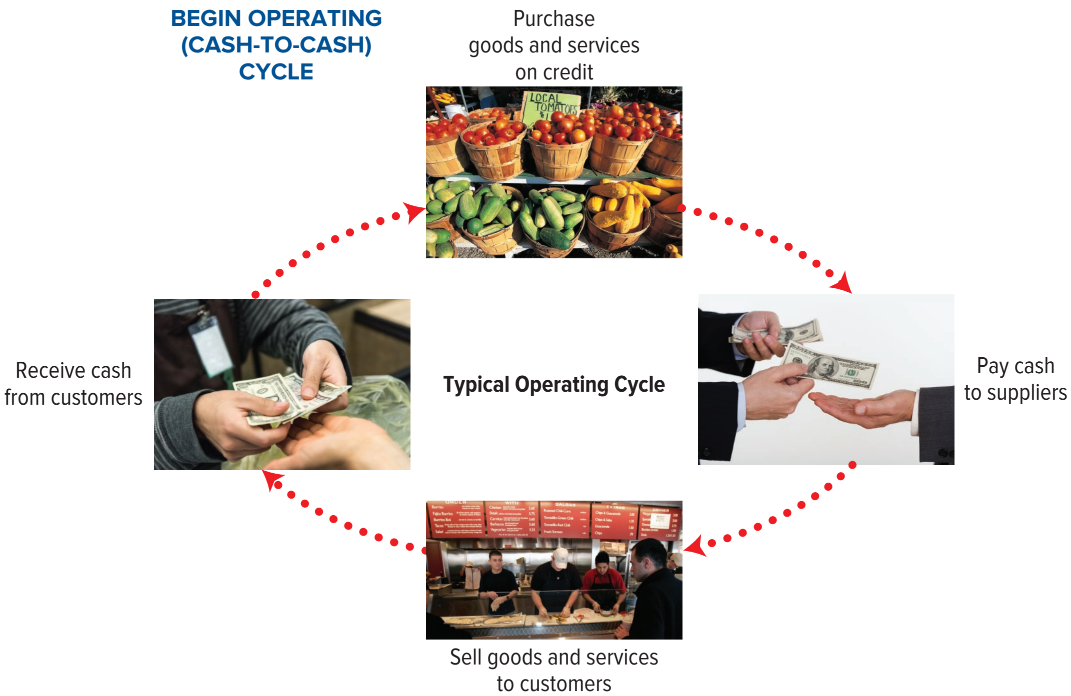
HOW DO BUSINESS ACTIVITIES AFFECT THE INCOME STATEMENT?

The Operating Cycle

The long-term objective for any business is to **turn cash into more cash.** If a company is to stay in business, this excess cash must be generated from operations (that is, from the activities for which the business was established), not from borrowing money or selling long-lived assets.

Companies (1) acquire inventory and the services of employees and (2) sell inventory or services to customers. The **operating (cash-to-cash) cycle** begins when a company receives goods to sell, pays for them, and sells to customers (or, in the case of a service company, has employees work to provide services to customers); it ends when customers pay cash to the company. The length of time for completion of the operating cycle depends on the nature of the business.

OPERATING (CASH-TO-CASH) CYCLE
The time it takes for a company to pay cash to suppliers, sell goods and services to customers, and collect cash from customers.



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The operating cycle for **Chipotle** is relatively short. It spends cash to purchase fresh ingredients, prepares the food, and sells it to customers for cash. In some companies, inventory is paid for well before it is sold. **Amazon.com**, for example, builds its inventory for months preceding the year-end holiday season. It may borrow funds from banks to pay for the inventory and then repays the loans with interest when it receives cash from customers. In other companies, cash is received from customers well after a sale takes place. For example, furniture retailers such as **Ethan Allen** often allow customers to make monthly payments over several years. Shortening the operating cycle by creating incentives that encourage customers to buy sooner and/or pay faster improves a company's cash flows.

Until a company ceases its activities, the operating cycle is repeated continuously. However, decision makers require information periodically about the company's financial condition and performance. As indicated in the conceptual framework in Exhibit 2.1, to measure income for a specific period of time, accountants follow the **time period assumption**, which assumes that the long life of a company can be reported in shorter time periods, such as months, quarters, and years.[1] Two types of issues arise in reporting periodic income to users:

TIME PERIOD ASSUMPTION
The long life of a company can be reported in shorter time periods, such as months, quarters, and years.

1. Recognition issues: **When** should the effects of operating activities be recognized (recorded)?
2. Measurement issues: **What amounts** should be recognized?

Before we examine the rules accountants follow in resolving these issues, however, let's examine the elements of the income statement that are affected by operating activities.

[1]In addition to the audited annual statements, most businesses prepare quarterly financial statements (also known as **interim reports** covering a three-month period) for external users. The Securities and Exchange Commission requires public companies to do so.

EXHIBIT 3.1

Chipotle Mexican Grill's Income Statement

CHIPOTLE MEXICAN GRILL, INC.
Consolidated Statement of Income*
For the Year ended December 31, 2017
(in millions of dollars, except per share data)

Operating activities (central focus of business)	Restaurant sales revenue	$4,477	
	Restaurant operating expenses:		
	Supplies expense	1,536	
	Wages expense	1,206	*Includes salaries expense*
	Rent expense	327	
	Insurance expense	143	
	Utilities expense	85	
	Repairs expense	51	
	Other operating expenses	373	
	General and administrative expenses:		
	Training expense	263	*Includes pre-opening costs*
	Advertising expense	46	
	Depreciation expense	163	
	Loss on disposal of assets	13	
	Total operating expenses	4,206	
	Income from operations	271	
Peripheral activities (not central focus of business)	Other items:		
	Interest revenue	6	
	Interest expense	(1)	
	Income before income taxes	276	
	Income tax expense	100	*Also called Provision for Income Taxes*
	Net income	$ 176	
	Earnings per share	$6.19	*= $176 million Net Income ÷ about 28.4 million weighted average number of common stock shares outstanding (per 2017 annual report)*

*The information has been adapted from actual statements and simplified for this chapter.

Source: Chipotle Mexican Grill, Inc.

LEARNING OBJECTIVE 3-2

Explain how business activities affect the elements of the income statement.

Elements of the Income Statement

Exhibit 3.1 shows a recent income statement for **Chipotle**, simplified for the purposes of this chapter. It has multiple subtotals, such as **operating income** and **income before income taxes.** This format is known as **multiple step** and is very common.[2] In fact, you can tell if a company uses the multiple-step format if you see the Operating Income subtotal (also called Income from Operations). As we discuss the elements of the income statement, also refer to the conceptual framework outlined in Exhibit 2.1.

Operating Revenues

REVENUES
Increases in assets or settlements of liabilities from the major or central ongoing operations of the business.

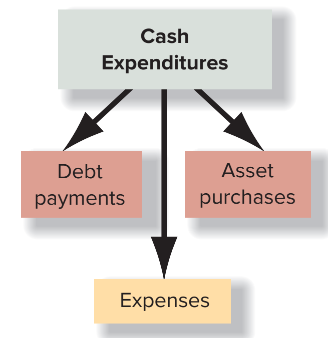
Revenues are defined as increases in assets or settlements of liabilities from the major or **central ongoing operations** of the business. Operating revenues result from the sale of goods or the rendering of services as the central focus of the business. When Chipotle sells burritos to consumers, it has **earned** revenue. When revenue is earned, assets, usually Cash or Accounts Receivable, often increase. Sometimes if a customer pays for goods or services in advance, often with a gift card, a liability account, usually Unearned (or Deferred) Revenue, is created. At this point, no revenue has been earned. There is simply a receipt of cash in exchange for a promise to provide a good or service in the future. When the company provides the promised goods or services to the customer, then the revenue is recognized and the liability is eliminated.

[2]Another common format, **single step,** reorganizes all accounts from the multiple-step format. All revenues and gains are listed together and all expenses and losses except taxes are listed together. The expense subtotal is then subtracted from the revenue subtotal to arrive at income before income taxes, the same subtotal as on the multiple-step statement.

Many companies generate revenues from a variety of sources. For example, **General Motors** reports revenues from its automotive sales as well as from providing financing to customers. In the restaurant industry, many companies, such as **McDonald's Corporation**, have company-owned stores but also sell franchise rights. The franchisor (seller) reports revenues from both the sales of food in company-owned stores and the fees from franchisees. Chipotle does not sell franchises. Therefore, the company generates revenue from one source—sales of food orders to customers—that is reported in the **Restaurant Sales Revenue** account.

Operating Expenses

Some students confuse the terms **expenditures** and **expenses.** An expenditure is any outflow of cash for any purpose, whether to buy equipment, pay off a bank loan, or pay employees their wages. **Expenses** are outflows or the using up of assets or increases in liabilities from **ongoing operations** incurred to generate revenues during the period. Therefore, **not all cash expenditures (outflows) are expenses, but expenses are necessary to generate revenues.**



Chipotle's employees make and serve food. The company uses electricity to operate equipment and light its facilities, and it uses food and paper supplies. Without incurring these expenses, Chipotle could not generate revenues. Expenses may be incurred before, after, or at the same time as cash is paid. When an expense is incurred, assets such as Supplies decrease (are used up) **or** liabilities such as Wages Payable or Utilities Payable increase. The following are Chipotle's primary operating expenses:

EXPENSES
Decreases in assets or increases in liabilities from ongoing operations incurred to generate revenues during the period.

Restaurant Operating Expenses:

- **Supplies Expense.** In Chipotle's restaurant operations, any food ingredients or beverage and packaging supplies that are used to produce and sell meals are expensed as they are used. For Chipotle, this is its largest expense at $1,536 million in 2017. In companies with a manufacturing or merchandising focus, the most significant expense is usually Cost of Goods Sold (or Cost of Sales), representing the cost of inventory used in generating sales.
- **Wages Expense.** When salaried and hourly employees work and generate sales for Chipotle, the company incurs an expense, although wages and salaries will be paid later. Wages Expense of $1,206 million is Chipotle's second largest expense. In purely service-oriented companies in which no products are produced or sold, the cost of having employees generate revenues is usually the largest expense. For example, **Federal Express** reported over $21,542 million in salaries expense for the year ended May 31, 2017.
- **Rent Expense, Insurance Expense, Utilities Expense, and Repairs Expense.** Renting facilities, insuring property and equipment at the stores, using utilities, and repairing and maintaining facilities and equipment are typical expenses related to operating stores. Usually, rent and insurance are paid before occupying the facilities, but utilities and repairs are paid after occupying the facilities.
- **Other Operating Expenses.** These expenses include a wide variety of accounts with smaller dollar balances.

General and Administrative Expenses: General and Administrative Expenses include costs of training employees and managers, advertising, and other expenses not directly related to operating stores. These often include expenses such as renting headquarters facilities and paying executive salaries.

Depreciation Expense: When a company uses buildings and equipment to generate revenues, a part of the cost of these assets is reported as an expense called Depreciation Expense. Chapter 8 discusses methods for estimating the amount of depreciation expense.

Losses (Gains) on Disposal of Assets: Companies sell property, plant, and equipment from time to time to maintain modern facilities. When assets other than investments are sold or disposed of for more than their undepreciated cost, **gains** result. If they are sold or disposed of for less than the undepreciated cost, **losses** result. In 2017, Chipotle reported a loss on disposal of assets of $13 million. Note that selling short- or long-term investments above or below cost also results in gains or losses, but these are not reported in the Operating Expenses section of the multiple-step income statement. Instead, they are reported in Other Items, as discussed in the next section.

GAINS
Result primarily from disposing of noncurrent assets and investments for more than the reported book value.

LOSSES
Result primarily from disposing of noncurrent assets and investments for less than the reported book value cost.

OPERATING INCOME (INCOME FROM OPERATIONS)
Net sales (operating revenues) less operating expenses (including cost of goods sold).

Operating revenues less operating expenses equals **Operating Income** (also called Income from Operations)—a measure of the profit from central ongoing operations.

Other Items

Not all activities affecting an income statement are central to ongoing operations. Any revenues, expenses, gains, or losses that result from these other activities are not included as part of operating income but are instead categorized as Other Items. Typically, these include the following:

- **Interest Revenue** (also **Investment Revenue, Investment Income,** or **Dividend Revenue**). Using excess cash to purchase stocks or bonds in other companies is an investing activity for Chipotle, not the central operation of making and selling fresh Mexican food. Therefore, any interest or dividends earned on investments in other companies is not included as operating revenue.
- **Interest Expense.** Likewise, because borrowing money is a financing activity, any cost of using that money (called interest) is not an operating expense. Except for financial institutions, incurring interest expense and earning interest revenue are **not** the central operations of most businesses, including Chipotle. We say these are peripheral (normal but not central) transactions.
- **Losses (Gains) on Sale of Investments.** When investments are sold for less (or more) than the original cost, a loss (or gain) results and is reported as an Other Item on the income statement. In 2017, Chipotle did not report any gain or loss from selling investments.

Income Tax Expense

Adding (subtracting) other items to (from) operating income gives the subtotal of **Income before Income Taxes** (or Pretax Income). Income Tax Expense (also called **Provision for Income Taxes**) is the last expense listed on the income statement before determining net income. All profit-making corporations are required to compute income taxes owed to federal, state, and foreign governments. Income tax expense is calculated as a percentage of pretax income determined by applying the tax rates of the federal, state, local, and foreign taxing authorities. Chipotle's effective tax rate in 2017 was 36.2 percent ($100 million in income tax expense divided by $276 million in income before income taxes). This indicates that, for every dollar of income before taxes that Chipotle made in 2017, the company paid nearly $0.36 to taxing authorities.

FINANCIAL ANALYSIS

Lower Federal Tax Rates and Corporate Impact

For businesses with tax years beginning after December 31, 2017, the U.S. corporate tax rate was reduced from 35 percent to 21 percent as part of the Tax Cuts and Jobs Act passed by Congress on December 22, 2017. Many corporations, including **Chipotle**, recognized a tax benefit in 2017 from applying the lower federal rate to amounts expected to be paid in the future (that is, it lowered deferred tax liabilities). At the same time, Chipotle, as well as others such as **Walmart**, **Starbucks**, and **Disney**, announced one-time cash and stock bonuses of up to $1,000 for qualified hourly and salaried restaurant workers and additional paid parental leave coverage for a broad range of workers.

Earnings per Share

Corporations are required to disclose earnings per share on the income statement or in the notes to the financial statements. This ratio is widely used in evaluating the operating performance and profitability of a company. At this introductory level, we can compute earnings per share simply as net income divided by the weighted average number of shares of stock outstanding (Net Income ÷ Weighted Average Number of Shares of Stock Outstanding). Please note, however, that the calculation of the ratio is actually much more complex and beyond the scope of this course. For simplicity, we use the $176 million net income in Exhibit 3.1 as the numerator and approximately 28.4 million weighted average number of shares computed by Chipotle as the denominator. For 2017, Chipotle reported $6.19 in earnings for each share of stock owned by investors.

DATA ANALYTICS

Using Big Data in the Restaurant Industry to Increase Revenues and Decrease Costs

Thanks to significant improvements in computing power, storage space, access to the cloud, and new software, large and small businesses, not just restaurants, can collect and analyze incredible amounts and types of data to enhance revenues and reduce costs. Data sources include point-of-sale terminals and information systems related to accounting, inventory, scheduling, marketing, and more. Here are a few examples of restaurants that use data analytics to optimize performance, make better and faster decisions, and improve the customer experience:

- **McDonald's** uses data to predict customer demand in drive-thru sales. By ensuring adequate staffing and alerting staff to the spike in demand, the efficiency of operations is improved along with enhancing the customer experience.
- **Wendy's** analyzes big data on past sales and customer demographics to identify the most profitable new restaurant locations.
- **Pizza Hut** uses software to track customer eye movements on digital, interactive menus in some of its restaurants to discover what customers subconsciously want.

Source: **https://www.hotschedules.com/blog/biggest-restaurant-brands-use-big-data-stay-competitive/**.

HOW ARE OPERATING ACTIVITIES RECOGNIZED AND MEASURED?

You probably determine your personal financial position by the cash balance in your bank account. Your financial performance is measured as the difference between your cash balance at the beginning of the period and the cash balance at the end of the period (that is, whether you end up with more or less cash). If you have a higher cash balance, cash receipts exceeded cash disbursements for the period. Many local retailers, medical offices, and other small businesses use **cash basis accounting**, in which revenues are recorded when cash is received and expenses are recorded when cash is paid, regardless of when the revenues are earned or the expenses incurred. This basis produces net operating cash flow information that is often quite adequate for organizations that do not need to report to external users. The following table illustrates the application of cash basis accounting for the first three years of a new business, Cade Company:

CASH BASIS
Income Measurement
Revenues (= cash receipts)
− Expenses (= cash payments)
Net Income (cash basis)

CASH BASIS ACCOUNTING
Records revenues when cash is received and expenses when cash is paid.

Cade Company Income Statements	Year 1	Year 2	Year 3	Total
Sales on credit	$ 60,000	$ 60,000	$ 60,000	$180,000
Cash receipts from customers	$ 20,000	$ 70,000	$ 90,000	$180,000
Cash disbursements for:				
Salaries to employees	(30,000)	(30,000)	(30,000)	(90,000)
Insurance for 3 years	(12,000)	(0)	(0)	(12,000)
Supplies	(3,000)	(7,000)	(5,000)	(15,000)
Net operating cash flows	**$(25,000)**	**$33,000**	**$55,000**	**$ 63,000**

In this illustration, $60,000 in sales was earned each year by Cade Company. However, because the sales were on account, customers spread out their payments over three years. Salaries to employees were paid in full each year. Insurance was prepaid at the beginning of the first year for equal coverage over the three years. Supplies were purchased on credit and used evenly over the three years. However, the company paid part of the first-year purchases in the second year.

Using cash basis accounting may lead to an incorrect interpretation of future company performance. Simply looking at the first year, investors and creditors might interpret the negative cash flows as a problem with the company's ability to generate cash flows in the future.

However, the other two years show positive cash flows. Likewise, performance over time appears uneven, when in actuality it is not. Sales were earned evenly each year, although collections from customers were not. The years in which insurance and supplies were paid for are not the same as the years in which these resources were used.

LEARNING OBJECTIVE 3-3

Explain the accrual basis of accounting and apply the revenue and expense recognition principles to measure income.

Accrual Accounting

Financial statements created under cash basis accounting normally postpone or accelerate recognition of revenues and expenses long before or after goods and services are produced and delivered (when cash is received or paid). They also do not necessarily reflect all assets or liabilities of a company on a particular date. For these reasons, cash basis financial statements are not very useful to external decision makers. Therefore, generally accepted accounting principles require **accrual basis accounting** for financial reporting.

ACCRUAL BASIS ACCOUNTING
Records revenues when earned and expenses when incurred, regardless of the timing of cash receipts or payments.

In accrual basis accounting, revenues and expenses are recognized when the transaction that causes them occurs, not necessarily when cash is received or paid. That is, **revenues are recognized when they are earned and expenses when they are incurred to generate revenues.**

Using the same information for Cade Company, we can apply the accrual basis of accounting.

Cade Company Income Statements	Year 1	Year 2	Year 3	Total
Sales revenue (earned)	$60,000	$60,000	$60,000	$180,000
Expenses (resources used or incurred):				
Salaries expense	(30,000)	(30,000)	(30,000)	(90,000)
Insurance expense	(4,000)	(4,000)	(4,000)	(12,000)
Supplies expense	(5,000)	(5,000)	(5,000)	(15,000)
Net income	**$21,000**	**$21,000**	**$21,000**	**$ 63,000**

ACCRUAL BASIS
Income Measurement
Revenues (= when earned)
− Expenses (= when incurred)
Net Income (accrual basis)

Regardless of when cash is received, Cade Company reported revenues when earned. Likewise, the company used insurance coverage and supplies evenly over the three years, despite prepaying the entire amount of insurance at the beginning of the first year and paying part of the first year's purchases in the second year. The $21,000 net income in the first year under accrual basis accounting is a better predictor of future performance than net operating cash flows reported under cash basis accounting. The two basic accounting principles that determine when revenues and expenses are recorded under accrual basis accounting are the **revenue recognition principle** and the **expense recognition principle** (also called the **matching principle**).

