

The background of the cover is a photograph of a city skyline at night, with several skyscrapers illuminated. In the foreground, a large display of fireworks is exploding, with bright white and yellow bursts and long, trailing streaks of red, orange, and blue light. The fireworks are reflected in the water in the foreground.

sixth edition

Financial Accounting

J. David Spiceland
Wayne Thomas
Don Herrmann

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email 960126734@qq.com

Financial Accounting

SIXTH EDITION

J. DAVID SPICELAND

University of Memphis

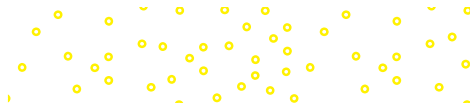
WAYNE THOMAS

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FINANCIAL ACCOUNTING

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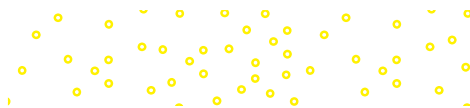
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Dedicated to

*David's wife Charlene, daughters Denise and Jessica, and three sons Mike, Michael, and David
Wayne's wife Julee, daughter Olivia and her husband Corbin, son Jake and his wife Bekah, and other
sons Eli and Luke.*

Don's wife Mary, daughter Rachel, and three sons David, Nathan, and Micah

*In addition, David and Wayne would like to dedicate the sixth edition of Financial Accounting to Don
Herrmann, who lost his battle with brain cancer on May 8, 2018. Don was a true friend, and his lasting
impact on us will never be forgotten.*

About the Authors

DAVID SPICELAND



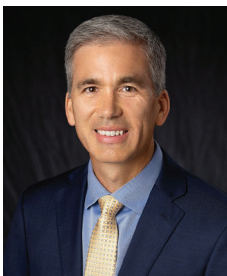
Courtesy of David Spiceland

David Spiceland is Accounting Professor Emeritus at the University of Memphis. He received his BS degree in finance from the University of Tennessee, his MBA from Southern Illinois University, and his PhD in accounting from the University of Arkansas.

Professor Spiceland's primary research interests are in earnings management and educational research. He has published articles in a variety of journals, including *The Accounting Review*, *Accounting and Business Research*, *Journal of Financial Research*, *Advances in Quantitative Analysis of Finance and Accounting*, and most accounting education journals: *Issues in Accounting Education*, *Journal of Accounting Education*, *Advances in Accounting Education*, *The Accounting Educators' Journal*, *Accounting Education*, *The Journal of Asynchronous Learning Networks*, and *Journal of Business Education*. David has received university and college awards and recognition for his teaching, research, and technological innovations in the classroom. David is a co-author on McGraw Hill's best-selling *Intermediate Accounting* text, with Mark Nelson, and Wayne Thomas.

David enjoys playing basketball, is a former all-state linebacker, and an avid fisherman. Cooking is a passion for David, who served as sous chef for Paula Deen at a Mid-South Fair cooking demonstration.

WAYNE THOMAS



Shevaun Williams & Associates

Wayne Thomas is the Senior Associate Dean for Faculty and Research Innovation, and the David C. Steed Chair of Accounting at the University of Oklahoma, where he teaches introductory financial accounting, intermediate accounting, and MBAs. He received his bachelor's degree in accounting from Southwestern Oklahoma State University, and his master's and PhD in accounting from Oklahoma State University.

Wayne has won teaching awards at the university, college, and departmental levels, and has received the Outstanding Educator Award from the Oklahoma Society of CPAs. In addition to *Financial Accounting*, he also co-authors McGraw Hill's best-selling *Intermediate Accounting*, with David Spiceland, Mark Nelson, and Jennifer Winchel. He also co-authors McGraw Hill's *Financial Accounting for Managers* with Michael Drake, Jake Thornock, and David Spiceland.

His primary research interests include accounting information in capital markets, techniques used by managers to manipulate earnings, the importance of financial disclosures, and financial statement analysis. He previously served as an editor of *The Accounting Review* and has published articles in a variety of journals, including *The Accounting Review*, *Journal of Accounting and Economics*, *Journal of Accounting Research*, *Review of Accounting Studies*, and *Contemporary Accounting Research*. He has won several research awards, including the American Accounting Association's Competitive Manuscript Award and the University of Oklahoma's highest research award, being named a George Lynn Cross Research Professor.

Wayne is married to Julee and they have four kids, Olivia, Jake, Eli, and Luke. He enjoys sports (basketball, tennis, golf, biking and ping pong), crossword puzzles, the outdoors, and spending time with his family.

DON HERRMANN



Courtesy of Don Herrmann

Don Herrmann passed away on May 8, 2018, after a 14-month battle with brain cancer. He was the Deloitte Professor of Accounting at Oklahoma State University, where he had been on the faculty since 2005. Don won several teaching awards and enjoyed teaching financial accounting, intermediate accounting, and doctoral students. He received his bachelor's degree in business from John Brown University, his master's degree in accounting from Kansas State University, and his PhD in accounting from Oklahoma State University. He was active in the AAA and served as president of the International Accounting Section.

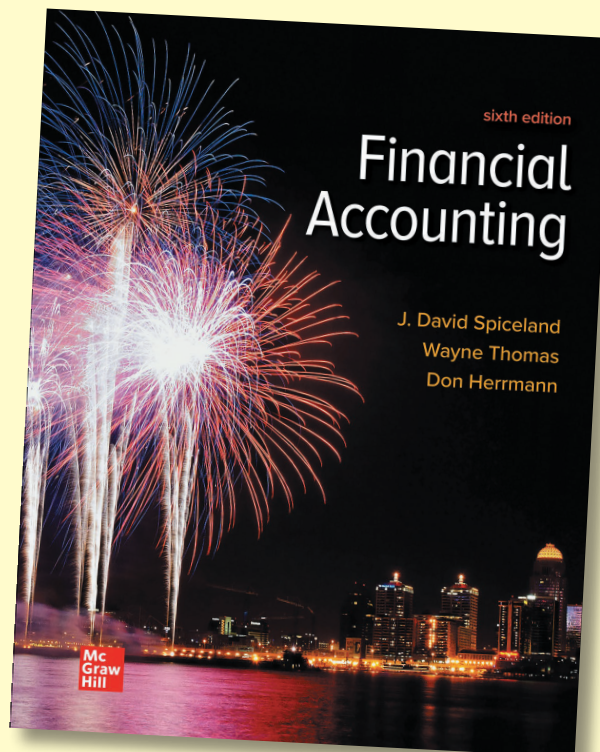
Don was best known for his warm and welcoming personality. He enjoyed serving in his local community and church, as well as hosting families and students in his home. His outgoing nature wasn't the type that filled a room with his presence, but it was the type that filled a one-on-one conversation with purpose.

