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FINANCIAL ACCOUNTING

10th Edition

LIBBY / LIBBY / HODGE





TENTH EDITION



FINANCIAL ACCOUNTING

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Patricia A. Libby

Ithaca College

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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

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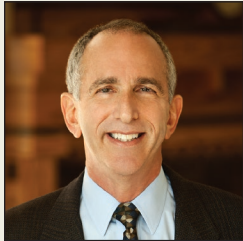
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ABOUT THE AUTHORS

ROBERT LIBBY



©Robert Libby

Robert Libby is the David A. Thomas Professor of Accounting and Accounting Area Coordinator at Cornell University, where he teaches the introductory financial accounting course.

He previously taught at the University of Illinois, Pennsylvania State University, the University of Texas at Austin, the University of Chicago, and the University of Michigan. He received his BS from Pennsylvania State University, 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.

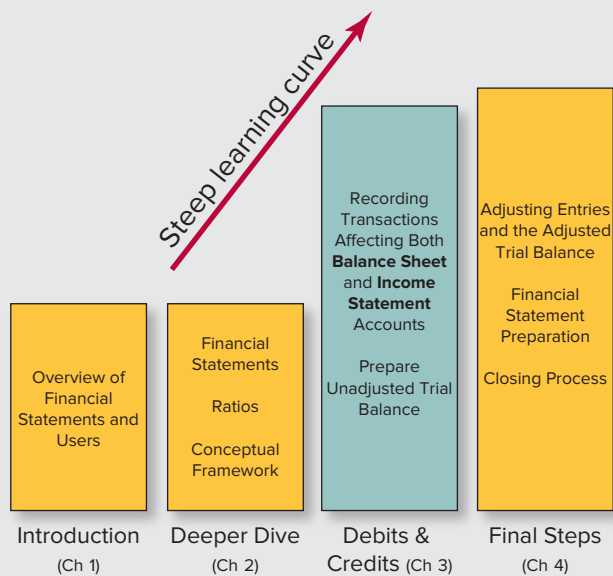
The market-leading Libby/Libby/Hodge approach spreads transaction analysis coverage over two chapters so that students have the time to master the material. In Chapter 2 of *Financial Accounting*, students are exposed to the accounting equation and transaction analysis for investing and financing transactions 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**



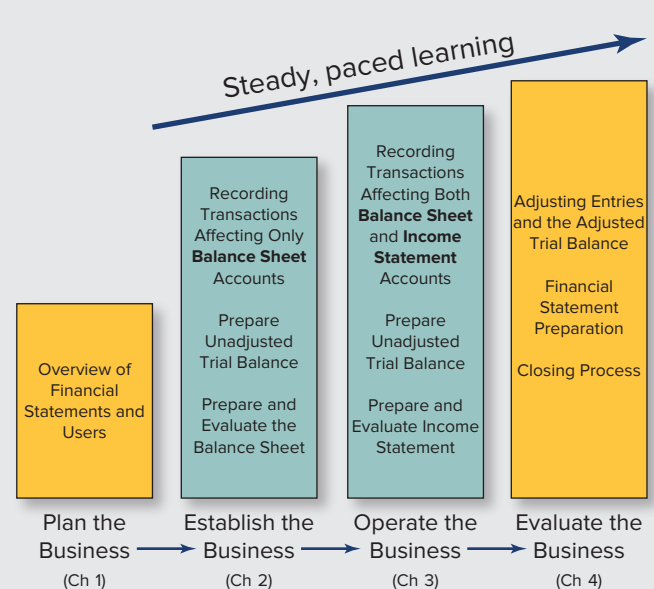
STUDENTS AND INSTRUCTORS

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.

Traditional Accounting Cycle Approach



Libby/Libby/Hodge Accounting Cycle Approach



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

DATA ANALYTICS



How Data Analytics Are Affecting What Auditors Do

Modern data analytics are changing the world of auditing. The availability of more data from clients' 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 +
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) 


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 

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?

