

FINANCIAL ACCOUNTING

10th Edition

LIBBY / LIBBY / HODGE



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



FINANCIAL ACCOUNTING, TENTH EDITION

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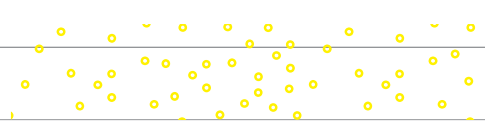
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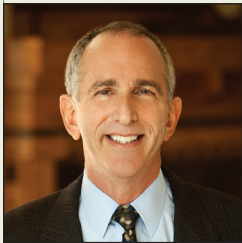
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ABOUT THE AUTHORS

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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.

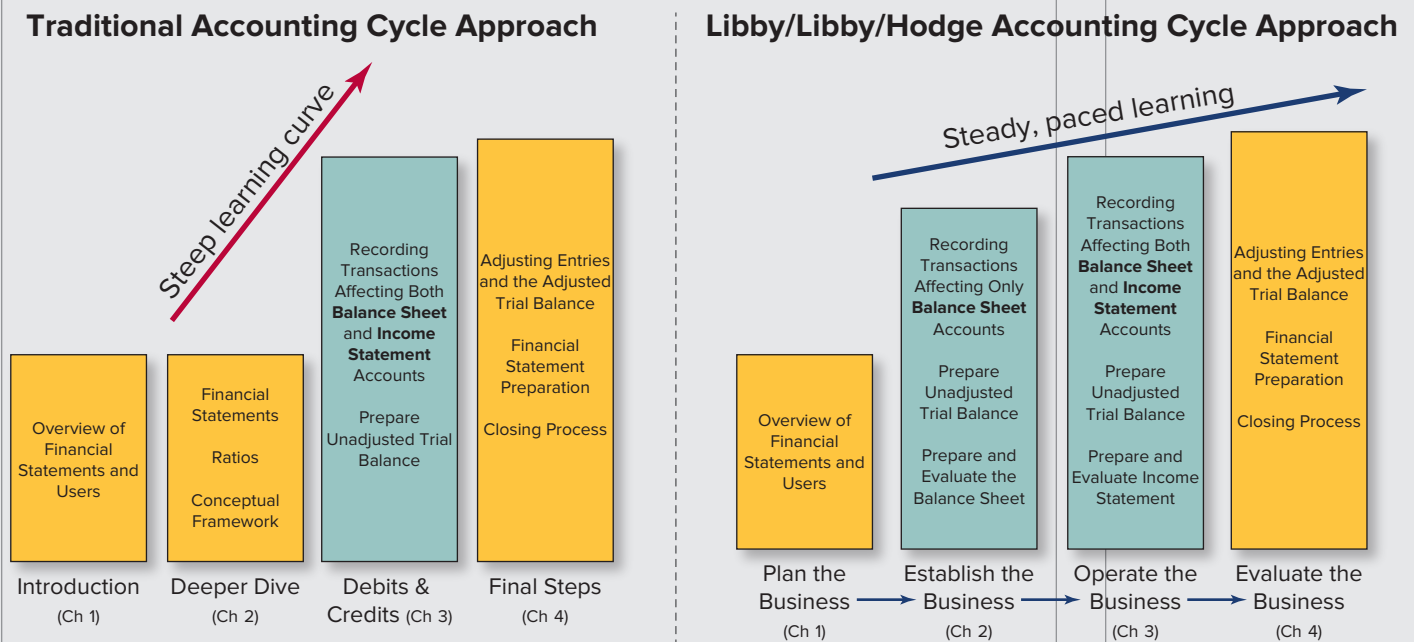
A BUILDING-BLOCK APPROACH TO TEACHING TRANSACTION ANALYSIS

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 outpace 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 **LeNature'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' enterprise-wide accounting systems, which combine the various record-keeping functions within an organiza-

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.

McGraw Hill Education

a. Received \$30,000 cash and an office building valued at \$220,000 in exchange for 5,000 shares of \$1.00 par value common stock to each of three architects (investors).

Requirement 1

	Received		Given	
a. Cash (+A)	\$ 30,000	Common stock (+SE)		\$ 15,000
Building (+A)	220,000	Additional paid-in capital (+SE)		235,000

Requirement 2

	Debit	Credit
a. Cash (+A)	30,000	
Building (+A)	220,000	
Common Stock (+SE)		15,000
Additional Paid-in Capital (+SE)		235,000

Requirement 3

Assets		=	General Ledger		=	Stockholders' Equity	
			Liabilities	+		- Common Stock +	
+ Cash -							
a. 30,000						15,000	a.
+ Building -							
a. 220,000							

...\$15,000 on the credit side of the Common Stock account, and \$235,000 on the credit side of the Additional Paid-in Capital account.

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.

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!

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.

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.

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.

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 non-alcoholic 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

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?

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?

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?

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



CP7-3 LO7-5



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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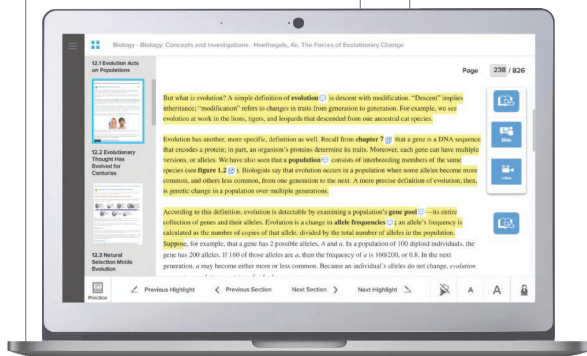
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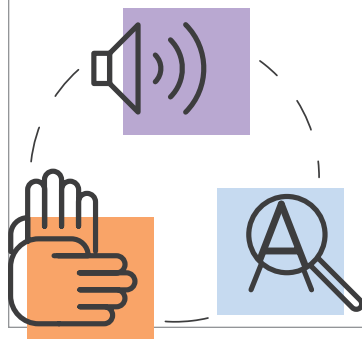
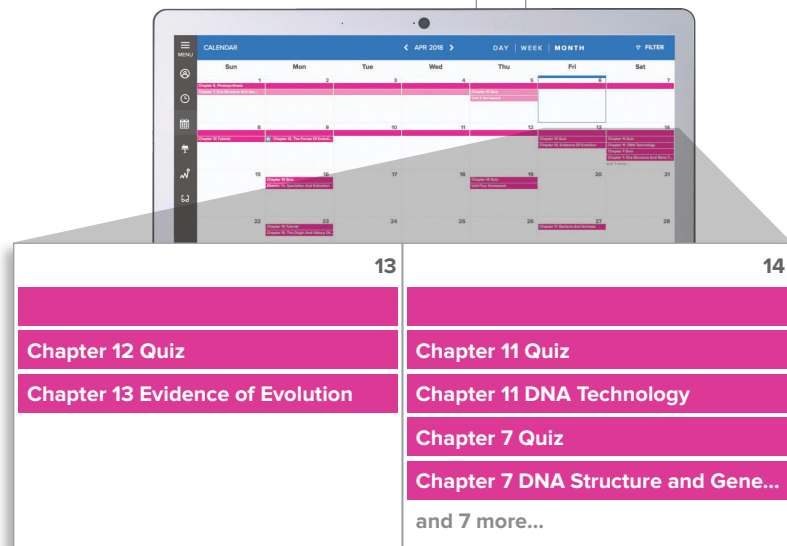
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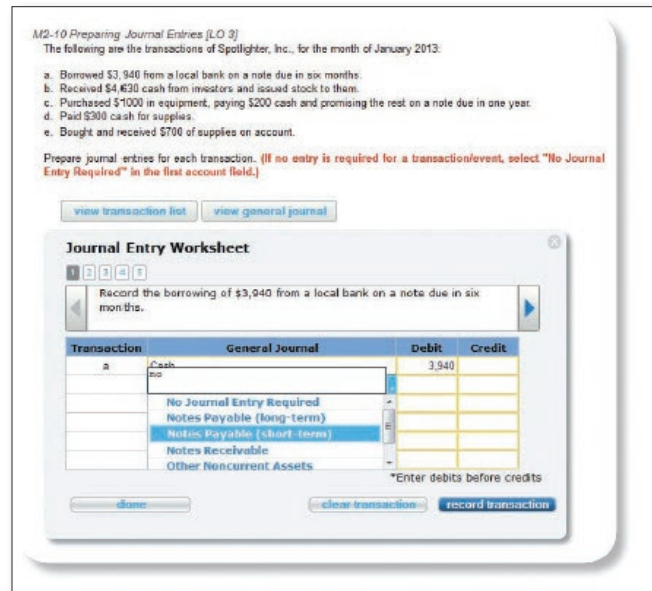
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Online Assignments

Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. Connect grades homework automatically and gives immediate feedback on any questions students may have missed. The extensive assignable, gradable end-of-chapter content includes a general journal application that looks and feels more like what you would find in a general ledger software package.

End-of-chapter questions in Connect include

- Mini-Exercises
- Exercises
- Problems
- Comprehensive Problems
- Continuing Problems
- Cases and Projects
- General Ledger Problems



General Ledger Problems

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

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

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

Post-closing ▾

Cash				Accounts Receivable			
Date	Debit	Credit	Balance	Date	Debit	Credit	Balance
Jan 01, 2015			3	Jan 01, 2015			5
Mar 01, 2015	12		15				
Mar 02, 2015		9	6				
Apr 03, 2015	23		29				
Jul 04, 2015		10	19				
Nov 06, 2015		13	6				

Supplies				Land			
Date	Debit	Credit	Balance	Date	Debit	Credit	Balance
Jan 01, 2015			12	Jan 01, 2015			0
Oct 05, 2015	18		30	Mar 02, 2015	9		9

Equipment				Accumulated Depreciation—Equipment			
Date	Debit	Credit	Balance	Date	Debit	Credit	Balance
Jan 01, 2015			60	Jan 01, 2015			6

Software				Accumulated Amortization			
Date	Debit	Credit	Balance	Date	Debit	Credit	Balance
Jan 01, 2015			15	Jan 01, 2015			5
Jul 04, 2015	10		25				

Accounts Payable				Notes Payable (short-term)			
Date	Debit	Credit	Balance	Date	Debit	Credit	Balance
Jan 01, 2015			5	Jan 01, 2015			0
Oct 05, 2015		18	23	Mar 01, 2015		12	12
Nov 06, 2015		13	10				

Common Stock				Retained Earnings			
Date	Debit	Credit	Balance	Date	Debit	Credit	Balance
Jan 01, 2015			71	Jan 01, 2015			8
Apr 03, 2015		23	94				

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

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

Post-closing ▾

H & H TOOL, INC.		
Trial Balance		
December 31, 2015		
Account Title	Debit	Credit
Cash	\$ 6	
Accounts Receivable	5	
Supplies	30	
Land	9	
Equipment	60	
Accumulated Depreciation—Equipment		6
Software		25
Accumulated Amortization		5
Accounts Payable		10
Notes Payable (short-term)		12
Common Stock		94
Retained Earnings		8
Total	\$ 135	\$ 135

previous next

NEW! Concept Overview Videos

The **Concept Overview Videos** provide engaging narratives of 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.