Above all else, family was first to Don. Some of his favorite family activities included camping, going to amusement parks, and coaching little league sports. He is survived by his wonderful wife Mary and four amazing children Rachel, David, Nathan, and Micah. As he battled through the different stages of cancer, he often reflected on his family. He was so proud of them and talked about them with a humble thankfulness.

Those of us who knew Don were fortunate to share our lives with him. He lived with a sense of purpose and a solid foundation. That foundation continues through his family and the people he's touched. He will be missed by many.

CELEBRATING STUDENT SUCCESS

Don't you love those moments in your course when students are fully engaged? When the "Aha!" revelations are bursting like fireworks? David Spiceland, Wayne Thomas, and Don Herrmann have developed a unique set of materials based directly on their collective years in the classroom. They've brought together best practices by (1) building a Framework for Financial Accounting; (2) reinforcing the Framework in each chapter's text and end-of-chapter assignments; and (3) enriching that Framework using real-world companies, Excel assignments, General Ledger problems, data analytics tools, and a variety of auto-graded ethics, earnings management, and real-world cases. The material is communicated in a student-friendly conversational writing style. After the proven success of the first five editions of *Financial Accounting*, we are confident that the sixth edition will not only motivate, engage, and challenge students—it will illuminate the financial accounting course like never before.



Spiceland's Accounting Series

The Spiceland Accounting series includes:

- *Financial Accounting 6e*
- *Intermediate Accounting 11e*
- *Financial Accounting for Managers, 1e*

Financial Accounting and Intermediate Accounting have proven records of market-leading success by engaging a broad range of students, offering a wide array of resources necessary for building accounting concepts, and giving instructors the variety of tools they need to structure their unique courses.

The authors are proud to introduce a new book in the series, *Financial Accounting for Managers*, for which they are joined by authors Michael Drake and Jake Thornock. *Financial Accounting for Managers* brings the proven Spiceland approach to today's students, featuring modern companies, robust analysis sections, auto-graded cases, and a focus on helping students think critically about how accounting information fuels business decisions.

The Spiceland Accounting Series is fully integrated with McGraw Hill's Connect, an educational platform that seamlessly joins Spiceland's superior content with enhanced digital tools to deliver precisely what a student needs, when and how they need it.



CREATING FUTURE BUSINESS LEADERS

From the first edition of *Financial Accounting*, the authors have been talking with standard setters, auditors, and business leaders across the country to ensure their materials are consistent with what's being practiced in the business world and presented in such a way to help students be ready for business success. In keeping with this feedback, the authors have focused their approach on five key areas:

- Developing an organized learning framework
- Fostering decision-making and analysis skills
- Helping students become better problem solvers
- Developing real-world perspectives & career-ready students
- Using technology to enhance learning

The result? Better-prepared students who have greater potential to take on leadership roles when they graduate and enter the business world.

Developing an Organized Learning Framework

The first step in student engagement is helping them see the “big picture.” The authors introduce an overall framework for financial accounting in Chapter 1 and then apply this framework to specific topics throughout the text and in a summary **Chapter Framework** illustration in each chapter. Within each chapter, students will see this framework on display with mini-financial statements presented in the margin for each journal entry.

Fostering Decision-Making and Analysis Skills

Companies today cite decision-making and analysis skills as top desired skills among recent graduates. Students are given opportunities to see real business decision-making practices in each chapter's—**Decision Maker's Perspectives** and **Decision Points**. Instructors can help students build their Excel, Tableau, and data visualization skills using a wide variety of **Data Analytics** and **Excel** assignments that are auto-gradable in Connect. Finally, **General Ledger Problems** allow students to see the big picture of how information flows through the accounting cycle—letting them solve problems as businesspeople would, by analyzing the effect of transactions on the financial statements.

Helping Students Become Better Problem Solvers

Students check their understanding along the way by using **Key Points** within each Learning Objective and in-chapter **Let's Review** problems of the chapter's primary topics. These items prepare students to successfully complete the assigned end-of-chapter materials. Let's Review problems are complemented by videos. The **Common Mistakes** feature is a student favorite, helping them avoid mistakes that regularly trip up both learners and professionals.

Developing Real-World Perspectives & Career-Ready Students

The authors know that students are most engaged when they see real-world examples that are applicable to their lives and future careers. As the chapter's topics are being presented, references to real companies in the chapter opening **Feature Story** and other related companies help keep topics relevant. Instructors can assign **Real-World Perspective** cases including Great Adventures Continuing Problem, Financial Analysis, Comparative Analysis, EDGAR Research, Ethics, and Earnings Management. Each of these cases is auto-gradable in Connect, allowing additional decision-making practice for students and ease of grading for instructors.

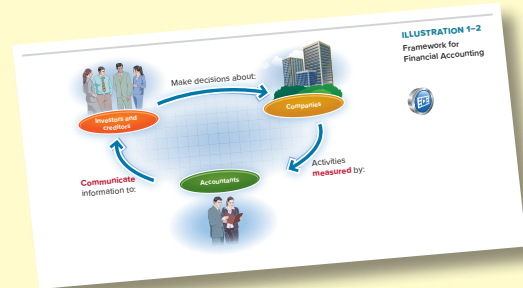
Using Technology to Enhance Learning

Today's students live online and seek out videos to aid their learning. Spiceland *Financial Accounting* reinforces students' conceptual understanding with videos such as **Let's Review**, **Interactive Illustrations**, **Concept Overview**, **Chapter Framework** and **Applying Excel**. End-of-chapter exercises are supplemented with **Hints/Guided Example videos**, and additional online resources like adaptive-learning **SmartBook**.