CONTINUING PROBLEM 

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**

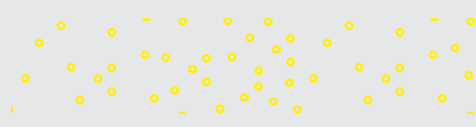
- Chapter 4 builds on Chapters 2 and 3 by explaining and illustrating end-of-period adjustments, financial statements, and closing the records for the first quarter for **Chipotle Mexican Grill**.
- Focus and contrast company data updated.
- Added a **DATA ANALYTICS** feature on the use of data analytics 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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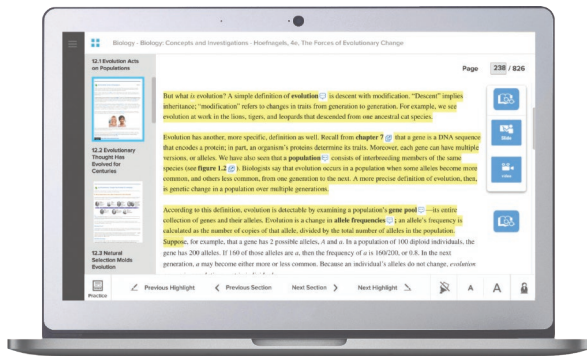
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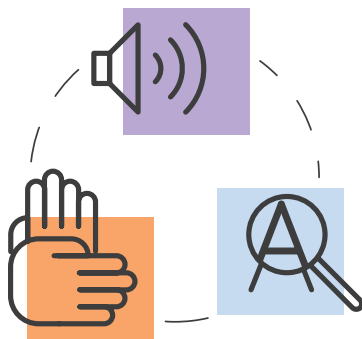
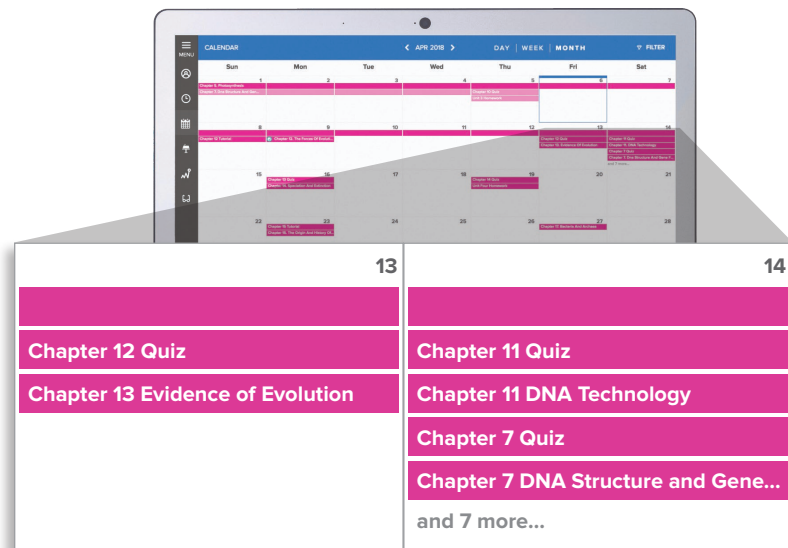
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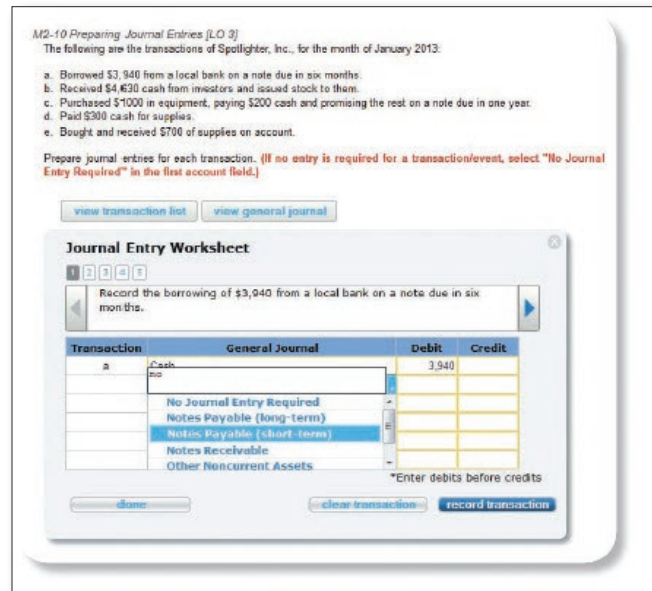
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Online Assignments