Required information
[The following information applies to the questions displayed below.]

In this module, you will learn how to prepare a trial balance and a classified balance sheet. A trial balance checks on the equality of debit and credit balances. A classified balance sheet separately classifies assets as current if they will be used up or turned into cash within one year. Liabilities are classified as current if they will be paid, settled, or fulfilled within one year.

Preparing a Trial Balance

NOODLECAKE STUDIOS, INC. Trial Balance As of August 31		
	Debit	Credit
Cash	20,700	
Supplies	600	
Equipment	9,600	
Software	9,000	
Logo/trademarks	300	
Accounts Payable		10,200
Notes Payable		20,000
Common Stock		10,000
Totals	48,200	48,200

Trial balance provides a check on debits = credits equality

Ending balances in T-accounts

If debits = credits on trial balance → Balance sheet will not balance

Knowledge Check 01

Chaco Company's trial was in balance at the end of the period and showed the following accounts:

Accounts Payable	25,200
Cash	48,200

NEW! Excel Simulations

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

Guided Examples

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

Prepare a schedule of net cash provided by operating activities.

	End of year	Beginning of year
Current assets:		
Cash	\$ 75,000	\$ 90,000
Accounts receivable	158,000	140,000
Inventory	285,000	248,000
Prepaid expenses	11,000	16,000
Current liabilities:		
Accounts payable	284,000	302,000
Accrued liabilities	9,500	11,200
Income taxes payable	27,000	24,000
Net income		\$ 94,500
Accumulated depreciation		
total credits		\$ 45,000

Floor Company did not record any gains or losses during the year.

Prepare a schedule of net cash provided by operating activities.

“It is a great textbook that comes with a great online work system to enhance students’ learning effectiveness. Connect is user-friendly, provides many good practice opportunities, and links well with e-book.”

—Wan-Ting Wu, University of Massachusetts Boston

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

Lease Overview

Income Taxes Overview

Pensions and Other Postretirement Benefits Overview

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FINANCIAL ACCOUNTING

1

Financial Statements and Business Decisions

Le-Nature's Inc. designed its business strategy to ride the growing wave of interest in noncarbonated beverages. And apparently its strategy was a huge success. Its financial statements reported growth in sales from \$156 to \$275 million in just three years. How did this small family-run business compete with the likes of Coke and Pepsi in this growing market? The business press suggested the first key to its success was manufacturing a broad range of products that fit into the fastest growing "healthy" segments: flavored waters, teas, and fruit drinks. Founder and CEO Gregory Podlucky said that an obsessive drive for quality and efficiency was just as critical. Matching customers' concerns for the environment and healthy living, Le-Nature's was praised as one of the first companies to switch to environmentally friendlier PET plastic bottles and to employ safe in-bottle pasteurization. Its 21st-century manufacturing operation in Latrobe, Pennsylvania, produced everything that goes into its products, from the injection-molded PET bottles to the final packaging. Complete control over the whole process assures quality and provides the flexibility to respond quickly to changes in customers' demands. When convenience stores moved to larger-sized drinks or school cafeterias switched from carbonated beverages to healthier drinks, Le-Nature's could change its production to meet the customers' needs. The company even opened a second new state-of-the-art manufacturing facility in Arizona to meet the apparent growing demand.

But here is the twist: Just three short months later, investigators discovered that Le-Nature's phenomenal sales growth was more fiction than fact. How could this apparent success story portrayed in the financial statements really be one of the most remarkable frauds in history?

Chapter 1 concentrates on the key financial statements that businesspeople rely upon when they evaluate a company's performance as well as the importance of accurate financial statements in making our economic system work. We discuss these issues in the context of Le-Nature's rise and fall.

Accounting knowledge will be valuable to you only if you can apply it in the real world. Learning is also easier when it takes place in real contexts. So at the beginning of each chapter, we always provide some background about the business that will provide the context for the chapter discussion.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- 1-1** Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers).
- 1-2** Identify the role of generally accepted accounting principles (GAAP) in determining financial statement content and how companies ensure the accuracy of their financial statements.



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UNDERSTANDING THE BUSINESS

Le-Nature's Inc., our focus company for this chapter, was founded by Gregory Podlucky and his brother Jonathan, who initially were the sole owners or **stockholders** of the company. They were also the managers of the company. Using expertise gained working at their parents' brewery (**Stoney's Beer**), the brothers were early believers in the trend toward healthier, noncarbonated beverages. Like most entrepreneurs, their growth ambitions quickly outpaced their own financial resources. So they turned to banks, including **Wells Fargo Bank** and other lenders, to finance additional manufacturing facilities and equipment. Different units of Wells Fargo continued to arrange lending to Le-Nature's as the need arose, becoming its largest lender or **creditor**. Creditors make money on the loans by charging **interest**. The Podlucky family also convinced others to buy stock in Le-Nature's. These individuals became part owners or stockholders along with the Podlucky family. They hoped to receive a portion of what the company earned in the form of cash payments called **dividends** and to eventually sell their share of the company at a higher price than they paid. Creditors are more willing to lend and stock prices usually rise when creditors and investors expect the company to do well in the future. Both groups often judge future performance based on information in the company's financial statements.

The Accounting System

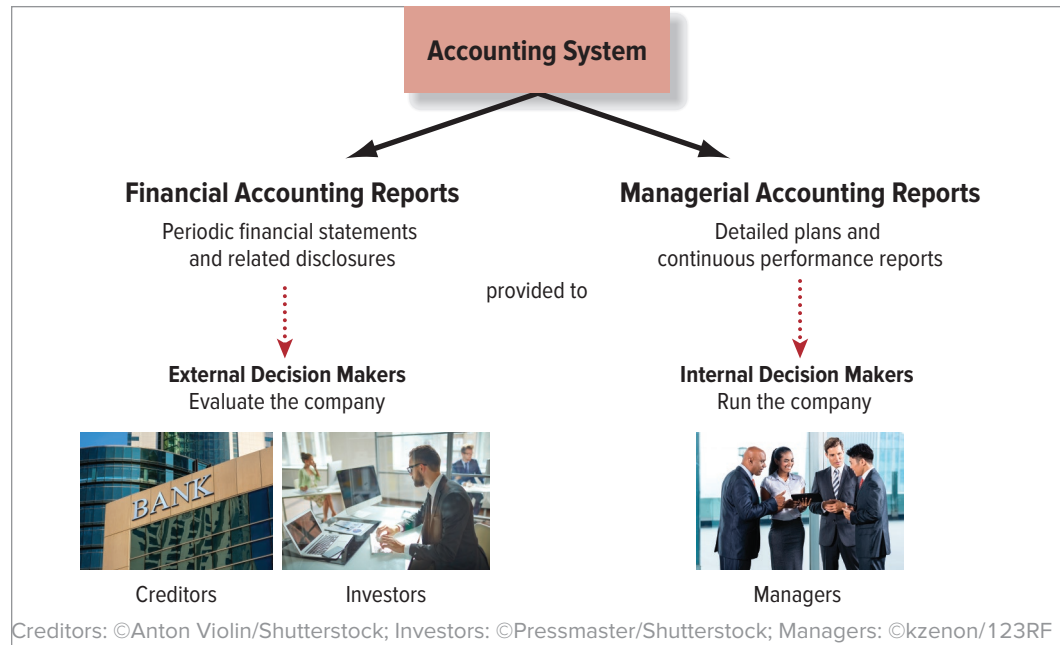
Managers (often called **internal decision makers**) need information about the company's business activities to manage the operating, investing, and financing activities of the firm. Stockholders and creditors (often called **external decision makers**) need information about these same business activities to assess whether the company will

Le-Nature's Inc.

USING FINANCIAL
STATEMENT
INFORMATION TO
MANAGE GROWTH

EXHIBIT 1.1

The Accounting System and Decision Makers



ACCOUNTING

A system that collects and processes (analyzes, measures, and records) financial information about an organization and reports that information to decision makers.

be able to pay back its debts with interest and pay dividends. All businesses must have an **accounting** system that collects and processes financial information about an organization’s business activities and reports that information to decision makers.

Le-Nature’s **business activities** included

- **Financing Activities:** borrowing or paying back money to lenders and receiving additional funds from stockholders or paying them dividends.
- **Investing Activities:** buying or selling items such as plant and equipment used in the production of beverages.
- **Operating Activities:** the day-to-day process of purchasing raw tea and other ingredients from suppliers, manufacturing beverages, delivering them to customers, collecting cash from customers, and paying suppliers.

Exhibit 1.1 outlines the two parts of the accounting system. Internal managers typically require continuous, detailed information because they must plan and manage the day-to-day operations of the organization. Developing accounting information for internal decision makers, called **managerial** or **management accounting**, is the subject of a separate accounting course. The focus of this text is accounting for external decision makers, called **financial accounting**, and the four basic financial statements and related disclosures that are periodically produced by that system.

Why Study Financial Accounting?

No matter what your business career goals, you can’t get away from financial accounting. You may want to work for an investment firm, a bank, or an accounting firm that would be involved in the financing of companies like **Le-Nature’s**. We will focus much of our discussion on the perspectives of **investors**, **creditors**, and **preparers** of financial statements. However, you might not be aware that managers within the firm also make direct use of financial statements. For example, **marketing managers** and **credit managers** use customers’ financial statements to decide whether to extend credit to their customers. **Supply chain managers** analyze suppliers’ financial statements to see whether the suppliers have the resources to meet demand and invest in future development. Both the employees’ unions and company **human resource managers** use financial statements

as a basis for contract negotiations over pay rates. Financial statement figures even serve as a basis for calculating employee bonuses. Regardless of the functional area of management in which you are employed, you will use financial statement data.