Revenue Recognition Principle

REVENUE RECOGNITION PRINCIPLE
Revenues are recognized (1) when the company transfers promised goods or services to customers (2) in the amount it expects to be entitled to receive.

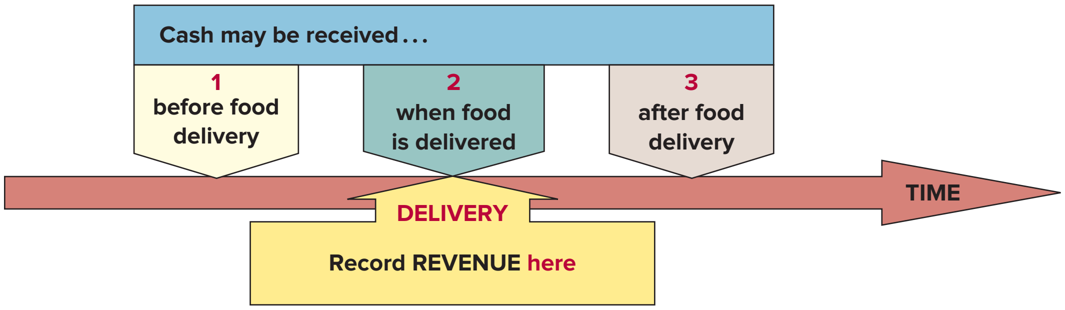
The core **revenue recognition principle** specifies both the timing and amount of revenue to be recognized during an accounting period. It requires that a company recognize revenue

1. **When the company transfers promised goods or services to customers**
2. **In the amount it expects to be entitled to receive.**

When **Chipotle** delivers food to customers, it recognizes revenue **regardless of when cash is received.** Exhibit 3.2 illustrates that revenue is earned when the business delivers goods or services,

EXHIBIT 3.2

Recording Revenues versus Cash Receipts



although cash can be received from customers (1) in a period **before** delivery, (2) in the **same** period as delivery, or (3) in a period **after** delivery. Let's see how to handle each of these cases.

1 **Cash is received *before* the goods or services are delivered.** Chipotle sells gift cards to customers for cash in exchange for the promise to provide future food orders. Because Chipotle has not delivered food at that point, it records **no revenue.** Instead, it creates a liability account (Unearned Revenue) representing the amount of food service owed to the customers. Later, when customers redeem their gift cards and Chipotle delivers the food, it earns and records the revenue while reducing the liability account because it has satisfied its promise to deliver.

On receipt of a $100 cash deposit:	Debit	Credit
Cash (+A)	100	
Unearned revenue (+L)		100
On delivery of ordered food:		
Unearned revenue (−L)	100	
Restaurant sales revenue (+R, +SE)		100

2 **Cash is received *in the same period as* the goods or services are delivered.** As is a typical timing of cash receipts and revenue recognition in the restaurant industry, Chipotle receives cash from most customers within a few minutes of them receiving their food. Chipotle delivers the food to the customer as ordered in exchange for cash, **earning revenue** in the process.

On delivery of ordered food for $12 cash:	Debit	Credit
Cash (+A)	12	
Restaurant sales revenue (+R, +SE)		12

3 **Cash is received *after* the goods or services are delivered.** When a business sells goods or services on account, the revenue is earned when the goods or services are delivered, not when cash is received at a later date. Let's assume that, to boost business, Chipotle agrees to deliver food ordered by select customers, such as departments at area colleges or local businesses. These customers pay for the food order when Chipotle bills them at the end of the month, rather than when they receive the food. When delivered, Chipotle records both Restaurant Sales Revenue and the asset Accounts Receivable, representing the customer's promise to pay in the future for past food deliveries. When the customer pays its monthly bill, Chipotle will increase its Cash account and decrease the asset Accounts Receivable.

On delivery of ordered food for $50 on account:	Debit	Credit
Accounts receivable (+A)	50	
Restaurant sales revenue (+R, +SE)		50
On receipt of cash after delivery:		
Cash (+A)	50	
Accounts receivable (−A)		50

Companies usually disclose their revenue recognition practices in the financial statement note titled Significant Accounting Policies or in a separate note. The following excerpt from Note 4 to recent financial statements describes how Chipotle recognizes its revenue:

4. Revenue Recognition

We recognize revenue, net of discounts and incentives, when payment is tendered at the point of sale. . . .

. . . We recognize revenue from gift cards when: (i) the gift card is redeemed by the customer; or (ii) we determine the likelihood of the gift card being redeemed by the customer is remote (gift card breakage) and there is not a legal obligation to remit the unredeemed gift cards to the relevant jurisdiction. . . .

We offered a limited-time frequency program called Chiptopia Summer Rewards during the third quarter of 2016, which allowed customers to redeem certain rewards earned through the first quarter of 2017. We deferred revenue reflecting the portion of the original rewards that were earned by program participants and not redeemed by September 30, 2016, and we recorded a corresponding liability on our condensed consolidated balance sheet. . .

Source: Chipotle Mexican Grill, Inc.

CHIPOTLE MEXICAN GRILL

REAL WORLD EXCERPT:

2018 First Quarter Report

FINANCIAL ANALYSIS

Revenue Recognition for More Complex Sales Contracts: A Five-Step Process

The FASB and IASB issued a joint revenue recognition accounting standard effective for 2018 financial statements. The standard requires a company to recognize revenue when it transfers goods and services to customers in the amount it expects to be entitled to receive. The standard also specifies how to handle more complex contracts with customers. The standard specifies five steps to recognizing revenue:

1. Identify the contract between the company and customer.
2. Identify the performance obligations (promised goods and services).
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations.
5. Recognize revenue when each performance obligation is satisfied (or over time if a service is provided over time).

For example, when **Dell** sells computers and a one-year warranty together in a single sale, it will determine the separate obligations (selling a computer and selling a warranty service) and split the sales price among them. Dell will then recognize the revenue allocated to the computer when it is delivered, and it will recognize one-twelfth of the revenue from the warranty each month it is in force. Accounting for bundled sales transactions is discussed in Chapter 6, with additional detailed coverage in intermediate accounting courses.

Chipotle adopted the new standard for 2018. However, the company does not have significant complex sales contracts and, therefore, noted that the adoption did not have an impact on its consolidated balance sheet, statements of income, or cash flows.

PAUSE FOR FEEDBACK

We just learned the **revenue recognition principle's** criteria: Recognize revenue (1) when the company transfers promised goods or services to customers (2) in the amount it expects to be entitled to receive.

SELF-STUDY QUIZ

Complete this quiz now to make sure you can apply the revenue recognition principle. The following transactions are samples of typical monthly operating activities of **Papa John's International, Inc.** (dollars in thousands), a company that makes and delivers pizza and sells franchises. If revenue is to be recognized in **January,** indicate the title of the revenue account and the amount of revenue to be recognized. For account titles, name the revenue account based on the nature of the transaction. For example, sales to customers are Restaurant Sales Revenue and sales of franchises are Franchise Fee Revenue.

ACTIVITY	REVENUE ACCOUNT TITLE	AMOUNT OF REVENUE RECOGNIZED IN JANUARY
(a) In January, Papa John's company-owned restaurants sold food to customers for $32,000 cash.		
(b) In January, Papa John's sold new franchises for $625 cash, providing $400 in services to these new franchisees during January; the remainder of the services will be provided over the next three months.		
(c) In January, Papa John's received $210 in cash from customers as deposits on large orders to be delivered in February.		
(d) In January, Papa John's delivered $1,630 to select customers on account; the customers will pay when billed at the end of January.		
(e) In January, customers paid $1,200 on account to Papa John's from December deliveries of pizza.		
(f) In January, Papa John's delivered $385 to customers who provided deposits in December.		

After you have completed your answers, check them on the bottom of page 115.

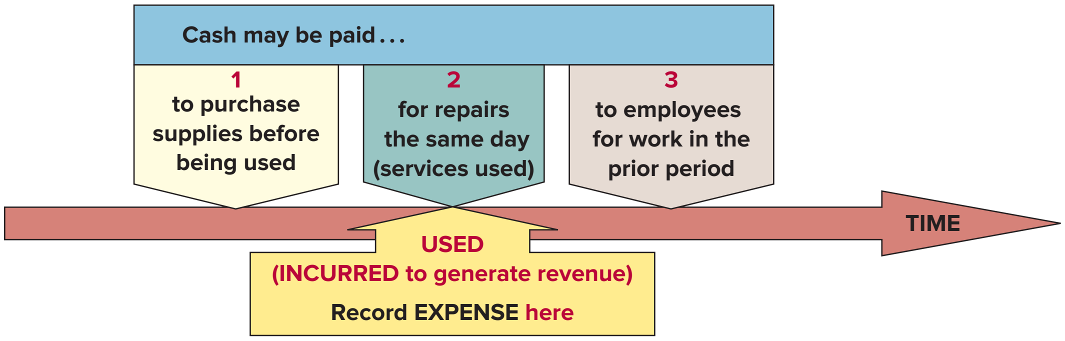


EXHIBIT 3.3

Recording Expenses versus Cash Payments

Expense Recognition Principle

The **expense recognition principle** (also called the **matching principle**) requires that costs incurred to generate revenues be recognized in the same period—a matching of costs with benefits. For example, when Chipotle's restaurants provide food service to customers, revenue is earned. The costs of generating the revenue include expenses incurred such as these:

EXPENSE RECOGNITION PRINCIPLE (OR MATCHING PRINCIPLE) Requires that expenses be recorded in the same time period when incurred in earning revenue.

- Salaries and wages to employees who worked **during the period.**
- Utilities for the electricity used **during the period.**
- Food, beverage, and packaging supplies used **during the period.**
- Facilities rented **during the period.**
- Grills and other equipment used **during the period.**

As with revenues and cash receipts, expenses are recorded as incurred, **regardless of when cash is paid.** Cash may be paid (1) **before,** (2) **during,** or (3) **after** an expense is incurred (see Exhibit 3.3). An entry will be made on the date the expense is incurred and another on the date the cash is paid, if they occur at different times. Let's see how to handle each of these cases related to the expense recognition principle.

1 **Cash is paid *before* the expense is incurred to generate revenue.** Companies purchase many assets that are used to generate revenues in future periods. Examples include buying insurance for future coverage, paying rent for future use of space, and acquiring supplies and equipment for future use. When revenues are generated in the future, the company records an expense for the portion of the cost of the assets used—costs are matched with the benefits. As an example, assume Chipotle buys paper supplies (napkins, bags, cups, etc.) in one month but uses them the following month. When acquired, the supplies are recorded as an asset called Supplies because they will benefit future periods. When they are used the following month, Supplies Expense is recorded for the month and the asset Supplies is reduced to the balance yet to be used. Similarly, rent, insurance, and advertising that are prepaid are often recorded in an asset account called Prepaid Expenses and expensed when used.

On payment of $200 cash for supplies:	Debit	Credit
Supplies (+A)	200	
Cash (−A)		200
On subsequent use of half of the supplies:		
Supplies expense (+E, −SE)	100	
Supplies (−A)		100

Solutions to SELF-STUDY QUIZ

Revenue Account Title	Amount of Revenue Recognized in January
(a) Restaurant Sales Revenue	$32,000
(b) Franchise Fee Revenue	$ 400
(c) No revenue earned in January	–
(d) Restaurant Sales Revenue	$ 1,630
(e) No revenue earned in January	–
(f) Restaurant Sales Revenue	$ 385

On payment of $275 cash for using a repair service:	Debit	Credit
Repairs expense (+E, −SE)	275	
Cash (−A)		275

2 **Cash is paid *in the same period* as the expense is incurred to generate revenue.** Expenses are sometimes incurred and paid for in the period in which they arise. An example is paying for repairs on grills the day of the service. If Chipotle spends $275 cash to repair grills so that food can be prepared to sell, an expense is incurred and recorded (Repairs Expense).

On the use of $400 in employees' services during the period:	Debit	Credit
Wages expense (+E, −SE)	400	
Wages payable (+L)		400
On payment of cash after using employees:		
Wages payable (−L)	400	
Cash (−A)		400

3 **Cash is paid *after* the cost is incurred to generate revenue.** Although rent and supplies are typically purchased before they are used, many costs are paid after goods or services have been received and used. Examples include using electric and gas utilities in the current period that are not paid for until the following period, using borrowed funds and incurring Interest Expense to be paid in the future, and owing wages to employees who worked in the current period. When Chipotle's restaurants use employees to make and serve food in the current accounting period (and thus assist in generating revenues), the company records Wages Expense for the amount incurred. Any amount that is then owed to employees at the end of the current period is recorded as a liability called Wages Payable (an accrued expense obligation).

PAUSE FOR FEEDBACK

The **expense recognition principle** (or matching principle) requires that costs incurred to generate revenues be recognized in the same period—that costs are matched with the revenues they generate. Regardless of when cash is paid, expense is recorded when incurred.

SELF-STUDY QUIZ

Complete this quiz now to make sure you can apply the expense recognition principle. The following transactions are samples of typical monthly operating activities of **Papa John's International, Inc.** (dollars in thousands). If an expense is to be recognized in **January,** indicate the title of the expense account and the amount of expense to be recognized.

ACTIVITY	EXPENSE ACCOUNT TITLE	AMOUNT OF EXPENSE RECOGNIZED IN JANUARY
(a) At the beginning of January, Papa John's restaurants paid $3,000 in rent for the months of January, February, and March.		
(b) In January, Papa John's paid suppliers $10,000 on account for supplies received in December.		
(c) In January, the food and paper products supplies used in making and selling pizza products to customers were $9,500. The supplies were purchased in December on account.		
(d) In late January, Papa John's received a $400 utility bill for electricity used in January. The bill will be paid in February.		

After you have completed your answers, check them at the bottom page 117.

GUIDED HELP 3-1

For additional step-by-step video instruction on identifying revenue and expense accounts and amounts for a given period, go to **www.mhhe.com/libby10e_gh3a**.

A QUESTION OF ETHICS

Management's Incentives to Violate Accounting Rules

Investors in the stock market base their decisions on their expectations of a company's future earnings. When companies announce quarterly and annual earnings information, investors evaluate how well the companies have met expectations and adjust their investing decisions accordingly. Companies that fail to meet expectations often experience a decline in stock price. Thus, managers are motivated to produce earnings results that meet or exceed investors' expectations to bolster stock prices. Greed may lead some managers to make unethical accounting and reporting decisions, often involving falsifying revenues and expenses. While this sometimes fools people for a short time, it rarely works in the long run and often leads to very bad consequences.

Fraud is a criminal offense for which managers may be sentenced to jail. Samples of fraud cases, a few involving faulty revenue and expense accounting, are shown below. Just imagine what it must have been like to be 65-year-old Bernie Ebbers or 21-year-old Barry Minkow, both sentenced to 25 years in prison for accounting fraud.

The CEO	The Fraud	Conviction/Plea	The Outcome
Joseph J. Erves, 53 **MARTA** (Atlanta's public transportation operator)	Falsified maintenance expense invoices that funneled payments to his personal bank account.	Convicted, January 2018	Sentenced to 2 years, 9 months
Oliver Schmidt, 48 **Volkswagen Group**	Installed software on diesel cars to cheat emissions performance tests in the U.S.	Pleaded guilty to the conspiracy, December 2017	Sentenced to 7 years
Holli Dawn Coulman, 44 **Hewlett Packard**	As executive assistant to HP senior vice president, used corporate credit cards to support her lavish lifestyle and other personal expenses.	Pleaded guilty to falsifying employee expenses, August 2015	Sentenced to 20 months; pay nearly $1 million in restitution
Elaine Martin, 67 **MarCon, Inc.**	Failed to record sales of used materials.	Convicted, February 2014	Sentenced to 7 years
Annette Bongiorno, 62, and **Joann Crupi,** 49 **Madoff Investment Securities**	Recorded trades of securities in the wrong accounting period as part of a Ponzi scheme.	Convicted, December 2014	Sentenced to 6 years each; forfeit a total of $188.9 billion
Bernard Madoff, 71 **Madoff Investment Securities**	Scammed $50 billion from investors in a Ponzi scheme (in which investors receive "returns" from money paid by subsequent investors).	Confessed, December 2008	Sentenced to 150 years
Bernie Ebbers, 65 **Worldcom**	Recorded $11 billion in operating expenses as if they were assets.	Convicted, July 2005	Sentenced to 25 years
Barry Minkow,* 21 **ZZZZ Best**	Made up customers and sales to show profits when, in reality, the company was a sham.	Convicted, December 1988	Sentenced to 25 years

*After early release in 1995, Minkow pursued additional fraudulent activities and is in federal prison until 2021.

Many others are affected by accounting fraud. Shareholders lose stock value, employees may lose their jobs (and pension funds, as in the case of **Enron**), and customers and suppliers may become wary of dealing with a company operating under the cloud of fraud. As a manager, you may face an ethical dilemma in the workplace. The ethical decision is the one you will be proud of 20 years later.

Solutions to SELF-STUDY QUIZ

Expense Account Title	Amount of Expense Recognized in January
(a) Rent Expense	$1,000 ($3,000 ÷ 3 months)
(b) No expense in January	Supplies will be expensed when used.
(c) Supplies Expense	$9,500
(d) Utilities Expense	$ 400

LEARNING OBJECTIVE 3-4

Apply transaction analysis to examine and record the effects of operating activities on the financial statements.

THE EXPANDED TRANSACTION ANALYSIS MODEL

We have discussed the variety of business activities affecting the income statement and how they are measured. Next, we need to determine how these business activities are recorded in the accounting system and reflected in the financial statements. Chapter 2 covered investing and financing activities that affect assets, liabilities, and stockholders' equity. We now expand the transaction analysis model to include operating activities.

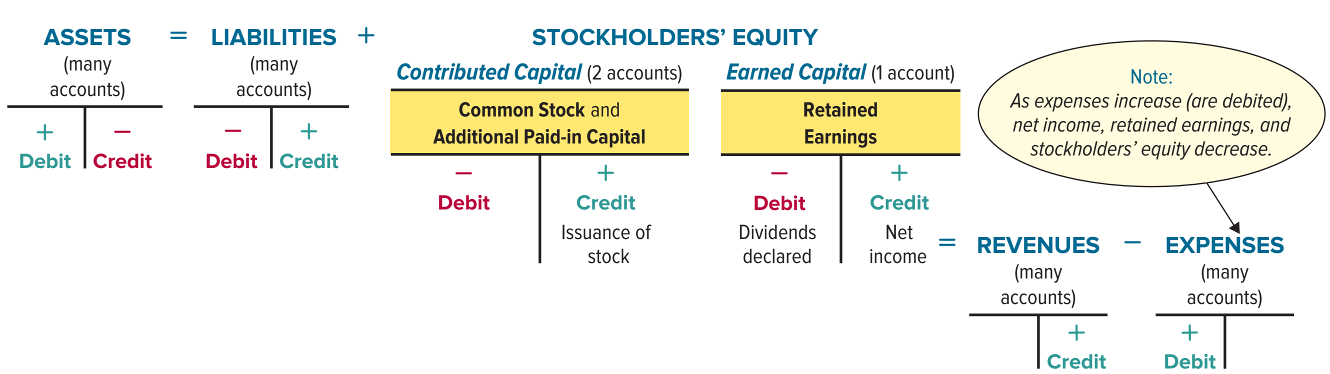
Transaction Analysis Rules

The complete transaction analysis model presented in Exhibit 3.4 includes **all five elements: assets, liabilities, stockholders' equity, revenues,** and **expenses.** Recall that the Retained Earnings account is the accumulation of all past revenues and expenses minus any income distributed to stockholders as dividends (that is, earnings not retained in the business).[3] When net income is positive, Retained Earnings increases; a net loss decreases Retained Earnings.