DEVELOPING AN ORGANIZED LEARNING FRAMEWORK

An Organized Learning Framework: The Big Picture

With a wide variety of students enrolled in financial accounting courses, getting them interested in the content and making it enjoyable to learn can be challenging. Spiceland's *Financial Accounting* achieves this by helping students see the "big picture." The authors introduce a simple overall framework for financial accounting—measure, communicate, make decisions—and then revisit and apply this framework throughout the text. This **organized learning framework** naturally fosters engagement by continually reminding students that accounting helps millions of people make informed business decisions.



An Organized Learning Framework: In Each Chapter

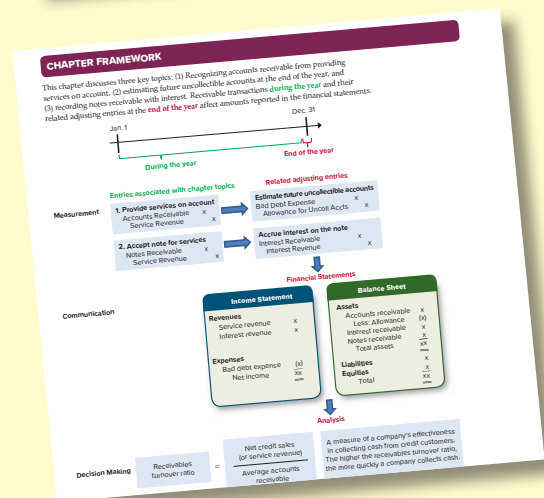
The framework of financial accounting is further reinforced within each chapter:

- New to the sixth edition, the authors include mini-financial statements with each journal entry. These figures continually remind students that every business activity that is *measured* is also *communicated* in the financial statements.
- New Chapter Framework illustrations have been added to the end of each chapter, providing students a flowchart visual through which they can see how the chapter's primary topics fit into the *measurement/communication/decision-making* framework of financial accounting. Each Chapter Framework includes five multiple-choice questions, with ten total questions assignable in Connect.
- A wide range of end-of-chapter assignments reinforce the *measurement* and *communication* functions of financial accounting.

Example. To see how companies record credit sales, consider an example. On March 1, a company provides services to a customer for \$500. The customer doesn't pay cash at the time of service, but instead promises to pay the \$500 by March 31. The company has provided the service and is entitled to receive \$500 and will therefore record the following:

	Debit	Credit
March 1 Accounts Receivable	500	
Service Revenue		500
(Provide services on account)		

Notice that instead of recording Cash, as in a cash sale, the company records another asset—Accounts Receivable—for the credit sale. Later, when \$500 cash is received from the customer, the company then records the increase to Cash. Also, Accounts Receivable is reduced because the customer no longer owes money to the company.



“Overall the chapters are very well organized so **that students would be able to build their foundation effectively.**”

—Jin Dong Park, *Towson University*

An Organized Learning Framework: Tying It All Together

To complete the *measurement/communication/decision-making* framework, Analysis sections are offered at the end of topical chapters (4-11). Using two real-world companies in each chapter, these sections are meant to highlight how the chapter's previous discussion of measurement and communication can be analyzed and used by decision-makers to understand a company's financial condition and performance. The Financial Statement Analysis chapter allows students to take a deep dive into these concepts by analyzing the financial statements of Nike and VF corporation.

Finally, the book's chapter layout provides an overall framework to the topics of the course. After an overview of the framework of financial accounting in Chapter 1, the **accounting cycle chapters** clearly distinguish activities During the Period (Chapter 2) from End of the Period (Chapter 3). Chapters 4-10 cover specific topics in **balance sheet order**, followed by Chapter 11 cash flows and Chapter 12 financial statement analysis.

FOSTERING DECISION-MAKING & ANALYSIS SKILLS

In today's environment, business graduates are being asked more than ever to be equipped in analyzing data and making decisions. To address this need, each chapter includes **Decision Maker's Perspective** sections, which offer insights into how the information discussed in the chapters affects decisions made by investors, creditors, managers, and others. Each chapter also contains **Decision Points** highlighting specific decisions in the chapter that can be made using financial accounting information.

New! Data Analytics assignments are provided with each chapter. Instructors can visit Connect to find a variety of auto-graded Data Analytics questions that introduce students to seeing data presented in the types of visual formats they'll see in today's business environments. These exercises have been thoughtfully developed and scaffolded to build data analytics exposure and skills. Assignable, auto-gradable materials include:

- Data Visualizations - Familiarize students with data visualizations. Students interpret data in a static visual to answer accounting questions.
- Tableau Dashboard Activities - Easily introduce students to Tableau. Students learn to gather the information they need from a live embedded Tableau dashboard - no prior knowledge of Tableau needed.
- Applying Tableau cases - Build student's data analytics skills. Students download an Excel file and build a Tableau dashboard with video tutorial guidance. Once they've completed their dashboard, they'll use it to answer auto-graded questions in Connect.

Decision Maker's Perspective

Investors Understand One-Time Gains

Investors typically take a close look at the components of a company's profits. For example, **Ford Motor Company** announced that it had earned a net income for the fourth quarter (the final three months of the year) of \$13.6 billion. Analysts had expected Ford to earn only \$1.7 to \$2.0 billion for that period. The day that Ford announced this earnings news, its stock price *fell* about 4.5%.

Why would Ford's stock price fall on a day when the company reported these seemingly high profits? A closer inspection of Ford's income statement shows that it included a one-time gain of \$12.4 billion for the fourth quarter. After subtracting this one-time gain, Ford actually earned only about \$1.2 billion from normal operations, easily missing analysts' expectations. This disappointing earnings performance is the reason the company's stock price fell.

Sales, Gross Profit, & Gross Profit by State in 2021

2019-2021 AVG GP% by Region

Region	2019	2020	2021
East	38.73%	38.82%	38.72%
Midwest	41.67%	39.87%	38.43%
Northeast	42.45%	43.35%	43.69%
South	38.0%	37.34%	37.13%
West	40.22%	41.12%	37.69%

Drawing from the data available, assess the following:

Complete this question by entering your answers in the tabs below.

Req 1 Req 2 Req 3 A1 Req 3 A2 Req 3B Req 4

Which region of the country appears to generate the highest gross profit ratio in 2021?

