

Fundamentals of

# FINANCIAL ACCOUNTING

FIFTH EDITION



PHILLIPS LIBBY LIBBY

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# Fundamentals of FINANCIAL ACCOUNTING



Fifth Edition

**FRED PHILLIPS**  
University of Saskatchewan

**ROBERT LIBBY**  
Cornell University

**PATRICIA A. LIBBY**  
Ithaca College



FUNDAMENTALS OF FINANCIAL ACCOUNTING, FIFTH EDITION

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## Dedicated to

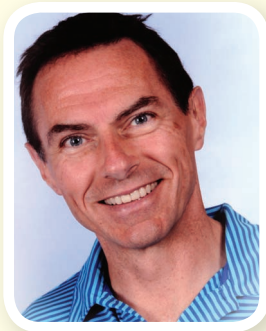
The best teachers I've ever had: Cal Slobodian (my Grade 10 math teacher)—thank you for showing me the fun in learning new ideas; Mick Norgrove (my favorite accounting professor)—I am grateful that you taught me to approach accounting problems as a detective solving a mystery case; Mom and Dad—thank you for encouraging and helping me to always do my best; and Barb, Harrison, and Daniel—thank you for reminding me that, although accounting is awesome, sometimes there are more important things in life.

**FRED PHILLIPS**

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

**PATRICIA AND ROBERT LIBBY**

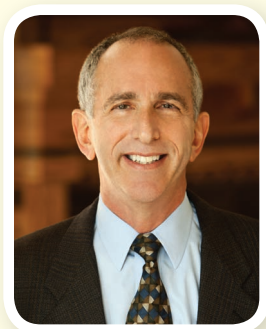
# Meet the Authors



## Fred Phillips

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

Fred's main career interest is accounting education. He has been recognized with more than 25 awards, as chosen by his students and peers. In 2006, Fred was awarded the title Master Teacher at the University of Saskatchewan. In 2011, he was admitted to the 3M National Teaching Fellowship, the highest honor for undergraduate teaching in Canada. In the same year, he won a national competition for an instructional case that is integrated throughout assignment materials in Chapters 5–12 of this textbook. In 2012, Fred received the L. S. Rosen Outstanding Educator Award, the American Accounting Association's Innovation in Auditing and Assurance Education Award, and the American Accounting Association's Award for Outstanding Research in Accounting Education. His peer-reviewed publications include education-focused research and instructional cases in *Issues in Accounting Education*, as well as professional judgment studies in *Journal of Accounting Research* and *Organizational Behavior and Human Decision Processes*, among others. Fred is a current member of the Teaching, Curriculum, & Learning and Two-Year College sections of the American Accounting Association. In his spare time, he likes to play tennis, drink iced cappuccinos, and relax with his family.



## Robert Libby

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

Bob is a widely published author and researcher specializing in behavioral accounting. He was selected as the AAA Outstanding Educator in 2000, received the AAA Outstanding Service Award in 2006, and received the AAA Notable Contributions to the Literature Award in 1985 and 1996. He is the only person to have received all three of the Association's highest awards

for teaching, service, and research. 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 is a member of the American Institute of CPAs and the editorial boards of *The Accounting Review* and *Accounting, Organizations, and Society*.

### Patricia A. Libby

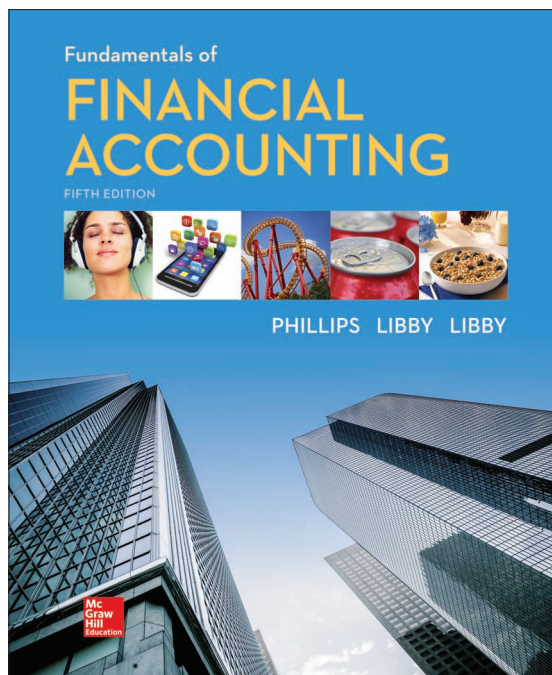
Patricia Libby is associate professor of accounting at Ithaca College, where she teaches the undergraduate financial accounting course. She previously taught graduate and undergraduate financial accounting at Eastern Michigan University and the University of Texas at Austin. Before entering academe,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

She received her BS from Pennsylvania State University, her MBA from DePaul University, and her PhD from the University of Michigan; she is also a CPA.

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



# Focused on Financial Accounting in the Context of Real Business



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

**Engaging Writing.** *Fundamentals of Financial Accounting* introduces students to financial accounting using an appropriate mix of conversational wording, clear and concise presentations, and everyday examples. It does this without ever sacrificing its rigor or the concepts that are important to grasping financial accounting. Students can feel comfortable as they are introduced to the world of financial accounting.

**Relevant Focus Companies.** Each chapter of *Fundamentals of Financial Accounting* makes financial accounting come alive by using a real company whose products and services are popular with students. Students learn financial accounting concepts through the use of examples from such companies as **American Eagle** (clothing), **Koss Corporation** (headphones), and **Under Armour** (sportswear).

**Proven Pedagogy.** The authors' approach to introducing the accounting cycle and using visual aids throughout the textbook 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. The current edition of this textbook also integrates an award-winning continuing case in the assignment materials for Chapters 5–12. This continuing case enables your students to learn key accounting judgments that affect business decisions in the workplace. Through ongoing research and development of innovative material, the authors are committed to helping your students succeed in accounting.

**Practical, applicable** to both accounting and non-accounting majors and a **very thorough** financial accounting textbook.

—Ronald Premuroso, University of Montana

Students should find the use of **companies from their generation**, as examples, interesting.

—Diane Marker, University of Toledo

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

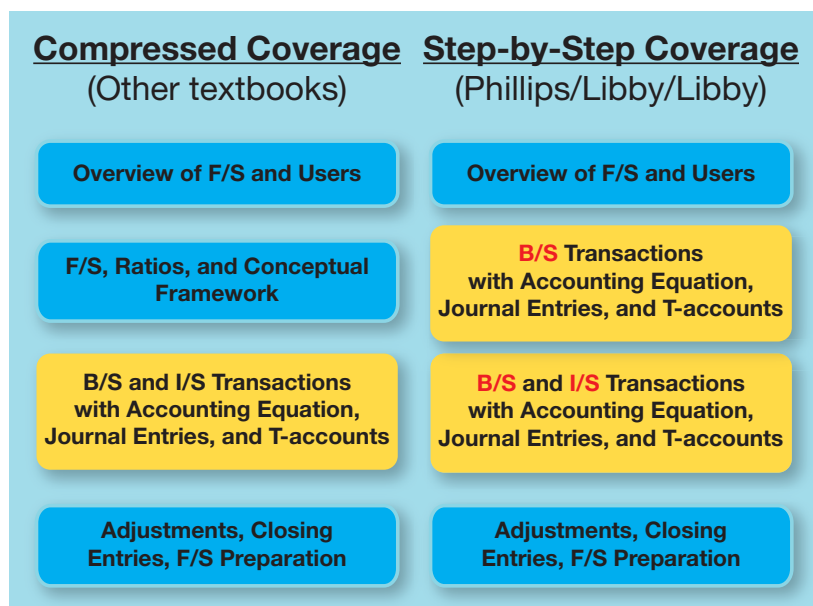
—Nancy Lynch, West Virginia University

# Dedicated to Student Motivation and Success

## A PROVEN TEACHING AND LEARNING METHODOLOGY

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

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



“

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

—Margaret Costello Lambert, Oakland Community College

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



# Real Companies Bring Accounting Concepts to Life

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

—Muriel Anderson, SUNY–Buffalo

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

—Lisa McKinney, University of Alabama

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

*Fundamentals of Financial Accounting* responds by using **carefully chosen focus companies that students not only recognize but are familiar with because they have visited or used their products.** From companies like the local pizza restaurant to the world’s most familiar businesses, each chapter features the business and accounting concepts underlying prominent companies such as **Walmart, Cedar Fair, American Eagle, National Beverage, Under Armour, and General Mills.**

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

## 9

### Long-Lived Tangible and Intangible Assets

CHAPTER NINE



YOUR LEARNING OBJECTIVES

- LO 9-1** Define, classify, and explain the nature of long-lived assets.
- LO 9-2** Apply the cost principle to the acquisition of long-lived assets.
- LO 9-3** Apply various depreciation methods as economic benefits are used up over time.
- LO 9-4** Explain the effect of asset impairment on the financial statements.
- LO 9-5** Analyze the disposal of long-lived tangible assets.
- LO 9-6** Analyze the acquisition, use, and disposal of long-lived intangible assets.
- LO 9-7** Interpret the fixed asset turnover ratio.
- LO 9-8** Describe factors to consider when comparing companies’ long-lived assets.
- LO 9-9** Analyze and report depletion of natural resources.
- LO 9-10** Calculate changes in depreciation arising from changes in estimates or capitalized cost.