Some students attempt to memorize journal entries in the introductory accounting course. However, they often are overwhelmed by the number and complexity of transactions as the course progresses. To avoid this pitfall, you instead should be able to **construct the transaction analysis model in** Exhibit 3.4 **on your own without assistance and use it to analyze transactions.** It will be very beneficial in future chapters when completing assignments and analyzing more complex transactions. Now let's study Exhibit 3.4 carefully to remember how the model is constructed and to understand the impact of operating activities on both the balance sheet and income statement:

- All accounts can increase or decrease, although revenues and expenses tend to increase throughout a period. For accounts on the left side of the accounting equation, the increase symbol + is written on the left side of the T-account. For accounts on the right side of the accounting equation, the increase symbol + is written on the right side of the T-account, **except for expenses, which increase on the left side of the T-account. That is because, as expenses increase, they have an opposite effect on net income, the Retained Earnings account (which increases on the credit side), and thus Stockholders' Equity.**
- Debits (dr) are written on the left of each T-account and credits (cr) are written on the right.
- Every transaction affects at least two accounts.

EXHIBIT 3.4 Expanded Transaction Analysis Model



[3] Instead of reducing Retained Earnings directly when dividends are declared, companies may use the account Dividends Declared, which has a debit balance.

- When a revenue or expense is recorded, either an asset or a liability will be affected as well:
  - Revenues increase stockholders' equity through the account Retained Earnings and therefore have **credit** balances (the positive side of Retained Earnings). Recording revenue requires either increasing an asset (such as Accounts Receivable when selling goods on account to customers) or decreasing a liability (such as Unearned Revenue that was recorded in the past when cash was received from customers before being earned).

A	=	L	+	SE	
+ or −				+	(+ revenue ↑ RE)

  - Expenses decrease stockholders' equity through Retained Earnings. As expenses increase, they have the opposite effect on net income, which affects Retained Earnings. Therefore, they have **debit** balances (opposite of the positive credit side in Retained Earnings). That is, to increase an expense, you debit it, thereby decreasing net income and Retained Earnings. Recording an expense requires either decreasing an asset (such as Supplies when used) or increasing a liability (such as Wages Payable when money is owed to employees).

A	=	L	+	SE	
− or +				−	(+ expense ↓ RE)

- When revenues exceed expenses, the company reports net income, increasing Retained Earnings and stockholders' equity. However, when expenses exceed revenues, a net loss results that decreases Retained Earnings and thus stockholders' equity.

In summary:

REVENUES	EXPENSES
• Increase net income and stockholders' equity	• Decrease net income and stockholders' equity
• ↑ with Credits	• ↑ with Debits
• Accounts have credit balances	• Accounts have debit balances

The steps to follow in analyzing transactions presented in Chapter 2 are now modified to determine the effects of earning revenues and incurring expenses. Now, as shown in Exhibit 3.5, when a transaction occurs, the questions to ask are:

EXHIBIT 3.5

Transaction Analysis Steps

Step 1: **Ask** → **Was a revenue earned by delivering goods or services?**
If so, credit the revenue account and debit the appropriate accounts for what was received.

or **Ask** → **Was an expense incurred to generate a revenue in the current period?**
If so, debit the expense account and credit the appropriate accounts for what was given.

or **Ask** → **If no revenue was earned or expense incurred, what was received and given?**

- **Identify the accounts affected by title** (e.g., Cash and Sales Revenue). Remember: *Make sure that at least two accounts change.*
- **Classify them by type of account:** asset (A), liability (L), stockholders' equity (SE), revenue/gain (R), or expense/loss (E).
- **Determine the direction of the effect.** Did the account increase (+) or decrease (−)?

Step 2: **Verify** → **Is the accounting equation in balance?** (A = L + SE)

Analyzing Common Transactions

Next, we continue our discussion with hypothetical operating activities for **Chipotle Mexican Grill**, building on the company's trial balance presented in Exhibit 3.6 (and at the end of Chapter 2). It included only investing and financing transactions assumed to have occurred during the first quarter of 2018.

EXHIBIT 3.6

Chipotle Mexican Grill's Trial Balance

CHIPOTLE MEXICAN GRILL—TRIAL BALANCE **(based on Chapter 2's hypothetical investing and financing transactions during the first quarter ended March 31, 2018)**		
(in millions)	**Debit**	**Credit**
Cash	389	
Short-term investments	333	
Accounts receivable	49	
Supplies	20	
Prepaid expenses	51	
Land	21	
Buildings	1,711	
Equipment	637	
Accumulated depreciation		979
Long-term investments	35	
Intangible assets	81	
Accounts payable		82
Unearned revenue		64
Dividends payable		2
Income taxes payable		18
Wages payable		83
Utilities payable		77
Notes payable *(current)*		0
Notes payable *(noncurrent)*		80
Other liabilities		279
Common stock		2
Additional paid-in capital		1,604
Treasury stock	2,334	
Retained earnings		2,391
Total	**5,661**	**5,661**

Using the transaction analysis steps in Exhibit 3.5, we now analyze, record, and post to the T-accounts the effects of this chapter's operating activities that we assume occurred during the first quarter. The T-accounts begin with the **trial balance amounts** in Exhibit 3.6. All amounts are in millions of dollars, except per share information. You should notice, in each journal entry, that

- When a revenue or expense is recorded, we insert (+R, +SE) for revenues and (+E, −SE) for expenses to emphasize the effect of the transaction on the accounting equation and to help you see that the equation remains in balance.
- Debits equal credits—another check you should make when preparing journal entries.

In Chapter 4, we complete the accounting cycle with the activities at the end of the quarter (on March 31).

(1) **Assume Chipotle purchased food, beverage, and packaging supplies costing \$370, paying \$290 in cash and owing the rest on account.**

	Debit	**Credit**
(*1*) Supplies (+A)	370	
Cash (−A)		290
Accounts payable (+L)		80

Assets		=	Liabilities		+	Stockholders' Equity
Supplies	+370		Accounts payable	+80		
Cash	−290					

+ Cash (A) −				+ Supplies (A) −				− Accounts Payable (L) +			
Bal.	389			Bal.	20					82	Bal.
		290	*(1)*	*(1)*	**370**					**80**	*(1)*

(2) At the beginning of January, Chipotle paid $80 cash for rent, insurance, and advertising to be used in the future (all prepaid expenses).

	Debit	Credit
(*2*) Prepaid expenses (+A)	80	
Cash (−A)		80

Assets		=	Liabilities	+	Stockholders' Equity
Prepaid expenses	+80				
Cash	−80				

+ Cash (A) −				+ Prepaid Expenses (A) −			
Bal.	389			Bal.	51		
		290	*(1)*	*(2)*	**80**		
		80	*(2)*				

(3) During the first quarter, Chipotle sold food and beverages to customers for $1,228; $44 was sold to universities on account (to be paid by the universities next quarter) and the rest was received in cash in the stores. **NOTE:** To measure revenues and expenses in a period, these accounts begin with a $0 balance; notice they are not listed on the trial balance in Exhibit 3.6 because they have no balances yet.

	Debit	Credit
(*3*) Cash (+A)	1,184	
Accounts receivable (+A)	44	
Restaurant sales revenue (+R, +SE)		1,228

Assets		=	Liabilities	+	Stockholders' Equity	
Cash	+1,184				Restaurant sales revenue (+R)	+1,228
Accounts receivable	+44					

+ Cash (A) −				+ Accounts Receivable (A) −				− Restaurant Sales Revenue (R) +			
Bal.	389			Bal.	49					0	Bal.
(3)	**1,184**	290	*(1)*	*(3)*	**44**					**1,228**	*(3)*
		80	*(2)*								

(4) Chipotle paid $41 for management training expenses.

	Debit	Credit
(*4*) Training expense (+E, −SE)	41	
Cash (−A)		41

Assets		=	Liabilities		+	Stockholders' Equity	
Cash	−41					Training expense (+E)	−41

+ Cash (A) −				+ Training Expense (E) −		
Bal.	389			Bal.	0	
(3)	1,184	290	*(1)*	***(4)***	**41**	
		80	*(2)*			
		41	***(4)***			

(5) **Chipotle paid employees $177 for work this quarter and $83 for work last quarter** (recorded last quarter as Wages Expense and Wages Payable).

	Debit	Credit
(5) Wages expense (+E, −SE)	177	
Wages payable (−L)	83	
Cash (−A)		260

Assets		=	Liabilities		+	Stockholders' Equity	
Cash	−260		Wages payable	−83		Wages expense (+E)	−177

+ Cash (A) −				− Wages Payable (L) +				+ Wages Expense (E) −		
Bal.	389					83	Bal.	Bal.	0	
(3)	1,184	290	*(1)*	***(5)***	**83**			***(5)***	**177**	
		80	*(2)*							
		41	*(4)*							
		260	***(5)***							

(6) **Chipotle sold equipment costing $9 for $5 cash, resulting in a loss of $4** (ignore any accumulated depreciation on the equipment, which will be explained in more depth in Chapter 8).

	Debit	Credit
(6) Cash (+A)	5	
Loss on disposal of assets (+E, −SE)	4	
Equipment (−A)		9

Assets		=	Liabilities		+	Stockholders' Equity	
Cash	+5					Loss on disposal of assets (+E)	−4
Equipment	−9						

+ Cash (A) −				+ Equipment −				+ Loss on Disposal of Assets (E) −		
Bal.	389			Bal.	637			Bal.	0	
(3)	1,184	290	*(1)*			**9**	***(6)***	***(6)***	**4**	
(6)	**5**	80	*(2)*							
		41	*(4)*							
		260	*(5)*							

(7) Chipotle received $39 cash from customers paying on their accounts.

	Debit	Credit
(7) Cash (+A)	39	
Accounts receivable (−A)		39

Assets		=	Liabilities		+	Stockholders' Equity
Cash	+39					
Accounts receivable	−39					

+ Cash (A) −

Bal.	389		
(3)	1,184	290	(1)
(6)	5	80	(2)
(7)	**39**	41	(4)
		260	(5)

+ Accounts Receivable (A) −

Bal.	49		
(3)	44	**39**	**(7)**

(8) During the quarter, assume Chipotle paid suppliers $74 on accounts payable, paid $72 on utilities payable from last year, and paid $18 in income taxes payable from last year.

	Debit	Credit
(8) Accounts payable (−L)	74	
Utilities payable (−L)	72	
Income taxes payable (−L)	18	
Cash (−A)		164

Assets		=	Liabilities		+	Stockholders' Equity
Cash	−164		Accounts payable	−74		
			Utilities payable	−72		
			Income taxes payable	−18		

+ Cash (A) −

Bal.	389		
(3)	1,184	290	(1)
(6)	5	80	(2)
(7)	39	41	(4)
		260	(5)
		164	**(8)**

− Accounts Payable (L) +

		82	Bal.
(8)	**74**	80	(1)

− Income Taxes Payable (L) +

		18	Bal.
(8)	**18**		

− Utilities Payable (L) +

		77	Bal.
(8)	**72**		

(9) Chipotle paid $75 for utilities used during the quarter and paid $19 for repairs of its buildings and equipment during the quarter.

	Debit	Credit
(9) Utilities expense (+E, −SE)	75	
Repairs expense (+E, −SE)	19	
Cash (−A)		94

Assets		=	Liabilities		+	Stockholders' Equity	
Cash	−94					Utilities expense (+E)	−75
						Repairs expense (+E)	−19

+ Cash (A) −			
Bal.	389		
(3)	1,184	290	*(1)*
(6)	5	80	*(2)*
(7)	39	41	*(4)*
		260	*(5)*
		164	*(8)*
		94	***(9)***

+ Utilities Expense (E) −		
Bal.	0	
(9)	**75**	

+ Repairs Expense (E) −		
Bal.	0	
(9)	**19**	

(10) **Assume Chipotle received $1 cash as interest revenue earned during the quarter.**

	Debit	Credit
(10) Cash (+A)	1	
Interest revenue (+R, +SE)		1

Assets		=	Liabilities		+	Stockholders' Equity	
Cash	+1					Interest revenue (+R)	+1

+ Cash (A) −			
Bal.	389		
(3)	1,184	290	*(1)*
(6)	5	80	*(2)*
(7)	39	41	*(4)*
(10)	**1**	260	*(5)*
		164	*(8)*
		94	*(9)*

− Interest Revenue (R) +		
	0	Bal.
	1	***(10)***

(11) **During the quarter, Chipotle sold gift cards to customers for $42 in cash** (expected to be redeemed for food next quarter).

	Debit	Credit
(11) Cash (+A)	42	
Unearned revenue (+L)		42

Assets		=	Liabilities		+	Stockholders' Equity
Cash	+42		Unearned revenue	+42		

+ Cash (A) −			
Bal.	389		
(3)	1,184	290	*(1)*
(6)	5	80	*(2)*
(7)	39	41	*(4)*
(10)	1	260	*(5)*
(11)	**42**	164	*(8)*
		94	*(9)*

− Unearned Revenue (L) +		
	64	Bal.
	42	***(11)***

Next, we determine the new balances in the T-accounts due to the operating activities this quarter, by adding the positive side and subtracting the negative side.

Balance Sheet Accounts:

+ Cash (A) −			
Bal.	389		
(3)	1,184	290	*(1)*
(6)	5	80	*(2)*
(7)	39	41	*(4)*
(10)	1	260	*(5)*
(11)	42	164	*(8)*
		94	*(9)*
	731		

+ Short-Term Investments (A) −			
Bal.	333		
	333		

+ Accounts Receivable (A) −			
Bal.	49		
(3)	44	39	*(7)*
	54		

+ Supplies (A) −			
Bal.	20		
(1)	370		
	390		

+ Prepaid Expenses (A) −			
Bal.	51		
(2)	80		
	131		

+ Land (A) −			
Bal.	21		
	21		

+ Buildings (A) −			
Bal.	1,711		
	1,711		

+ Equipment (A) −			
Bal.	637		
		9	*(6)*
	628		

− Accumulated Depreciation +			
		979	Bal.
		979	

+ Long-Term Investments (A) −			
Bal.	35		
	35		

+ Intangible Assets (A) −			
Bal.	81		
	81		

− Accounts Payable (L) +			
		82	Bal.
(8)	74	80	*(1)*
		88	

− Unearned Revenue (L) +			
		64	Bal.
		42	*(11)*
		106	

− Dividends Payable (L) +			
		2	Bal.
		2	

− Wages Payable (L) +			
		83	Bal.
(5)	83		
		0	

− Utilities Payable (L) +			
		77	Bal.
(8)	72		
		5	

− Income Taxes Payable (L) +			
		18	Bal.
(8)	18		
		0	

− Notes Payable *(noncurrent)* (L) +			
		80	Bal.
		80	

− Other Liabilities (L) +			
		279	Bal.
		279	

− Common Stock (SE) +			
		2	Bal.
		2	

− Additional Paid-in Capital (SE) +			
		1,604	Bal.
		1,604	

+ Treasury Stock −			
Bal.	2,334		
	2,334		

− Retained Earnings (SE) +			
		2,391	Bal.
		2,391	

Income Statement Accounts:

− Restaurant Sales Revenue (R) +			
		0	Bal.
		1,228	*(3)*
		1,228	

− Interest Revenue (R) +			
		0	Bal.
		1	*(10)*
		1	

+ Wages Expense (E) −			
Bal.	0		
(5)	177		
	177		

+ Utilities Expense (E) −			
Bal.	0		
(9)	75		
	75		

+ Repairs Expense (E) −			
Bal.	0		
(9)	19		
	19		

+ Training Expense (E) −			
Bal.	0		
(4)	41		
	41		

+ Loss on Disposal of Assets (E) −			
Bal.	0		
(6)	4		
	4		

PAUSE FOR FEEDBACK

We just illustrated the steps in analyzing and recording transactions, including those involving earning revenue and incurring expenses.

Transaction Analysis Steps:

Step 1: **Ask** → **Was a revenue earned by delivering goods or services?**
If so, credit the revenue account and debit the appropriate accounts for what was received.

or **Ask** → **Was an expense incurred to generate a revenue in the current period?**
If so, debit the expense account and credit the appropriate accounts for what was given.

or **Ask** → **If no revenue was earned or expense incurred, what was received and given?**

- **Identify the accounts affected by title** (e.g., Cash and Notes Payable). Remember: *Make sure that at least two accounts change.*
- **Classify them by type of account:** asset (A), liability (L), stockholders' equity (SE), revenue/gain (R), or expense/loss (E).
- **Determine the direction of the effect.** Did the account increase (+) or decrease (−)?

Step 2: **Verify** → **Is the accounting equation in balance? (A = L + SE)**

SELF-STUDY QUIZ

Now it's your turn. Analyze and record the journal entries for each of the selected **June** transactions for Florida Flippers, Inc., a scuba diving and instruction business. Then post the effects to the T-accounts. Account titles and beginning balances are provided in the T-accounts that follow. Be sure to check that debits equal credits in each journal entry and that the accounting equation remains in balance.

a. In June, new customers paid Florida Flippers $8,200 in cash for diving trips; $5,200 was for trips made in June and the rest is for trips that will be provided in July.
b. In June, customers paid $3,900 in cash for instruction they received in May.
c. At the beginning of June, Florida Flippers paid a total of $6,000 cash for insurance to cover the months of June, July, and August.
d. In June, Florida Flippers paid $4,000 in wages to employees who worked in June.

	Debit	Credit
a.		
b.		
c.		
d.		

+ Cash (A) −

Beg.	25,000		
End.			

+ Accounts Receivable (A) −

Beg.	4,500		
End.			

+ Prepaid Insurance (A) −

Beg.	0		
End.			

− Unearned Revenue (L) +

		0	Beg.
			End.

− Diving Trip Revenue (R) +

		0	Beg.
			End.

+ Wages Expense (E) −

Beg.	0		
End.			

After you have completed your answers, check them below.

GUIDED HELP 3-2

For additional step-by-step video instruction on analyzing, recording, and posting transaction effects, go to **www.mhhe.com/libby10e_gh3b.**

Solutions to SELF-STUDY QUIZ

	Debit	Credit
a. Cash (+A)	8,200	
Diving trip revenue (+R, +SE)		5,200
Unearned revenue (+L)		3,000
b. Cash (+A)	3,900	
Accounts receivable (−A)		3,900
c. Prepaid insurance (+A)	6,000	
Cash (−A)		6,000
d. Wages expense (+E, −SE)	4,000	
Cash (−A)		4,000

+ Cash (A) −

Beg.	25,000	6,000	*(c)*
(a)	8,200	4,000	*(d)*
(b)	3,900		
End.	27,100		

+ Accounts Receivable (A) −

Beg.	4,500	3,900	*(b)*
End.	600		

+ Prepaid Insurance (A) −

Beg.	0		
(c)	6,000		
End.	6,000		

− Unearned Revenue (L) +

		0	Beg.
		3,000	*(a)*
		3,000	End.

− Diving Trip Revenue (R) +

		0	Beg.
		5,200	*(a)*
		5,200	End.

+ Wages Expense (E) −

Beg.	0		
(d)	4,000		
End.	4,000		

LEARNING OBJECTIVE 3-5

Prepare a classified income statement.

HOW IS THE INCOME STATEMENT PREPARED AND ANALYZED?

As we discussed in Chapter 2, companies can prepare financial statements at any point in time. Before we consider creating any statements for **Chipotle**, however, we must first determine that the debits equal credits, after recording all of the transactions illustrated above, by generating a trial balance. Accounts are listed in financial statement order: assets, liabilities, stockholders' equity, revenues/gains, and expenses/losses.

CHIPOTLE MEXICAN GRILL—**UNADJUSTED** TRIAL BALANCE

Based on hypothetical transactions for the first quarter ended March 31, 2018

(in millions)	**Debit**	**Credit**
Cash	731	
Short-term investments	333	
Accounts receivable	54	
Supplies	390	
Prepaid expenses	131	
Land	21	
Buildings	1,711	
Equipment	628	
Accumulated depreciation		979
Long-term investments	35	
Intangible assets	81	
Accounts payable		88
Unearned revenue		106
Dividends payable		2
Income taxes payable		0
Wages payable		0
Utilities payable		5
Notes payable *(current)*		0
Notes payable *(noncurrent)*		80
Other liabilities		279
Common stock		2
Additional paid-in capital		1,604
Treasury stock	2,334	
Retained earnings		2,391
Restaurant sales revenue		1,228
Interest revenue		1
Wages expense	177	
Utilities expense	75	
Repairs expense	19	
Training expense	41	
Loss on disposal of assets	4	
Income tax expense	0	
Total	**6,765**	**6,765**

Although debits do equal credits, why is the trial balance labeled "unadjusted"? Does it make sense that supplies were purchased during the quarter, but no Supplies Expense was recorded to show the amount of supplies used? How likely is it that gift cards were sold, but none were redeemed by customers during the quarter? And didn't Chipotle use property and equipment during the quarter to generate revenues? The answer to all of these questions is that **no end-of-period adjustments**

have been made yet to reflect all revenues earned and expenses incurred during the quarter. Therefore, the trial balance is **unadjusted** until all adjustments are made, as we illustrate in Chapter 4.