East
 Midwest
 Northeast
 South
 West

Transaction Type

(All)
 Issue common stock for cash
 Purchase supplies on account
 Provide services to customers for cash
 Pay workers' salaries for the month
 Pay suppliers on account
 Pay dividends to stockholders

Individual Transactions

Transaction	Date	Amount
Issue commo.	January 20	5,600
Purchase supplies on account	September 25	9,900
	January 5	5,900
	January 21	5,900
	February 20	6,100
	28	6,400
	March 9	5,900
	20	5,700
	8	5,700
	19	6,000
	May 13	5,800
	24	5,900
	June 10	5,900
	26	6,200
	July 6	5,400
	24	6,000
	August 7	5,700
	September 11	5,600
	23	5,800
	22	6,300
	October 10	6,000
	23	5,800
	November 12	5,600
	24	5,600

Assets = Liabilities + Stockholders' Equity

Revenues, Expenses, and Dividends

Required:

Complete this question by entering your answers in the tabs below.

Req 1 Req 2A Req 2B Req 2C Req 3 Req 4

Determine the total effect on the accounting equation for the entire year for all transactions combined. Verify the accounting equation balances.

Assets	Liabilities	Stockholders' Equity
=	+	=

HELPING STUDENTS BECOME BETTER PROBLEM SOLVERS

Building Better Problem Solvers In honing analytical skills and becoming good problem solvers, it's crucial that students have the right tools and guidance to help them along the way—especially when learning the accounting cycle. The **accounting cycle chapters** clearly distinguish activities During the Period (Chapter 2) from End of the Period (Chapter 3). Chapters 4–10 cover specific topics in **balance sheet order**. Throughout the chapters, several features keep students on the right track as they learn the accounting process.

General Ledger Problems Expanded general ledger problems provide a much-improved student experience when working with accounting cycle questions with improved navigation and less scrolling. Students can audit their mistakes by easily linking back to their original entries and are able to 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.

The Great Adventures Continuing Problem progresses from chapter to chapter, encompassing the accounting issues of each new chapter as the story unfolds. These problems allow students to see how each chapter's topics can be integrated into the operations of a single company. Great Adventures problems are also available in McGraw Hill Connect's General Ledger format.



Let's Review sections within each chapter test students' comprehension of key concepts. These short review exercises, with solutions, are intended to reinforce understanding of specific chapter material and allow students to apply concepts and procedures learned in the chapter prior to attempting their homework assignment. Each Let's Review exercise also contains **Suggested Homework**, which enables instructors to easily assign corresponding homework. For the sixth edition, 22 **Let's Review Videos** show students how to solve the exercise and model that approach for related homework.

Let's Review Bogey Incorporated has the following transactions during May:

BE
 May 1 Purchase a storage building by obtaining a loan of \$5,000.
 May 6 Provide services to customers for cash, \$1,800.
 May 12 Pay \$1,200 cash for advertising in May.
 May 17 Repay \$1,000 of the amount borrowed on May 1.
 May 25 Purchase office supplies for \$800 cash.

Required:
Indicate how each transaction affects the accounting equation.

Solution:

	Assets	=	Liabilities	+	Stockholders' Equity	
					Common Stock	Retained Earnings
May 1	+\$5,000		+\$5,000			
May 6	+\$1,800					+\$1,800
May 12	-\$1,200					-\$1,200
May 17	-\$1,000		-\$1,000			
May 25	+\$ 800					
	-\$ 800					
	+\$4,600	=	+\$4,000	+	\$ 600	

Suggested Homework:
BE2-2, BE2-4;
E2-2, E2-3, E2-4;
P2-1A&B, P2-2A&B

Common Mistakes made by students and professionals are highlighted throughout each of the chapters. With greater awareness of the potential pitfalls, students can avoid making the same mistakes and gain a deeper understanding of the chapter material.

X **COMMON MISTAKE**

When recording the interest payable on a borrowed amount, students sometimes mistakenly credit the liability associated with the principal amount (Notes Payable). We record interest payable in a *separate account* (Interest Payable) to keep the balance owed for principal separate from the balance owed for interest.

The **Flip Side** feature demonstrates how various transactions are viewed by each side. Including the “flip side” of a transaction—in context—enhances students' understanding of both the initial and the related transaction. Selected homework materials also include the Flip Side transactions, to reinforce student understanding.

Interest Receivable. We can see an example of accrued revenues if we review the flip side of transaction (2), which we discussed in the previous section as interest expense. The bank lends Eagle Soccer Academy \$100,000 and charges Eagle annual interest of 12% (or 1% per month) on the borrowed amount. Interest for the month of December is \$1,000 (= \$100,000 × 12% × 1/12). At the end of December, the bank needs an adjusting entry to record an asset for the amount expected to be received (Interest Receivable) from Eagle and to recognize revenue (Interest Revenue).

The bank's end-of-period adjusting entry is presented below.

Flip Side

Key Points provide quick synopses of the critical pieces of information presented throughout each chapter.

K **KEY POINT**

Adjusting entries are a necessary part of accrual-basis accounting. They are used to record changes in assets and liabilities (and their related revenues and expenses) that have occurred during the period but have not yet been recorded by the end of the period.

DEVELOPING REAL-WORLD PERSPECTIVES & CAREER-READY STUDENTS

Students retain more information when they see how concepts are applied in the real world. Each chapter begins with a Feature Story that involves real companies and offers business insights related to the material in the chapter. As the chapter's topics are being presented, references to the companies in the Feature Story and other related companies help keep topics relevant. The authors understand that students are best engaged when the discussion involves companies that students find interesting and whose products or services are familiar, such as Apple, American Eagle Outfitters, Best Buy, Six Flags, Disney, and Zoom. In Chapter 12, full financial statement analysis is provided for Nike versus VF Corporation. The authors carry these real-world companies into the end-of-chapter material, asking students to analyze real-world situations.

The **Real-World Perspectives** section of each chapter offers cases and activities that ask students to apply the knowledge and skills they've learned to real, realistic, or provocative situations. Students are placed in the role of decision maker, presented with a set of information, and asked to draw conclusions that test their understanding of the issues discussed in the chapters. Each chapter offers an engaging mix of activities and opportunities to perform real-world financial accounting analysis, conduct EDGAR research, understand earnings management, address ethical dilemmas, and practice written communication. Ethics, Earnings Management, EDGAR and Financial Analysis cases are auto-gradable in Connect.