FOCUS COMPANY: CEDAR FAIR

M

ost people agonize over how much money to spend on a house or which car to buy. After all, they will own these expensive items for many years to come. The same concerns exist when companies acquire long-lived assets. One of the major challenges business managers face is determining the right amount to invest in long-lived assets.

The task is especially challenging for companies such as **Disney, Six Flags, and Cedar Fair**, which operate amusement parks. Unlike merchandising companies, an amusement park cannot build up an inventory of unused rollercoaster seats to be sold sometime in the future. If managers build more rides than needed to satisfy park-goers, some rides will run with empty seats. Although the company will still incur all the costs of running the rides, it will generate only a fraction of the potential revenues. On the other hand, amusement parks can also run into trouble if they have too few rides to satisfy patrons. Fortunately for managers, accounting reports provide information to evaluate a company’s investment in long-lived assets.

In this chapter, you will study specific long-lived asset decisions at Cedar Fair, which is headquartered in Sandusky, Ohio, and owns and operates 11 amusement parks, four water parks, and five hotels throughout North America. You will see the significant effect that long-lived assets can have on a company’s financial statements. Although manufacturing companies, retailers, and even airlines must deal with the same issues as Cedar Fair, the impact on this amusement park company is particularly significant because it relies almost exclusively on long-lived assets. As of December 31, 2013, in fact, Cedar Fair’s rides, hotels, and other long-lived assets accounted for more than 90 percent of its total assets.

THAT WAS THEN

In the past few chapters, you learned about the sale of goods and services to customers.


THIS IS NOW

This chapter focuses on the assets that enable companies to produce and sell goods and services.

# From Concepts to Comprehension— Reinforcement Is Key


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

**Picture**




Receives  
Gives

**Name**



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

**Analyze**



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

**COACH'S TIP**

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

## Coach's Tips

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

## How's it going? Self-Study Practice

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



### How's it going?

### Self-Study Practice

The following transactions are typical operating activities for Florida Flippers, a scuba diving and instruction company. Indicate the amount of revenue, if any, that should be recognized in June for each activity using the accrual basis of accounting.

Operating Activity	Amount of Revenue Earned in June
1. In June, Florida Flippers provided \$32,000 in diving instruction to customers for cash.	<input style="width: 100%; height: 20px;" type="text"/>
2. In June, new customers paid \$8,200 cash for diving trips to be provided by Florida Flippers; \$5,200 in trips were made in June and the rest will be provided in July.	<input style="width: 100%; height: 20px;" type="text"/>
3. In June, customers paid \$3,900 cash for instruction they received in May.	<input style="width: 100%; height: 20px;" type="text"/>

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



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

—Anne Clem, Iowa State University

## Spotlight Features

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

### SPOTLIGHT ON **The World**

IFRS Does Not Allow LIFO

U.S. GAAP does not allow companies to use LIFO for financial reporting.

### SPOTLIGHT ON **Financial Reporting**

“Shoppers Are Buying More. They’re Also Stealing More.”

The attention deficit disorder (ADD) has been identified as a problem for companies.

### SPOTLIGHT ON **Controls**

Is That a Control, Too?

The policy business to control that Example

### SPOTLIGHT ON **Ethics**

Dodging Bullets

Example

### SPOTLIGHT ON **Business Decisions**

JOBS Act Enables Crowdfunding Equity


Until recently, equity financing for startup companies has typically been limited to the personal savings of company founders, or their friends and relatives. But now, the government’s **Jumpstart Our Business Startups (JOBS) Act** aims to help startup companies raise money from a large number of small investors over the Internet. Prompted by the JOBS Act, the Securities and Exchange Commission (SEC) plans to allow companies to raise up to \$1 million in equity financing from a large number of small investors.



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

## Videos

Selected **Spotlight on Ethics, Financial Reporting,** and **Business Decisions** features are brought to life in 2- to 5-minute newsmagazine-style videos, which are available and assignable in McGraw-Hill Education’s **Connect Accounting**. These investigative videos written by author Fred Phillips tie to specific topics in **Fundamentals of Financial Accounting**. Bring business and accounting into your classroom in a way that is sure to engage students and get them talking. Instructors can assign students to watch the videos and answer questions regarding the content in *Connect*.



Chapter	Video Title	Video Description
Chapter 3 (page 99)	Time Is Money	In 2000–01, Computer Associates violated the time period assumption in order to present a picture of smooth, steady growth. This video illustrates the effect of shifting sales from one period to another and asks students to discuss its impact.
Chapter 4 (page 170)	Anatomy of a Business Failure	Circuit City once was a leading electronics retailer. But, as this video demonstrates, the company’s financial problems led to a free-fall in the company’s stock price. This video walks students through the series of events that ultimately ended when Circuit City liquidated in January 2009.
Chapter 5 (page 226)	Granny Does Time	After twelve years of honest bookkeeping, a grandmother begins embezzling from her employer by writing checks to herself, recording them as inventory purchases, and then destroying them when preparing the bank reconciliation. This is a must-see video for future business owners and financial advisers because it underscores the importance of internal controls over cash and inventory.
Chapter 7 (page 305)	Dodging Bullets	Body armor made by DHB Industries in 2004–05 for the U.S. Marines and local police departments did not meet quality standards. Knowing the impact of an inventory write-down, DHB tried to conceal its problems. By telling these events, this video invites students to consider how fraudulent actions may put innocent people in harm’s way.
Chapter 8 (page 349)	Resetting the Clock	This video describes how a credit manager at MCI used his knowledge of the allowance method to avoid recording \$70 million in bad debts. The video shows students how small initial missteps led the credit manager to redirect his genuine ambition into criminal actions, which ended in a prison sentence and personal ruin.
Chapter 8 (page 351)	Financial Crisis Delays Collections	Discusses the decline and recovery of receivables turnover at <b>K-Swiss</b> before and after the 2008–09 financial crisis.
Chapter 9 (page 384)	Simple Violations, Serious Consequences	This video describes how the simple act of capitalizing expenses enabled <b>WorldCom</b> to mislead financial statement users. Students are invited to consider the judgment inherent in many seemingly simple accounting decisions.
Chapter 12 (page 552)	Financial Crisis Cuts Cash Flows	Discusses the disparity between net income and operating cash flows at <b>Lehman Brothers</b> immediately preceding the 2008–09 financial crisis.

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

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

# Practice and Review Materials

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



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

—Brian Nagle, Duquesne University

## Demonstration Case

End-of-chapter review material begins with a demonstration case that provides another self-study opportunity for students. The demonstration case is practice material that mimics what students will see in the homework. The accompanying solution allows students to check their understanding of the material before completing and submitting homework for a grade. It can also serve as a study tool for exams.

## Chapter Summary

Each chapter concludes with an end-of-chapter summary, organized by chapter learning objective, that revisits the learning objectives from the beginning of the chapter.

## Key Terms

Includes key terms, definitions, and page references. Full definitions for all key terms are found in the back of the text.

## Homework Helper

Homework Helper immediately precedes each chapter's homework materials and highlights subtleties discussed in the chapter and providing practice advice so that students can avoid common pitfalls when completing homework.

### → HOMEWORK HELPER

#### Alternative terms

- The up-to-date ending cash balance is also called the true cash balance or correct cash balance.

#### Helpful reminders

- When preparing a bank reconciliation, your goals are to determine which transactions the bank has not yet processed and which transactions your company has not yet processed. You will record transactions correctly processed by the bank but not yet processed by your company.
- If you are having trouble reconciling cash balances, you may be overlooking an outstanding check or deposit. Try counting the number of checks or deposits processed by the bank and by your company to ensure you have identified them all.