We begin with a brief but comprehensive overview of the information reported in the four basic financial statements and the people and organizations involved in their preparation and use. This overview provides a context in which you can learn the more detailed material presented in the chapters that follow. Then we will discuss the parties that are responsible for the accuracy of financial statements as well as the consequences of misstated financial statements. Le-Nature's stockholders and creditors used its financial statements to learn more about the company before making their investment and lending decisions. In doing so, they assumed that the statements accurately represented Le-Nature's financial condition.

Your Goals for Chapter 1

To understand the way in which creditors and stockholders used Le-Nature's financial statements, we must first understand what specific information is presented in the four basic financial statements for a company such as Le-Nature's. **PLEASE NOTE: Rather than trying to memorize the definitions of every term used in this chapter, try to focus your attention on learning the general content, structure, and use of the statements. Specifically:**

- **Content:** the categories of items (often called **elements**) reported on each of the four statements.
- **Structure:** the **equation** that shows how the elements within the statement are organized and related.
- **Use:** how the information is **used** by stockholders and creditors to make investment and lending decisions.

The Pause for Feedback–Self-Study Quizzes at key points in the chapter will help you assess whether you have reached these goals. Remember that because this chapter is an overview, each concept discussed here will be discussed again in Chapters 2 through 5.

ORGANIZATION OF THE CHAPTER

The Four Basic Financial Statements: An Overview

- Balance Sheet
- Income Statement
- Statement of Stockholders' Equity
- Statement of Cash Flows
- Relationships Among the Statements
- Notes and Financial Statement Formats

Responsibilities for the Accounting Communication Process

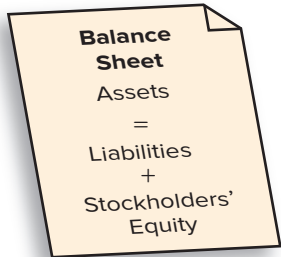
- Generally Accepted Accounting Principles
- Ensuring the Accuracy of Financial Statements

LEARNING OBJECTIVE 1-1

Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers).

BALANCE SHEET (STATEMENT OF FINANCIAL POSITION)

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



ACCOUNTING ENTITY

The organization for which financial data are to be collected.

BASIC ACCOUNTING EQUATION (BALANCE SHEET EQUATION)

Assets = Liabilities + Stockholders' Equity.

THE FOUR BASIC FINANCIAL STATEMENTS: AN OVERVIEW

Four financial statements are normally prepared by profit-making organizations for use by investors, creditors, and other external decision makers.

1. On its **balance sheet**, **Le-Nature's** reports the economic resources it owns and the sources of financing for those resources.
2. On its **income statement**, Le-Nature's reports its ability to sell goods for more than their cost to produce and sell.
3. On its **statement of stockholders' equity**, Le-Nature's reports additional contributions from or payments to investors and the amount of income the company reinvested for future growth.
4. On its **statement of cash flows**, Le-Nature's reports its ability to generate cash and how it was used.

The four basic statements can be prepared at any point in time (such as the end of the year, quarter, or month) and can apply to any time span (such as one year, one quarter, or one month). Like most companies, Le-Nature's prepared financial statements for external users (investors and creditors) at the end of each quarter (known as **quarterly reports**) and at the end of the year (known as **annual reports**).

The Balance Sheet

The purpose of the **balance sheet** is to report the financial position (amount of assets, liabilities, and stockholders' equity) of an accounting entity at a particular point in time. We can learn a great deal about what the balance sheet reports just by reading the statement from the top. The balance sheet **Le-Nature's Inc.** presented to creditors and stockholders is shown in Exhibit 1.2.

Structure

Notice that the **heading** specifically identifies four significant items related to the statement:

1. **Name of the entity**, Le-Nature's Inc.
2. **Title of the statement**, Balance Sheet.
3. **Specific date of the statement**, At December 31, 2015.
4. **Unit of measure** (in millions of dollars).

The organization for which financial data are to be collected, called an **accounting entity**, must be precisely defined. On the balance sheet, the business entity itself, not the business owners, is viewed as owning the resources it uses and being responsible for its debts. The heading of each statement indicates the time dimension of the report. The balance sheet is like a financial snapshot indicating the entity's financial position at a specific point in time—in this case, December 31, 2015—which is stated clearly on the balance sheet. Financial reports are normally denominated in the currency of the country in which they are located. U.S. companies report in U.S. dollars, Canadian companies in Canadian dollars, and Mexican companies in Mexican pesos. Le-Nature's statements report in millions of dollars. That is, they round the last six digits to the nearest **million** dollars. The listing of Cash \$10.6 on Le-Nature's balance sheet actually means \$10,600,000.

Notice that Le-Nature's balance sheet has three major captions: assets, liabilities, and stockholders' equity. The **basic accounting equation**, often called the balance sheet equation, explains their relationship:

Assets	=	Liabilities	+	Stockholders' Equity
Economic resources (e.g., cash, inventory, buildings)		Financing from creditors (e.g., amounts owed to suppliers, employees, banks)		Financing from stockholders (e.g., common stock, retained earnings)

LE-NATURE'S INC.*		EXPLANATION	
Balance Sheet		<i>Name of the entity</i>	
At December 31, 2015		<i>Title of the statement</i>	
(in millions of dollars)		<i>Specific date of the statement</i>	
		<i>Unit of measure</i>	
Assets:		Resources controlled by the company	
Cash	\$ 10.6	<i>Amount of cash in the company's bank accounts</i>	
Accounts receivable	6.6	<i>Amounts owed by customers from prior sales</i>	
Inventories	51.2	<i>Ingredients and beverages ready for sale</i>	
Property, plant, and equipment	459.0	<i>Factories, production equipment, and land</i>	
Total assets	<u>\$527.4</u>	Total amount of company's resources	
Liabilities and stockholders' equity:		Sources of financing for company's resources	
Liabilities		<i>Financing supplied by creditors</i>	
Accounts payable	\$ 26.0	<i>Amounts owed to suppliers for prior purchases</i>	
Notes payable to banks	381.7	<i>Amounts owed to banks on written debt contracts</i>	
Total liabilities	<u>407.7</u>		
Stockholders' equity		<i>Financing provided by stockholders</i>	
Common stock	55.7	<i>Amounts invested in the business by stockholders</i>	
Retained earnings	64.0	<i>Past earnings not distributed to stockholders</i>	
Total stockholders' equity	<u>119.7</u>		
Total liabilities and stockholders' equity	<u>\$527.4</u>	Total sources of financing for company's resources	
The notes are an integral part of these financial statements.			

EXHIBIT 1.2

Balance Sheet

The basic accounting equation shows what we mean when we refer to a company's **financial position**: the economic resources that the company owns and the sources of financing for those resources.

Elements

Assets are the economic resources owned by the entity. Le-Nature's lists four items under the category Assets. The exact items listed as assets on a company's balance sheet depend on the nature of its operations. But these are common names used by many companies. The four items listed by Le-Nature's are the economic resources needed to manufacture and sell beverages to retailers and vending companies. Each of these economic resources is expected to provide future benefits to the firm. To prepare to manufacture the beverages, Le-Nature's first needed cash to purchase land on which to build factories and install production machinery (property, plant, and equipment). Le-Nature's then began purchasing ingredients and producing beverages, which led to the balance assigned to inventories. When Le-Nature's sells its beverages to grocery stores and others, it sells them on credit and receives promises to pay called accounts receivable, which are collected in cash later.

Every asset on the balance sheet is initially measured at the total cost incurred to acquire it. Balance sheets do not generally show the amounts for which the assets could currently be sold.

Liabilities and stockholders' equity are the sources of financing for the company's economic resources. **Liabilities** indicate the amount of financing provided by creditors. They are the company's debts or obligations. Under the category Liabilities, Le-Nature's lists



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*The Le-Nature's statements presented are constructed based on a simplified version of its audited 2005 statements. As we discuss in the section titled "Ensuring the Accuracy of Financial Statements," Le-Nature's statements were later found to be fraudulent. (Thus, 2015 is used in the header for illustration purposes.) The Le-Nature's fraud provides an important warning about the importance of accuracy in financial reporting.

two items. The accounts payable arise from the purchase of goods or services from suppliers on credit without a formal written contract (or a note). The notes payable to banks result from cash borrowings based on a formal written debt contract with banks.

Stockholders' equity indicates the amount of financing provided by owners of the business and reinvested earnings.¹ The investment of cash and other assets in the business by the stockholders is called common stock. The amount of earnings (profits) reinvested in the business (and thus not distributed to stockholders in the form of dividends) is called retained earnings.

In Exhibit 1.2, the Stockholders' Equity section reports two items. The founders and other stockholders' investment of \$55.7 million is reported as common stock. Le-Nature's total earnings (or losses incurred) less all dividends paid to the stockholders since formation of the corporation equals \$64 million and is reported as retained earnings. Total stockholders' equity is the sum of the common stock plus the retained earnings.



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 stockholders because assets provide a basis for judging whether the company has sufficient resources available to operate. Assets are also important because they could be sold for cash in the event that Le-Nature's goes out of business.

Le-Nature's debts are important because creditors and stockholders are concerned about whether the company has sufficient sources of cash to pay its debts. Le-Nature's debts are also relevant to Wells Fargo Bank's decision to lend money to the company because existing creditors share its claim against Le-Nature's assets. If a business does not pay its creditors, the creditors may force the sale of assets sufficient to meet their claims. The sale of assets often fails to cover all of a company's debts, and some creditors may take a loss.

Le-Nature's stockholders' equity is important to Wells Fargo Bank because creditors' claims legally come before those of owners. If Le-Nature's goes out of business and its assets are sold, the proceeds of that sale must be used to pay back creditors before the stockholders receive any money. Thus, creditors consider stockholders' equity a protective "cushion."



PAUSE FOR FEEDBACK

We just learned the **balance sheet** is a statement of financial position that reports dollar amounts for a company's assets, liabilities, and stockholders' equity at a specific point in time. These elements are related in the basic accounting equation: **Assets = Liabilities + Stockholders' Equity**. Before you move on, complete the following questions to test your understanding of these concepts.