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

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	18,000
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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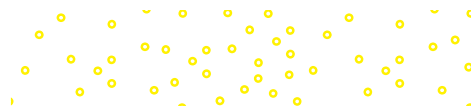
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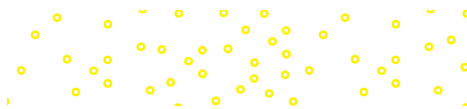
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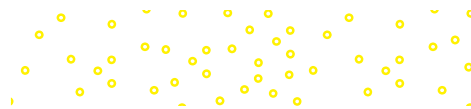
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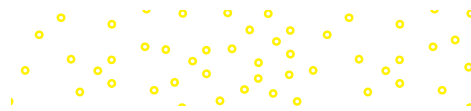
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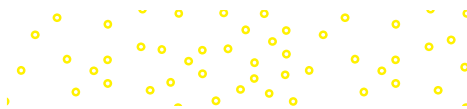
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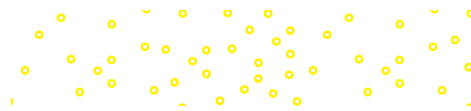
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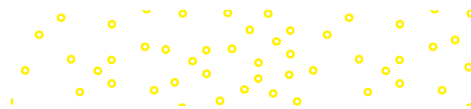
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MBA Companion (Available in McGraw-Hill Education's Create)

Leases, Income Taxes, and Retirement Obligations

Under Armour

Lease Overview

Income Taxes Overview

Pensions and Other Postretirement Benefits Overview



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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Le-Nature's Inc.

USING FINANCIAL
STATEMENT
INFORMATION TO
MANAGE GROWTH

UNDERSTANDING THE BUSINESS

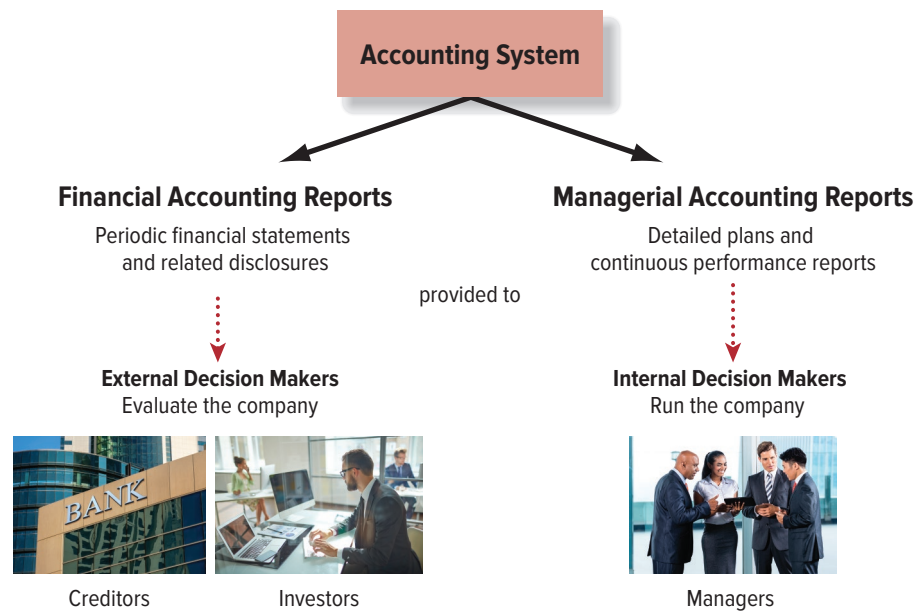
Le-Nature's Inc., our focus company for this chapter, was founded by Gregory Podlucky and his brother Jonathan, who initially were the sole owners or **stockholders** of the company. They were also the managers of the company. Using expertise gained working at their parents' brewery (**Stoney's Beer**), 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

EXHIBIT 1.1

The Accounting System and Decision Makers



Creditors: ©Anton Violin/Shutterstock; Investors: ©Pressmaster/Shutterstock; Managers: ©kzenon/123RF

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.