Classified Income Statement

The following classified income statement (that is, it is categorized into operating activities and peripheral activities) is presented to highlight the structure, **but note that, because it is based on unadjusted balances, it would not be presented to external users.**

CHIPOTLE MEXICAN GRILL, INC.
Consolidated Statement of Income*
UNADJUSTED
For the Quarter ended March 31, 2018
(in millions of dollars)

Restaurant sales revenue	$1,228
Restaurant operating expenses:	
Wages expense	177
Utilities expense	75
Repairs expense	19
General and administrative expenses:	
Training expense	41
Loss on disposal of assets	4
Total operating expenses	316
Income from operations	912
Other items:	
Interest revenue	1
Income before income taxes	913
Income tax expense	0
Net income	$ 913

*Based on hypothetical activities for the quarter.

When comparing this statement with **Chipotle**'s 2017 income statement in Exhibit 3.1, we notice that the income from operations for the first quarter ($912) exceeds all income from operations for 2017 ($271). Because a more representative amount for one quarter would be about 25 percent, obviously, numerous adjustments are necessary to revenues and expenses, such as providing food service to customers with gift cards (earning a revenue) and using food, packaging, and beverage supplies, renting facilities, and using buildings and equipment during the quarter to generate revenue (incurring expenses). We would not want to use the information for analysis until it has been adjusted. Instead, we use the 2017 income statement in Exhibit 3.1 to determine how effective Chipotle's management is at generating profit.

KEY RATIO ANALYSIS

Net Profit Margin

LEARNING OBJECTIVE 3-6
Compute and interpret the net profit margin ratio.

? **ANALYTICAL QUESTION**

How effective is management at generating profit on every dollar of sales?

% **RATIO AND COMPARISONS**

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales (or Operating Revenues)*}}$$

*Net sales is sales revenue less any returns from customers and other reductions. For companies in the service industry, total operating revenues is equivalent to net sales.

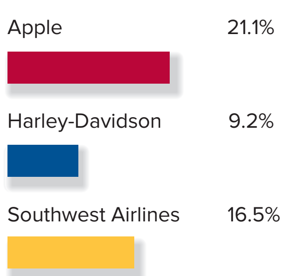
The 2017 ratio for **Chipotle** using reported amounts (from Exhibit 3.1) is (dollars in millions):

$$\frac{\$176}{\$4{,}477} = 0.0393 \text{ or } 3.93\%$$

COMPARISONS OVER TIME Chipotle Mexican Grill, Inc.		
2017	**2016**	**2015**
0.0393	0.0059	0.1057

COMPARISONS WITH COMPETITORS El Pollo Loco Holdings	Fiesta Restaurant Group, Inc.
2017	**2017**
0.0215	(0.0542)

Selected Focus Companies' Net Profit Margin Ratios for 2017



INTERPRETATIONS

In General Net profit margin measures how much of every sales dollar generated during the period is profit. A rising net profit margin signals more efficient management of sales and expenses. Differences among industries result from the nature of the products or services provided and the intensity of competition. Differences among competitors in the same industry reflect how each company responds to changes in competition (and demand for the product or service) and changes in managing sales volume, sales price, and costs. Financial analysts expect well-run businesses to maintain or improve their net profit margin over time.

Focus Company Analysis Chipotle's net profit margin varied over the three-year period, from about $0.11 in 2015 to less than $0.01 in 2016 to nearly $0.04 in 2017 in net income for every dollar of sales revenue. As indicated by management in the annual report, revenue was lower throughout 2016 due to the food-borne illness incidents associated with Chipotle restaurants, reported primarily during the fourth quarter of 2015 and first quarter of 2016. At the same time, all other expenses increased throughout the years. Between the immediate crisis affecting 2016's financial performance and the company's performance in 2017, Chipotle's management did a better job of generating revenues while expenses continued to increase. However, Chipotle's net profit margin has yet to return to the level between 10 and 11 percent which it realized for 2015 and for several years prior to the 2016 incidents.

El Pollo Loco and **Fiesta Restaurant Group** each had a lower net profit margin than Chipotle, suggesting that, despite its image issues, Chipotle is more effective at generating revenue while controlling costs. Fiesta Restaurant Group actually reported a net loss in 2017 due to the effects of the hurricanes in 2017 that affected restaurants in Texas and Florida and a $61.8 million loss due to the the closure of over 45 unprofitable restaurants. Fiesta Restaurant Group is much smaller in size than Chipotle and more regional (in the southeastern U.S. and Texas), which suggests lower economies of scale and higher risk, as experienced with hurricanes in the region. Differences in business strategies, size, and locations explain some of the wide variation in the ratio analysis.

A Few Cautions The decisions that management makes to maintain the company's net profit margin in the current period may have negative long-run implications. Analysts should perform additional analysis of the ratio to identify trends in each component of revenues and expenses. This involves dividing each line on the income statement by net sales. Statements presented with these percentages are called **common-sized income statements.** Changes in the percentages of the individual components of net income provide information on shifts in management's strategies.

FOCUS ON CASH FLOWS

LEARNING OBJECTIVE 3-7

Identify operating transactions and demonstrate how they affect cash flows.

Operating Activities

In this chapter, we focus on cash flows from operating activities: **cash from** operating sources, primarily customers, and **cash to** suppliers and others involved in operations. The accounts most often associated with operating activities are current assets, such as Accounts Receivable, Inventories, and Prepaid Expenses, and current liabilities, such as Accounts Payable, Wages Payable, and Unearned Revenue.

As discussed in Chapter 2, companies report cash inflows and outflows over a period of time in their **statement of cash flows.** This statement is divided into three categories:

- **O** — Operating activities include those primarily with customers and suppliers, and interest payments and earnings on investments.
- **I** — Investing activities include buying and selling noncurrent assets and investments.
- **F** — Financing activities include borrowing and repaying debt, including short-term bank loans; issuing and repurchasing stock; and paying dividends.

Only transactions affecting cash are reported on the statement. An important step in constructing and analyzing the statement of cash flows is identifying the various transactions as operating, investing, or financing. Let's analyze the Cash T-account for **Chipotle**'s assumed transactions in this chapter, adding to transactions *(a)–(f)* from Chapter 2. Refer to transactions *(1)–(11)* illustrated earlier in the chapter and remember, **if you see Cash in a transaction, it will be reflected on the statement of cash flows.**

		+ Cash (A) −						
		1/1/18	186				
From investors	**+F**	*(a)*	300	54	*(c)*	**−I**	**To purchase noncurrent assets**
From bank	**+F**	*(b)*	2	1	*(d)*	**−F**	**To repay notes payable to the bank**
				44	*(e)*	**−I**	**To purchase investments in other companies**
From customers	**+O**	*(3)*	1,184	290	*(1)*	**−O**	**To pay suppliers of food and paper products**
From sale of noncurrent asset	**+I**	*(6)*	5	80	*(2)*	**−O**	**To pay suppliers of rental facilities, insurance, and advertising**
From customers	**+O**	*(7)*	39	41	*(4)*	**−O**	**To pay to train employees**
From earnings on investments	**+O**	*(10)*	1	260	*(5)*	**−O**	**To pay employees for working**
From customers	**+O**	*(11)*	42	164	*(8)*	**−O**	**To pay suppliers and taxes**
				94	*(9)*	**−O**	**To pay suppliers of utilities and repairs**
			731				

PAUSE FOR FEEDBACK

As we discussed, every transaction affecting cash can be classified either as an operating, investing, or financing effect.

Operating effects relate to receipts of cash from customers, payments to suppliers (employees, utilities, and other suppliers of goods and services for operating the business), and any interest paid or investment income received.

Investing effects relate to purchasing/selling investments or property and equipment or lending funds to/receiving repayment from others.

Financing effects relate to borrowing or repaying banks, issuing stock to investors, repurchasing stock from investors, or paying dividends to investors.

SELF-STUDY QUIZ

Mattel, Inc., designs, manufactures, and markets a broad variety of toys (e.g., Barbie, Hot Wheels, Fisher-Price brands, and American Girl dolls) worldwide. Indicate whether these transactions from a recent statement of cash flows were operating (O), investing (I), or financing (F) activities and the direction of their effects on cash (+ for increases in cash; − for decreases in cash):

TRANSACTIONS	TYPE OF ACTIVITY (O, I, OR F)	EFFECT ON CASH FLOWS (+ OR −)
1. Purchases of property, plant, and equipment		
2. Receipts from customers		
3. Payments of dividends		
4. Payments to employees		
5. Receipts of investment income		

After you have completed your answers, check them below.

DEMONSTRATION CASE

This case is a continuation of the Terrific Lawn Maintenance Corporation transactions introduced in Chapter 2. In that chapter, the company was established and supplies, property, and equipment were purchased. Terrific Lawn is now ready for business. The balance sheet at April 7, 2019, based on the first week of investing and financing activities (from Chapter 2) is as follows:

TERRIFIC LAWN MAINTENANCE CORPORATION
Balance Sheet
April 7, 2019

Assets	
Current Assets:	
Cash	$ 3,800
Notes receivable	1,250
Total current assets	5,050
Equipment	4,600
Land	3,750
Total assets	**$13,400**
Liabilities and Stockholders' Equity	
Current Liabilities:	
Short-term notes payable	$ 400
Total current liabilities	400
Long-term notes payable	4,000
Total liabilities	4,400
Stockholders' Equity:	
Common stock ($0.10 par)	150
Additional paid-in capital	8,850
Total stockholders' equity	9,000
Total liabilities and stockholders' equity	**$13,400**

Solutions to SELF-STUDY QUIZ

1. I − 2. O + 3. F − 4. O − 5. O +

The following additional activities occurred during the rest of April 2019:

a. Purchased and used during April gasoline for mowers and edgers, paying $90 in cash at a local gas station.

b. In early April, received from the city $1,600 cash in advance for lawn maintenance service for April through July ($400 each month). (Record the entire amount as Unearned Revenue.)

c. In early April, purchased $300 of insurance covering six months, April through September. (Record the entire payment as Prepaid Expenses.)

d. Mowed lawns for residential customers who are billed every two weeks. A total of $5,200 of service was billed in April.

e. Residential customers paid $3,500 on their accounts.

f. Paid wages every two weeks. Total cash paid in April was $3,900.

g. Received a bill for $320 from the local gas station for additional gasoline purchased on account and used in April. The bill will be paid in May.

h. Paid $700 principal and $40 interest on note owed to XYZ Lawn Supply.

i. Paid $100 on accounts payable.

j. Collected $1,250 principal and $12 interest on the note owed by the city to Terrific Lawn Maintenance Corporation.

Required:

1. *a.* On a separate sheet of paper, set up T-accounts for Cash, Accounts Receivable, Notes Receivable, Prepaid Expenses, Equipment, Land, Accounts Payable, Short-Term Notes Payable, Unearned Revenue (same as deferred revenue), Long-Term Notes Payable, Common Stock, Additional Paid-in Capital, Retained Earnings, Mowing Revenue, Interest Revenue, Wages Expense, Fuel Expense, and Interest Expense. Beginning balances for the balance sheet accounts should be taken from the preceding balance sheet. Beginning balances for operating accounts are $0. Indicate these balances on the T-accounts.

b. Analyze each transaction, referring to the expanded transaction analysis model presented in this chapter.

c. On a separate sheet of paper, prepare journal entries in chronological order and indicate their effects on the accounting model (Assets = Liabilities + Stockholders' Equity). Include the equality checks: (1) Debits = Credits and (2) the accounting equation is in balance.

d. Enter the effects of each transaction in the appropriate T-accounts. Identify each amount with its letter in the preceding list of activities.

e. Compute balances in each of the T-accounts.

2. Use the amounts in the T-accounts to prepare an unadjusted classified income statement for Terrific Lawn Maintenance Corporation for the month ended April 30, 2019. (Adjustments to accounts will be presented in Chapter 4.)

3. On the Cash T-account, identify each transaction as O for operating activity, I for investing activity, or F for financing activity.

Now check your answers with the following suggested solution.

SUGGESTED SOLUTION

1. ***b.*** **and** ***c.*** Transaction analysis, journal entries, and the effect on the accounting model:

Equality Checks for All
Debits = Credits • Equation balances

Journal Entries	Debit	Credit	A	= L	+ SE	
(a) Fuel expense (+E, −SE)	90					
Cash (−A)		90	−90		+E	−90
(b) Cash (+A)	1,600					
Unearned revenue (+L)		1,600	+1,600	+1,600		
(c) Prepaid expenses (+A)	300		+300			
Cash (−A)		300	−300			
(d) Accounts receivable (+A)	5,200					
Mowing revenue (+R, +SE)		5,200	+5,200		+R	+5,200
(e) Cash (+A)	3,500		+3,500			
Accounts receivable (−A)		3,500	−3,500			
(f) Wages expense (+E, −SE)	3,900					
Cash (−A)		3,900	−3,900		+E	−3,900
(g) Fuel expense (+E, −SE)	320					
Accounts payable (+L)		320		+320	+E	−320
(h) Interest expense (+E, −SE)	40					
Long-term notes payable (−L)	700					
Cash (−A)		740	−740	−700	+E	−40
(i) Accounts payable (−L)	100					
Cash (−A)		100	−100	−100		
(j) Cash (+A)	1,262					
Notes receivable (−A)		1,250	+1,262		+R	+12
Interest revenue (+R, +SE)		12	−1,250			

1. ***a.***, ***d.***, **and** ***e.*** **T-Accounts:**
Assets

+ Cash (A) −

	Debit	Credit	
Beg.	3,800		
(b)	1,600	90	*(a)*
(e)	3,500	300	*(c)*
(j)	1,262	3,900	*(f)*
		740	*(h)*
		100	*(i)*
	5,032		

+ Accounts Receivable (A) −

	Debit	Credit	
Beg.	0		
(d)	5,200	3,500	*(e)*
	1,700		

+ Notes Receivable (A) −

	Debit	Credit	
Beg.	1,250		
		1,250	*(j)*
	0		

+ Prepaid Expenses (A) −

	Debit	Credit
Beg.	0	
(c)	300	
	300	

+ Equipment (A) −

	Debit	Credit
Beg.	4,600	
	4,600	

+ Land (A) −

	Debit	Credit
Beg.	3,750	
	3,750	

Liabilities

− Accounts Payable (L) +			
		0	Beg.
(i)	100	320	*(g)*
		220	

− Short-Term Notes Payable (L) +			
		400	Beg.
		400	

− Unearned Revenue (L) +			
		0	Beg.
		1,600	*(b)*
		1,600	

− Long-Term Notes Payable (L) +			
		4,000	Beg.
(h)	700		
		3,300	

Stockholders' Equity

− Common Stock (SE) +			
		150	Beg.
		150	

− Additional Paid-in Capital (SE) +			
		8,850	Beg.
		8,850	

− Retained Earnings (SE) +			
		0	Beg.
		0	

Revenues

− Mowing Revenue (R) +			
		0	Beg.
		5,200	*(d)*
		5,200	

− Interest Revenue (R) +			
		0	Beg.
		12	*(j)*
		12	

Expenses

+ Wages Expense (E) −			
Beg.	0		
(f)	3,900		
	3,900		

+ Fuel Expense (E) −			
Beg.	0		
(a)	90		
(g)	320		
	410		

+ Interest Expense (E) −			
Beg.	0		
(h)	40		
	40		

2. Income Statement:

TERRIFIC LAWN MAINTENANCE CORPORATION
Unadjusted Income Statement
For the Month Ended April 30, 2019

Mowing revenue	$5,200
Operating expenses:	
Wages expense	3,900
Fuel expense	410
Total operating expenses	4,310
Income from operations	890
Other items:	
Interest revenue	12
Interest expense	(40)
Income before taxes	862
Income tax expense	0
Net income	$ 862

To be computed and recorded after adjustments are made to revenue and expense accounts (Chapter 4)

3. **Cash flow activities identified (O = operating, I = investing, and F = financing):**

		+ Cash (A)	−		
	Beg.	3,800			
From customers +O	(b)	1,600	90	(a)	−O To suppliers of fuel
From customers +O	(e)	3,500	300	(c)	−O To suppliers of insurance coverage
$12 for interest +O; $1,250 for principal +I	(j)	1,262	3,900	(f)	−O To employees
			740	(h)	−O $40 for interest; −F $700 for principal
			100	(i)	−O To suppliers
		5,032			

CHAPTER TAKE-AWAYS

3-1. Describe a typical business operating cycle and explain the necessity for the time period assumption. p. 106

- The operating cycle, or cash-to-cash cycle, is the time needed to purchase goods or services from suppliers, sell the goods or services to customers, and collect cash from customers.
- Time period assumption—to measure and report financial information periodically, we assume the long life of a company can be cut into shorter periods.

3-2. Explain how business activities affect the elements of the income statement. p. 108

- Elements of the income statement:
  a. Revenues—increases in assets or settlements of liabilities from major or central ongoing operations.
  b. Expenses—decreases in assets or increases in liabilities from major or central ongoing operations.
  c. Gains—increases in assets or settlements of liabilities from peripheral activities.
  d. Losses—decreases in assets or increases in liabilities from peripheral activities.

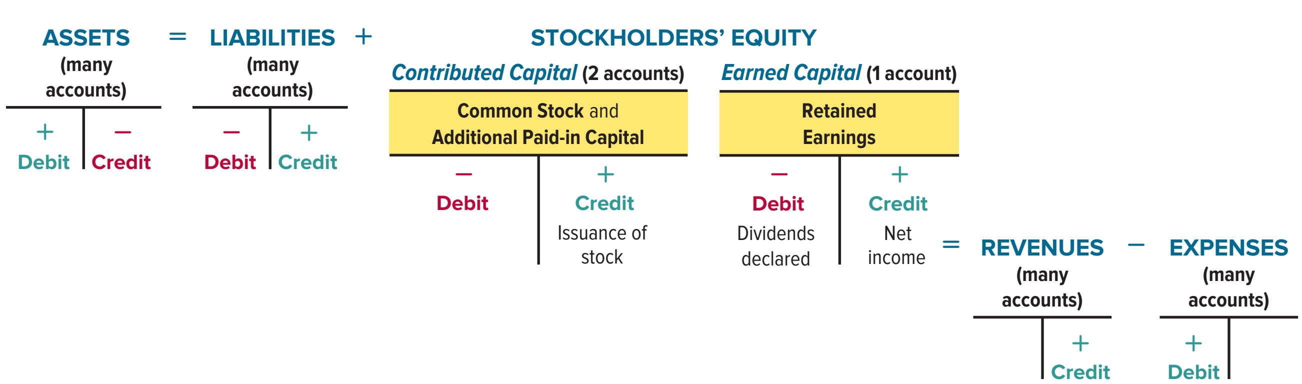
3-3. Explain the accrual basis of accounting and apply the revenue and expense recognition principles to measure income. p. 112

In accrual basis accounting, revenues are recognized when earned and expenses are recognized when incurred.

- Revenue recognition principle—recognize revenues (1) when the company transfers promised goods or services to customers (2) in the amount it expects to be entitled to receive.
- Expense recognition principle (matching)—recognize expenses when they are incurred in generating revenue (a matching of costs with benefits).

3-4. Apply transaction analysis to examine and record the effects of operating activities on the financial statements. p. 118

The expanded transaction analysis model includes revenues and expenses:



3-5. Prepare a classified income statement. **p. 128**

Until the accounts have been updated to include all revenues earned and expenses incurred in the period (due to a difference in the timing of when cash is received or paid), the financial statements are unadjusted:

- Classified income statement—net income is needed to determine ending Retained Earnings; classifications include Operating Revenues, Operating Expenses (to determine Operating Income), Other Items (to determine Pretax Income), Income Tax Expense, Net Income (or Net Loss), and Earnings per Share.