#### Frequent mistakes

- Do not change your cash records for reconciling items related to updating the bank statement.

# Build Confidence and Success

## PRACTICE MATERIAL


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

- Describe three ways in which liabilities are used to finance business activities.
- Define *liability*. What's the difference between a current liability and a long-term liability?
- What three factors influence the dollar amount reported for liabilities?
- Define *accrued liability*. Give an example of a typical accrued liability.
- Why is Unearned Revenue considered a liability?
- Why are payroll taxes and sales taxes considered liabilities?
- Your company plans to hire an employee at a yearly salary of \$70,000. Someone in your company says the actual cost will be lower because of payroll deductions. Someone else says it will be higher. Who is right? What is likely to be the total cost to the company? Explain. 
- If a company has a long-term loan that has only two years remaining until it matures, how is it reported on the balance sheet (a) this year and (b) next year?
- What are the reasons that some bonds are issued at a discount and others are issued at a premium?
- What is the difference between the stated interest rate and the market interest rate on a bond?
- Will the stated interest rate be higher than the market interest rate or will the market interest rate be higher than the stated interest rate when a bond is issued at (a) face value, (b) a discount, and (c) a premium?
- What is the carrying value of a bond payable?
- What is the difference between a secured bond and a debenture? Which type carries more risk for the lender?
- What is a contingent liability? How is a contingent liability reported under GAAP? How does this differ under IFRS?
- (Supplement 10A) How is interest expense calculated using the straight-line method of amortization for a bond issued at (a) a discount and (b) a premium?
- (Supplement 10B) How is interest expense calculated using the effective-interest method of amortization for a bond issued at (a) a discount and (b) a premium?
- (Supplement 10C) How is interest expense calculated using the simplified approach to the effective-interest method for a bond issued at (a) a discount and (b) a premium?

## MULTIPLE CHOICE

- Which of the following best describes Accrued Liabilities?
  - Long-term liabilities
  - \$100,000 in the long-term liability section.
  - \$100,000 plus the interest to be paid over the five-year

## Multiperspective Discussion Questions

Each chapter includes 10–20 questions that ask students to explain and discuss terms and concepts presented in the chapter. Selected questions, denoted with an icon , are designed to help students begin developing critical thinking skills. These questions are ideal for sparking debate at the beginning of class or when transitioning between or reviewing topics.

## Multiple-Choice Questions

Each chapter includes 10 multiple-choice questions that let students practice basic concepts. Solutions for these questions are provided in the back of the text.

## Mini-Exercises

These assignments illustrate and apply a single learning objective from the chapter.

## Exercises

These additional assignments illustrate and apply single and multiple learning objectives from the chapter.

## Problems (Coached, Group A, and Group B)

Each chapter includes three problem sets to help students develop decision-making skills. Coached problems include question-specific tips to assist students who need a little help getting started. Groups A and B are similar problems but without the coaching.

## Level-up Questions



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

### MINI-EXERCISES



#### LO 1-4 M1-1 Identifying Definitions with Abbreviations

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

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

#### PA3-4 Analyzing, Journalizing, and Interpreting Business Activities

LO 3-3, 3-5



On September 1, Pat Hopkins established Ona Cloud Corporation (OCC) as a provider of cloud computing services. Pat contributed \$10,000 for 1,000 shares of OCC. On September 8, OCC borrowed \$30,000 from a bank, promising to repay the bank in two years. On September 10, OCC wrote a check for \$20,000 to acquire computer equipment. On September 15, OCC received \$1,000 of supplies purchased on account and, on September 16, paid \$1,500 for September rent. Through September 22, OCC billed its customers for \$8,000 of services, of which OCC collected \$6,000 in cash. On September 28, OCC paid \$200 for Internet and phone service this month. On September 29, OCC paid wages of \$4,000 for the month. Finally, on September 30, OCC submitted its electricity meter reading online and determined that the total charges for the month will be \$300. This amount will be paid on October 14 through a preauthorized online payment.

#### Required:

- Indicate the accounting equation effects of the September events, using a table similar to the one shown for Demonstration Case B on page 000. Reference each transaction by date.
- Prepare journal entries to record the September events described above. Reference each transaction by date.
- Using your answer to requirement 1 or 2, calculate OCC's preliminary net income for September. Is OCC profitable, based on its preliminary net income?
- Identify at least two adjustments that OCC will be required to make before it can prepare a final income statement for September.

## Comprehensive Problems

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

### C4-2 From Recording Transactions (Including Adjusting Journal Entries) to Preparing Financial Statements and Closing Journal Entries (Chapters 2, 3, and 4)

LO 2-3, 3-3, 4-1, 4-2, 4-4, 4-5, 4-6

Brothers Harry and Herman Hausyerday began operations of their machine shop (H & H Tool, Inc.) on January 1, 2013. The annual reporting period ends December 31. The trial balance on January 1, 2015, follows (the amounts are rounded to thousands of dollars to simplify):



Account Titles	Debit	Credit
Cash	\$ 3	
Accounts Receivable	5	
Supplies	12	
Land	0	
Equipment	60	
Accumulated Depreciation		\$ 6
Software	15	

**NEW!**



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

## Skills Development Cases

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

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

## Continuing Cases

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

Chapters 5–12 present a continuing case involving Wiki Art Gallery. This case depicts a setting in which accounting information is used for determining a company's selling price. By examining accounting decisions, again in an easy-to-use multiple-choice format, students can learn that not all numbers are what they appear at first glance.

### CONTINUING CASES



#### CC6-1 Accounting for Merchandising Operations

Nicole's Getaway Spa (NGS) has been so successful that Nicole has decided to expand her spa by selling merchandise. She sells things such as nail polish, at-home spa kits, cosmetics, and aromatherapy items. Nicole uses a perpetual inventory system and is starting to realize all of the work that is created when inventory is involved in a business. The following transactions were selected from among those completed by NGS in August.

- Aug. 2** Sold 10 items of merchandise to Salon World on account at a selling price of \$1,000 (total); terms 2/10, n/30. The goods cost NGS \$650.
- Aug. 3** Sold 5 identical items of merchandise to Cosmetics R Us on account at a selling price of \$500 (total); terms 2/10, n/30. The goods cost NGS \$400.
- Aug. 6** Cosmetics R Us returned one of the items purchased on August 3. The item could still be sold by NGS in the future and credit was given to the customer.
- Aug. 10** Collected payment from Salon World, fully paying off the account balance.
- Aug. 20** Sold two at-home spa kits to Meghan Witzel for \$300 cash. The goods cost NGS \$96.
- Aug. 22** Cosmetics R Us paid its remaining account balance in full.

# What's New in the Fifth Edition?

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

- Integrated **new focus companies**, including **SonicGateway**, an app developer, **Koss Corporation**, a headphone manufacturer, and **Google**.
- **Reorganized topics within Chapters 5–7** to improve cohesiveness and introduce additional depth.
  - Chapter 5 introduces the topic of fraud (as in the fourth edition), but now it also discusses and illustrates the related topic of internal controls, including cash controls and electronic documentation of cash disbursements.
  - Chapter 6 discusses and illustrates merchandising operations, including inventory sales (as in the fourth edition), but this topic is now preceded by merchandise inventory purchases, consistent with the natural sequence of business events.
  - Chapter 7 focuses on inventory costing and valuation (as in the fourth edition) but now discusses inventory turnover and gross profit analyses in assessing the likelihood of inventory write-downs.
- Incorporated a **streamlined chart of accounts in all chapters** (leading, for example, to replacing Contributed Capital with Common Stock and limiting revenue account names to Sales Revenue and Service Revenue).
- **Eliminated dr/cr abbreviations** previously used in the fourth edition as prefixes for each journal entry line, also **eliminated parenthetical effects** (+ A, – L, etc.) in journal entries after Chapter 4 for all accounts other than contra-accounts.
- **Repositioned** exhibits to be more adjacent to related discussion in the text.
- Reviewed, updated, and introduced new end-of-chapter material in each chapter to support new topics and learning objectives, including **new Connect problem formats that auto-post** from journal entries to T-accounts to trial balances.
- Fine **line-editing guided by student data from LearnSmart**.