Financial Analysis: American Eagle Outfitters, Inc. & The Buckle, Inc. ask students to gather information from the annual report of American Eagle located in Appendix A and Buckle in Appendix B. **Comparative Analysis**—In addition to separately analyzing the financial information of American Eagle and Buckle, students are asked to compare financial information between the two companies. These questions are auto-gradable in Connect!

Excel activities and exercises help foster career readiness by offering students hands-on training in multiple ways:

- **New! Integrated Excel** assignments pair the power of Microsoft Excel with the power of Connect. A seamless integration of Excel within Connect, Integrated Excel questions allow students to work in live, auto-graded Excel spreadsheets – no additional logins, no need to upload or download files. Instructors can choose to grade by formula or solution value, and students receive instant cell-level feedback via integrated Check My Work functionality.
- **Applying Excel** features in each chapter help build students' Excel skills, showing them how Excel can be used to make efficient calculations and analysis. Applying Excel video solutions housed in Connect complement the feature, allowing students to view the power of Excel to analyze business scenarios.

The screenshot shows a Microsoft Excel spreadsheet with the following content:

1	The Chestnut Street Company plans to issue \$825,000, 10-year bonds that pay 7 percent					
2	semiannually on March 31st and September 30th.					
3						
4	Information relating to this bond is found below:					
5	Face Value:	\$825,000				
6	Number of Years:	10				
7	Stated Interest Rate:	7%				
8						
9	Number of Payments per Year:	2				
10	Required:					
11	Calculate or provide the information requested using a formula or cell reference unless					
12	you are instructed to use a specific function.					
13						
14	1) Assume the Market Interest Rate is:	8%				
15						
16	a.	How many total payments or periods will this bond pay interest?				
17						
18						
19	b.	Calculate the amount of interest that will be paid on March 31st.				
20						
21	c.	Calculate the selling price of this bond using the PV Function				
22						
23	d.	Use the IF function to show the balance in the Premium or Discount				
24		account at the time the bond is issued based on the selling				
25		price you calculated in letter c.				
26						
27						
28	2) Assume the Market Interest Rate is:	6%				
29						
30	a.	Calculate the amount of interest that will be paid on March 31st.				
31						
32	b.	Calculate the selling price of this bond using the PV Function				
33						
34	c.	Use the IF function to show the balance in the Premium or Discount				
35		account at the time the bond is issued based on the selling				
36		price you calculated in letter c.				
37						
38						
39						

USING TECHNOLOGY TO ENHANCE LEARNING

Connect and Spiceland's *Financial Accounting* are tightly integrated to continue honing students' conceptual understanding, problem-solving, decision-making & analysis skills.



All end-of-chapter items in the textbook that can be built into Connect have been included with feedback and explanations and many with **Hints/Guided Example Videos** to help students work through their homework in an effective manner.

ASSESSMENT & PRACTICE: END-OF-CHAPTER AND TEST BANK

Algorithmic Content & End-of-Chapter assignments

New algorithmic problems have been added, allowing students more practice and you more opportunities for students to demonstrate their understanding.

Extensive end-of-chapter assignments are available in the text and Connect:

- Self-Study Questions
- Data Analytics & Excel
- Review Questions
- Brief Exercises
- Exercises (set Set B in the test bank)
- Problems Set A & B (with Set C in the test bank)
- Real-World Perspectives
 - Great Adventures continuing case
 - Financial analysis cases
 - Ethics case
 - EDGAR Research case
 - Written Communication case
 - Earnings Management case

Using EDGAR (Electronic Data Gathering, Analysis, and Retrieval system), find the annual report (10-K) for Apple for the year ended September 28, 2019. Locate the "Consolidated Statements of Operations" (Income statement) and "Consolidated Balance Sheets." You also may find the annual report at the company's website.

Required:
Determine the following from the company's financial statements:

1. What amount does the company report for accounts receivable? What does this amount represent?
2. What amount does the company report for accounts payable? What does this amount represent?
3. The company reports a single amount for "Other current liabilities" in the liability section of the balance sheet. What are some possible liabilities included in this amount?
4. What amount does the company report for common stock (including additional paid-in capital)? What does this amount represent?
5. Determine whether the company's total assets equal total liabilities plus total stockholders' (or shareholders') equity.
6. What amount does the company report for net sales? When a sale is made, does the company debit or credit the Sales Revenue account?
7. Do the company's total revenues exceed total expenses? By how much?

Complete this question by entering your answers in the tabs below.

Required 1	Required 2	Required 3	Required 4	Required 5	Required 6	Required 7
------------	------------	------------	------------	------------	------------	------------

Accounts receivable

The accounts receivable account represents the

< Required 1 Required 2 >

Concept Overview Videos

Concept Overview Videos provide engaging narratives of all chapter learning objectives in an assignable, interactive online format. These videos follow the structure of the text and match specific learning objectives within each chapter of *Financial Accounting*. Concept Overview Videos provide additional explanation and enhancement of material from the text chapter, allowing students to learn, study, and practice at their own pace. Assignable assessment questions paired with the videos help students test their knowledge, ensuring that they are retaining concepts.

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

If no-par value stock is issued, the corporation debits Cash and credits Common Stock. If par value or stated value stock is issued, the corporation debits Cash and credits two equity accounts—Common Stock at the par value or stated value per share and Additional Paid-in Capital for the portion above par or stated value.

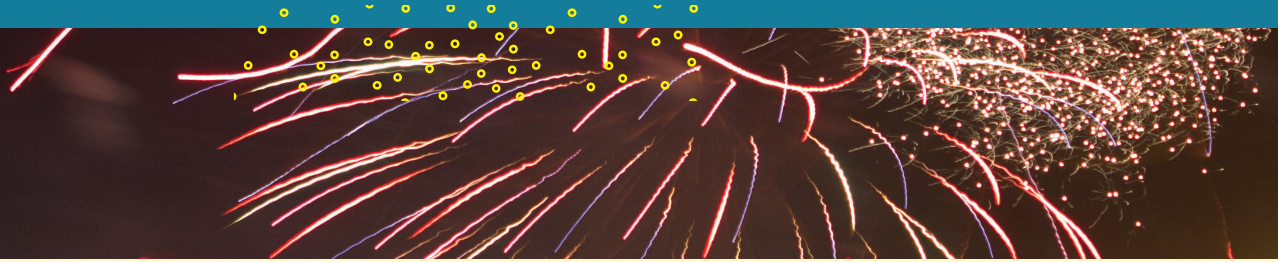
Knowledge Check 01
On January 1, Year 1, Davidson Corporation issues 1,000 shares of \$1 par value common stock for \$20 per share. Complete the necessary journal entry for the issuance of common stock by indicating the relevant account names and dollar amounts below. If more than one account title is debited or credited, enter the account titles in their alphabetical order.