3-6. Compute and interpret the net profit margin ratio. **p. 130**

The net profit margin ratio (Net Income [or Net Loss] ÷ Net Sales [or Operating Revenues]) measures the profit generated per dollar of sales (operating revenues). The higher the ratio when compared to competitors or over time, the more effective the company is at generating revenues and/or controlling costs.

3-7. Identify operating activities and demonstrate how they affect cash flows. **p. 130**

Operating activities include those primarily with customers and suppliers, and interest payments and earnings on investments. Only when cash is received or paid in an operating activity is the statement of cash flows affected.

In this chapter, we discussed the operating cycle and accounting concepts relevant to income determination: the time period assumption, definitions of the income statement elements (revenues, expenses, gains, and losses), the revenue recognition principle, and the expense recognition principle. The accounting principles are defined in accordance with the accrual basis of accounting, which requires revenues to be recorded when earned and expenses to be recorded when incurred in the process of generating revenues. We expanded the transaction analysis model introduced in Chapter 2 by adding revenues and expenses and prepared an unadjusted classified income statement. In Chapter 4, we discuss the activities that occur at the end of the accounting period: the adjustment process, the preparation of adjusted financial statements, and the closing process.

KEY RATIO

Net profit margin ratio measures the profit generated per dollar of sales (operating revenues). A high ratio as compared to competitors or over time suggests that a company is generating revenues and/or controlling expenses more effectively. The ratio is computed as follows (see the "Key Ratio Analysis" box):

$$\text{Net Profit Margin Ratio} = \frac{\text{Net Income}}{\text{Net Sales (or Operating Revenues)}}$$

FINDING FINANCIAL INFORMATION

Balance Sheet

Current Assets
- Cash
- Short-term investments
- Accounts receivable
- Inventory (goods to be sold)
- Supplies
- Prepaid expenses

Noncurrent Assets
- Long-term investments
- Land
- Buildings
- Equipment
- (Accumulated depreciation)
- Intangible assets

Current Liabilities
- Accounts payable
- Short-term notes payable
- Accrued expenses payable (e.g., wages, taxes)
- Unearned revenue

Noncurrent Liabilities
- Long-term notes payable
- Long-term debt

Stockholders' Equity
- Common stock
- Additional paid-in capital
- Retained earnings

Income Statement

Revenues (operating)
- Sales (from various operating activities)

Expenses (operating)
- Cost of goods sold (used inventory)
- Rent, wages, depreciation, insurance, etc.
- Losses (gains) on disposal of assets

Operating Income

Other Items
- Interest expense
- Interest revenue
- Losses (gains) on sale of investments

Pretax Income
- Income tax expense

Net Income

Earnings per Share

Statement of Cash Flows

Operating Activities
+ Cash from customers
+ Cash from interest and dividends
− Cash to suppliers
− Cash to employees
− Interest paid
− Income taxes paid

Notes

Under Summary of Significant Accounting Policies
Description of the company's revenue recognition policy.

KEY TERMS

Accrual Basis Accounting p. 112
Cash Basis Accounting p. 111
Expense Recognition Principle (or Matching Principle) p. 115
Expenses p. 109
Gains p. 109
Losses p. 109
Operating (Cash-to-Cash) Cycle p. 107
Operating Income (Income from Operations) p. 110
Revenue Recognition Principle p. 112
Revenues p. 108
Time Period Assumption p. 107

QUESTIONS

1. Describe a typical business operating cycle.
2. Explain what the time period assumption means.
3. Write the income statement equation and define each element.
4. Explain the difference between
   a. Revenues and gains.
   b. Expenses and losses.
5. Define **accrual accounting** and contrast it with cash basis accounting.
6. What criteria must normally be met for revenue to be recognized under accrual basis accounting?
7. Explain the expense recognition principle.
8. Explain why stockholders' equity is increased by revenues and decreased by expenses.
9. Explain why revenues are recorded as credits and expenses are recorded as debits.
10. Complete the following matrix by entering either **debit** or **credit** in each cell:

Item	Increase	Decrease
Revenues		
Losses		
Gains		
Expenses		

11. Complete the following matrix by entering either **increase** or **decrease** in each cell:

Item	Debit	Credit
Revenues		
Losses		
Gains		
Expenses		

12. Identify whether the following transactions affect cash flow from operating, investing, or financing activities and indicate the effect of each on cash (+ for increase and − for decrease). If there is no cash flow effect, write "None."

Transaction	Operating, Investing, or Financing Effect on Cash	Direction of the Effect on Cash
Cash paid to suppliers		
Sale of goods on account		
Cash received from customers		
Purchase of investments		
Cash paid for interest		
Issuance of stock for cash		

13. State the equation for the net profit margin ratio and explain how it is interpreted.

MULTIPLE-CHOICE QUESTIONS

1. Which of the following is **not** a specific account in a company's chart of accounts?
   a. Gain on Sale of Assets
   b. Interest Revenue
   c. Net Income
   d. Unearned Revenue
2. Which of the following is **not** one of the criteria that normally must be met for revenue to be recognized according to the revenue recognition principle for accrual basis accounting?
   a. Cash has been collected.
   b. Services have been performed.
   c. Goods have been transferred.
   d. The amount the company expects to be entitled to receive is determinable.
3. The expense recognition principle controls
   a. Where on the income statement expenses should be presented.
   b. When costs are recognized as expenses on the income statement.
   c. The ordering of current assets and current liabilities on the balance sheet.
   d. How costs are allocated between Cost of Sales (sometimes called Cost of Goods Sold) and general and administrative expenses.
4. When expenses exceed revenues in a given period,
   a. Retained earnings are not impacted.
   b. Retained earnings are decreased.
   c. Retained earnings are increased.
   d. One cannot determine the impact on retained earnings without additional information.
5. On January 1, 2020, Anson Company started the year with a $300,000 credit balance in Retained Earnings, a $50,000 balance in Common Stock, and a $300,000 balance in Additional Paid-in Capital. During 2020, the company earned net income of $45,000, declared a dividend of $15,000, and issued 900 additional shares of stock (par value of $1 per share) for $10,000. What is total stockholders' equity on December 31, 2020?
   a. $692,500.
   b. $695,000.
   c. $690,000.
   d. None of the above.
6. During 2019, CliffCo Inc. incurred operating expenses of $250,000, of which $150,000 was paid in cash; the balance will be paid in January 2020. Transaction analysis of operating expenses for 2019 should reflect only the following:
   a. Decrease stockholders' equity, $150,000; decrease assets, $150,000.
   b. Decrease assets, $250,000; decrease stockholders' equity, $250,000.
   c. Decrease stockholders' equity, $250,000; decrease assets, $150,000; increase liabilities, $100,000.
   d. Decrease assets, $250,000; increase liabilities, $100,000; decrease stockholders' equity, $150,000.
   e. None of the above is correct.

7. Which of the following is the entry to be recorded by a law firm when it receives a $2,000 retainer from a new client at the initial client meeting?
   a. Debit to Cash, $2,000; credit to Legal Fees Revenue, $2,000.
   b. Debit to Accounts Receivable, $2,000; credit to Legal Fees Revenue, $2,000.
   c. Debit to Unearned Revenue, $2,000; credit to Legal Fees Revenue, $2,000.
   d. Debit to Cash, $2,000; credit to Unearned Revenue, $2,000.
   e. Debit to Unearned Revenue, $2,000; credit to Cash, $2,000.
8. You have observed that the net profit margin ratio for a retail chain has increased steadily over the last three years. The **most** likely explanation is which of the following?
   a. Salaries for upper management as a percentage of total expenses have decreased over the last three years.
   b. A successful advertising campaign increased sales companywide, but with no increases in operating expenses.
   c. New stores were added throughout the last three years and sales increased as a result of the additional new locations.
   d. The company began construction of a new, larger main office location three years ago that was put into use at the end of the second year.
9. Cash payments for salaries are reported in what section of the statement of cash flows?
   a. Operating.
   b. Investing.
   c. Financing.
   d. None of the above.
10. This period a company collects $100 cash on an account receivable from a customer for a sale last period. How would the receipt of cash impact the following two financial statements this period?

	Income Statement	Statement of Cash Flows
a.	Revenue + $100	Inflow from investing
b.	No impact	Inflow from operations
c.	Revenue − $100	Inflow from operations
d.	No impact	Inflow from financing

MINI-EXERCISES

connect

M3-1 Matching Definitions with Terms
LO3-1, 3-2, 3-3

Match each definition with its related term by entering the appropriate letter in the space provided. There should be only one definition per term (that is, there are more definitions than terms).

Term	Definition
____ (1) Losses	A. Record revenues when earned and measurable (when the company transfers promised goods or services to customers, it should record the amount it expects to be entitled to receive).
____ (2) Expense recognition principle	B. The time it takes to purchase goods or services from suppliers, sell goods or services to customers, and collect cash from customers.
____ (3) Revenues	C. Record expenses when incurred in earning revenue.
____ (4) Time period assumption	D. Decreases in assets or increases in liabilities from central ongoing operations.
____ (5) Operating cycle	E. Report the long life of a company in shorter time periods.
	F. Increases in assets or decreases in liabilities from central ongoing operations.
	G. Decreases in assets or increases in liabilities from peripheral transactions.

Reporting Cash Basis versus Accrual Basis Income

M3-2
LO3-3

Skidmore Music Company had the following transactions in March:

a. Sold instruments to customers for $18,000; received $8,000 in cash and the rest on account. The cost of the instruments was $9,000.
b. Purchased $4,000 of new instruments inventory; paid $1,000 in cash and owed the rest on account.
c. Paid $900 in wages to employees who worked during the month.
d. Received $5,000 from customers as deposits on orders of new instruments to be sold to the customers in April.
e. Received a $300 bill for March utilities that will be paid in April.

Complete the following statements:

Cash Basis Income Statement		Accrual Basis Income Statement	
Revenues:		Revenues:	
Cash sales		Sales to customers	
Customer deposits			
Expenses:		Expenses:	
Inventory purchases		Cost of sales	
Wages paid		Wages expense	
		Utilities expense	
Net income		Net income	

Identifying Revenues

M3-3
LO3-2, 3-3

The following transactions are July activities of Bennett's Bowling, Inc., which operates several bowling centers, offering customers lanes for games and merchandise for sale. If revenue is to be recognized in **July,** indicate the revenue account title and amount. If revenue is not to be recognized in July, explain why.

Activity	Revenue Account Title and Amount
a. Bennett's collected $15,000 from customers for games played in July.	
b. Bennett's sold bowling merchandise inventory from its pro shop for $800; received $300 in cash and customers owed the rest on account. (Consider only the effect on revenue here. The cost of goods sold [expense] for this sale is analyzed in M3-4[*e*].)	
c. Bennett's received $400 from customers who purchased merchandise in June on account.	
d. The men's and ladies' bowling leagues gave Bennett's a deposit of $2,500 for the upcoming fall season.	

Identifying Expenses

M3-4
LO3-2, 3-3

The following transactions are July activities of Bennett's Bowling, Inc., which operates several bowling centers, offering customers lanes for games and merchandise for sale. If expense is to be recognized in **July,** indicate the expense account title and amount. If expense is not to be recognized in July, explain why.

Activity	Expense Account Title and Amount
e. Bennett's provided to customers bowling merchandise inventory costing Bennett's $680. (Consider only the effect on cost of goods sold [expense] here. The revenue is analyzed in M3-3[*b*].)	
f. Bennett's paid $500 on the electricity bill for June (recorded as an expense in June).	
g. Bennett's paid $3,600 to employees for work in July.	
h. Bennett's purchased $1,500 in insurance for coverage from August 1 to November 1.	
i. Bennett's paid $700 to plumbers for repairing a broken pipe in the restrooms.	
j. Bennett's received the July electricity bill for $900 to be paid in August.	

M3-5
LO3-4

Recording Revenues

For each of the transactions in M3-3, write the journal entry in good form.

M3-6
LO3-4

Recording Expenses

For each of the transactions in M3-4, write the journal entry in good form.

M3-7
LO3-4

Determining the Financial Statement Effects of Operating Activities Involving Revenues

The following transactions are July activities of Bennett's Bowling, Inc., which operates several bowling centers, offering customers lanes for games and merchandise for sale. For each of the following transactions, complete the tabulation, indicating the amount and effect (+ for increase and − for decrease) of each transaction. (Remember that A = L + SE; R − E = NI; and NI affects SE through Retained Earnings.) Write NE if there is no effect. The first transaction is provided as an example.

	BALANCE SHEET			INCOME STATEMENT		
Transaction	Assets	Liabilities	Stockholders' Equity	Revenues	Expenses	Net Income
a. Bennett's collected $15,000 from customers for games played in July.	+15,000	NE	+15,000	+15,000	NE	+15,000
b. Bennett's sold bowling merchandise inventory from its pro shop for $800; received $300 in cash and customers owed the rest on account. (Consider only the effect on revenue here. The cost of goods sold [expense] for this sale will be analyzed in M3-8[*e*].)						
c. Bennett's received $400 from customers who purchased merchandise in June on account.						
d. The men's and ladies' bowling leagues gave Bennett's a deposit of $2,500 for the upcoming fall season.						

M3-8
LO3-4

Determining the Financial Statement Effects of Operating Activities Involving Expenses

The following transactions are July activities of Bennett's Bowling, Inc., which operates several bowling centers, offering customers lanes for games and merchandise for sale. For each of the following transactions, complete the tabulation, indicating the amount and effect (+ for increase and − for decrease) of each transaction. (Remember that A = L + SE; R − E = NI; and NI affects SE through Retained Earnings.) Write NE if there is no effect. The first transaction is provided as an example.

	BALANCE SHEET			INCOME STATEMENT		
Transaction	Assets	Liabilities	Stockholders' Equity	Revenues	Expenses	Net Income
e. Bennett's provided to customers bowling merchandise inventory costing Bennett's $680. (Consider only the effect on cost of goods sold [expense] here. The revenue is analyzed in M3-7[*b*].)	−680	NE	−680	NE	+680	−680
f. Bennett's paid $500 on the electricity bill for June (recorded as an expense in June).						
g. Bennett's paid $3,600 to employees for work in July.						
h. Bennett's purchased $1,500 in insurance for coverage from August 1 to November 1.						
i. Bennett's paid $700 to plumbers for repairing a broken pipe in the restrooms.						
j. Bennett's received the July electricity bill for $900 to be paid in August.						

M3-9
LO3-5

Preparing a Simple Income Statement

Given the transactions in M3-7 and M3-8 (including the examples), prepare an unadjusted income statement for Bennett's Bowling, Inc., for the month of July.

M3-10
LO3-6, 3-7

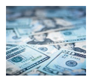
Computing and Explaining the Net Profit Margin Ratio

The following data are from annual reports of Jen's Jewelry Company:

	2021	2020	2019
Total assets	$ 60,000	$ 53,000	$ 41,000
Total liabilities	14,000	11,000	6,000
Total stockholders' equity	46,000	42,000	35,000
Sales revenue	163,000	151,000	132,000
Net income	51,000	40,000	25,000

Compute Jen's net profit margin ratio for each year. What do these results suggest to you about Jen's Jewelry Company?

M3-11 Identifying the Operating Activities in a Statement of Cash Flows
LO3-7



Given the transactions in M3-7 and M3-8 (including the examples), indicate how the transactions will affect the statement of cash flows for Bennett's Bowling, Inc., for the month of July. Create a table similar to the one below for transactions (*a*) through (*j*). Use O for operating, I for investing, and F for financing activities and indicate the direction of their effects on cash (+ for increases in cash; − for decreases in cash). Also include the amount of cash to be reported on the statement. If there is no effect on the statement of cash flows, write NE.

Transaction	Type of Activity (O, I, or F)	Effect on Cash Flows (+ or − and amount)
a.		
b.		
etc.		

EXERCISES

E3-1 Matching Definitions with Terms
LO3-1, 3-2, 3-3

Match each definition with its related term by entering the appropriate letter in the space provided. There should be only one definition per term (that is, there are more definitions than terms).

Term

___ (1) Expenses
___ (2) Gains
___ (3) Revenue recognition principle
___ (4) Cash basis accounting
___ (5) Unearned revenue
___ (6) Operating cycle
___ (7) Accrual basis accounting
___ (8) Prepaid expenses
___ (9) Revenues − Expenses = Net Income
___ (10) Ending Retained Earnings = Beginning Retained Earnings + Net Income − Dividends Declared

Definition

A. Report the long life of a company in shorter periods.
B. Record expenses when incurred in earning revenue.
C. The time it takes to purchase goods or services from suppliers, sell goods or services to customers, and collect cash from customers.
D. Record revenues when earned and expenses when incurred.
E. Increases in assets or decreases in liabilities from peripheral transactions.
F. An asset account used to record cash paid before expenses have been incurred.
G. Record revenues when earned and measurable (when the company transfers promised goods or services to customers, and in the amount the company expects to receive).
H. Decreases in assets or increases in liabilities from peripheral transactions.
I. Record revenues when received and expenses when paid.
J. The income statement equation.
K. Decreases in assets or increases in liabilities from central ongoing operations.
L. The retained earnings equation.
M. A liability account used to record cash received before revenues have been earned.

Reporting Cash Basis versus Accrual Basis Income

E3-2
LO3-3

Lay Perfect Pillow Company sells specialty pillows and accessories to customers. Its fiscal year ends on December 31. The following transactions occurred in the current year:

a. Purchased $250,000 of new pillow inventory; paid $90,000 in cash and owed the rest on account.
b. Paid employees $180,300 in wages for work during the year; an additional $3,700 for the current year's wages will be paid in January of the next year.
c. Sold pillows to customers for $750,000; received $500,000 in cash and customers owed the rest on account. The cost of the pillow inventory to Lay Perfect Pillow was $485,000.
d. Paid $17,200 cash for utilities for the year.
e. Received $70,000 from customers as deposits on orders of new pillows to be sold to the customers in January of the next year.
f. Received a $1,930 utilities bill for December of the current year that will be paid in January of the next year.

Required:

1. Complete the following statements:

Cash Basis Income Statement		Accrual Basis Income Statement	
Revenues:		Revenues:	
Cash sales		Sales to customers	
Customer deposits			
Expenses:		Expenses:	
Inventory purchases		Cost of sales	
Wages paid		Wages expense	
Utilities paid		Utilities expense	
Net income		Net income	

2. Which basis of accounting (cash or accrual) provides more useful information to investors, creditors, and other users? Why?

Identifying Revenues

E3-3
LO3-2, 3-3

Revenues are normally recognized when the company transfers promised goods or services in the amount the company expects to be entitled to receive. The amount recorded is the cash-equivalent sales price. Assume that the following transactions occurred in **September:**

a. A popular ski magazine company receives a total of $12,345 today from subscribers. The subscriptions begin in the next fiscal year. Answer from the magazine company's standpoint.
b. On September 1 of the current year, a bank lends $15,000 to a company; the note principal and $1,500 ($15,000 × 10 percent) annual interest are due in one year. Answer from the bank's standpoint.
c. **Fucillo Automotive Group** (offering a wide variety of car and truck brands) sells a Ford F-150 truck with a list, or "sticker," price of $34,050 for $32,000 cash.
d. **Macy's** department store orders 1,000 men's shirts for $16 each for future delivery from **PVH Corp.**, manufacturer of IZOD, ARROW, Van Heusen, Calvin Klein, and Tommy Hilfiger and other brand-name apparel. The terms require payment in full within 30 days of delivery. Answer from PVH Corp.'s standpoint.
e. PVH Corp. completes production of the shirts described in (*d*) and delivers the order. Answer from PVH's standpoint.
f. PVH Corp. receives payment from Macy's for the events described in (*d*) and (*e*). Answer from PVH's standpoint.
g. A customer purchases a ticket from **American Airlines** for $780 cash to travel the following January. Answer from American Airlines's standpoint.
h. **Ford Motor Company** issues $15 million in new common stock.
i. **Michigan State University** receives $70,000,000 cash for 50,000 seven-game season football tickets to be played in the upcoming season.
j. Michigan State plays the first football game referred to in (*i*).
k. **Precision Builders** signs a contract with a customer for the construction of a new $1,500,000 warehouse. At the signing, Precision receives a check for $200,000 as a deposit on the future construction. Answer from Precision's standpoint.

l. **Best Buy** receives inventory of 100 laptop computers from **Dell;** Best Buy promises to pay $96,000 within three months. Answer from Dell's standpoint.

m. **Amazon.com** delivers a $300 lamp to a customer who charges the purchase on his Amazon.com Store Card. Answer from Amazon's standpoint.