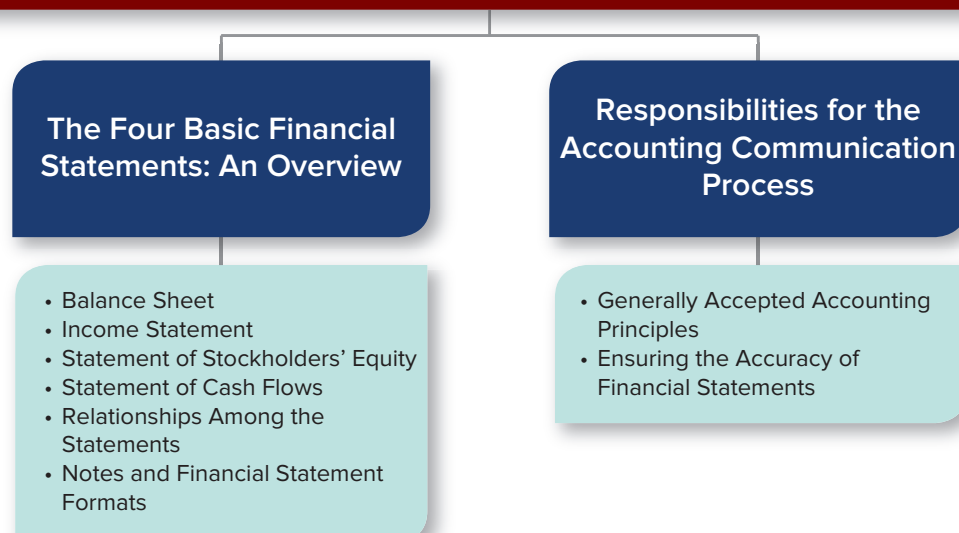
Your Goals for Chapter 1

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



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).

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).

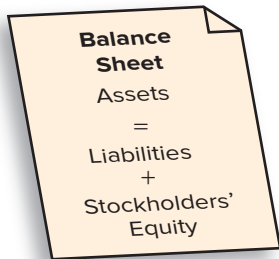
The organization for which financial data are to be collected, called an **accounting entity**, must be precisely defined. On the balance sheet, the business entity itself, not the business owners, is viewed as owning the resources it uses and being responsible for its debts. The heading of each statement 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)

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.

LE-NATURE'S INC.*	
Balance Sheet	
At December 31, 2015	
(in millions of dollars)	
Assets:	
Cash	\$ 10.6
Accounts receivable	6.6
Inventories	51.2
Property, plant, and equipment	459.0
Total assets	<u>\$527.4</u>
Liabilities and stockholders' equity:	
Liabilities	
Accounts payable	\$ 26.0
Notes payable to banks	381.7
Total liabilities	<u>407.7</u>
Stockholders' equity	
Common stock	55.7
Retained earnings	64.0
Total stockholders' equity	<u>119.7</u>
Total liabilities and stockholders' equity	<u>\$527.4</u>
The notes are an integral part of these financial statements.	

EXPLANATION*Name of the entity**Title of the statement**Specific date of the statement**Unit of measure***Resources controlled by the company***Amount of cash in the company's bank accounts**Amounts owed by customers from prior sales**Ingredients and beverages ready for sale**Factories, production equipment, and land***Total amount of company's resources****Sources of financing for company's resources***Financing supplied by creditors**Amounts owed to suppliers for prior purchases**Amounts owed to banks on written debt contracts**Financing provided by stockholders**Amounts invested in the business by stockholders**Past earnings not distributed to stockholders***Total sources of financing for company's resources****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.

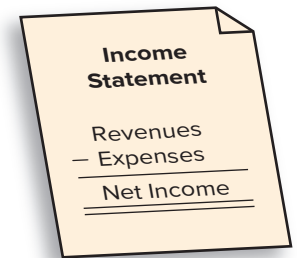
-
- Assets (\$527.4) = Liabilities (\$407.7) + Stockholders' Equity (\$119.7) (in millions).
 - L, A, A, SE, A, A, L, SE (reading down the columns).
-

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

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