## CHAPTER 1: BUSINESS DECISIONS AND FINANCIAL ACCOUNTING

Focus Company: **SonicGateway**

- **New** contemporary focus company: replaced pizza company with **SonicGateway**, a private company that develops game apps for smartphones and tablets
- **New** description of financial statement users, with new illustration (Exhibit 1.2)
- Revision to account names to match streamlined chart of accounts
- Updated IFRS map in Spotlight on the World
- Expanded discussion of conceptual framework, with new illustration (Exhibit 1.9)
- Updated demonstration case featuring **Under Armour**
- Reviewed and updated all end-of-chapter material, including new exercise and problem formats to expand number of algorithmic online problems

## CHAPTER 2: THE BALANCE SHEET

Focus Company: **SonicGateway**

- **New** contemporary focus company: replaced pizza company with **SonicGateway**, thereby replacing peculiar

Cookware account with contemporary intangible accounts such as Software and Trademarks

- **New** margin illustration of accounting cycle
- Expanded learning objectives to include trial balance preparation
- Revised illustration of T-accounts to include normal balance (Exhibit 2.7)
- Updated analysis of current ratios in Exhibit 2.14 and Spotlight on Financial Reporting to focus on technology companies, including **Apple**, **Expedia**, **Electronic Arts**, **Facebook**, and **LinkedIn**
- Reviewed and updated all end-of-chapter material, including new problem formats that automatically post journal entries to T-accounts and prepare trial balances

## CHAPTER 3: THE INCOME STATEMENT

Focus Company: **SonicGateway**

- **New** contemporary focus company: replaced pizza company with **SonicGateway**, thereby allowing revenue recognition to be illustrated when game app icon shows “installation completed”



- **New** illustrations to compare timing of revenue recognition and cash receipt (Exhibit 3.5)
- **New** Spotlight on Financial Reporting to illustrate revenue recognition policy of **Take-Two Interactive** (software maker of Grand Theft Auto)
- **New** illustrations to compare timing of expense recognition and cash payment (Exhibit 3.6)
- **New** transactions to illustrate contemporary technology, such as online **Facebook** advertising, automated monthly disbursements, and e-commerce sales with online receipts similar to **PayPal**
- **New** format for accounting equation effects to illustrate link between income statement and balance sheet
- **New** Spotlight on Financial Reporting to focus on technology companies, including **Electronic Arts, Activision Blizzard, Facebook, and LinkedIn**
- Updated demonstration case featuring **Carnival Corporation**
- Reviewed and updated all end-of-chapter material, including new problem formats that automatically post journal entries to T-accounts and prepare trial balances

## CHAPTER 4: ADJUSTMENTS, FINANCIAL STATEMENTS, AND FINANCIAL RESULTS

Focus Company: **SonicGateway**

- **New** contemporary focus company: replaced pizza company with **SonicGateway**, thereby allowing repeated practice with depreciation and amortization
- **New** illustration to tie adjustments to accounting cycle (Exhibit 4.2)
- **New** illustration of adjustment effects on balance sheet and income statement (Exhibit 4.5)
- Continued use of new accounting equation format illustrating link between income statement and balance sheet
- Eliminated journal entry to record the simultaneous declaration/payment of dividends (journal entries for dividends are explained properly in Chapter 11)
- Reviewed and updated all end-of-chapter material, including new problem formats that automatically post journal entries to T-accounts and prepare trial balances

## CHAPTER 5: FRAUD, INTERNAL CONTROL, AND CASH

Focus Company: **Koss Corporation**

- Substantially changed from the fourth edition: removed discussion of press releases, illustration of European financial statements, introduction of the basic business

model, and the repeated coverage of external users; inserted explanation and examples of internal control and cash reporting

- **New** focus company (**Koss Corporation**) to illustrate how internal control deficiencies allowed the VP-Finance to steal \$31.5 million to pay for extravagant credit card purchases
- **New** categorization of fraud types and new illustration of Fraud Triangle
- Expanded discussion of internal control to include new COSO cube
- **New** illustration of electronic documents used to process cash disbursements
- **New** discussion of petty cash transactions and p-cards in Spotlight on Controls
- **New** discussion and illustration of reporting restricted cash
- Reviewed, updated, and introduced new end-of-chapter material to support new topics and learning objectives, including new problem that automatically posts to T-accounts and new continuing case problem that includes cash disbursement documents

“

*The new format [of Chapters 5 and 6] provides enhanced treatment of fraud categories and internal control components.*

—Audrey Agnello, Niagara County Community College

## CHAPTER 6: MERCHANDISING OPERATIONS AND THE MULTISTEP INCOME STATEMENT

Focus Company: **Walmart**

- Substantially changed from the fourth edition: removed internal control topics (now in Chapter 5), relocated journal entries for inventory purchases (previously in Chapter 7) to accompany inventory sales in this chapter (Chapter 6)
- Updated focus company illustrations (**Walmart**) and introduced **Life Time Fitness** to contrast financial statements of service company with merchandiser (Exhibit 6.2)
- **New** illustration of cost of goods sold equations to distinguish periodic and perpetual inventory systems
- Expanded discussion of shrinkage to include book-to-physical adjustment

- **New** exhibit comparing journal entries for inventory purchase and sale transactions (Exhibit 6.8) in a perpetual system (periodic system entries are included in the chapter supplement)
- **New** Spotlight on Financial Reporting discussing the cost of shoplifting at **JC Penney**
- Updated demonstration case featuring **Oakley** and **Sunglass Hut**
- Reviewed and updated all end-of-chapter material

## CHAPTER 7: INVENTORIES AND COST OF GOODS SOLD

Focus Company: **American Eagle Outfitters**

- Removed journal entries for inventory purchases (now in Chapter 6) to accompany inventory sales in that chapter
- Updated focus company illustrations
- **New** Spotlight on Financial Reporting discussing the LCM write-down at **Lululemon** for its see-through yoga pants fiasco
- Updated inventory turnover analysis in Exhibit 7.7, involving **Harley-Davidson**, **McDonald's**, and **American Eagle**
- **New** Spotlight on Financial Reporting to tie inventory turnover and gross profit to LCM
- Updated demonstration case featuring **Oakley** and **Sunglass Hut**
- Reviewed, updated, and introduced new end-of-chapter material, including new problem formats that automatically post journal entries to T-accounts and prepare trial balances

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

Focus Company: **VF Corporation (VFC)**

- Updated focus company illustrations for **VF Corp.**—the maker of **North Face** jackets, **JanSport** backpacks, **Wrangler** jeans, and **Vans** shoes
- Updated Spotlight on Financial Reporting showing credit card costs at **Target**
- **New** numbers in aging method illustration
- Updated receivables turnover analysis in Exhibit 8.7, involving VF Corp., **Kellogg's**, and **Skechers**
- Updated demonstration case featuring **Rocky Mountain Chocolate Factory**
- Reviewed, updated, and introduced new end-of-chapter material, including comprehensive problem with automatic posting from journal entries to T-accounts and trial balance preparation

## CHAPTER 9: LONG-LIVED TANGIBLE AND INTANGIBLE ASSETS

Focus Company: **Cedar Fair**

- Updated focus company illustrations
- Updated Spotlight on the World to include component allocation of golf course bunkers at **Clublink Enterprises**
- Eliminated discussion of cash-only tangible asset purchase
- Revised depreciation formula presentations to highlight depreciation rates
- **New** illustration to explain calculation and journalizing of gain/loss on disposal
- Changed Spotlight on Business Decisions to a Spotlight on Financial Reporting to introduce new option for private companies to amortize goodwill over 10 years or less
- Revised amortization presentation to show Accumulated Amortization rather than directly reducing asset
- Updated fixed asset turnover analysis in Exhibit 9.5, involving **Cedar Fair**, **Six Flags**, and **Facebook**
- **New** illustration in Homework Helper to show common causes of changes in account balances
- Reviewed, updated, and introduced new end-of-chapter material, including new problem format that automatically posts journal entries to T-accounts and prepares a trial balance

## CHAPTER 10: LIABILITIES

Focus Company: **General Mills**

- Updated focus company illustrations
- **New** Spotlight on Business Decisions to discuss accounting for crowdfunding liabilities arising from **Indiegogo**, **Kickstarter**, and **Prosper** arrangements
- **New** illustration to distinguish different bond types and features
- Replaced quick ratio with debt-to-assets ratio
- New Chapter Supplement 10D included in *Connect* on installment notes.
- Reviewed, updated, and introduced new end-of-chapter material

## CHAPTER 11: STOCKHOLDERS' EQUITY

Focus Company: **National Beverage Corporation**

- Updated focus company illustrations
- **New** Spotlight on Business Decisions to discuss the government's JOBS Act and crowdfunding equity