Required:
For each of the transactions, if revenue is to be recognized in September, indicate the revenue account title and amount. If revenue is not to be recognized in September, explain why.

E3-4
LO3-2, 3-3

Identifying Expenses

Revenues are normally recognized when a company transfers promised goods or services to customers in the amount the company expects to be entitled to receive. Expense recognition is guided by an attempt to match the costs associated with the generation of those revenues to the same time period. Assume that the following transactions occurred in **January:**

a. **McGraw-Hill Education** uses $3,800 worth of electricity and natural gas in its headquarters building for which it has not yet been billed.

b. At the beginning of January, **Turner Construction Company** pays $963 for magazine advertising to run in monthly publications each of the first three months of the year.

c. **Dell** pays its computer service technicians $403,000 in salaries for the two weeks ended January 7. Answer from Dell's standpoint.

d. The **University of Florida** orders 60,000 football tickets from its printer and pays $8,340 in advance for the custom printing. The first game will be played in September. Answer from the university's standpoint.

e. The campus bookstore receives 500 accounting texts at a cost of $210 each. The terms indicate that payment is due within 30 days of delivery.

f. During the last week of January, the campus bookstore sold 400 accounting texts received in (*e*) at a sales price of $280 each.

g. **Fucillo Automotive Group** pays its salespersons $63,800 in commissions related to December automobile sales. Answer from Fucillo's standpoint.

h. On January 31, Fucillo Automotive Group determines that it will pay its salespersons $55,560 in commissions related to January sales. The payment will be made in early February. Answer from Fucillo's standpoint.

i. A new grill is received and installed at a **Wendy's** restaurant at the end of the day on January 31; a $12,750 cash payment is made on that day to the grill supply company. Answer from Wendy's standpoint.

j. **Mall of America** (in Bloomington, MN) had janitorial supplies costing $3,500 in storage. An additional $2,600 worth of supplies was purchased during January. At the end of January, $1,400 worth of janitorial supplies remained in storage.

k. An **Iowa State University** employee works eight hours, at $23 per hour, on January 31; however, payday is not until February 3. Answer from the university's point of view.

l. Wang Company paid $4,800 for a fire insurance policy on January 1. The policy covers 12 months beginning on January 1. Answer from Wang's point of view.

m. Derek Incorporated has its delivery van repaired in January for $600 and charges the amount on account.

n. Hass Company, a farm equipment company, receives its phone bill at the end of January for $154 for January calls. The bill has not been paid to date.

o. Martin Company receives and pays in January a $2,034 invoice (bill) from a consulting firm for services received in January. Answer from Martin's standpoint.

p. Parillo's Taxi Company pays a $595 invoice from a consulting firm for services received and recorded in December.

q. **PVH Corp.**, manufacturer of IZOD, ARROW, Van Heusen, Calvin Klein, and Tommy Hilfiger apparel among other brands, completes production of 450 men's shirts ordered by **Macy's** department stores at a cost of $16 each and delivers the order in January. Answer from PVH Corp.'s standpoint.

Required:
For each of the transactions, if an expense is to be recognized in January, indicate the expense account title and the amount. If an expense is not to be recognized in January, indicate why.

Determining Financial Statement Effects of Various Transactions

E3-5
LO3-4

Amazon.com, Inc., headquartered in Seattle, WA, started its electronic commerce business in 1995 and expanded rapidly. The following transactions occurred during a recent year (dollars in millions):

a. Issued stock for $623 cash (example).
b. Purchased equipment costing $6,320, paying $4,893 in cash and charging the rest on account.
c. Paid $5,000 in principal and $300 in interest expense on long-term debt.
d. Earned $177,866 in sales revenue; collected $123,949 in cash with the customers owing the rest on their Amazon credit card account.
e. Incurred $25,249 in shipping expenses, all on credit.
f. Paid $118,241 cash on accounts owed to suppliers.
g. Incurred $10,069 in marketing expenses; paid cash.
h. Collected $38,200 in cash from customers paying on their Amazon credit card account.
i. Borrowed $16,231 in cash as long-term debt.
j. Used inventory costing $111,934 when sold to customers.
k. Paid $830 in income tax recorded as an expense in the prior year.

Required:
For each of the transactions, complete the tabulation, indicating the effect (+ for increase and − for decrease) of each transaction. (Remember that A = L + SE; R − E = NI; and NI affects SE through Retained Earnings.) Write NE if there is no effect. The first transaction is provided as an example.

	BALANCE SHEET			INCOME STATEMENT		
Transaction	Assets	Liabilities	Stockholders' Equity	Revenues	Expenses	Net Income
(a) (example)	+623	NE	+623	NE	NE	NE

Determining Financial Statement Effects of Various Transactions

E3-6
LO3-4

Wolverine World Wide, Inc., manufactures military, work, sport, and casual footwear and leather accessories under a variety of brand names, such as Hush Puppies, Wolverine, Merrell, Stride Rite, and Bates, to a global market. The following transactions occurred during a recent year. Dollars are in millions.

a. Issued common stock to investors for $21.4 cash (example).
b. Purchased $1,626.6 of additional inventory on account.
c. Paid $40.1 on long-term debt principal and $3.7 in interest on the debt.
d. Sold $2,350.0 of products to customers on account; cost of the products sold was $1,426.6. (**Hint:** There are two separate effects needed for *(d)*: one for earning revenue and one for incurring an expense.)
e. Paid cash dividends of $23.0 to shareholders.
f. Purchased for cash $32.4 in additional property, plant, and equipment.
g. Incurred $713.6 in selling expenses, paying three-fourths in cash and owing the rest on account.
h. Earned $0.50 of interest on investments, receiving 80 percent in cash.
i. Incurred $35.0 in interest expense to be paid at the beginning of next year.

Required:
For each of the transactions, complete the tabulation, indicating the effect (+ for increase and − for decrease) of each transaction. (Remember that A = L + SE; R − E = NI; and NI affects SE through Retained Earnings.) Write NE if there is no effect. The first transaction is provided as an example.

	BALANCE SHEET			INCOME STATEMENT		
Transaction	Assets	Liabilities	Stockholders' Equity	Revenues	Expenses	Net Income
(a) (example)	+ 21.4	NE	+ 21.4	NE	NE	NE

E3-7
LO3-4

Recording Journal Entries

Sysco Corporation, formed in 1969, is the largest global distributor of food service products, serving over 500,000 restaurants, hotels, schools, hospitals, and other institutions. The following summarized transactions are typical of those that occurred in a recent year (dollars are in millions).

a. Purchased buildings costing $432 and equipment costing $254 for cash.
b. Borrowed $119 from a bank, signing a short-term note.
c. Provided $55,371 in service to customers during the year, with $28,558 on account and the rest received in cash.
d. Paid $132,074 cash on accounts payable.
e. Purchased $41,683 of inventory on account.
f. Paid payroll, $6,540 during the year.
g. Received $22,043 on account paid by customers.
h. Purchased and used fuel of $1,750 in delivery vehicles during the year (paid for in cash).
i. Declared $698 in dividends at the end of the year to be paid the following year.
j. Incurred $121 in utility usage during the year; paid $110 in cash and owed the rest on account.

Required:
For each of the transactions, prepare journal entries. Determine whether the accounting equation remains in balance and debits equal credits after each entry.

E3-8
LO3-4

Recording Journal Entries

Vail Resorts, Inc., owns and operates 11 premier year-round ski resort properties (located in the Colorado Rocky Mountains, the Lake Tahoe area, the upper midwest, Vermont, and Australia). The company also owns a collection of luxury hotels, resorts, and lodging properties. The company sells lift tickets, ski lessons, and ski equipment. The following hypothetical **December** transactions are typical of those that occur at the resorts.

a. Borrowed $2,300,000 from the bank on December 1, signing a note payable due in six months.
b. Purchased a new snowplow for $98,000 cash on December 31.
c. Purchased ski equipment inventory for $35,000 on account to sell in the ski shops.
d. Incurred $62,000 in routine repairs expense for the chairlifts; paid cash.
e. Sold $390,000 of January through March season passes and received cash.
f. Sold a pair of skis from inventory in a ski shop to a customer for $700 on account. (The cost of the skis was $400). (**Hint:** Record two entries.)
g. Sold daily lift passes in December for a total of $320,000 in cash.
h. Received a $3,500 deposit on a townhouse to be rented for five days in January.
i. Paid half the charges incurred on account in (*c*).
j. Received $400 on account from the customer in (*f*).
k. Paid $245,000 in wages to employees for the month of December.

Required:
1. Prepare journal entries for each transaction. (Remember to check that debits equal credits and that the accounting equation is in balance after each transaction.)
2. Assume that Vail Resorts had a $1,000 balance in Accounts Receivable at the beginning of December. Determine the ending balance in the Accounts Receivable account at the end of December based on transactions (*a*) through (*k*). Show your work in T-account format.

E3-9
LO3-4

Recording Journal Entries

Blaine Air Transport Service, Inc., providing air delivery service for businesses, has been in operation for three years. The following transactions occurred in February:

February 1	Paid $275 for rent of hangar space in February.
February 2	Purchased fuel costing $490 on account for the next flight to Dallas.
February 4	Received customer payment of $820 to ship several items to Philadelphia next month.
February 7	Flew cargo from Denver to Dallas; the customer paid $910 for the air transport.
February 10	Paid $175 for an advertisement in the local paper to run on February 19.
February 14	Paid pilot $2,300 in wages for flying in January (recorded as expense in January).

February 18	Flew cargo for two customers from Dallas to Albuquerque for $3,800; one customer paid $1,600 cash and the other asked to be billed.
February 25	Purchased on account $2,550 in spare parts for the planes.
February 27	Declared a $200 cash dividend to be paid in March.

Required:
Prepare journal entries for each transaction. Be sure to categorize each account as an asset (A), liability (L), stockholders' equity (SE), revenue (R), or expense (E).

E3-10 LO3-3, 3-4

Analyzing the Effects of Transactions in T-Accounts and Computing Cash Basis versus Accrual Basis Net Income

Stacey's Piano Rebuilding Company has been operating for one year. At the start of the second year, its income statement accounts had zero balances and its balance sheet account balances were as follows:

Cash	$ 6,400	Accounts payable	$ 9,600
Accounts receivable	32,000	Unearned revenue	3,840
Supplies	1,500	Long-term note payable	48,500
Equipment	9,500	Common stock	1,600
Land	7,400	Additional paid-in capital	7,000
Building	25,300	Retained earnings	11,560

Required:
1. Create T-accounts for the balance sheet accounts and for these additional accounts: Rebuilding Fees Revenue, Rent Revenue, Wages Expense, and Utilities Expense. Enter the beginning balances.
2. Enter the following transactions for January of the second year into the T-accounts, using the letter of each transaction as the reference:
   a. Rebuilt and delivered five pianos in January to customers who paid $19,000 in cash.
   b. Received a $600 deposit from a customer who wanted her piano rebuilt.
   c. Rented a part of the building to a bicycle repair shop; received $850 for rent in January.
   d. Received $7,200 from customers as payment on their accounts.
   e. Received an electric and gas utility bill for $400 to be paid in February.
   f. Ordered $960 in supplies.
   g. Paid $2,300 on account in January.
   h. Received from the home of Stacey Eddy, the major shareholder, a $920 tool (equipment) to use in the business in exchange for 100 shares of $1 par value stock.
   i. Paid $16,500 in wages to employees who worked in January.
   j. Declared and paid a $2,200 dividend (reduce Retained Earnings and Cash).
   k. Received and paid cash for the supplies in (*f*).
3. Using the data from the T-accounts, amounts for the following at the end of January of the second year were

   Revenues $ _______ − Expenses $ _______ = Net Income $ _______
   Assets $ _______ = Liabilities $ _______ + Stockholders' Equity $ _______

4. What is net income if Stacey's used the cash basis of accounting? Why does this differ from accrual basis net income [in requirement (3)]?

E3-11 LO3-5

Preparing an Income Statement

Refer to E3-10.

Required:
Use the ending balances in the T-accounts in E3-10 to prepare an unadjusted classified income statement for January of the second year (ignore income taxes).

E3-12 LO3-7

Identifying Activities Affecting the Statement of Cash Flows

Refer to E3-10.

Required:
Use the transactions in E3-10 to identify the operating (O), investing (I), and financing (F) activities and the direction (+ for increase, − for decrease) and amount of the effect. If there is no effect, use NE.

E3-13 **Recording Journal Entries, Posting Effects to T-Accounts, and Computing Cash versus Accrual Basis Net Income**
LO3-3, 3-4

At January 1 (beginning of its fiscal year), Conover, Inc., a financial services consulting firm, reported the following account balances (in thousands, except for par and market value per share):

Cash	$ 1,900	Accounts payable	$ 210
Short-term investments	410	Unearned revenue	1,320
Accounts receivable	3,570	Salaries payable	870
Supplies	150	Short-term note payable	780
Prepaid expenses	4,720	Common stock ($1 par value)	50
Office equipment	1,530	Additional paid-in capital	6,560
Accumulated depreciation–office equipment*	(480)	Retained earnings	2,010

*This account has a credit balance representing the portion of the cost of the equipment used in the past.

Required:

1. Prepare journal entries for the following transactions for the current year. Use the balance sheet account titles above and the revenue or expense account titles mentioned in requirement (2):
   a. Received $9,500 cash for consulting services rendered.
   b. Issued 10 additional shares of common stock at a market price of $120 per share.
   c. Purchased $640 of office equipment, paying 25 percent in cash and owing the rest on a short-term note.
   d. Received $890 from clients for consulting services to be performed in the next year.
   e. Bought $470 of supplies on account.
   f. Incurred and paid $1,800 in utilities for the current year.
   g. Consulted for clients in the current year for fees totaling $1,620, due from clients in the next year.
   h. Received $2,980 from clients paying on their accounts.
   i. Incurred $6,210 in salaries in the current year, paying $5,300 and owing the rest (to be paid next year).
   j. Purchased $1,230 in short-term investments and paid $800 for insurance coverage beginning in the next fiscal year.
   k. Received $10 in interest revenue earned in the current year on short-term investments.
2. Create T-accounts for the balance sheet accounts and for these additional accounts: Consulting Fees Revenue, Interest Revenue, Salaries Expense, and Utilities Expense. Enter the beginning balances of the balance sheet accounts. Conover's income statement accounts had zero balances. Post the journal entry effects in requirement (1) above into the T-accounts, using the letter of each transaction as the reference.
3. Using the data from the T-accounts, amounts for the following at the end of the current year were

   Revenues $ _______ − Expenses $ _______ = Net Income $ _______
   Assets $ _______ = Liabilities $ _______ + Stockholders' Equity $ _______

4. What would net income be if Conover, Inc., used the cash basis of accounting? Why does this differ from accrual basis net income [in requirement (3)]?

E3-14 **Preparing an Income Statement**
LO3-5

Refer to E3-13.

Required:
Use the ending balances in the T-accounts in E3-13 to prepare in good form an unadjusted classified income statement for the current year ended December 31. (Ignore income taxes.)

E3-15 **Analyzing the Effects of Transactions in T-Accounts**
LO3-4

Lisa Frees and Amelia Ellinger have been operating a catering business for several years. In March, the partners plan to expand by opening a retail sales shop. They have decided to form the business as a corporation called Traveling Gourmet, Inc. The following transactions occurred in March:

a. Received $80,000 cash from each of the two shareholders to form the corporation, in addition to $2,000 in accounts receivable, $5,300 in equipment, a van (equipment) appraised at a fair value of $13,000, and $1,200 in supplies. Gave the two owners each 500 shares of common stock with a par value of $1 per share.
b. Purchased a vacant store for sale in a good location for $360,000, making a $72,000 cash down payment and signing a 10-year mortgage note from a local bank for the rest.
c. Borrowed $50,000 from the local bank on a 10 percent, one-year note.
d. Purchased food and paper supplies costing 10,200 in March; paid cash.

e. Catered four parties in March for $4,200; $1,600 was billed and the rest was received in cash.
f. Sold food at the retail store for $16,900 cash; the food and paper supplies used cost $10,830. (**Hint:** Record the revenue effect separate from the expense effect.)
g. Received a $420 telephone bill for March to be paid in April.
h. Paid $363 in gas for the van in March.
i. Paid $6,280 in wages to employees who worked in March.
j. Paid a $300 dividend from the corporation to each owner.
k. Purchased $50,000 of equipment (refrigerated display cases, cabinets, tables, and chairs) and renovated and decorated the new store for $20,000 (added to the cost of the building); paid cash.

Required:

1. Set up appropriate T-accounts for Cash, Accounts Receivable, Supplies, Equipment, Building, Accounts Payable, Note Payable, Mortgage Payable, Common Stock, Additional Paid-in Capital, Retained Earnings, Food Sales Revenue, Catering Sales Revenue, Supplies Expense, Utilities Expense, Wages Expense, and Fuel Expense.
2. Record in the T-accounts the effects of each transaction for Traveling Gourmet, Inc., in March. Identify the amounts with the letters starting with (*a*). Compute ending balances.

Preparing an Income Statement, Identifying Cash Flow Effects, and Analyzing Results

E3-16
LO3-5, 3-7

Refer to E3-15.

Required:
Use the balances in the completed T-accounts in E3-15 to respond to the following:

1. Prepare an unadjusted classified income statement in good form for the month of March.
2. Identify operating (O), investing (I), and financing (F) activities affecting cash flows. Include the direction and amount of the effect. If there is no effect on cash flows, use NE.
3. What do you think about the success of this company based on the results of the first month of operations? (**Hint:** Compare net income to cash flows from operations.)

Inferring Operating Transactions and Preparing an Income Statement and Balance Sheet

E3-17
LO3-2, 3-3, 3-4, 3-5

Kate's Kite Company (a corporation) sells and repairs kites from manufacturers around the world. Its stores are located in rented space in malls and shopping centers. During its first month of operations ended April 30, Kate's Kite Company completed eight transactions with the dollar effects indicated in the following schedule:

	DOLLAR EFFECT OF EACH OF THE EIGHT TRANSACTIONS								
Accounts	**(a)**	**(b)**	**(c)**	**(d)**	**(e)**	**(f)**	**(g)**	**(h)**	**Ending Balance**
Cash	$82,000	$(15,400)	$(6,200)	$ 9,820		$(1,300)	$(2,480)	$3,960	
Accounts Receivable				4,180					
Inventory			24,800	(7,000)					
Prepaid Expenses							1,860		
Store Fixtures		15,400							
Accounts Payable			18,600		$ 1,480				
Unearned Revenue								2,510	
Common Stock ($1 par value)	10,000								
Additional Paid-in Capital	72,000								
Sales Revenue				14,000				1,450	
Cost of Sales				7,000					
Wages Expense						1,300			
Rent Expense							620		
Utilities Expense					1,480				

Required:

1. Write a brief explanation of transactions (*a*) through (*h*). Include any assumptions that you made.
2. Compute the ending balance in each account and prepare an unadjusted classified income statement and a classified balance sheet for Kate's Kite Company on April 30.

E3-18 LO3-4, 3-6

Analyzing the Effects of Transactions Using T-Accounts and Interpreting the Net Profit Margin Ratio as a Financial Analyst

Massa Company, which has been operating for three years, provides marketing consulting services worldwide for dot-com companies. You are a financial analyst assigned to report on the Massa management team's effectiveness at managing its assets efficiently. At the start of 2019 (its fourth year), Massa's T-account balances were as follows. Dollars are in thousands.