SELF-STUDY QUIZ

1. **Le-Nature's** assets are listed in one section and **liabilities** and **stockholders' equity** in another. Notice that the two sections balance in conformity with the basic accounting equation. In the following chapters, you will learn that the basic accounting equation is the basic building block for the entire accounting process. Your task here is to verify that total assets

¹A corporation is a business that is incorporated under the laws of a particular state. The owners are called **stockholders** or **shareholders**. Ownership is represented by shares of capital stock that usually can be bought and sold freely. The corporation operates as a separate legal entity, separate and apart from its owners. The stockholders enjoy limited liability; they are liable for the debts of the corporation only to the extent of their investments. Chapter Supplement A discusses forms of ownership in more detail.

(\$527.4 million) is correct using the numbers for liabilities and stockholders' equity presented in Exhibit 1.2.

- Learning which items belong in each of the balance sheet categories is an important first step in understanding their meaning. Without referring to Exhibit 1.2, mark each balance sheet item in the following list as an asset (A), a liability (L), or a stockholders' equity (SE) item.

- | | |
|--|---|
| <input type="checkbox"/> Accounts payable | <input type="checkbox"/> Property, plant, and equipment |
| <input type="checkbox"/> Accounts receivable | <input type="checkbox"/> Inventories |
| <input type="checkbox"/> Cash | <input type="checkbox"/> Notes payable |
| <input type="checkbox"/> Common stock | <input type="checkbox"/> Retained earnings |

After you have completed your answers, check them below.

The Income Statement

Structure

The **income statement** (statement of income, statement of earnings, statement of operations, statement of comprehensive income²) reports the accountant's primary measure of performance of a business, revenues less expenses during the accounting period. While the term *profit* is used widely for this measure of performance, accountants prefer to use the technical terms **net income** or *net earnings*. **Le-Nature's** net income measures its success in selling beverages for more than the cost to generate those sales.

A quick reading of Le-Nature's income statement (Exhibit 1.3) indicates a great deal about its purpose and content. The heading identifies the name of the entity, the title of the report, and the unit of measure used in the statement. Unlike the balance sheet, however, which reports as of a certain date, the income statement reports for a specified period of time (in this case for the year ended December 31, 2015). The time period covered by the financial statements (one year in this case) is called an **accounting period**. Notice that Le-Nature's income statement has three major captions: revenues, expenses, and net income. The income statement equation that describes their relationship is

Revenues	=	Expenses	+	Net Income
(Cash and promises received from delivery of goods and services)		(Resources used to earn period's revenues)		(Revenues earned minus expenses incurred)

Elements

Companies earn **revenues** from the sale of goods or services to customers (in Le-Nature's case, from the sale of beverages). Revenues normally are amounts expected to be received for goods or services that have been delivered to a customer, **whether or not the customer has paid for the goods or services**. Retail stores such as **Walmart** and **McDonald's** often receive cash from consumers at the time of sale. However, when Le-Nature's delivers its beverages to retail stores, it receives a promise of future payment called an account receivable, which later is collected in cash. In either case, the business recognizes total sales (cash and credit) as revenue for the period. Various terms are used in income statements to describe different sources of revenue (e.g., provision of services, sale of goods, rental of property). Le-Nature's lists only one, sales revenue, in its income statement.

- Assets (\$527.4) = Liabilities (\$407.7) + Stockholders' Equity (\$119.7) (in millions).
- L, A, A, SE, A, A, L, SE (reading down the columns).

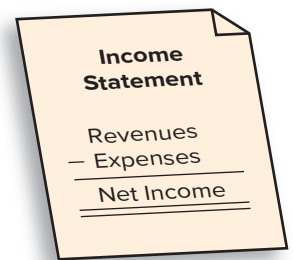
²Comprehensive income is sometimes presented in a separate statement. This advanced topic is discussed in Chapter 5.

INCOME STATEMENT (STATEMENT OF INCOME, STATEMENT OF EARNINGS, STATEMENT OF OPERATIONS, STATEMENT OF COMPREHENSIVE INCOME)

Reports the revenues less the expenses of the accounting period.

ACCOUNTING PERIOD

The time period covered by the financial statements.



Solution to SELF-STUDY QUIZ

EXHIBIT 1.3

Income Statement

LE-NATURE'S INC.*		EXPLANATION
Income Statement		<i>Name of the entity</i>
For the Year Ended December 31, 2015		<i>Title of the statement</i>
(in millions of dollars)		<i>Accounting period</i>
		<i>Unit of measure</i>
Revenues		<i>Cash and promises received from sale of beverages</i>
Sales revenue	\$275.1	
Expenses		<i>Cost to produce beverages sold</i>
Cost of goods sold	140.8	<i>Other operating expenses (utilities, delivery costs, etc.)</i>
Selling, general, and administrative expenses	77.1	<i>Cost of using borrowed funds</i>
Interest expense	17.2	
Income before income taxes	40.0	<i>Income taxes on period's income before income taxes</i>
Income tax expense	17.1	<i>Revenues earned minus expenses incurred</i>
Net income	\$ 22.9	
The notes are an integral part of these financial statements.		
*The Le-Nature's statements presented are a simplified version of its audited 2005 statements.		

Expenses represent the dollar amount of resources the entity used to earn revenues during the period. Expenses reported in one accounting period actually may be paid for in another accounting period. Some expenses require the payment of cash immediately, while others require payment at a later date. Some also may require the use of another resource, such as an inventory item, which may have been paid for in a prior period. Le-Nature's lists four types of expenses on its income statement, which are described in Exhibit 1.3. These expenses include income tax expense, which, as a corporation, Le-Nature's must pay on the subtotal income before income taxes.

Net income or net earnings (often called "the bottom line") is the excess of total revenues over total expenses. If total expenses exceed total revenues, a net loss is reported.³ We noted earlier that revenues are not necessarily the same as collections from customers and expenses are not necessarily the same as payments to suppliers. As a result, net income normally **does not equal** the net cash generated by operations. This latter amount is reported on the cash flow statement discussed later in this chapter.

**FINANCIAL ANALYSIS****Analyzing the Income Statement: Beyond the Bottom Line**

Investors and creditors such as **Wells Fargo Bank** closely monitor a firm's net income because it indicates the firm's ability to sell goods and services for more than they cost to produce and deliver. Investors buy stock when they believe that future earnings will improve and lead to dividends and the ability to sell their stock for more than they paid. Lenders also rely on future earnings to provide the resources to repay loans. The details of the statement also are important. For example, **Le-Nature's** had to sell more than \$275 million worth of beverages to make just under \$23 million. If a competitor were to lower prices just 10 percent, forcing Le-Nature's to do the same, its net income could easily turn into a net loss. These factors and others help investors and creditors estimate the company's future earnings.

³Net losses are normally noted by parentheses around the income figure.

PAUSE FOR FEEDBACK 

As noted above, the **income statement** is a statement of operations that reports revenues, expenses, and net income for a stated period of time. To practice your understanding of these concepts, complete the following questions.

SELF-STUDY QUIZ

- Learning which items belong in each of the income statement categories is an important first step in understanding their meaning. Without referring to Exhibit 1.3, mark each income statement item in the following list as a revenue (R) or an expense (E).

_____ Cost of goods sold	_____ Sales revenue
_____ Income tax	_____ Selling, general, and administrative

- Assume that during the period 2015, **Le-Nature's** delivered beverages for which customers paid or promised to pay amounts totaling \$275.1 million. During the same period, it collected \$250.0 million in cash from its customers. Without referring to Exhibit 1.3, indicate which of these two amounts will be shown on Le-Nature's income statement as **sales revenue** for 2015. Why did you select your answer?
- Assume that during the period 2015, Le-Nature's **produced** beverages with a total cost of production of \$142.1 million. During the same period, it **delivered** to customers beverages that cost a total of \$140.8 million to produce. Without referring to Exhibit 1.3, indicate which of the two numbers will be shown on Le-Nature's income statement as **cost of goods sold expense** for 2015. Why did you select your answer?



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AP Images

After you have completed your answers, check them below.

Statement of Stockholders' Equity

Structure

Le-Nature's prepares a separate **statement of stockholders' equity**, shown in Exhibit 1.4. The heading identifies the name of the entity, the title of the report, and the unit of measure used in the statement. Like the income statement, the statement of stockholders' equity covers a specified period of time (the accounting period), which in this case is one year. The statement reports the changes in each of the company's stockholders' equity accounts during that period.

Le-Nature's had no changes in common stock during the period. Had it issued or repurchased common stock during the year, the transactions would be reported on separate lines. The retained earnings column reports the way that net income and the distribution of dividends affected the company's financial position during the accounting period. Net income earned during the year increases the balance of retained earnings, showing the relationship of the income statement to the balance sheet.⁴ Declaring dividends to the stockholders decreases retained earnings.

- E, E, R, E (reading down the columns).
- Sales revenue in the amount of \$275.1 million is recognized. Sales revenue is normally reported on the income statement when goods or services have been delivered to customers who have either paid or promised to pay for them in the future.
- Cost of goods sold expense is \$140.8. Expenses are the dollar amount of resources used up to earn revenues during the period. Only those beverages that have been delivered to customers have been used up.

⁴Net losses are subtracted.

STATEMENT OF STOCKHOLDERS' EQUITY

The statement reports the changes in each of the company's stockholders' equity accounts during the period.

Solutions to SELF-STUDY QUIZ

EXHIBIT 1.4

Statement of Stockholders' Equity

Statement of Stockholders' Equity	
Beginning balance	
+ Increases	
– Decreases	
Ending balance	

LE-NATURE'S INC.*			EXPLANATION
Statement of Stockholders' Equity			<i>Name of the entity</i>
For the Year Ended December 31, 2015			<i>Title of the statement</i>
(in millions of dollars)			<i>Accounting period</i>
	Common Stock	Retained Earnings	<i>Unit of measure</i>
Balance December 31, 2014	\$55.7	\$43.1	<i>Last period's ending balances</i>
Net income for 2015		22.9	<i>Net income reported on the income statement</i>
Dividends for 2015		(2.0)	<i>Dividends declared during the period</i>
Balance December 31, 2015	\$55.7	\$64.0	<i>Ending balances on the balance sheet</i>

The notes are an integral part of these financial statements.
*The Le-Nature's statements presented are a simplified version of its audited 2005 statements.