- Revised list of reasons for stock repurchases, supported by **new** Spotlight on Business Decisions involving **Safe-way's** treasury stock purchase to boost EPS
- Revised Spotlight on Business Decisions to quantify tax savings from **National Beverage's** cash dividend distribution prior to reaching the fiscal cliff
- Expanded illustration of dividend journal entries to include closing entry
- Simplified stock dividend discussion and moved journal entries for small and large stock dividends to chapter supplement
- **New** section to illustrate simple statement of stockholders' equity
- Revised EPS and ROE illustrations to show impact of preferred dividends
- Updated ratio analyses in Exhibit 11.7, involving **National Beverage** and **PepsiCo**
- Inserted cash dividends into demonstration case A and deleted demonstration case B
- Reviewed, updated, and introduced new end-of-chapter material, including new comprehensive problem in a format that automatically posts journal entries to T-accounts and prepares a trial balance

## CHAPTER 12: STATEMENT OF CASH FLOWS

Focus Company: **Under Armour Inc.**

- Updated focus company illustrations
- Final section of chapter illustrates user analyses that are possible with direct method but not indirect method presentation
- Deleted spreadsheet approach, previously in chapter supplement
- Revised demonstration cases to be more consistent with approaches illustrated in chapter
- Reviewed and updated all end-of-chapter material

## CHAPTER 13: MEASURING AND EVALUATING FINANCIAL PERFORMANCE

Focus Company: **Lowe's**

- Updated focus company analyses
- Revised Exhibit 13.5 and related discussion to reflect changes made to all other chapters

- **New** Spotlight on Business Decisions to discuss impact of supply chain financing on current ratio
- Updated discussion to reflect FASB's August 2014 going concern standards update
- Reviewed and updated all end-of-chapter material

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

- Updated excerpts from the fiscal 2013 Annual Reports of **The Home Depot** and **Lowe's**

## APPENDIX C: PRESENT AND FUTURE VALUE CONCEPTS

- Reduced emphasis on tables and greater emphasis on Excel
- **New** introduction of online and mobile apps to compute present and future values (includes bond pricing and market interest rate computations)
- Significantly enhanced the quantity and quality of end-of-chapter material, with greater emphasis on Excel and financial calculator app

## APPENDIX D: INVESTMENTS IN OTHER CORPORATIONS

Focus Company: **Google, Inc.**

- **New** focus company (**Google, Inc.**) to provide contemporary context for topics
- **New** discussion of Google's acquisitions of **YouTube**, **Nest**, and **DoubleClick**
- Revised discussion of mergers and acquisitions

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McGraw-Hill Education *Connect Accounting* is a digital teaching and learning environment that gives students the means to better connect with their coursework, with their instructors, and with the important concepts that they will need to know for success now and in the future. With *Connect Accounting*, instructors can deliver assignments, quizzes and tests easily online. Students can review course material and practice important skills.

*Connect Accounting* provides the following features:

- SmartBook and LearnSmart.
- SmartBook Achieve.
- Auto-graded online homework.
- General ledger software.
- Auto-graded Excel simulations.
- Powerful learning resources including interactive presentations and guided examples to pinpoint and connect key concepts for review.

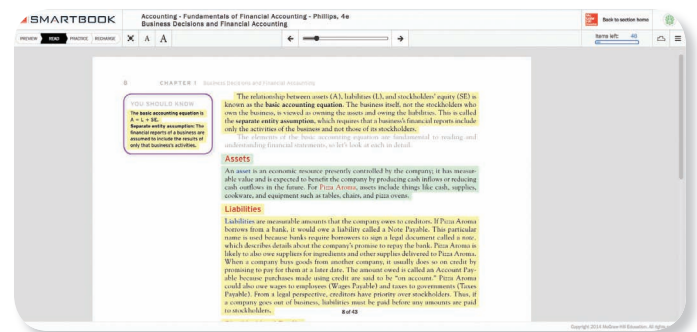
In short, *Connect Accounting* offers students powerful tools and features that optimize their time and energy, enabling them to focus on learning.

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LearnSmart® is the market-leading adaptive study resource that is proven to strengthen memory recall, increase class retention, and boost grades. LearnSmart allows students to study more efficiently because they are made aware of what they know and don't know.

SmartBook®, which is powered by LearnSmart, is the first and only adaptive reading experience designed to change the way students read and learn. It creates a personalized reading experience by highlighting the most impactful concepts a student needs to learn at that moment in time. As a student engages with SmartBook, the reading experience continuously adapts by highlighting content based on what the student knows and doesn't know. This ensures that the focus is on the content he or she needs to learn, while simultaneously promoting long-term retention of material. Use SmartBook's real-time reports to quickly identify the concepts that require more attention from individual students—or the entire class. The end result? Students are more engaged with course content, can better prioritize their time, and come to class ready to participate.



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SmartBook Achieve®—a revolutionary study and learning experience—pinpoints an individual student's knowledge gaps and provides targeted, interactive learning help at the moment of need. The rich, dynamic learning resources delivered in that moment of need help students learn the material, retain more knowledge, and earn better grades. The program's continuously adaptive learning path ensures that every minute a student spends with Achieve is returned as the most value-added minute possible.

## ONLINE ASSIGNMENTS

*Connect Accounting* 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. Our assignable, gradable end-of-chapter content includes a general journal application that looks and feels more like what you would find in a general ledger software package. Also, select questions have been redesigned to test students' knowledge more fully. They now include tables for students to work through rather than requiring that all calculations be done offline.

### M2-10 Preparing Journal Entries [LO 3]

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

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

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

view transaction list view general journal

#### Journal Entry Worksheet

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

Transaction	General Journal	Debit	Credit
a	Cash	3,940	
	Notes Payable (long-term)		
	Notes Payable (short-term)		
	Notes Receivable		
	Other Noncurrent Assets		

\*Enter debits before credits

done clear transaction record transaction

## GENERAL LEDGER SIMULATION

New general ledger simulation for select questions provides a much-improved student experience when working with accounting cycle questions. Students' work in the general journal is automatically posted to the ledger, navigation is much simpler, scrolling is no longer an issue and students can easily link back to their original entries simply by clicking in the ledger if edits are needed. Many questions now have critical thinking components added, to maximize students' foundational knowledge of accounting concepts and principles.

## INTERACTIVE PRESENTATIONS


The interactive presentations provide engaging narratives of all chapter learning objectives in an assignable, interactive online format. They follow the structure of the text and are organized to match the specific learning objectives within each chapter of *Fundamentals of Financial Accounting*. While the interactive presentations are not meant to replace the textbook, they 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.

Chapter 02: The Balance Sheet  
Learning Objective 2-2: Apply transaction analysis to accounting transactions. 1 of 5

#### Transaction Analysis 1

Analyze Transactions

Zac Jones incorporates Majestic Medical, Inc. by contributing \$40,000 cash.

Picture: 

Name:

- Majestic Medical just received \$40,000 cash
- Majestic Medical gave \$40,000 of stock (contributed capital)

Analyze:

Assets = Liabilities + Stockholders' Equity	
Cash	Contributed Capital
+ \$40,000	+ \$40,000

connect | menu | next | exit

## GUIDED EXAMPLES

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

## IN ACTION VIDEOS

These tutorial videos, available in the *Connect Accounting* eBook, illustrate the thought processes applicable to a sample of topics, including how to analyze transactions, adjust accounts, account for inventory and receivables, and prepare a statement of cash flows.

## EXCEL SIMULATIONS

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

## STUDENT RESOURCE LIBRARY

The *Connect Accounting* Student Resources give students access to additional resources such as recorded lectures, online practice materials, an eBook, and more.

**Guided Example**

b. Borrowed \$35,000 cash from a bank and signed a note due in two years.

Assets		=	Liabilities		+	Stockholders' Equity
Cash	Equipment	=	Accounts Payable	Notes Payable	+	Contributed Capital
Beg. 0	0	=	0	0	+	0
(b) +35,000		=		+35,000	+	

Date	Account Titles	Debit	Credit
b.	dr Cash (+A)	35,000	
	cr Notes Payable (+L)		35,000

Assets		=	Liabilities		+	Stockholders' Equity
dr +	Cash	=	cr -		+	
b.	35,000	=			+	

The McGraw-Hill Companies

In the T-accounts, this entry is posted as a debit to Cash and as a credit to Notes Payable for \$35,000.

1. Compute a predetermined overhead rate.  
2. Prepare schedules of cost of goods manufactured and cost of goods sold.  
3. Compute underapplied or overapplied overhead cost to close the balance in Manufacturing Overhead to the appropriate accounts.