Assets

Cash	
3,200	

Accounts Receivable	
8,000	

Long-Term Investments	
6,400	

Liabilities

Accounts Payable	
	2,400

Unearned Revenue	
	5,600

Long-Term Notes Payable	
	1,600

Stockholders' Equity

Common Stock ($0.10 par value)	
	800

Additional Paid-in Capital	
	4,000

Retained Earnings	
	3,200

Revenues

Consulting Fee Revenue	

Interest Revenue	

Expenses

Wages Expense	

Travel Expense	

Utilities Expense	

Rent Expense	

Required:

1. Using the data from these T-accounts, amounts for the following on January 1, 2019, were

   Assets $ _______ = Liabilities $ _______ + Stockholders' Equity $ _______

2. Enter in the T-accounts the following transactions for 2019:
   a. Provided $58,000 in services to clients who paid $48,000 in cash and owed the rest on account.
   b. Received $5,600 cash from clients on account.
   c. Received $400 in cash as interest revenue on investments.
   d. Paid $36,000 in wages, $12,000 in travel, $7,600 in rent, and $1,600 on accounts payable.
   e. Received $1,600 in cash from clients in advance of services Massa will provide next year.
   f. Received a utility bill for $800 for 2019 services.
   g. Declared and immediately paid $480 in dividends to stockholders.

3. Compute ending balances in the T-accounts to determine amounts for the following on December 31, 2019:

Revenues $ _____ − Expenses $ _____ = Net Income $ _____

Assets $ _____ = Liabilities $ _____ + Stockholders' Equity $ _____

4. Calculate the net profit margin ratio for 2019. If the company had a net profit margin ratio of 2.9 percent in 2018 and 2.5 percent in 2017, what does your computation suggest to you about Massa Company? What would you say in your report?

Inferring Transactions and Computing Effects Using T-Accounts

E3-19
LO3-4

Gannett Co., Inc., states in a recent annual report that it is "an innovative, digitally focused media and marketing solutions company committed to strengthening communities across our network. Gannett owns ReachLocal, Inc. (ReachLocal), a digital marketing solutions company, the USA TODAY NETWORK (made up of USA TODAY (USAT) and 109 local media organizations in 34 states in the U.S. and Guam, including digital sites and affiliates), and Newsquest (a wholly owned subsidiary operating in the United Kingdom (U.K.) with more than 170 local media brands)." Gannett's annual report included the following accounts. Dollars are in millions:

Accounts Receivable			
1/1	358		
	3,146	?	
12/31	352		

Prepaid Expenses			
1/1	35		
	803	?	
12/31	56		

Unearned Subscriptions Revenue			
		133	1/1
	?	2,690	
		123	12/31

Required:

1. For each T-account, describe the typical transactions that affect each account (that is, the economic events that occur to make these accounts increase and decrease).
2. For each T-account, compute the missing amounts.

Finding Financial Information as an Investor

E3-20
LO3-5, 3-6

You are evaluating your current portfolio of investments to determine those that are not performing to your expectations. You have all of the companies' most recent annual reports.

Required:

For each of the following, indicate where you would locate the information in an annual report. (**Hint:** The information may be in more than one location.)

1. Description of a company's primary business(es).
2. Income taxes paid.
3. Accounts receivable.
4. Cash flow from operating activities.
5. Description of a company's revenue recognition policy.
6. The inventory sold during the year.
7. The data needed to compute the net profit margin ratio.

connect

PROBLEMS

Recording Nonquantitative Journal Entries (AP3-1)

P3-1
LO3-4

The following is a list of accounts for Sanjeev Corporation, which has been operating for three years. These accounts are listed and numbered for identification. Following the accounts is a series of transactions. For each transaction, indicate the account(s) that should be debited and credited by entering the appropriate account number(s) to the right of each transaction. If no journal entry is needed, write **none** after the transaction. The first transaction is used as an example.

Account No.	Account Title	Account No.	Account Title
1	Cash	10	Income Taxes Payable
2	Accounts Receivable	11	Common Stock
3	Supplies	12	Additional Paid-in Capital
4	Prepaid Expenses	13	Retained Earnings
5	Equipment	14	Service Revenue
6	Patents	15	Operating Expenses (wages, supplies)
7	Accounts Payable	16	Income Tax Expense
8	Note Payable	17	Interest Expense
9	Wages Payable		

Transactions	Debit	Credit
a. *Example:* Purchased equipment for use in the business; paid one-third cash and signed a note payable for the balance.	5	1, 8
b. Paid cash for salaries and wages earned by employees this period.	______	______
c. Paid cash on accounts payable for expenses incurred last period.	______	______
d. Purchased supplies to be used later; paid cash.	______	______
e. Performed services this period on credit.	______	______
f. Collected cash on accounts receivable for services performed last period.	______	______
g. Issued stock to new investors for cash greater than par value.	______	______
h. Paid operating expenses incurred this period.	______	______
i. Incurred operating expenses this period to be paid next period.	______	______
j. Purchased a patent (an intangible asset); paid cash.	______	______
k. Collected cash for services performed this period.	______	______
l. Used some of the supplies on hand for operations.	______	______
m. Paid three-fourths of the income tax expense incurred for the year; the balance will be paid next year.	______	______
n. Made a payment on the equipment note in (*a*); the payment was part principal and part interest expense.	______	______
o. On the last day of the current period, paid cash for an insurance policy covering the next two years.	______	______

P3-2
LO3-4

Recording Journal Entries (AP3-2)

Ryan Terlecki organized a new Internet company, CapUniverse, Inc. The company specializes in baseball-type caps with logos printed on them. Ryan, who is never without a cap, believes that his target market is college and high school students. You have been hired to record the transactions occurring in the first month of operations.

a. Issued 2,000 shares of $0.01 par value common stock to investors for cash at $20 per share.
b. Borrowed $60,000 from the bank to provide additional funding to begin operations; the note is due in two years.
c. Paid $3,000 cash for rent of a warehouse: $1,500 for the current month's rent and another $1,500 for next month's rent.
d. Paid $2,400 for a one-year fire insurance policy on the warehouse (recorded as a prepaid expense).
e. Purchased furniture and fixtures for the warehouse for $15,000, paying $3,000 cash and the rest on account. The amount is due within 30 days.
f. Purchased for $2,800 cash **The University of Pennsylvania**, **Notre Dame**, **The University of Texas at Austin**, **The Ohio State University**, and **Michigan State University** baseball caps as inventory to sell online.
g. Placed advertisements on **Google** for a total of $350 cash; the ads were run immediately..
h. Sold caps totaling $1,700, half of which was charged on account. The cost of the caps sold was $900. (**Hint:** Make two entries.)
i. Made full payment for the furniture and fixtures purchased on account in (*e*).
j. Received $210 from a customer on account.

Required:
For each of the transactions, prepare journal entries. Be sure to categorize each account as an asset (A), liability (L), stockholders' equity (SE), revenue (R), or expense (E). Note that transaction (*h*) will require two entries, one for revenue and one for the related expense.

P3-3
LO3-4, 3-7

Determining Financial Statement Effects of Various Transactions and Identifying Cash Flow Effects (AP3-3)

According to its annual report, **The Wendy's Company** "is the third largest quick-service restaurant company in the hamburger sandwich segment" with more than 6,500 restaurants worldwide. The company operates its own restaurants (about 13 percent of the 6,500 restaurants) and sells franchises to others (about 87 percent of the restaurants). The following activities were inferred from a recent annual report.

a. Purchased food and paper products; paid part in cash and the rest on account.
b. Purchased additional investments.
c. Incurred restaurant operating costs in company-owned facilities; paid part in cash and the rest on account.
d. Served food to customers for cash.
e. Used food and paper products.
f. Paid cash dividends.
g. Sold franchises, receiving part in cash and the rest in notes due from franchisees.
h. Paid interest on debt incurred and due during the period.

Required:

1. For each of the transactions, complete the tabulation, indicating the effect (+ for increase and − for decrease) of each transaction. (Remember that A = L + SE; R − E = NI; and NI affects SE through Retained Earnings.) Write NE if there is no effect. The first transaction is provided as an example.

	BALANCE SHEET			INCOME STATEMENT		
Transaction	Assets	Liabilities	Stockholders' Equity	Revenues	Expenses	Net Income
(*a*)	+/−	+	NE	NE	NE	NE

2. Where, if at all, would each transaction be reported on the statement of cash flows? Use O for operating activities, I for investing activities, F for financing activities, and NE if the transaction would not be included on the statement.

P3-4
LO3-4, 3-5, 3-6

Analyzing the Effects of Transactions Using T-Accounts, Preparing an Income Statement, and Evaluating the Net Profit Margin Ratio as a Manager (AP3-4)

Kaylee James, a connoisseur of fine chocolate, opened Kaylee's Sweets in Collegetown on February 1. The shop specializes in a selection of gourmet chocolate candies and a line of gourmet ice cream. You have been hired as manager. Your duties include maintaining the store's financial records. The following transactions occurred in February, the first month of operations.

a. Received four shareholders' contributions totaling $30,200 cash to form the corporation; issued 400 shares of $0.10 par value common stock.
b. Paid three months' rent for the store at $1,750 per month (recorded as prepaid expenses).
c. Purchased and received candy for $6,000 on account, due in 60 days.
d. Purchased supplies for $1,560 cash.
e. Negotiated and signed a two-year $11,000 loan at the bank, receiving cash at the time.
f. Used the money from (*e*) to purchase a computer for $2,750 (for recordkeeping and inventory tracking); used the balance for furniture and fixtures for the store.
g. Placed a grand opening advertisement in the local paper for $400 cash; the ad ran in the current month.
h. Made sales on Valentine's Day totaling $3,500; $2,675 was in cash and the rest on accounts receivable. The cost of the candy sold was $1,600.
i. Made a $550 payment on accounts payable.
j. Incurred and paid employee wages of $1,300.
k. Collected accounts receivable of $600 from customers.
l. Made a repair to one of the display cases for $400 cash.
m. Made cash sales of $1,200 during the rest of the month. The cost of the candy sold was $600.

Required:

1. Set up appropriate T-accounts for Cash, Accounts Receivable, Supplies, Inventory, Prepaid Expenses, Equipment, Furniture and Fixtures, Accounts Payable, Notes Payable, Common Stock, Additional Paid-in Capital, Sales Revenue, Cost of Goods Sold (expense), Repair Expense, Advertising Expense, and Wage Expense. All accounts begin with zero balances.
2. Record in the T-accounts the effects of each transaction for Kaylee's Sweets in February, referencing each transaction in the accounts with the transaction letter. Show the ending balances in the T-accounts. Note that transactions (*h*) and (*m*) require two types of entries, one for revenue recognition and one for the expense.
3. Prepare an unadjusted income statement at the end of the first month of operations ended February 28.
4. Write a short memo to Kaylee offering your opinion on the results of operations during the first month of business.
5. After three years in business, you are being evaluated for a promotion. One measure is how effectively you managed the sales and expenses of the business. The following data are available:

	2021*	2020	2019
Total assets	$88,000	$58,500	$52,500
Total liabilities	49,500	22,000	18,500
Total stockholders' equity	38,500	36,500	34,000
Net sales revenue	93,500	82,500	55,000
Net income	22,000	11,000	4,400

*At the end of 2021, Kaylee decided to open a second store, requiring loans and inventory purchases prior to the store's opening in early 2022.

Compute the net profit margin ratio for each year and evaluate the results. Do you think you should be promoted? Why?

P3-5 LO3-7 Identifying Cash Flow Effects (AP3-5)

Refer to P3-4.

Required:

For the transactions listed in P3-4, indicate the type of effect on cash flows (O for operating, I for investing, and F for financing) and the direction (+ for increase and − for decrease) and amount of the effect. If there is no effect, write NE.

P3-6 LO3-4, 3-5, 3-6 Analyzing the Effects of Transactions Using T-Accounts, Preparing an Income Statement, and Evaluating the Net Profit Margin Ratio (AP3-6)

Following are account balances (in millions of dollars) from a recent **FedEx** annual report, followed by several typical transactions. Assume that the following are account balances on May 31 (end of the prior fiscal year):

Account	Balance	Account	Balance
Property and equipment (net)	$13,894	Receivables	$1,549
Retained earnings	9,606	Other current assets	879
Accounts payable	1,257	Cash	884
Prepaid expenses	108	Spare parts, supplies, and fuel	394
Accrued expenses payable	2,070	Other noncurrent liabilities	3,290
Long-term notes payable	1,490	Other current liabilities	1,939
Other noncurrent assets	2,552	Additional paid-in capital	607
Common stock ($0.10 par value)	1		

These accounts are not necessarily in good order and have normal debit or credit balances. Assume the following transactions (in millions, except for par value) occurred the next fiscal year beginning June 1 (the current year):

a. Provided delivery service to customers, who paid $1,390 in cash and owed $24,704 on account.
b. Purchased new equipment costing $3,434; signed a long-term note.

c. Paid $7,864 cash to rent equipment and aircraft, with $3,136 for rent this year and the rest for rent next year.
d. Spent $864 cash to repair facilities and equipment during the year.
e. Collected $24,285 from customers on account.
f. Repaid $150 on a long-term note (ignore interest).
g. Issued 20 million additional shares of $0.10 par value stock for $16 (that's $16 million).
h. Paid employees $9,276 for work during the year.
i. Purchased spare parts, supplies, and fuel for the aircraft and equipment for $6,564 cash.
j. Used $6,450 in spare parts, supplies, and fuel for the aircraft and equipment during the year.
k. Paid $784 on accounts payable.
l. Ordered $88 in spare parts and supplies.

Required:

1. Prepare journal entries for each transaction. Use the account titles that FedEx uses as listed above for balance sheet account effects.
2. Prepare T-accounts for the current year from the preceding list; enter the ending balances from May 31 as the respective beginning balances for June 1 of the current year. You will need additional T-accounts for income statement accounts; enter zero for beginning balances. Post the effects of the transactions in the T-accounts, and compute ending balances.
3. Prepare an unadjusted income statement for the current year ended May 31.
4. Compute the company's net profit margin ratio for the current year ended May 31. Round your answer to two decimal places. What do the results suggest to you about FedEx?

Recording Journal Entries and Identifying Cash Flow Effects

P3-7
LO3-4, 3-7

Cedar Fair, L.P. (Limited Partnership), is one of the largest regional amusement park operators in the world, owning 11 amusement parks, two water parks, and four hotels. The parks include **Cedar Point** in Ohio; **Valleyfair** near Minneapolis/St. Paul; **Dorney Park** and **Wildwater Kingdom** near Allentown, Pennsylvania; **Worlds of Fun** in Kansas City; **Great America** in Santa Clara, California; and **Canada's Wonderland** near Toronto, Canada, among several others. The following are summarized transactions similar to those that occurred in a recent year. Dollars are in thousands.

a. Guests at the parks paid $596,042 cash in admissions.
b. The primary operating expenses for the year were employee wages of $433,416, with $401,630 paid in cash and the rest to be paid to employees in the following year.
c. Cedar Fair paid $47,100 principal on long-term notes payable.
d. The parks sells merchandise in park stores. The cash received during the year for sales was $365,693. The cost of the inventory sold during the year was $92,057.
e. Cedar Fair purchased and built additional rides and other equipment during the year, paying $90,190 in cash.
f. Guests may stay in the parks at accommodations owned by the company. During the year, accommodations revenue was $82,994; $81,855 was paid by the guests in cash and the rest was owed on account.
g. Interest incurred and paid on long-term debt was $153,326.
h. The company purchased $147,531 in inventory for the park stores during the year, paying $119,431 in cash and owing the rest on account.
i. Advertising costs for the parks were $140,426 for the year; $134,044 was paid in cash and the rest was owed on account.
j. Cedar Fair paid $11,600 on accounts payable during the year.

Required:

1. For each of these transactions, record journal entries. Use the letter of each transaction as its reference. Note that transaction (*d*) will require two entries, one for revenue recognition and one for the related expense.
2. Use the following chart to identify whether each transaction results in a cash flow effect from operating (O), investing (I), or financing (F) activities and indicate the direction and amount of the effect on cash (+ for increase and − for decrease). If there is no cash flow effect, write **none.** The first transaction is provided as an example.

Transaction	Operating, Investing, or Financing Effect	Direction and Amount of the Effect (in thousands)
(*a*)	O	+596,042

ALTERNATE PROBLEMS

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AP3-1 LO3-4 Recording Nonquantitative Journal Entries (P3-1)

The following is a series of accounts for Kruger & Laurenzo, Incorporated, which has been operating for two years. The accounts are listed and numbered for identification. Following the accounts is a series of transactions. For each transaction, indicate the account(s) that should be debited and credited by entering the appropriate account number(s) to the right of each transaction. If no journal entry is needed, write **none** after the transaction. The first transaction is given as an example.

Account No.	Account Title	Account No.	Account Title
1	Cash	9	Wages Payable
2	Accounts Receivable	10	Income Taxes Payable
3	Supplies	11	Common Stock
4	Prepaid Expenses	12	Additional Paid-in Capital
5	Buildings	13	Retained Earnings
6	Land	14	Service Revenue
7	Accounts Payable	15	Other Expenses (wages, supplies, interest)
8	Mortgage Payable	16	Income Tax Expense

Transactions	Debit	Credit
a. *Example:* Issued stock to new investors.	1	11, 12
b. Incurred and recorded operating expenses on credit to be paid next period.	______	______
c. Purchased on credit but did not use supplies this period.	______	______
d. Performed services for customers this period on credit.	______	______
e. Prepaid a fire insurance policy this period to cover the next 12 months.	______	______
f. Purchased a building this period by making a 20 percent cash down payment and signing a mortgage loan for the balance.	______	______
g. Collected cash this year for services rendered and recorded in the prior year.	______	______
h. Collected cash for services rendered this period.	______	______
i. Paid cash this period for wages earned and recorded last period.	______	______
j. Paid cash for operating expenses charged on accounts payable in the prior period.	______	______
k. Paid cash for operating expenses incurred in the current period.	______	______
l. Made a payment on the mortgage loan, which was part principal repayment and part interest.	______	______
m. This period a shareholder sold some shares of her stock to another person for an amount above the original issuance price.	______	______
n. Used supplies on hand to clean the offices.	______	______
o. Recorded income taxes for this period to be paid at the beginning of the next period.	______	______
p. Declared and paid a cash dividend this period.	______	______

AP3-2 LO3-4 Recording Journal Entries (P3-2)

Jimmy Langenberger is the president of TemPro, Inc., a company that provides temporary employees for not-for-profit companies. TemPro has been operating for five years; its revenues are increasing with each passing year. You have been hired to help Jimmy analyze the following transactions for the first two weeks of April:

a. Billed the local **United Way** office $23,500 for temporary services provided.
b. Paid $3,005 for supplies purchased and recorded on account last period.
c. Purchased supplies for the office for $2,600 on account.

d. Purchased a new computer for the office costing $3,800 cash.
e. Placed an advertisement in the local paper for $1,400 cash.
f. Paid employee wages of $11,900. Of this amount, $3,800 had been earned by employees and recorded in the Wages Payable account in the prior period.
g. Issued 3,000 additional shares of common stock for cash at $45 per share in anticipation of building a new office. The common stock had a par value of $0.50 per share.
h. Received $12,500 on account from the local United Way office for the services provided in (*a*).
i. Billed Family & Children's Services $14,500 for services rendered.
j. Purchased land as the site of a future office for $10,000. Paid $3,000 cash as a down payment and signed a note payable for the balance.
k. Received the April telephone bill for $1,950 to be paid next month.

Required:
For each of the transactions, prepare journal entries. Be sure to categorize each account as an asset (A), liability (L), stockholders' equity (SE), revenue (R), or expense (E).

Determining Financial Statement Effects of Various Transactions and Identifying Cash Flow Effects (P3-3)

AP3-3
LO3-4, 3-7

Barnes & Noble is the nation's largest bookseller and a leading retailer of digital media and electronic products, including the Nook for eReading. The following activities were inferred from a recent annual report.

a. *Example:* Incurred expenses; paid part in cash and part on credit.
b. Paid interest on long-term debt.
c. Sold merchandise for a profit to customers on account. (**Hint:** Indicate the effects of the sale; then reduce inventory for the amount sold—two transactions.)
d. Sold equipment for cash for more than its cost.
e. Collected cash on account.
f. Used supplies.
g. Repaid long-term debt principal.
h. Received interest on investments.
i. Purchased equipment; paid part in cash and part on credit.
j. Paid cash on account.
k. Issued additional stock for cash.
l. Paid rent to mall owners.