The retained earnings equation that describes these relationships is

$$\text{Beginning Retained Earnings} + \text{Net Income} - \text{Dividends} = \text{Ending Retained Earnings}$$

Elements

The statement starts with the beginning balances in the stockholders' equity accounts, lists the increases and decreases, and reports the resulting ending balances. The retained earnings portion of the statement in Exhibit 1.4 begins with Le-Nature's **beginning-of-the-year retained earnings**. The current year's **net income** reported on the income statement is added and the current year's **dividends** are subtracted from this amount. During 2015, Le-Nature earned \$22.9 million, as shown on the income statement (Exhibit 1.3). This amount was added to the beginning-of-the-year retained earnings. Also, during 2015, Le-Nature's declared and paid a total of \$2.0 million in dividends to its stockholders. This amount was subtracted in computing **end-of-the-year retained earnings** on the balance sheet. Note that retained earnings increased by the portion of income reinvested in the business (\$22.9 million – \$2.0 million = \$20.9 million). The ending retained earnings amount of \$64.0 million is the same as that reported in Exhibit 1.2 on Le-Nature's balance sheet. Thus, the retained earnings portion of the statement indicates the relationship of the income statement to the balance sheet.

FINANCIAL ANALYSIS**Interpreting Retained Earnings**

Reinvestment of earnings, or retained earnings, is an important source of financing for **Le-Nature's**, representing more than 12 percent of its financing. Creditors such as **Wells Fargo Bank** closely monitor a firm's statement of stockholders' equity because the firm's policy on dividend payments to the stockholders affects its ability to repay its debts. Every dollar Le-Nature's pays to stockholders as a dividend is not available for use in paying back its debt to Wells Fargo. Investors examine retained earnings to determine whether the company is reinvesting a sufficient portion of earnings to support future growth.

**PAUSE FOR FEEDBACK**

The **statement of stockholders' equity** explains changes in stockholders' equity accounts, including the change in the retained earnings balance caused by net income and dividends during the reporting period. Check your understanding of these relationships by completing the following question.

SELF-STUDY QUIZ

1. Assume that a company's financial statements reported the following amounts: beginning retained earnings, \$5,510; total assets, \$20,450; dividends, \$900; cost of goods sold expense, \$19,475; and net income, \$1,780. Without referring to Exhibit 1.4, compute ending retained earnings.

After you have completed your answer, check it below.

GUIDED HELP 1-1



For additional step-by-step video instruction on preparing the balance sheet, income statement, and statement of stockholders' equity, go to www.mhhe.com/libby10e_gh1.

Statement of Cash Flows

Structure

Le-Nature's statement of cash flows is presented in Exhibit 1.5. The **statement of cash flows** (cash flow statement) divides Le-Nature's cash inflows and outflows (receipts and payments) into the three primary categories of cash flows in a typical business: cash flows from operating, investing, and financing activities. The heading identifies the name of the entity, the title of the report, and the unit of measure used in the statement. Like the income statement, the cash flow statement covers a specified period of time (the accounting period), which in this case is one year.

As discussed earlier in this chapter, reported revenues do not always equal cash collected from customers because some sales may be on credit. Also, expenses reported on the income statement may not be equal to the cash paid out during the period because expenses may be incurred in one period and paid for in another. Because the income statement does not provide information concerning cash flows, accountants prepare the statement of cash flows to report inflows and outflows of cash. The cash flow statement equation describes the causes of the change in cash reported on the balance sheet from the end of the last period to the end of the current period:

$$\begin{array}{r}
 +/\text{-- Cash Flows from Operating Activities (CFO)} \\
 +/\text{-- Cash Flows from Investing Activities (CFI)} \\
 +/\text{-- Cash Flows from Financing Activities (CFF)} \\
 \hline
 \text{Change in Cash} \\
 + \text{ Beginning Cash Balance} \\
 \hline
 \text{Ending Cash Balance}
 \end{array}$$

Note that each of the three cash flow sources can be positive or negative.

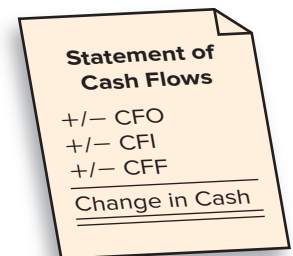
Elements

Cash flows from operating activities are cash flows that are directly related to earning income. For example, when customers pay Le-Nature's for the beverages it has delivered to them, it lists the amounts collected as cash collected from customers. When Le-Nature's pays salaries to its production employees or pays bills received from its tea suppliers, it includes the amounts in cash paid to suppliers and employees.

1. Beginning Retained Earnings (\$5,510) + Net Income (\$1,780) – Dividends (\$900) = Ending Retained Earnings (\$6,390).

STATEMENT OF CASH FLOWS (CASH FLOW STATEMENT)

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



Solutions to SELF-STUDY QUIZ

EXHIBIT 1.5

Statement of Cash Flows

LE-NATURE'S INC.***Statement of Cash Flows (Summary)
For the Year Ended December 31, 2015
(in millions of dollars)**

Cash flows from operating activities	\$ 87.5
Cash flows from investing activities	(125.5)
Cash flows from financing activities	<u>47.0</u>
Net increase (decrease) in cash	9.0
Cash balance December 31, 2014	<u>1.6</u>
Cash balance December 31, 2015	<u>\$ 10.6</u>

The notes are an integral part of these financial statements.

*The Le-Nature's statements presented are a simplified version of its audited 2005 statements.

EXPLANATION

Name of the entity

Title of the statement

Accounting period

Unit of measure

Cash flows directly related to earning income

Cash flows from purchase/sale of plant, equipment, & investments

Cash flows from investors and creditors

Change in cash during the period

Last period's cash on the balance sheet

Ending cash on the balance sheet

Cash flows from investing activities include cash flows related to the acquisition or sale of the company's plant and equipment and investments. This year, Le-Nature's had only one cash outflow from investing activities, the purchase of additional manufacturing equipment to meet growing demand for its products.

Cash flows from financing activities are cash flows directly related to the financing of the enterprise itself. They involve the receipt or payment of money to investors and creditors (except for suppliers). This year, Le-Nature's borrowed additional money from the bank to purchase most of the new manufacturing equipment. It also paid out dividends to the stockholders.⁵

FINANCIAL ANALYSIS**Interpreting the Cash Flow Statement**

Bankers often consider the Operating Activities section to be most important because it indicates the company's ability to generate cash from sales to meet its current cash needs. Any amount left over can be used to pay back the bank debt or expand the company. Stockholders will invest in a company only if they believe that it will eventually generate more cash from operations than it uses so that cash will become available to pay dividends and expand.

**PAUSE FOR FEEDBACK**

The **statement of cash flows** reports inflows and outflows of cash for a stated period of time classified into three categories: operating, investing, and financing activities. Answer the following questions to test your understanding of the concepts involved.

SELF-STUDY QUIZ

1. Assume that during the period 2015, **Le-Nature's** delivered beverages to customers who paid or promised to pay a total of \$275.1 million. During the same period, it collected \$250.0 million in cash from customers. Which of the two amounts will be shown on Le-Nature's cash flow statement for 2015?

⁵The complete statement of cash flows is discussed in Chapter 12.

2. Your task here is to verify that Le-Nature's cash balance increased by \$9.0 million during the year using the totals for cash flows from operating, investing, and financing activities presented in Exhibit 1.5. Recall the cash flow statement equation:

$$\begin{array}{r}
 +/\text{-- Cash Flows from Operating Activities (CFO)} \\
 +/\text{-- Cash Flows from Investing Activities (CFI)} \\
 +/\text{-- Cash Flows from Financing Activities (CFF)} \\
 \hline
 \text{Change in Cash}
 \end{array}$$

After you have completed your answers, check them below.

Relationships Among the Statements

Our discussion of the four basic financial statements has focused on what elements are reported in each statement, how the elements are related by the equation for each statement, and how the information is important to the decisions of investors, creditors, and others. We also have discovered how the statements, all of which are outputs from the same system, are related to one another. In particular, we learned

- ① Net income from the income statement results in an increase in ending retained earnings on the statement of stockholders' equity.
- ② Ending retained earnings from the statement of stockholders' equity is one of the two components of stockholders' equity on the balance sheet.
- ③ The change in cash on the cash flow statement added to the beginning-of-the-year balance in cash equals the end-of-year balance in cash on the balance sheet.

Thus, we can think of the income statement as explaining, through the statement of stockholders' equity, how the operations of the company improved or harmed the financial position of the company during the year. The cash flow statement explains how the operating, investing, and financing activities of the company affected the cash balance on the balance sheet during the year. These relationships are illustrated in Exhibit 1.6 for **Le-Nature's** financial statements.

Notes and Financial Statement Formats

At the bottom of each of **Le-Nature's** four basic financial statements is this statement: **"The notes are an integral part of these financial statements."** This is the accounting equivalent of the Surgeon General's warning on a package of cigarettes. It warns users that failure to read the **notes** (or footnotes) to the financial statements will result in an incomplete picture of the company's financial health. Throughout this book, we will discuss many note disclosures because understanding their content is critical to understanding the company.

A few additional formatting conventions are worth noting here. Assets are listed on the balance sheet by ease of conversion to cash. Liabilities are listed by their maturity (due date).

1. The firm recognizes \$250.0 million on the cash flow statement because this number represents the actual cash collected from customers related to current and prior years' sales.