[View transaction list](#)

Journal entry worksheet

< 1 >

Record the issue of additional common stock.



Hints/Guided Example Videos

Hint/Guided Example videos are narrated, animated, and step-by-step walkthroughs of algorithmic versions of assigned exercises in Connect. Presented to the student as hints, Guided Examples provide just-in-time remediation—and help—students get immediate feedback, focused on the areas where they need the most guidance.

Hint

Acquired a delivery truck on October 3, Year 1	\$10,000
Residual value	\$0
Service life	5 years
Total miles expected to be driven	100,000 miles
Actual mileage in Year 1	5,000 miles
Actual mileage in Year 2	15,000 miles

ACTIVITY-BASED

Depreciation rate per mile	Depreciation cost
	Total miles expected to be driven
	Cost - \$10,000
	100,000 expected miles
	0.10 per mile
Depreciation expense	Depreciation rate per mile × Actual mileage in a year
Dec. 31, Year 1	
Depreciation expense	0.10 per mile × 5,000 miles = \$500
Dec. 31, Year 2	
Depreciation expense	0.10 per mile × 15,000 miles = \$1,500

Interactive Illustration Videos

Interactive Illustrations provide video-based explanations of key illustrations in the chapter. These videos transform a static illustration in the text into a dynamic, step-by-step walk through of the illustration, deepening students' understanding of the concepts or the calculations shown.

Links among Financial Statements

EAGLES GOLF ACADEMY Income Statement		EAGLES GOLF ACADEMY Statement of Stockholders' Equity	
Revenue	\$7,200	Common Stock	Retained Earnings
Expenses	6,000	0	0
Net income	\$1,200	25,000	1,200
		1,200	1,200
		25,000	26,200

EAGLES GOLF ACADEMY Balance Sheet		EAGLES GOLF ACADEMY Statement of Cash Flows	
Cash	\$14,000	Cash flows from operating activities	\$1,900
Other assets	33,000	Cash flows from investing activities	24,000
Total assets	\$47,000	Cash flows from financing activities	34,800
		Net increase in cash	6,700
		Cash at the beginning of the year	0
		Cash at the end of the year	6,700

Let's Review Videos

Let's Review videos relate to the Let's Review sections in the text, showing students how to solve certain exercises. In walking students through a particular scenario or question, these videos model how students can approach problem solving.

MAY 1	Purchase a storage building by obtaining a loan of \$5,000	MAY 6	Provide services to customers for cash of \$1,800
MAY 12	Pay \$1,200 cash for advertising in May	MAY 17	Repay \$1,000 of the amount borrowed on May 1
MAY 25	Purchase office supplies for \$800 cash		

Requirements:
• Indicate how each transaction affects the accounting equation.

	ASSETS	=	LIABILITIES	+	STOCKHOLDERS' EQUITY
					Common Stock Retained Earnings
May 1	+5,000		+5,000		
May 6	+1,800				+1,800
May 12	-1,200				-1,200
May 17	-1,000		-1,000		
May 25	+ 800				
	- 800				
	<u>+4,600</u>	=	<u>+4,000</u>	+	<u>600</u>

Test Builder in Connect

Available within Connect, Test Builder is a cloud-based tool that enables instructors to format tests that can be printed or administered within a LMS. Test Builder offers a modern, streamlined interface for easy content configuration that matches course needs, without requiring a download.

Test Builder allows you to:

- access all test bank content from a particular title.
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- add instructions and configure default settings.

Test Builder provides a secure interface for better protection of content and allows for just-in-time updates to flow directly into assessments.

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NEW IN THE SIXTH EDITION

We've incorporated an enormous amount of feedback from over 700 reviewers, focus group, and symposium participants over the last five editions. The list of changes and improvements on the next few pages is testament to the many hours that reviewers spent thinking about and analyzing our earlier editions, helping us to make *Financial Accounting* the **best book of its kind**.

Overall Updates in the Sixth Edition:

- **Text was reduced** in many places to simplify and clarify discussion.
- **Feature stories, real-world examples, and ratio analyses** in each chapter were updated to the most recent year.
- **Financial statement effects** were highlighted in the margin of all journal entries.
- **Chapter Framework** illustrations at the end of each chapter were modified to include Analysis in most chapters.
- **Five self-study multiple-choice questions** were added to the Chapter Framework illustration in each chapter. **Five additional questions** are available online.
- **Great Adventures Continuing Case** adds content from each successive chapter to build a comprehensive set of financial statements.
- **Financial Analysis Cases** using American Eagle Outfitter (Appendix A) and Buckle (Appendix B) were updated for each chapter.
- **An auto-gradable EDGAR Research Case** was added to each chapter.
- **Ethics Cases** and **Earnings Management Cases** are now algorithmic and auto-gradable.
- **Written Communication Cases** were added to Connect to allow instructors the option of manual grading.
- **Integrated Excel, Applying Excel, Data Visualizations, Tableau Dashboard Activities, and Applying Tableau** are available online in Connect.
- **Revised illustrations** throughout the text to continue to offer clear and visual learning tools for students.
- **Usage data** from SmartBook and Connect were used in developing changes to the 6th edition.

CHAPTER 1:

- Revised the explanation of stockholders' equity in LO1-2 to focus on how those claims arise.
- Changed discussion of the statement of stockholders' equity in LO1-3 and the calculation of retained earnings.
- Revised Illustrations 1-6, 1-7, and 1-8 to make clearer the link between financial statements.
- The Great Adventure Continuing Case was modified to be auto-graded in Connect.