Required:
1. For each of the transactions, complete the tabulation, indicating the effect (+ for increase and − for decrease) of each transaction. (Remember that A = L + SE; R − E = NI; and NI affects SE through Retained Earnings.) Write NE if there is no effect. The first transaction is provided as an example.

	BALANCE SHEET			INCOME STATEMENT		
Transaction	Assets	Liabilities	Stockholders' Equity	Revenues	Expenses	Net Income
(*a*)	−	+	−	NE	+	−

2. For each transaction, indicate where, if at all, it would be reported on the statement of cash flows. Use O for operating activities, I for investing activities, F for financing activities, and NE if the transaction would not be included on the statement.

Analyzing the Effects of Transactions Using T-Accounts, Preparing an Income Statement, and Evaluating the Net Profit Margin Ratio as a Manager (P3-4)

AP3-4
LO3-4, 3-5, 3-6



Alpine Stables, Inc., is established in Denver, Colorado, on April 1, 2020, to provide stables, animal care, and grounds for riding and showing horses. You have been hired as the new assistant controller. The following transactions for April 2020 are provided for your review.

a. Received contributions of $60,000 in cash from five investors ($12,000 each), a barn valued at $100,000, land valued at $90,000, and supplies valued at $12,000. Each investor received 3,000 shares of stock with a par value of $0.01 per share.

b. Built a small barn for $62,000. The company paid half the amount in cash on April 1, 2020, and signed a three-year note payable for the balance.
c. Provided $35,260 in animal care services for customers, all on credit.
d. Rented stables to customers who cared for their own animals; received cash of $13,200.
e. Received from a customer $2,400 to board her horse in May, June, and July (record as unearned revenue).
f. Purchased hay and feed supplies on account for $3,810 to be used in the summer.
g. Paid $1,240 in cash for water utilities incurred in the month.
h. Paid $2,700 on accounts payable for previous purchases.
i. Received $10,000 from customers on accounts receivable.
j. Paid $6,000 in wages to employees who worked during the month.
k. At the end of the month, purchased a two-year insurance policy for $3,600.
l. Received an electric utility bill for $1,800 for usage in April; the bill will be paid next month.
m. Paid $100 cash dividend to each of the five investors at the end of the month.

Required:

1. Set up appropriate T-accounts. All accounts begin with zero balances.
2. Record in the T-accounts the effects of each transaction for Alpine Stables in April, referencing each transaction in the accounts with the transaction letter. Show the ending balances in the T-accounts.
3. Prepare an unadjusted income statement for April.
4. Write a short memo to the five owners offering your opinion on the results of operations during the first month of business.
5. After three years in business, you are being evaluated for a promotion to chief financial officer. One measure is how effectively you have managed the revenues and expenses of the business. The following annual data are available:

	2022*	2021	2020
Total assets	$480,000	$320,000	$300,000
Total liabilities	125,000	28,000	30,000
Total stockholders' equity	355,000	292,000	270,000
Operating revenue	450,000	400,000	360,000
Net income	50,000	30,000	(10,000)

*At the end of 2022, Alpine Stables decided to build an indoor riding arena for giving lessons year-round. The company borrowed construction funds from a local bank in 2022 and the arena was opened in early 2023.

Compute the net profit margin ratio for each year and evaluate the results. Do you think you should be promoted? Why?

AP3-5
LO3-7

Identifiying Cash Flow Effects (P3-5)

Refer to AP3-4.

Required:
For the transactions listed in AP3-4, indicate the type of activity (O for operating, I for investing, and F for financing) and the direction (+ for increase, − for decrease) and amount of the effect. If the transaction had no effect on cash flows, write NE.

AP3-6
LO3-4, 3-5, 3-6

Analyzing the Effects of Transactions Using T-Accounts, Preparing an Income Statement, and Evaluating the Net Profit Margin Ratio (P3-6)

The following are the summary account balances from a recent balance sheet of **Exxon Mobil Corporation**. The accounts have normal debit or credit balances, but they are not necessarily listed in good order. The amounts are shown in millions of dollars for the end of the prior year. Assume the year-end is December 31.

Cash	$ 12,664	Short-term investments	$ 404
Long-term notes payable	7,711	Retained earnings	151,232
Accounts receivable	38,642	Accounts payable	57,067
Inventories	11,665	Income taxes payable	12,727
Other long-term debt	83,481	Prepaid expenses	3,359
Property and equipment, net	214,664	Long-term investments	34,333
Common stock	9,512	Other assets and intangibles	9,092
Other current assets	6,229	Short-term notes payable	9,322

Source: Exxon Mobil Corp.

The following is a list of hypothetical transactions for January of the current year (in millions of dollars):

a. Purchased new equipment for $1,610 on account.
b. Received $3,100 on accounts receivable.
c. Received and paid $3 for utility bills for utility usage during January.
d. Earned $39,780 in sales of fuel to gas station franchisee customers, all on account; cost of sales was $5,984. [**Hint:** Record two journal entries.]
e. Paid employees $1,238 for wages earned during the month.
f. Paid three-fourths of the income taxes payable (rounded to the nearest million).
g. Purchased $23 in supplies on account (include in Inventories).
h. Prepaid $82 to rent a warehouse next month.
i. Paid $10 of other long-term debt principal and $1 in interest expense on the debt.
j. Purchased a patent (an intangible asset) for $6 cash.

Required:

1. Prepare journal entries for each transaction. Use the account titles that Exxon Mobil uses in the list above when a balance sheet account is affected.
2. Prepare T-accounts for the current year from the preceding list; enter the beginning balances based on the prior year's December 31 ending balances. You will need additional T-accounts for income statement accounts; enter zero for beginning balances. Post the effects of the transactions in the T-accounts, and compute ending balances.
3. Prepare an unadjusted income statement for January of the current year.
4. Compute the company's net profit margin ratio for the month ended January 31 of the current year. What does it suggest to you about Exxon Mobil Corporation?

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CONTINUING PROBLEM

Accounting for Operating Activities in a New Business (the Accounting Cycle)

CON3-1
LO3-4, 3-5, 3-6

Penny's Pool Service & Supply, Inc. (PPSS), had the following transactions related to operating the business in its first year's busiest quarter ended September 30:

a. Placed and paid for $2,600 in advertisements with several area newspapers (including the online versions), all of which ran in the newspapers during the quarter.
b. Cleaned pools for customers for $19,200, receiving $16,000 in cash with the rest owed by customers who will pay when billed in October.
c. Paid **Pool Corporation, Inc.**, a pool supply wholesaler, $10,600 for inventory received by PPSS in May.
d. As an incentive to maintain customer loyalty, PPSS offered customers a discount for prepaying next year's pool cleaning service. PPSS received $10,000 from customers who took advantage of the discount.
e. Paid the office receptionist $4,500, with $1,500 owed from work in the prior quarter and the rest from work in the current quarter. Last quarter's amount was recorded as an expense and a liability, Wages Payable.
f. Had the company van repaired, paying $310 to the mechanic.
g. Paid $220 for phone, water, and electric utilities used during the quarter.

h. Received $75 cash in interest earned during the current quarter on short-term investments.
i. Received a property tax bill for $600 for use of the land and building in the quarter; the bill will be paid next quarter.
j. Paid $2,400 for the next quarter's insurance coverage.

Required:
1. For each of the events, prepare journal entries, checking that debits equal credits.
2. Based only on these quarterly transactions, prepare a classified income statement (with income from operations determined separately from other items) for the quarter ended September 30.
3. Calculate the net profit margin ratio at September 30. What does this ratio indicate about the ability of PPSS to control operations?

COMPREHENSIVE PROBLEM (CHAPTERS 1–3)

connect

COMP3-1
LO1-1, 2-4, 2-5, 3-4, 3-5, 3-6

GL

Recording Journal Entries, Posting Effects to T-Accounts, Preparing Unadjusted Financial Statements, and Performing Ratio Analysis

In April 2019, Sarah Jones created a new business, IthacaDeep, Inc., offering therapeutic deep massage for stress reduction, pain management, injury recovery, and relief from muscle strains and tightness experienced by anyone, especially athletes, fitness enthusiasts, runners, and physical laborers. You have been hired to record the transactions occurring in the first month of operations.

a. Received investment of cash by three organizers and issued to them a total of 200 shares of $0.05 par value stock with a market price of $40 per share.
b. Borrowed $20,000 from a local bank, signing a note due in three years.
c. Signed a one-year lease for a space near a health club, paying $600 for April rent and $1,800 for rent for May, June, and July.
d. Purchased equipment costing $15,200, paying 20 percent in cash and owing the rest on account to the supplier, due in 60 days.
e. Ordered a business computer and printer from **Dell** for $2,900.
f. Loaned $1,000 to an employee who signed a note due in three months.
g. Purchased supplies for $2,600 on account.
h. Paid **Facebook** $2,000 as a budget for advertising. (Facebook charges the advertiser's account per click, drawing down the balance. The average click is $0.27.)
i. Paid $2,400 for 12 months of insurance coverage, with one-twelfth covering April and the rest covering the remainder of the fiscal year (end of March next year).
j. Purchased short-term investments for $10,000 cash.
k. Along with her four other licensed massage therapists, Sarah and her team provided $42,000 of deep tissue service to clients in April who paid half in cash and agreed to pay the rest in May.
l. Paid employees $18,000 in wages for work in April.
m. At the end of April, received a $310 utility bill for the use of gas and electric in April. The bill will be paid in May.
n. Paid $1,500 on the long-term note owed to the bank (ignore interest).
o. Earned and received $25 in interest on the short-term investments.
p. Sent the team to Boston in April to receive additional specialty training, costing IthacaDeep $2,100 cash.
q. Received $1,400 from clients for a series of services to be performed beginning in May.

Required:
1. Prepare journal entries for each transaction, using the letter next to each as a reference.
2. Create T-accounts and post the effects of the transactions to the T-accounts.
3. Prepare an unadjusted trial balance for IthacaDeep, Inc., at the end of April.
4. Prepare an unadjusted classified income statement (include a line for income tax expense and earnings per share), statement of stockholders' equity, and classified balance sheet from the trial balance created in requirement (3) above.
5. Compute the following ratios: (1) current ratio and (2) net profit margin ratio. Round your answers to two decimal points. What do your results suggest about IthacaDeep, Inc.?

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CASES AND PROJECTS

Annual Report Cases

Finding Financial Information

CP3-1
LO3-2, 3-4, 3-6

Refer to the financial statements of **American Eagle Outfitters** in Appendix B at the end of the book. The dollars are in thousands in the requirements; show your answers in thousands of dollars.

Required:

1. State the amount of the largest expense on the income statement for the year ended February 3, 2018, and describe the transaction represented by the expense.
2. Assuming that all net sales are on credit, how much cash did American Eagle Outfitters collect from customers?* (**Hint:** Use a T-account of accounts receivable to infer collection.)
3. A shareholder has complained that "more dividends should be paid because the company had net earnings of $204,163. Since this amount is all cash, more of it should go to the owners." Explain why the shareholder's assumption that earnings equal net cash inflow is valid. If you believe that the assumption is **not** valid, state so and support your position concisely.
4. Describe and contrast the purpose of an income statement versus a balance sheet.
5. Compute the company's net profit margin percentage for each year presented. Round your percentage to two decimal places. Explain its meaning.

Finding Financial Information

CP3-2
LO3-2, 3-4, 3-6

Refer to the financial statements of **Express, Inc.** in Appendix C at the end of the book. The dollars are in thousands in the requirements; show your answers in thousands of dollars.

Required:

1. What is the company's revenue recognition policy? (**Hint:** Look in the notes to the financial statements.)
2. Assuming that $50,000 of cost of goods sold was due to non-inventory purchase expenses (distribution and occupancy costs), how much inventory did the company buy during the year? (**Hint:** Use a T-account of inventory to infer how much was purchased.)
3. Calculate selling, general, and administrative expenses as a percentage of sales for each year presented. Are these expenses increasing or decreasing over time compared to sales revenue?
4. By what percent did selling, general, and administrative expenses increase or decrease from fiscal years 2017 and 2016 and between fiscal years 2015 and 2016? (**Hint:** Percentage Change = [Current Year Amount − Prior Year Amount] ÷ Prior Year Amount. Round your **percentage** to one decimal place.)
5. Compute the company's net profit margin percentage for each year presented and explain its meaning. Round your percentage to two decimal places.

Comparing Companies within an Industry

CP3-3
LO3-2, 3-4, 3-6

Refer to the financial statements of **American Eagle Outfitters** in Appendix B, **Express, Inc.** in Appendix C, and the Industry Ratio Report in Appendix D at the end of this book. Answer all dollar amounts in thousands.

Required:

1. By what title does each company call its income statement? Explain what "Consolidated" means.
2. Which company had higher net income for the most recent fiscal year?
3. Compute the net profit margin ratio for both companies for the most recent fiscal year. Round your answers to two decimal places. Which company is managing revenues and expenses more effectively?

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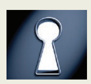
*Note that most retailers settle sales in cash at the register and would not have accounts receivable related to sales unless they had layaway or private credit. For American Eagle, the accounts receivable on the balance sheet primarily relates to amounts owed from landlords for their construction allowances for building new American Eagle stores in malls.

4. Compare the net profit margin percentage for both companies for the most recent year presented to the industry average. Round your percentages to two decimal places. On average, are these two companies managing sales and expenses better or worse than their competitors?
5. How much cash was provided by operating activities for each year by each company? What was the percentage change in operating cash flows (1) from fiscal year ended 2015 to 2016 and (2) from fiscal year ended 2016 to 2017? (**Hint:** Percentage Change = [Current Year Amount − Prior Year Amount] ÷ Prior Year Amount.) Round your **percentage** to one decimal place.

Financial Reporting and Analysis Cases

CP3-4
LO3-6



Analyzing a Company over Time

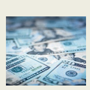
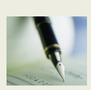
Refer to the annual report for **American Eagle Outfitters** in Appendix B.

Required:

1. The annual report or 10-K report for American Eagle Outfitters provides selected financial data for the last five years. Compute the net profit margin ratio for each of the years presented, rounding your answers to three decimal places. Use income from continuing operations in place of net income. (**Hint:** See Item 6 from the 10-K, which is disclosed within the annual report for the data.)
2. In Chapter 2, we discussed the current ratio. American Eagle Outfitters reported the current ratio in Item 6 of the 10-K. Observe the trends over time for both the net profit margin and the current ratio. What do they suggest about American Eagle Outfitters?

Critical Thinking Cases

CP3-5
LO3-3, 3-4, 3-5

Making a Decision as a Bank Loan Officer: Analyzing and Restating Financial Statements That Have Major Deficiencies (Challenging)

Julio Estela started a small boat repair service company during the current year. He is interested in obtaining a $100,000 loan from your bank to build a dry dock to store boats for customers in the winter months. At the end of the year, he prepared the following statements based on information stored in a large filing cabinet:

ESTELA COMPANY
Profit for the Current Year

Service fees collected in cash during the current year		$ 55,000
Cash dividends received		10,000
Total		65,000
Expense for operations paid during the current year	$22,000	
Cash stolen	500	
New tools purchased during the current year (cash paid)	1,000	
Supplies purchased for use on service jobs (cash paid)	3,200	
Total		26,700
Profit		$ 38,300

Assets Owned at the End of the Current Year

Cash in checking account	$ 29,300
Building (at current market value)	32,000
Tools and equipment	18,000
Land (at current market value)	30,000
Stock in ABC Industrial	130,000
Total	$239,300

The following is a summary of completed transactions:

a. Received the following contributions (at fair value) to the business from the owner when it was started in exchange for 1,000 shares of $1 par value common stock in the new company:

Building	$21,000	Land	$20,000
Tools and equipment	17,000	Cash	1,000

b. Earned service fees during the current year of $87,000; of the cash collected, $20,000 was for deposits from customers on work to be done by Julio in the next year.
c. Received the cash dividends on shares of ABC Industrial stock purchased by Julio Estela six years earlier (the stock was not owned by the company).
d. Incurred operating expenses during the current year of $61,000.
e. Determined amount of supplies on hand (unused) at the end of the current year as $700.

Required:
1. Did Julio prepare the income statement on a cash basis or an accrual basis? Explain how you can tell. Which basis should be used? Explain why.
2. Reconstruct the correct entries under accrual accounting principles and post the effects to T-accounts.
3. Prepare an accrual-based income statement, statement of stockholder's equity (only one shareholder), and a classified balance sheet. Explain (using footnotes) the reason for each change that you make to the income statement.
4. What additional information would assist you in formulating your decision regarding the loan to Julio?
5. Based on the revised financial statements and any additional information needed, write a letter to Julio explaining your decision at this time regarding the loan.

Evaluating an Ethical Dilemma

CP3-6
LO3-3

Mike Lynch is the manager of an upstate New York regional office for an insurance company. As the regional manager, his compensation package comprises a base salary, commissions, and a bonus when the region sells new policies in excess of its quota. Mike has been under enormous pressure lately, stemming largely from two factors. First, he is experiencing a mounting personal debt due to a family member's illness. Second, compounding his worries, the region's sales of new policies have dipped below the normal quota for the first time in years.

You have been working for Mike for two years, and like everyone else in the office, you consider yourself lucky to work for such a supportive boss. You also feel great sympathy for his personal problems over the last few months. In your position as accountant for the regional office, you are only too aware of the drop in new policy sales and the impact this will have on the manager's bonus. While you are working late at year-end, Mike stops by your office.

Mike asks you to change the manner in which you have accounted for a new property insurance policy for a large local business. A substantial check for the premium came in the mail on December 31, the last day of the reporting year. The premium covers a period beginning on January 5. You deposited the check and correctly debited Cash and credited an **unearned revenue** account. Mike says, "Hey, we have the money this year, so why not count the revenue this year? I never did understand why you accountants are so picky about these things anyway. I'd like you to change the way you have recorded the transaction. I want you to credit a *revenue* account. And anyway, I've done favors for you in the past, and I am asking for such a small thing in return." With that, he leaves for the day.

Required:
1. How should you handle this situation?
2. What are the ethical implications of Mike's request?
3. Who are the parties who would be helped or harmed if you complied with the request?
4. If you fail to comply with his request, how will you explain your position to him in the morning?

Financial Reporting and Analysis Team Project

CP3-7
LO3-2, 3-3, 3-6

Team Project: Analysis of Income Statements and Ratios

As a team, select an industry to analyze. Yahoo! Finance provides lists of industries at **finance.yahoo.com/industries.** Click on an industry for a list of companies in that industry. Alternatively, go to Google Finance at **finance.google.com/finance,** search for a company you are interested in, and you will be presented with a list including that company and its competitors. Each team member should acquire the annual report or 10-K for one publicly traded company in the industry, with each member selecting a different company (the SEC EDGAR service at **www.sec.gov** and the company's investor relations website itself are good sources).

Required:
On an individual basis, each team member should write a short report answering the following questions about the selected company. Discuss any patterns across the companies that you as a team observe. Then, as a team, write a short report comparing and contrasting your companies.

1. For the most recent year, what is (are) the major revenue account(s)? What percentage is each to total operating revenues? (Calculated as Revenue A ÷ Total operating revenues.)
2. For the most recent year, what is (are) the major expense account(s)? What percentage is each to total operating expenses? (Calculated as Expense A ÷ Total operating expenses.)
3. Ratio Analysis:
   a. What does the net profit margin ratio measure in general?
   b. Compute the ratio for the last three years.
   c. What do your results suggest about the company?
   d. If available, find the industry ratio for the most recent year, compare it to your results, and discuss why you believe your company's ratio differs from or is similar to the industry ratio.
4. Describe the company's revenue recognition policy, if reported (usually in the Significant Accounting Policies note to the financial statements).
5. The ratio of Cash from Operating Activities divided by Net Income measures how liberal (that is, speeding up revenue recognition or delaying expense recognition) or conservative (that is, taking care not to record revenues too early or expenses too late) management is in choosing among various revenue and expense recognition policies. A ratio above 1.0 suggests more conservative policies; a ratio below 1.0 suggests more liberal policies. Compute the ratio for each of the last three years. What do your results suggest about the company's choice of accounting policies?

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