2.	+/- Cash Flows from Operating Activities (CFO)	\$ 87.5
	+/- Cash Flows from Investing Activities (CFI)	(125.5)
	+/- Cash Flows from Financing Activities (CFF)	47.0
	<u>Change in Cash</u>	<u>\$ 9.0</u>

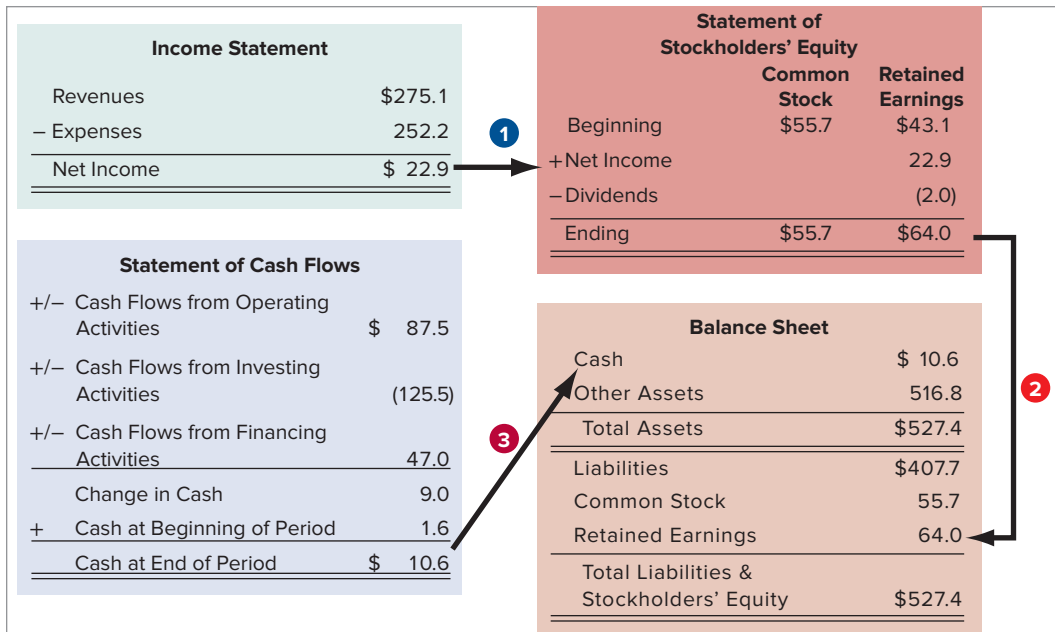
NOTES (FOOTNOTES)

Provide supplemental information about the financial condition of a company, without which the financial statements cannot be fully understood.

Solutions to SELF-STUDY QUIZ

EXHIBIT 1.6

Relationships Among Le-Nature's Statements



Most financial statements include the monetary unit sign (in the United States, the \$) beside the first dollar amount in a group of items (e.g., the cash amount in the assets). Also, it is common to place a single underline below the last item in a group before a total or subtotal (e.g., property, plant, and equipment). For group totals (e.g., total assets), a dollar sign is placed beside each amount and a double underline is set below. The same conventions are followed in all four basic financial statements.

Summary of the Four Basic Financial Statements

We have learned a great deal about the content of the four basic financial statements. Exhibit 1.7 summarizes this information. Take a few minutes to review the information in the exhibit before you move on to the next section of the chapter.

RESPONSIBILITIES FOR THE ACCOUNTING COMMUNICATION PROCESS

For decision makers to use the information in **Le-Nature's** financial statements effectively, they have to know (1) the information conveyed by the statements and the measurement rules applied in computing the numbers on the statements and (2) that the numbers on the statements are correct. The rules that determine the content and measurement rules of the statements are called **generally accepted accounting principles**, or **GAAP**.

Generally Accepted Accounting Principles

How Are Generally Accepted Accounting Principles Determined?

The accounting system in use today has a long history. Its foundations are normally traced back to the works of an Italian monk and mathematician, Fr. Luca Pacioli, published in 1494. However, prior to 1933, each company's management largely determined its financial reporting practices. Thus, little uniformity in practice existed among companies.

In the United States, Congress created the **Securities and Exchange Commission (SEC)** and gave it broad powers to determine the measurement rules for financial statements that companies issuing stock to the public (publicly traded companies) must provide to

LEARNING OBJECTIVE 1-2

Identify the role of generally accepted accounting principles (GAAP) in determining financial statement content and how companies ensure the accuracy of their financial statements.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

The measurement and disclosure rules used to develop the information in financial statements.

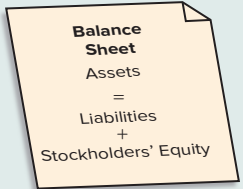
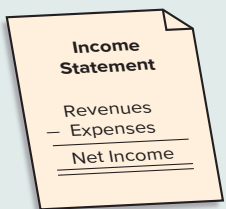
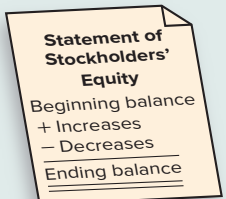
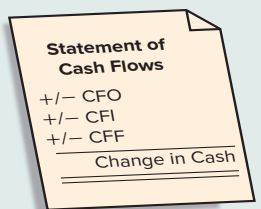
Financial Statement	Purpose	Structure	Examples of Content
Balance Sheet (Statement of Financial Position)	Reports the financial position (economic resources and sources of financing) of an accounting entity <i>at a point in time</i> .		Cash, accounts receivable, plant and equipment, long-term debt, common stock
Income Statement (Statement of Income, Statement of Earnings, Statement of Operations)	Reports the accountant's primary measure of economic performance <i>during the accounting period</i> .		Sales revenue, cost of goods sold, selling expense, interest expense
Statement of Stockholders' Equity	Reports changes in the company's common stock and retained earnings <i>during the accounting period</i> .		Beginning and ending stockholders' equity balances, stock issuances, net income, dividends
Statement of Cash Flows (Cash Flow Statement)	Reports inflows (receipts) and outflows (payments) of cash <i>during the accounting period</i> in the categories operating, investing, and financing.		Cash collected from customers, cash paid to suppliers, cash paid to purchase equipment, cash borrowed from banks

EXHIBIT 1.7

Summary of the Four Basic Financial Statements

stockholders.⁶ The SEC has worked with organizations of professional accountants and other interested parties to establish groups that are given the primary responsibilities to work out the detailed rules that become generally accepted accounting principles. Today, the **Financial Accounting Standards Board (FASB)** has this responsibility. The official pronouncements of the FASB are called the **FASB Accounting Standards Codification**.

Why Is GAAP Important to Managers and External Users?

Generally accepted accounting principles (GAAP) are of great interest to the companies that must prepare financial statements, their auditors, and the readers of the statements. Companies and their managers and owners are most directly affected by the information presented in financial statements. Companies incur the cost of preparing the statements and bear the major economic consequences of their publication, which include, among others,

1. Effects on the selling price of a company's stock.
2. Effects on the amount of bonuses received by management and employees.
3. Loss of competitive information to other companies.

⁶Contrary to popular belief, these rules are different from those that companies follow when filing their income tax returns. We discuss these differences further in later chapters.



As a consequence of these and other concerns, changes in GAAP are actively debated, political lobbying often takes place, and final rules are a compromise among the wishes of interested parties. Most managers do not need to learn all the details included in these standards. Our approach is to focus on those details that have the greatest impact on the numbers presented in financial statements and are appropriate for an introductory course.



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 Standards (IFRS)** issued by the **International Accounting Standards Board (IASB)**. Examples of jurisdictions requiring the use of IFRS currently include

- **European Union (Germany, France, the Netherlands, Belgium, Bulgaria, Poland, etc.) and United Kingdom**
- **Australia and New Zealand**
- **Hong Kong (S.A.R. of China), Malaysia, and Republic of Korea**
- **Israel and Turkey**
- **Brazil and Chile**
- **Canada and Mexico**

In the United States, the Securities and Exchange Commission now allows foreign companies whose stock is traded in the United States to use IFRS, and it is considering the appropriateness of IFRS for U.S. domestic companies. To prepare you to deal with statements prepared under U.S. GAAP and IFRS, we will point out key differences between IFRS and U.S. GAAP starting in Chapter 5. The basic principles and practices we discuss in Chapters 1 through 4 apply equally to both sets of standards.

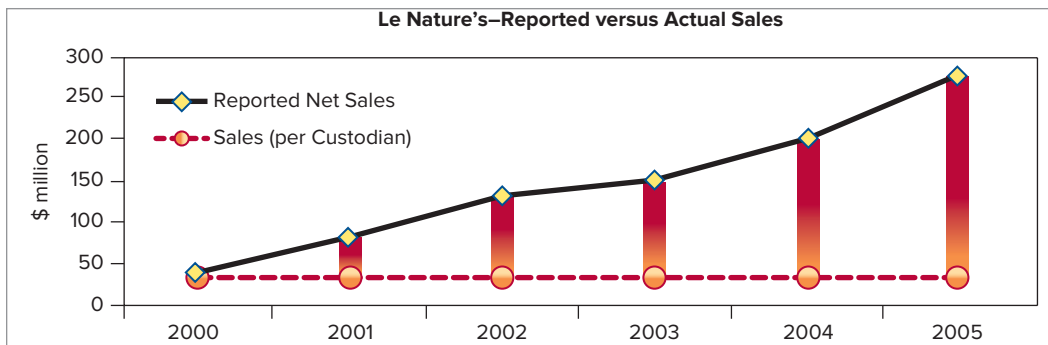
SOURCE: IFRS Foundation, 2015

Ensuring the Accuracy of Financial Statements

What If the Numbers Are Wrong?

Shortly after the issuance of the statements presented in this chapter in 2005 (yes, it happened in 2005 not 2015), **Le-Nature's** worked with the Wachovia Capital Markets group from **Wells Fargo Bank** to borrow an additional \$285 million from various lenders. Why would lenders agree to risk such a large amount? Le-Nature's financial statements played a major role in the lenders' decisions to back the loan. The statements presented a picture of a growth company with amazing future prospects. Reported revenues grew from \$40 to \$275 million (or nearly 600 percent) in just six years! Reported net income rose by 2,400 percent in the same period! Clearly, Le-Nature's looked like a good bet. But if the numbers are wrong, all bets are off.

The truth about Le-Nature's was revealed when several non-family-member stockholders suspected that all was not right and filed a lawsuit seeking an independent trustee to examine the company. Court records reveal an amazing story. According to the bankruptcy custodian, reported annual sales of \$274 million were really about \$32 million. Gregory Podlucky and his co-conspirators forged checks, invoices, and revenue and expense records to massively overstate revenues and profits. The \$10.6 million its balance sheet claimed for cash turned out to be \$1.8 million and the company had written checks totaling \$2.9 million against that balance. The balance sheet also understated liabilities by \$200 million. The company was never a real success—it was all fake.