CHAPTER 2:

- Revised discussion of Illustration 2-6 to make clear the effects of debits and credits in the expanded accounting equation.
- Revised discussion to make clear the meaning of the balance of retained earnings in an unadjusted trial balance.

CHAPTER 3:

- Revised and reduced discussion in LO3-1 and LO3-2 to explain timing differences caused by accrual-basis accounting.
- Modified Illustrations 3-2 and 3-3 to differentiate revenue and expense recognition under accrual-basis versus cash-basis accounting.
- Modified adjusting entry illustrations to include related entries made during the year.
- Included a T-account in the margin beside each of the adjusting entries to

emphasize the effect on asset and liability balances.

- Expanded E3-7 to include transactions during the year.
- Revised and clarified the timing of accrual accounting in E3-8, E3-10, E3-12, E3-13, P3-1A&B, P3-3A&B, and P3-4A&B.
- Added BE3-21, BE3-22, BE3-23, BE3-24, and BE3-25 to include the financial statement effects of adjusting entries.
- Revised BE3-14, BE-18, E3-13, P3-3A, and P3-5B to exclude depreciation (several other assignments include depreciation).

CHAPTER 4:

- Changed the feature story to focus on Live Nation Entertainment.
- Expanded discussion of types of payments received from customer to more modern forms.
- Revised discussion of bank reconciliation to include more modern transactions and revised several related end-of-chapter assignments in a similar way.
- Expanded discussion of the reasons to explain cash holdings in the Analysis section.

CHAPTER 5:

- Revised the Feature Story to provide additional discussion of net revenues reported.
- Revised Part A in several places to emphasize revenue being reported for

the amount the company is entitled to receive from customers.

- Added BE5-2 for sales discounts and BE5-18 for notes receivable and interest.
- Added BE5-22, BE5-23, BE5-24, BE5-25, and BE5-26 to determine financial statement effects of transactions.

CHAPTER 6:

- Modified Illustrations 6-6 and 6-7 to make clear the calculation of ending inventory and cost of goods sold.
- Modified Illustration 6-9 to improve clarity.
- Added discussion in Part B to clarify how inventory transactions are recorded and reported in practice under FIFO and LIFO.
- Added BE6-15 to record adjusting entry for lower of cost or net realizable value.
- Added BE6-24, BE6-25, BE6-26, BE6-27, and BE6-28 to determine financial statement effects of transactions.

CHAPTER 7:

- Modified discussion of capitalizing versus expensing an expenditure in LO7-1.
- Modified discussion of purchased versus internally developed intangible assets in LO7-2.
- Created new Illustration 7-6 to demonstrate the difference in treatment between purchased and internally-developed patent.
- Created new Illustration 7-13 to demonstrate partial-year depreciation.

- Changed companies used in the Analysis section to Disney and Netflix.
- Added BE7-11 and BE7-17 to record depreciation.
- Added BE7-23, BE7-24, BE7-25, BE7-26, and BE7-27 to determine financial statement effects of transactions.
- Changed E7-4 to include various expenditures related to intangibles.

CHAPTER 8:

- Revised discussion of notes payable and associated interest (Learning Objective 8-2).
- Added discussion and journal entry for reclassifying current portion of long-term debt.
- Added BE8-9 to reclassify current portion of long-term debt.
- Added BE8-19, BE8-20, BE8-21, and BE8-22 to determine financial statement effects of transactions.
- Added E8-12 for recording long-term notes payable and reclassifying current portion.

CHAPTER 9:

- Revised Part A to include a simple overview of installment notes, leases, and bonds issued at face amount.
- Revised discussion of reclassification of current portion of long-term installment notes.

- Provided additional clarification of the meaning of discounts and premiums on bonds.
- Added carrying value to Glossary.
- Added BE9-4, BE9-5, E9-4, and E9-5 on installment notes.
- Added P3-9A and P3-9B on leases.
- Added E9-9 for comparison of installment note and lease.
- Added BE9-24, BE9-25, and BE9-26 to determine financial statement effects of transactions.
- Revised E9-1 to include a comparison of interest payments and dividend payments.

CHAPTER 10:

- Changed the feature story to Zoom.
- Modified Illustrations 10-3, 10-4, and 10-5.
- Added Key Point for retained earnings.
- Added discussion of Apple's recent 4-for-1 stock split.
- Changed Illustration 10-18 to include analysis of Citigroup's equity section of the balance sheet.
- Modified text to include a bullet list of items reported in the statement of stockholders' equity in Illustration 10-20.
- Changed the Analysis section to include Zoom versus Microsoft.
- Added BE10-10 and BE10-11.

- Added BE10-18, BE10-19, BE10-20, BE10-21, and BE10-22 to determine financial statement effects of transactions.
- Added E10-4, E10-9, and E10-10.
- Revised E10-2.

CHAPTER 11:

- Revised Illustration 11-8 and its related discussion.
- Clarified the discussion of the indirect method in LO 11-3 to tie directly to income statement adjustments and balance sheet adjustments.
- Added new E11-10 and E11-11 for investing and financing cash flows.

CHAPTER 12:

- Changed Feature Story to VF Corporation.
- Changed comparison to Nike versus VF Corporation throughout the chapter.

APPENDIX C:

- Added new Illustration C-11 to demonstrate effect of interest rates on present value and future value relationship.
- Added new EC-3, EC-4, EC-7, EC-8, EC-12, EC-13, EC-15, and EC-16.

APPENDIX D:

- Simplified the discussion of debt investments to include purchase of bonds at face amount as the primary example.
- Added new ED-10 for purchase of debt investment at face amount.



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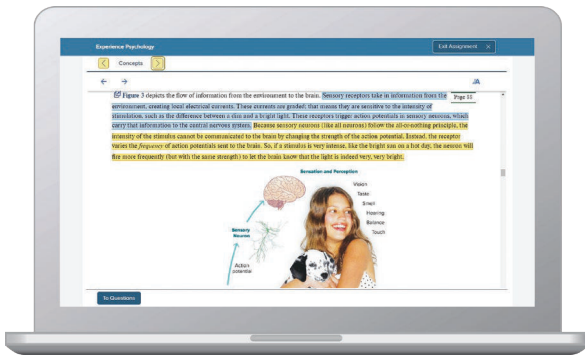
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- Jordan Cunningham,
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A HEARTFELT THANKS TO THE MANY VOICES . . .