2	The allocation base for overhead is direct labor hours.		
3			
4	Data for the year just ended:		
5	Estimated total manufacturing overhead cost		\$ 275,000
6	Estimated total direct labor hours		25,000
7	Actual total direct labor hours		27,760
8			
9	Actual costs for the year:		
10	Purchase of raw materials (all direct)		\$375,000
11	Direct labor cost		\$536,300
12	Manufacturing overhead costs		\$302,750
13			
14	Inventories:	Beginning	Ending
15	Raw materials (all direct)	\$ 15,000	\$ 11,375
16	Work in process	\$ 27,875	\$ 22,350
17	Finished goods	\$ 34,600	\$ 26,450
18			
19	Use the data to answer the following.		
20			
21	1. Compute applied overhead and determine the amount of underapplied or overapplied overhead:		
22	Actual manufacturing overhead cost		
23	Predetermined overhead rate		\$11.00
24	Actual direct labor hours		=E7/F25
25	Manufacturing overhead applied		

Attempt(s) 3/3

“Students like the flexibility that **Connect** offers. It has made a major difference in the student athletes' participation and performance. They can complete their work and catch up on lectures anytime and anywhere.

—Professor Lisa McKinney, M.T.A., CPA, University of Alabama

## McGRAW-HILL EDUCATION CONNECT ACCOUNTING FEATURES

Connect Accounting offers powerful tools, resources, and features to make managing assignments easier, so faculty can spend more time teaching.

### SIMPLE ASSIGNMENT MANAGEMENT AND SMART GRADING

With Connect Accounting, creating assignments is easier than ever, so instructors can spend more time teaching and less time managing.

- Create and deliver assignments easily with selectable end-of-chapter questions and test bank items.
- Have assignments scored automatically, giving students immediate feedback on their work and side-by-side comparisons with correct answers.
- Access and review each response; manually change grades or leave comments for students to review.
- Reinforce classroom concepts with practice assignments, instant quizzes, and exams.

### POWERFUL INSTRUCTOR AND STUDENT REPORTS

Connect Accounting keeps instructors informed about how each student, section, and class is performing, allowing for more productive use of lecture and office hours. The progress-tracking function enables you to:

- View scored work immediately and track individual or group performance with assignment and grade reports.
- Access an instant view of student or class performance relative to learning objectives.
- Collect data and generate reports required by many accreditation organizations, such as AACSB and AICPA.

**Assignment Results**

Use the options below to view assignment scores.

Select the checkboxes on columns you want to export or print.

Student	Total 710 pts	Chapter 2 Practice 150 pts	Chapter 2 Homework 50 pts	Chapter 2 Quiz 100 pts	Chapter 3 LearnSmart 100 pts
Adam, Nikki	691.65	145.90 (97.27 %)	49.23 (98.46 %)	100.00 (100.00 %)	100.00 (100.00 %)
Augle, Mark	429.90	82.00 (55.20 %)	25.00 (50.00 %)	70.00 (70.00 %)	100.00 (100.00 %)
Banks, Gideon	601.92	131.00 (87.33 %)	21.22 (42.44 %)	90.00 (90.00 %)	100.00 (100.00 %)
Basa, Malik	697.60	148.00 (99.20 %)	50.00 (100.00 %)	100.00 (100.00 %)	100.00 (100.00 %)
Bell, George	524.30	102.90 (68.60 %)	35.00 (70.00 %)	70.00 (70.00 %)	100.00 (100.00 %)
Bhaisaheb, Janam	615.00	130.00 (86.67 %)	45.00 (90.00 %)	90.00 (90.00 %)	100.00 (100.00 %)
Birbaam, Bill	620.00	130.00 (86.67 %)	40.00 (80.00 %)	90.00 (90.00 %)	100.00 (100.00 %)
Brown, Daniel	649.71	135.00 (90.00 %)	44.71 (89.42 %)	100.00 (100.00 %)	100.00 (100.00 %)
Castaldo, Irene	610.00	130.00 (86.67 %)	40.00 (80.00 %)	80.00 (80.00 %)	100.00 (100.00 %)

**Student performance**

Look up a student to view performance reports:

Smith, Clark

Submitted assignments results

Assignments	Score	Started	Submitted	Time spent (hr:mi)	Date scored
Chapter 2 LearnSmart Total Value (Points): 100.00, Average Score: 0.00 (0.00%)					
Attempt 1	0.00(0.00%)	10/14/15 12:06AM EST	10/14/15 12:06AM EST	0:00	10/14/15 12:06AM EST
Chapter 2 Practice Total Value (Points): 150.00, Average Score: 145.00 (96.67%)					
Attempt 1	145.00(96.67%)	10/13/15 05:41AM EST	10/13/15 05:53AM EST	0:11	10/14/15 11:25PM EDT
Chapter 2 Homework Total Value (Points): 50.00, Average Score: 50.00 (100.00%)					
Attempt 1	50.00(100.00%)	10/13/15 05:54AM EST	10/13/15 06:03AM EST	0:09	
Chapter 2 Quiz Total Value (Points): 100.00, Average Score: 100.00 (100.00%)					
Attempt 1	100.00(100.00%)	10/13/15 06:03AM EST	10/13/15 06:10AM EST	0:06	
Chapter 3 LearnSmart Total Value (Points): 100.00, Average Score: 100.00 (100.00%)					
Attempt 1	100.00(100.00%)	10/13/15 06:38AM EST	10/13/15 06:48AM EST	0:07	10/13/15 06:48AM EST
Chapter 3 Practice Total Value (Points): 150.00, Average Score: 140.00 (93.33%)					
Attempt 1	140.00(93.33%)	10/13/15 06:10AM EST	10/13/15 06:21AM EST	0:10	
Chapter 3 Homework Total Value (Points): 50.00, Average Score: 50.00 (100.00%)					
Attempt 1	50.00(100.00%)	10/13/15 06:21AM EST	10/13/15 06:28AM EST	0:07	
Chapter 3 Quiz Total Value (Points): 100.00, Average Score: 100.00 (100.00%)					
Attempt 1	100.00(100.00%)	10/13/15 06:29AM EST	10/13/15 06:37AM EST	0:08	

\* Submitted past due date \* Extension \* Not yet graded

## CONNECT INSIGHT

The first and only analytics tool of its kind, Connect Insight™ is a series of visual data displays—each framed by an intuitive question—to provide at-a-glance information regarding how your class is doing.

Connect Insight provides a quick analysis on five key insights, available at a moment's notice from your tablet device.

- How are my students doing?
- How is my section doing?
- How is this student doing?
- How are my assignments doing?
- How is this assignment going?

## INSTRUCTOR LIBRARY

The *Connect Accounting* Instructor Library is a repository for additional resources to improve student engagement in and out of class. You can select and use any asset that enhances your lecture. The *Connect Accounting* Instructor Library includes

- Presentation slides, which include animated PowerPoint exhibits and walkthroughs of key exercises.
- Solutions manual.
- Test bank.
- Instructor's resource manual.
- Instructor Excel templates. Solutions to the student Excel Templates used to solve selected end-of-chapter exercises and problems. These assignments are designated by the Excel icon.