Podlucky was borrowing more and more money and using it to pay off his earlier creditors (this is called a **Ponzi scheme**). At the same time, he was stealing cash to support a lavish lifestyle. When the trustee arrived, Podlucky and his bodyguard were feverishly shredding documents. Federal agents found \$20 million in gems; diamond-encrusted watches; and gold, silver, and platinum jewelry in safes in a secret room at the Latrobe plant. Podlucky also had spent more than \$10 million of company money on his 25,000-square-foot mansion that was under construction. A sample of the resulting newspaper headlines follows:

Market Predicts Le-Nature's Is All Washed Up

Grand jury hears LeNature's ex-accountant's testimony

Debt holders sue Wachovia over Le Nature's Loan

Ex-LeNature's exec found guilty of fraud

Le-Nature's Fraud: 2 More Sentenced in \$800M Fraud

Ex-Pa. soft-drink CEO gets 20 years in prison

Accountant Guilty of Helping CEO Commit Fraud

While this crime may read like a fantastic novel, the consequences for many were severe. This was the largest fraud ever heard in the Federal District Court of Western Pennsylvania. The final prison tally is listed below.

The Prison Tally	
Defendant	Sentence
Gregory Podlucky, CEO	20 years in federal prison
Robert Lynn, President	15 years in federal prison
Andrew Murin, Consultant	10 years in federal prison
Jonathan Podlucky, COO	5 years in federal prison
Karla Podlucky (CEO's wife)	4¼ years in federal prison
G. Jesse Podlucky (CEO's son)	9 years in federal prison
Donald Pollinger, Businessman	5 years in federal prison
Tammy Jo Andreycak, Bookkeeper	5 years in federal prison

Crime clearly did not pay for Podlucky and his co-conspirators.

AUDIT

An examination of the financial reports to ensure that they represent what they claim and conform with generally accepted accounting principles.

Ethical Conduct

Ethics are standards of conduct for judging right from wrong, honest from dishonest, and fair from unfair. Intentional misreporting of financial statements in the Le-Nature’s case was clearly unethical and illegal. However, many situations are less clear-cut and require that individuals weigh one moral principle (e.g., honesty) against another (e.g., loyalty to a friend). When money is involved, people can easily fool themselves into believing that bad acts are justified. To avoid falling prey to this tendency, when faced with an ethical dilemma, it is often recommended that you follow a three-step process:

1. Identify the benefits of a decision (often to the manager or employee involved) and who will be harmed (other employees, owners, creditors, the environment).
2. Identify alternative courses of action.
3. Choose the one you would like your family and friends to see reported on your local news. That is usually the ethical choice.

In the Le-Nature’s case, Podlucky and his co-conspirators clearly did not follow this process. Little besides the jewelry and the Latrobe plant were left to satisfy Le-Nature’s over \$800 million in debts. The nonfamily stockholders lost all of their money. Over 240 plant workers lost their jobs. And the town of Latrobe, Pennsylvania, suffered a severe economic blow.

Responsibility and the Need for Controls

As a manager in a business, you are responsible for setting up systems to prevent and detect unethical behavior. Primary responsibility for the information in the financial statements lies with management, represented by the highest officer of the company and the highest financial officer. Companies should take three important steps to assure investors that the company’s records are accurate: (1) they should maintain a system of controls over both the records and the assets of the company, (2) they should hire outside independent auditors to **audit** the fairness of the financial statements, and (3) they should form a committee of the board of directors to oversee the integrity of these other safeguards. These safeguards failed in Le-Nature’s case. The company had no controls, the independent auditors were duped by management, and the board included only Podlucky’s cronies. We will discuss the roles of management, auditors, and directors in more detail in Chapter 5.

Three steps to ensure the accuracy of records:

System of Controls

External Auditors

Board of Directors



Safe: ©PhotoDisc/Getty Images; Officer: ©LifetimeStock/Shutterstock; Auditor: ©anekoho/Shutterstock; Board: ©anekoho/Shutterstock

Those responsible for fraudulent financial statements are subject to criminal and civil penalties. As noted above, those criminally liable at Le-Nature’s are serving a total of more than 70 years in prison and have been forced to forfeit all of their assets to be paid to

creditors who suffered losses. The auditors who missed the fraud agreed to pay \$50 million to the creditors, and Wachovia Capital Markets, which marketed the loans, agreed to pay \$80 million. The bottling equipment company that provided false documents to support Le-Nature's loans has paid a \$15 million fine and \$110 million in restitution. Other civil suits are still in process.

Although financial statement fraud is a fairly rare event, the misrepresentations in Le-Nature's statements aptly illustrate the importance of fairly presented financial statements to investors and creditors. Although most managers and owners act in an honest and responsible fashion, this incident, and the much larger frauds at **Enron** and **WorldCom**, are stark reminders of the economic consequences of lack of fair presentation in financial reports. All three companies were forced into bankruptcy when their fraudulent financial reporting practices were brought to light. Penalties against Enron and WorldCom's audit firm, **Arthur Andersen**, also led to its bankruptcy and dissolution. Thousands lost their jobs.

DEMONSTRATION CASE

At the end of most chapters, one or more demonstration cases are presented. These cases provide an overview of the primary issues discussed in the chapter. Each demonstration case is followed by a recommended solution. You should read the case carefully and then prepare your own solution before you study the recommended solution. This self-evaluation is highly recommended. The introductory case presented here reviews the elements reported on the income statement, statement of stockholders' equity, and balance sheet and how the elements within the statements are related.

Pier 1 Imports, Inc., sells a wide variety of furniture, decorative home furnishings, dining and kitchen goods, bath and bedding accessories, candles, gifts, and other specialty items for the home through over 1,000 retail stores in North America. Its merchandise largely consists of items that feature a significant degree of handcraftsmanship and are mostly imported directly from foreign suppliers. Following is a list of the financial statement items and amounts adapted from a recent Pier 1 income statement and balance sheet. The numbers are presented in millions of dollars for the current year ended February 28. Assume that the company did not pay dividends, issue stock, or retire stock during the year. Retained earnings at the beginning of the year was \$193.

Accounts payable	\$237	Long-term debt	94
Accounts receivable	15	Net income	100
Cash	301	Net sales	1,401
Common stock	120	Properties, net	92
Cost of sales	861	Retained earnings	293
Income before income taxes	103	Selling, general, and administrative expenses	432
Income tax expense	3	Total assets	744
Interest expense	5	Total liabilities	331
Inventories	336	Total liabilities and shareholders' equity	744
		Total shareholders' equity	413

Required:

1. Prepare a balance sheet, an income statement, and a statement of stockholders' equity for the year following the formats in Exhibits 1.2, 1.3, and 1.4.
2. Specify what information these three statements provide.
3. Indicate the other statement that would be included in Pier 1's annual report.
4. Securities regulations require that Pier 1's statements be subject to an independent audit. Suggest why Pier 1 might voluntarily subject its statements to an independent audit if there were no such requirement.

SUGGESTED SOLUTION

1.

PIER 1 IMPORTS, INC.	
Balance Sheet	
At February 28, Current Year	
(in millions of dollars)	
Assets	
Cash	\$301
Accounts receivable	15
Inventories	336
Properties, net	<u>92</u>
Total assets	<u>\$744</u>
Liabilities and shareholders' equity	
Liabilities:	
Accounts payable	\$237
Long-term debt	<u>94</u>
Total liabilities	<u>331</u>
Shareholders' equity:	
Common stock	120
Retained earnings	<u>293</u>
Total shareholders' equity	<u>413</u>
Total liabilities and shareholders' equity	<u>\$744</u>

PIER 1 IMPORTS, INC.	
Income Statement	
For the Year Ended February 28, Current Year	
(in millions of dollars)	
Net sales	\$1,401
Cost of sales	861
Selling, general, and administrative expenses	432
Interest expense	<u>5</u>
Income before income taxes	103
Income tax expense	<u>3</u>
Net income	<u>\$ 100</u>

PIER 1 IMPORTS, INC.		
Statement of Stockholders' Equity		
For the Year Ended February 28, Current Year		
(in millions of dollars)		
	Common Stock	Retained Earnings
Balance February 28, prior year	\$120	\$193
+ Net income	—	100
– Dividends	—	—
Balance February 28, current year	<u>\$120</u>	<u>\$293</u>

- The balance sheet reports the amount of assets, liabilities, and stockholders' equity of an accounting entity at a point in time. The income statement reports the accountant's primary measure of performance of a business, revenues less expenses, during the accounting period. The statement of stockholders' equity reports on changes in the stockholders' equity accounts during the accounting period.
- Pier 1 also would present a statement of cash flows.
- Users will have greater confidence in the accuracy of financial statement information if they know that the people who audited the statements were required to meet professional standards of ethics and competence.

Chapter Supplement A

Types of Business Entities

This textbook emphasizes **accounting for profit-making business entities**. The three main types of business entities are sole proprietorship, partnership, and corporation. A **sole proprietorship** is an unincorporated business owned by one person; it usually is small in size and is common in the service, retailing, and farming industries. Often the owner is the manager. Legally, the business and the owner are not separate entities. Accounting views the business as a separate entity, however, that must be accounted for separately from its owner.

A **partnership** is an unincorporated business owned by two or more persons known as **partners**. The agreements between the owners are specified in a partnership contract. This contract deals with matters such as division of income each reporting period and distribution of resources of the business on termination of its operations. A partnership is not legally separate from its owners. Legally, each partner in a general

partnership is responsible for the debts of the business (each general partner has **unlimited liability**). The partnership, however, is a separate business entity to be accounted for separately from its several owners.

A **corporation** is a business incorporated under the laws of a particular state. The owners are called **stockholders** or **shareholders**. Ownership is represented by shares of capital stock that usually can be bought and sold freely. When the organizers file an approved application for incorporation, the state issues a charter. This charter gives the corporation the right to operate as a separate legal entity, separate and apart from its owners. The stockholders enjoy **limited liability**. Stockholders are liable for the corporation's debts only to the extent of their investments. The corporate charter specifies the types and amounts of stock that can be issued. Most states require a minimum of two or three stockholders and a minimum amount of resources to be contributed at the time of organization. The stockholders elect a governing board of directors, which in turn employs managers and exercises general supervision of the corporation. Accounting also views the corporation as a separate business entity that must be accounted for separately from its owners. Limited liability companies (**LLCs**) and limited liability partnerships (**LLPs**) have many characteristics similar to corporations.

In terms of economic importance, the corporation is the dominant form of business organization in the United States. This dominance is caused by the many advantages of the corporate form: (1) limited liability for the stockholders, (2) continuity of life, (3) ease in transferring ownership (stock), and (4) opportunities to raise large amounts of money by selling shares to a large number of people. The primary disadvantage of a corporation is that its income may be subject to double taxation (income is taxed when it is earned and again when it is distributed to stockholders as dividends). In this textbook, we emphasize the corporate form of business. Nevertheless, the accounting concepts and procedures that we discuss also apply to other types of businesses.

Chapter Supplement B

Employment in the Accounting Profession Today

Since 1900, accounting has attained the stature of professions such as law, medicine, engineering, and architecture. As with all recognized professions, accounting is subject to professional competence requirements, is dedicated to service to the public, requires a high level of academic study, and rests on a common body of knowledge. An accountant may be licensed as a certified public accountant, or CPA. This designation is granted only on completion of requirements specified by the state that issues the license. Although CPA requirements vary among states, they include a college degree with a specified number of accounting courses and a total of 150 credit hours, good character, professional experience, and successful completion of a professional examination. The CPA examination is prepared by the American Institute of Certified Public Accountants.

Accountants (including CPAs) commonly are engaged in professional practice or are employed by businesses, government entities, nonprofit organizations, and so on. Accountants employed in these activities may take and pass a professional examination to become a certified management accountant, or CMA (the CMA examination is administered by the Institute of Management Accountants), or a certified internal auditor, or CIA (the CIA examination is administered by the Institute of Internal Auditors).

Practice of Public Accounting

Although an individual may practice public accounting, usually two or more individuals organize an accounting firm in the form of a partnership (in many cases, a limited liability partnership, or LLP). Accounting firms vary in size from a one-person office, to regional firms, to the Big Four firms (**Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers**), which have hundreds of offices located worldwide. Accounting firms usually render three types of services: audit or assurance services, management consulting or advisory services, and tax services.

Audit or Assurance Services

Audit or assurance services are independent professional services that improve the quality of information for decision makers. The most important assurance service performed by the CPA in public practice is financial statement auditing. The purpose of an audit is to lend credibility to the financial reports, that is, to ensure that they fairly represent what they claim. An audit involves an examination of the financial reports (prepared by the management of the entity) to ensure that they conform with GAAP. Other areas of assurance services include electronic commerce integrity and security and information systems reliability.

Management Consulting or Advisory Services

Many independent CPA firms offer management consulting services. These services usually are accounting based and encompass such activities as the design and installation of accounting and profit-planning

and control (budget) systems; financial advice; forecasting; inventory controls; cost-effectiveness studies; and operational analysis. To maintain their independence, CPAs are prohibited from performing certain consulting services for the public companies that they audit.

Tax Services

CPAs in public practice usually provide income tax services to their clients. These services include both tax planning as a part of the decision-making process and the determination of the income tax liability (reported on the annual income tax return). Because of the increasing complexity of state and federal tax laws, a high level of competence is required, which CPAs specializing in taxation can provide. The CPA's involvement in tax planning often is quite significant. Most major business decisions have significant tax impacts; in fact, tax-planning considerations often govern certain business decisions.

Employment by Organizations

Many accountants, including CPAs, CMAs, and CIAs, are employed by profit-making and nonprofit organizations. An organization, depending on its size and complexity, may employ from a few to hundreds of accountants. In a business enterprise, the chief financial officer is a key member of the management team. This responsibility usually entails a wide range of management, financial, and accounting duties.

In a business entity, accountants typically are engaged in a wide variety of activities, such as general management, general accounting, cost accounting, profit planning and control (budgeting), internal auditing, and information systems management. A primary function of the accountants in organizations is to provide data that are useful for internal managerial decision making and for controlling operations. The functions of external reporting, tax planning, control of assets, and a host of related responsibilities normally also are performed by accountants in industry.

Employment in the Public and Not-for-Profit Sector

The vast and complex operations of governmental units, from the local to the international level, create a need for accountants. The same holds true for other not-for-profit organizations such as hospitals and universities. Accountants employed in the public and not-for-profit sector perform functions similar to those performed by their counterparts in private organizations. The Government Accountability Office (GAO) and the regulatory agencies, such as the SEC and Federal Communications Commission (FCC), also use the services of accountants in carrying out their regulatory duties.

CHAPTER TAKE-AWAYS

1-1. Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers). p. 6

The **balance sheet** is a statement of financial position that reports dollar amounts for the assets, liabilities, and stockholders' equity at a specific point in time.

The **income statement** is a statement of operations that reports revenues, expenses, and net income for a stated period of time.

The **statement of stockholders' equity** explains changes in stockholders' equity accounts (common stock and retained earnings) that occurred during a stated period of time.

The **statement of cash flows** reports inflows and outflows of cash for a stated period of time.

The statements are used by investors and creditors to evaluate different aspects of the firm's financial position and performance.

1-2. Identify the role of generally accepted accounting principles (GAAP) in determining financial statement content and how companies ensure the accuracy of their financial statements. p. 16

GAAP refers to the measurement rules used to develop the information in financial statements. Knowledge of GAAP is necessary for accurate interpretation of the numbers in financial statements.

Management has primary responsibility for the accuracy of a company's financial information. Auditors are responsible for expressing an opinion on the fairness of the financial statement presentations based on their examination of the reports and records of the company.

Users will have confidence in the accuracy of financial statement numbers only if the people associated with their preparation and audit have reputations for ethical behavior and competence. Management and auditors also can be held legally liable for fraudulent financial statements.

In this chapter, we studied the basic financial statements that communicate financial information to external users. Chapters 2, 3, and 4 provide a more detailed look at financial statements and examine how to translate data about business transactions into these statements. Learning how to translate back and forth between business transactions and financial statements is the key to using financial statements in planning and decision making. Chapter 2 begins our discussion of the way that the accounting function collects data about business transactions and processes the data to provide periodic financial statements, with emphasis on the balance sheet. To accomplish this purpose, Chapter 2 discusses key accounting concepts, the accounting model, transaction analysis, and analytical tools. We examine the typical business activities of an actual service-oriented company to demonstrate the concepts in Chapters 2, 3, and 4.

FINDING FINANCIAL INFORMATION

Balance Sheet

Assets = Liabilities + Stockholders' Equity

Income Statement

Revenues
 - Expenses
 Net Income

Statement of Stockholders' Equity

Beginning balance
 + Increases
 - Decreases
 Ending balance

Statement of Cash Flows

+/- Cash Flows from Operating Activities
 +/- Cash Flows from Investing Activities
 +/- Cash Flows from Financing Activities
 Net Change in Cash

KEY TERMS

Accounting p. 4

Accounting Entity p. 6

Accounting Period p. 9

Audit p. 20

Balance Sheet (Statement of Financial Position) p. 6

Basic Accounting Equation (Balance Sheet Equation) p. 6

Generally Accepted Accounting Principles (GAAP) p. 16

Income Statement (Statement of Income, Statement of Earnings, Statement of Operations, or Statement of Comprehensive Income) p. 9

Notes (Footnotes) p. 15

Statement of Cash Flows (Cash Flow Statement) p. 13

Statement of Stockholders' Equity p. 11

QUESTIONS

1. Define **accounting**.
2. Briefly distinguish financial accounting from managerial accounting.
3. The accounting process generates financial reports for both internal and external users. Identify some of the groups of users.
4. Briefly distinguish investors from creditors.
5. What is an accounting entity? Why is a business treated as a separate entity for accounting purposes?
6. Complete the following:

Name of Statement	Alternative Title
a. Income statement	a. _____
b. Balance sheet	b. _____
c. Cash Flow Statement	c. _____

7. What information should be included in the heading of each of the four primary financial statements?
8. What are the purposes of (a) the income statement, (b) the balance sheet, (c) the statement of cash flows, and (d) the statement of stockholders' equity?

9. Explain why the income statement and the statement of cash flows are dated “For the Year Ended December 31,” whereas the balance sheet is dated “At December 31.”
10. Briefly explain the importance of assets and liabilities to the decisions of investors and creditors.
11. Briefly define **net income** and **net loss**.
12. Explain the equation for the income statement. What are the three major items reported on the income statement?
13. Explain the equation for the balance sheet. Define the three major components reported on the balance sheet.
14. Explain the equation for the statement of cash flows. Explain the three major components reported on the statement of cash flows.
15. Explain the equation for retained earnings. Explain the four major items reported on the statement of stockholders’ equity related to retained earnings.
16. The financial statements discussed in this chapter are aimed at **external** users. Briefly explain how a company’s **internal** managers in different functional areas (e.g., marketing, purchasing, human resources) might use financial statement information from their own and other companies.
17. Briefly describe the way that accounting measurement rules (generally accepted accounting principles) are determined in the United States.
18. Briefly explain the responsibility of company management and the independent auditors in the accounting communication process.
19. (Supplement A) Briefly differentiate between a sole proprietorship, a partnership, and a corporation.
20. (Supplement B) List and briefly explain the three primary services that CPAs in public practice provide.

MULTIPLE-CHOICE QUESTIONS

1. Which of the following is **not** one of the four basic financial statements?
 - a. Balance sheet
 - b. Audit report
 - c. Income statement
 - d. Statement of cash flows
2. As stated in the audit report, or **Report of Independent Accountants**, the primary responsibility for a company’s financial statements lies with
 - a. The owners of the company.
 - b. Independent financial analysts.
 - c. The auditors.
 - d. The company’s management.
3. Which of the following is true?
 - a. FASB creates SEC.
 - b. GAAP creates FASB.
 - c. SEC creates AICPA.
 - d. FASB creates U.S. GAAP.
4. Which of the following regarding retained earnings is false?
 - a. Retained earnings is increased by net income and decreased by a net loss.
 - b. Retained earnings is a component of stockholders’ equity on the balance sheet.
 - c. Retained earnings is an asset on the balance sheet.
 - d. Retained earnings represents earnings not distributed to stockholders in the form of dividends.
5. Which of the following is **not** one of the four items required to be shown in the heading of a financial statement?
 - a. The financial statement preparer’s name.
 - b. The title of the financial statement.
 - c. The unit of measure in the financial statement.
 - d. The name of the business entity.
6. Which of the following statements regarding the statement of cash flows is true?
 - a. The statement of cash flows separates cash inflows and outflows into three major categories: operating, investing, and financing.
 - b. The ending cash balance shown on the statement of cash flows must agree with the amount shown on the balance sheet for the same fiscal period.
 - c. The total increase or decrease in cash shown on the statement of cash flows must agree with the “bottom line” (net income or net loss) reported on the income statement.
 - d. Both (a) and (b) are true.
 - e. All of the above are true.