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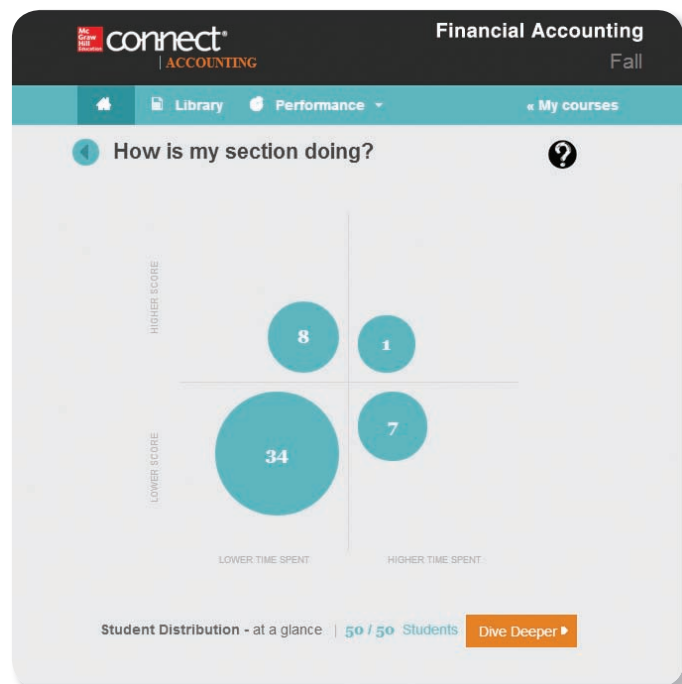
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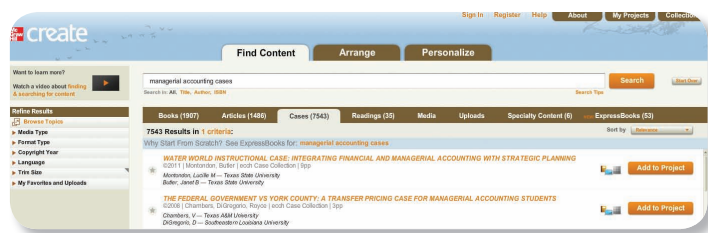
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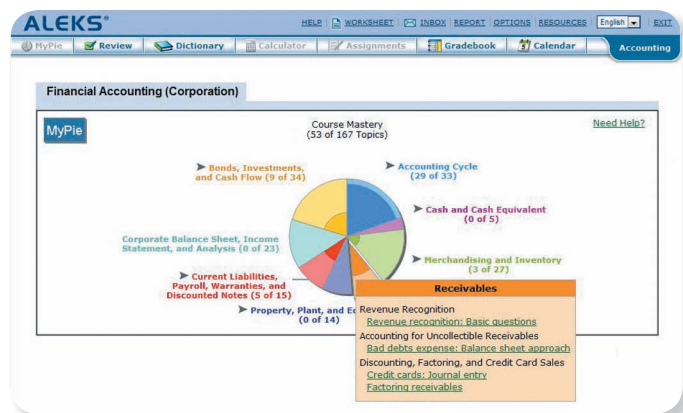
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## Advice on Working in Teams

Accounting information is always created and shared with others, making teamwork an important skill to develop. Our research finds that, whether you select your own teammates or your instructor assigns them to you, taking certain steps can improve your chances of your team being successful.\* We share four of our key observations below.

**1. Know what you want.** Talk with your teammates about the quality of work your team aspires to produce and the amount of commitment to reach that goal. Define the general rules by which the team will work. How will the team determine who does what? How often will you meet, and for how long? How will you keep in touch between meetings? Spending a few minutes at the start to put these “rules” in writing can save you much frustration and disappointment later.

**2. Plan how to get there.** Team projects can feel overwhelming at first, and you may be tempted to quickly split up the work so that everyone can get started on it. Do not do this. Take time to identify (a) the specific steps needed to complete the project, (b) the skills required at each step, and (c) the strengths of each team member. Two benefits of being in a team are that you do not have to be an expert in everything and you do not have to do it all yourself. So assign work to team members based on their strengths and workload, ensuring that everyone gets to do their fair share. Our research shows that teams earn better grades when everyone participates in a meaningful way.

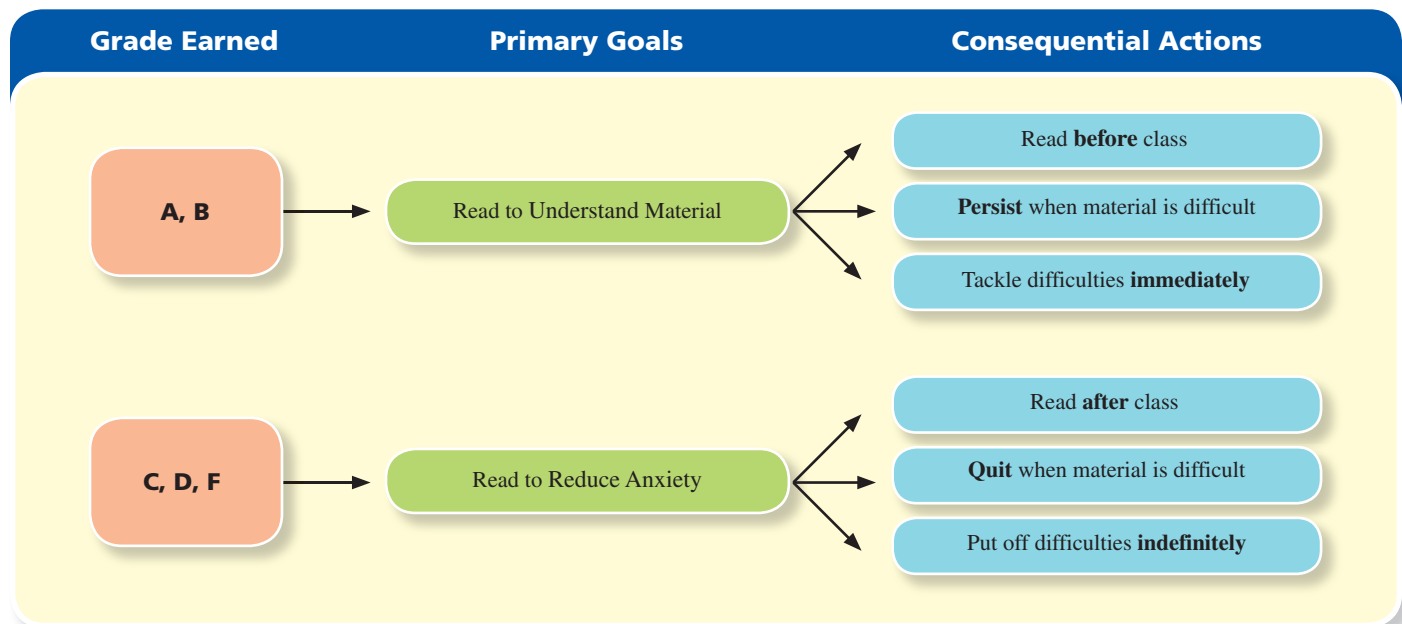
**3. Work as a team.** Teams are more than just groups of people. To be a team, you must be committed to the same goal and be willing to “step up” when you can. Teams can accomplish much when working as a single unit, but not without the individual effort made by team members. Our research shows that the highest project grades are earned when team members work together bringing their skills and abilities to bear on each task.

**4. Build the team.** Teams rarely are perfect when they first start. It takes time to build the trust that is needed when relying on others. Help each other along by scheduling times to review each other’s work and to give constructive feedback on how it can be improved. As a team, assess the whole team’s performance and the openness of its communications. Do this often, and small difficulties will be less likely to turn into big problems.

\*S. Hilton and F. Phillips, “Instructor-Assigned and Student-Selected Groups: A View from Inside,” *Issues in Accounting Education* 25, pp. 15–33 (2010).

# Advice on Using Your Text

**What does it take to do well in your Financial Accounting course?** Our research finds that the way you read and use your textbook can have a major impact on your course performance.\* The following graphic summarizes our primary findings, which suggest four things you can do to improve your chances of earning a good grade.



**1. Read the chapters to learn rather than just to get through them.** Learning doesn't miraculously occur just because your eyes have skimmed all the assigned lines of the textbook. You have to think and focus while reading to sink the material into your understanding and memory. Use the text's learning objectives to focus on what's really important in the chapters.

**2. Don't be discouraged if you initially find some material challenging to learn.** At one time or another, both the best and weakest students describe themselves as "confused" and "having a good grasp of the material," "anxious" and "confident," and "overwhelmed" and "comfortable." The simple fact is that, for anyone, learning new material can be challenging and initially confusing. Success does not depend as much on whether you become confused as it does on what you do when you become confused.

**3. Clear up confusion as it arises.** A key difference between the most and least successful students is how they respond to

difficulty and confusion. When successful students are confused or unsure, they immediately try to enhance their understanding through rereading, self-testing, and seeking outside help if necessary. In contrast, unsuccessful students try to reduce anxiety by delaying further reading or by resorting to memorizing without understanding. Aim to clear up confusion when it arises because accounting in particular is a subject for which your understanding of later material depends on your understanding of earlier material.

**4. Think of reading as the initial stage of studying.** Abandon the idea that "studying" only occurs during the final hours before an exam. By initially reading with the same intensity that occurs when later reviewing for an exam, you can create extra time for practicing exercises and problems. This combination of concentrated reading and extensive practice is likely to contribute to better learning and superior exam scores.

\*B. J. Phillips and F. Phillips, "Sink or Skim: Textbook Reading Behaviors of Introductory Accounting Students," *Issues in Accounting Education* 22, pp. 21-44 (2007).

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Fundamentals of  
**FINANCIAL ACCOUNTING**

# 1

# Business Decisions and Financial Accounting

## CHAPTER ONE

### YOUR LEARNING OBJECTIVES

- LO 1-1** Describe various organizational forms and business decision makers.
- LO 1-2** Describe the purpose, structure, and content of the four basic financial statements.
- LO 1-3** Explain how financial statements are used by decision makers.
- LO 1-4** Describe factors that contribute to useful financial information.

#### THAT WAS THEN

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



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## FOCUS COMPANY: SONICGATEWAY



**W**elcome to the world of business and financial accounting. One of our goals for this book is to help you see the role that accounting plays in helping people turn their good ideas into successful businesses. The founder of **FedEx** first introduced his ideas about a nationwide transportation business in a college essay. With the help of accounting, FedEx has become a multibillion-dollar business. Perhaps the only thing stopping you from doing this is that you don't feel you know what's involved in starting and running a business. We're here to help with that.

Another important goal for us is to explain topics in ways that you can relate to. We want you to see that your personal life experiences help you to learn accounting. Often, we will explain topics in the context of a real business. For example, in the first four chapters, you will learn the steps that two former students took to start their own business and turn their dream into reality. By reading about their experiences, you'll gain a realistic understanding of how accounting is a key part of all businesses. So, let's get started.

For Scott Wilson and Angus Kemp, the last five years have been exciting. After graduating from college, they started a business that develops and sells apps for smartphones and tablets. Their first app—a game called Static Charge—is now approaching 100,000 downloads, and they continue to work on other games to sell at their own online store. They've benefited greatly from the advice of Laurie West—a CPA (certified public accountant)—who has helped them establish their business and understand how to monitor its success. As you will read in this chapter, Laurie met with Scott in June to answer his many questions about getting started. By following Laurie's business and accounting advice, Scott and Angus successfully launched their company, which they named **SonicGateway Inc.**<sup>1</sup>

<sup>1</sup>Scott, Angus, and Laurie are real people, but we have disguised their names to protect their privacy. Scott and Angus invite you to check out their website ([www.sonicgateway.com](http://www.sonicgateway.com)), like them on Facebook, and follow them on Twitter (@sonicgateway). They would also appreciate you checking out their apps and visiting their web store.

### THIS IS NOW

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



## ORGANIZATION OF THE CHAPTER

### Understand the business

- Organizational forms
- Accounting for business decisions

### Study the accounting methods

- The basic accounting equation
- Financial statements

### Evaluate the results

- Using financial statements
- Useful financial information

### Review the chapter

- Demonstration case
- Chapter summary
- Key terms
- Homework helper
- Practice material

## Understand the Business



“Scott, we should start by talking about how you and Angus want to organize your business.”

“Well, we’re starting a technology company to sell apps in Apple’s App Store and on Google Play. What else do we need to know?”



### Learning Objective 1-1

Describe various organizational forms and business decision makers.

## ORGANIZATIONAL FORMS

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

### Sole Proprietorship

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

### Partnership

A partnership is similar to a sole proprietorship, except that profits, taxes, and legal liability are the responsibility of two or more owners instead of just one. It is slightly more expensive to form than a sole proprietorship because a lawyer typically is needed to draw up a partnership agreement, which describes how profits are shared between partners and how that would change if new partners are added or existing partners leave. The key advantage of a partnership over a sole proprietorship is that, by having more owners, a partnership typically has more resources available to it, which can fuel the business’s growth.

## Corporation

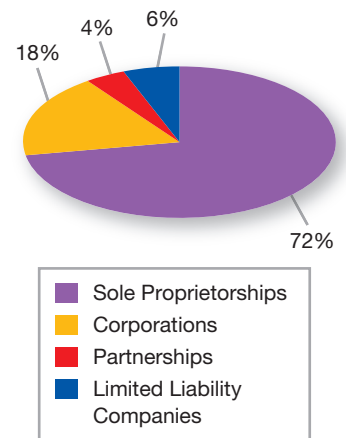
Unlike sole proprietorships and partnerships, a corporation is a separate entity from both legal and accounting perspectives. This means that a corporation, not its owners, is legally responsible for its own taxes and debts. Thus, owners cannot lose more than their investment in the corporation, which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

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

## Other

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

Percentage of Organizational Forms in the U.S.



Source: [IRS.gov](http://IRS.gov).

**"We're interested in limiting our legal liability and getting some financing by selling ownership shares to investors, so we will create a private corporation called SonicGateway Inc. What's next?"**



## ACCOUNTING FOR BUSINESS DECISIONS

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

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

### YOU SHOULD KNOW

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

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



## EXHIBIT 1.1

## The Accounting System Reports Information for Decision Makers



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



“Others outside your business will need financial information about your business. For example, where will the money come from to start your business?”

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



## YOU SHOULD KNOW

**Financial statements:** Accounting reports that summarize the financial results of operating, investing, and financing activities.

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

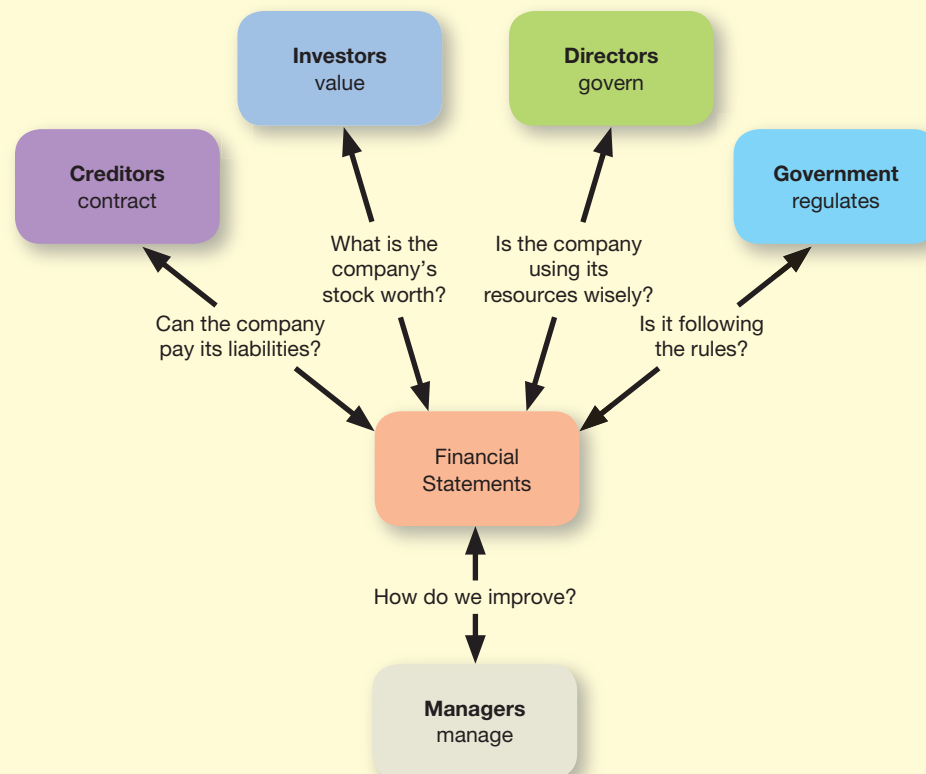
company, so they rely extensively on the financial statements. The four main groups of external users are (1) creditors, (2) investors, (3) directors, and (4) government.

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

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

## EXHIBIT 1.2

## External and Internal Users and Uses of Financial Statements



be the main external user. Scott will be expected to prepare financial statements to obtain the loan and then regularly provide updated financial reports until the loan is repaid. Scott's buddy, Angus, also will be interested in monitoring his investment in **SonicGateway**.

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

**“I want to sound intelligent when I talk to my banker, but I don’t know much about accounting.”**



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

## Study the Accounting Methods

### Learning Objective 1-2

Describe the purpose, structure, and content of the four basic financial statements.

### THE BASIC ACCOUNTING EQUATION

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

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

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

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

#### Assets

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

#### Liabilities

**Liabilities** are measurable amounts that the company owes to creditors. If SonicGateway borrows from a bank, it would owe a liability called a Note Payable. This particular name is

### YOU SHOULD KNOW

The **basic accounting equation** is  $A = L + SE$ .

#### Separate entity assumption:

The financial reports of a business are assumed to include the results of only that business's activities.

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

## Stockholders' Equity

Stockholders' equity represents the owners' claims on the business. These claims arise for two reasons.

1. First, the owners have a claim on amounts they contributed directly to the company in exchange for its stock (Common Stock).
2. Second, the owners have a claim on amounts the company has earned through profitable business operations (Retained Earnings).

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

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

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

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

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