The version of *Financial Accounting* you are reading would not be the same book without the valuable suggestions, keen insights, and constructive criticisms of the list of reviewers below. Each professor listed here contributed in substantive ways to the organization of chapters, coverage of topics, and selective use of pedagogy. We are grateful to them for taking the time to read each chapter and offer their insights.

We also acknowledge those reviewers who helped in the genesis of this text with the first second and third edition reviews—we appreciate your efforts to this day!

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We also would like to acknowledge the many talented people who contributed to the creation of this sixth edition and thank them for their valuable contributions. Teresa Farough did a wonderful job accuracy checking our manuscript. Mark McCarthy of East Carolina University contributed a helpful accuracy check of the page proofs; we thank him for his speedy and insightful comments. We also appreciate the willingness of The Buckle, Inc., and American Eagle Outfitters, Inc., to allow us to use their companies' annual reports.

Thanks to Rachel Cox of Oklahoma State University for reviewing the Test Bank, and to Jeannie Folk of Northwestern University for revising the test bank and the PowerPoint. Helen Roybark of Radford University for accuracy checking the PowerPoint. Beth Kobylarz did an outstanding job as Lead Subject Matter Expert for the revisions to Connect; Mark Sears and Ashley Newton of the University of Oklahoma and all of the staff at AnsrSource contributed their invaluable expertise as Connect reviewers. Ashley Newton of the University of Oklahoma also did a wonderful job with the Concept Overview Videos and Applying Excel video resources.

We also appreciate the expert attention given to this project by the staff at McGraw Hill Education, especially Tim Vertovec, Vice President BEC Portfolio, Rebecca Olson, Executive Director; Noelle Bathurst, Senior Portfolio Manager; Lauren Schur, Marketing Manager; Christina Sanders, Lead Product Developer; Danielle McLimore, Assessment Product Developer; Kevin Moran, Director of Digital Content; Pat Frederickson, Lead Content Project Manager; Angela Norris, Senior Content Project Manager; Matt Diamond, Senior Designer; Traci Vaske, Senior Content Licensing Specialist; and Laura Fuller, Buyer.

SUPPLEMENTS WITH THE SAME VOICE

Last but not least, we thank the authors of *Financial Accounting*, who write all of the major **supplements**, including the Solutions Manual, Instructor's Manual, all end-of-chapter material, additional online Exercises and Problems. The test bank includes over 3,000 questions, including more than 1,900 multiple-choice questions and more than 1,125 other types of questions and problems. The authors actively engage in the development of ALL technology-related supplements, such as SmartBook, Interactive Illustrations, Let's Review videos, Chapter Framework videos, Applying Excel videos, Auto-Graded Integrated Excel, Auto-Graded Excel Simulations, and PowerPoints.

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A Framework for Financial Accounting

Learning Objectives

PART A: ACCOUNTING AS A MEASUREMENT/ COMMUNICATION PROCESS

- **LO1-1** Describe the two primary functions of financial accounting.
- **LO1-2** Understand the business activities that financial accounting measures.
- **LO1-3** Determine how financial accounting information is communicated through financial statements.
- **LO1-4** Describe the role that financial accounting plays in the decision-making process.

PART B: FINANCIAL ACCOUNTING INFORMATION

- **LO1-5** Explain the term generally accepted accounting principles (GAAP) and describe the role of GAAP in financial accounting.

PART C: CAREERS IN ACCOUNTING

- **LO1-6** Identify career opportunities in accounting.

APPENDIX: CONCEPTUAL FRAMEWORK

- **LO1-7** Explain the nature of the conceptual framework used to develop generally accepted accounting principles.

SELF-STUDY MATERIALS

- Let's Review—Measuring business activities (p. 8).
- Let's Review—Communicating through financial statements (p. 17).
- Chapter Framework with questions and answers available (p. 31).
- Key Points by Learning Objective (p. 32).
- Glossary of Key Terms (p. 33).
- Self-Study Questions with answers available (p. 34).
- Videos including Concept Overview, Applying Excel, Let's Review, and Interactive Illustrations to demonstrate key topics (in Connect).

WHY STUDY ACCOUNTING? BECAUSE IT'S THE LANGUAGE OF BUSINESS

Some of you are reading this book because you are majoring in accounting, and it's obvious why you need to get a good understanding of this material. Others of you are not majoring in accounting. Perhaps you're planning a major in finance, management information systems, marketing, supply chain, or a major outside of business or just reading this book to learn more about accounting. You may be wondering if the material in this book will be important for you. To help you make that decision, consider the following.

Managers, investors, lenders, suppliers, customers, and many others make important decisions every day about a company. They make decisions related to how a company finances its operations, manages its operating costs, minimizes its risks, utilizes its resources, maintains its supply chain, and generates profits for its owners, to name just a few. To make good decisions, these individuals need timely and reliable information.

This is where accounting plays an important role in our society. The primary functions of accounting are to measure the activities of a company and communicate those measurements to help individuals make good decisions. The better the information they have, the better the decisions they'll make. Understanding accounting means understanding the *language of business*. When you speak that language, you'll be able to better communicate with others, make better decisions, help others make better decisions, and play a role in creating a more prosperous society.

You'll see in this book how accounting information helps tell a company's financial story. Telling this story involves critical thinking and professional judgment. These skills require a dynamic profession filled with individuals who are well-equipped to make business decisions and be part of any management team. Given the importance of business decisions in our society, there should be no surprise that demand for accounting information and for accountants remains strong. No matter what you choose as a major, if your goals are to make better business decisions, accounting will help you get there.

Feature Story



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PART A

ACCOUNTING AS A MEASUREMENT/ COMMUNICATION PROCESS

Welcome to accounting. A common misconception about this course is that it is a math class, much like college algebra, calculus, or business statistics. You will soon see that this is *not* a math class. Don't say to yourself, "I'm not good at math, so I probably won't be good at accounting." Though it's true that we use numbers heavily throughout each chapter, accounting is far more than adding, subtracting, and solving for unknown variables. So, what exactly is accounting? We'll take a close look at this next.

Defining Accounting

LO1-1

Describe the two primary functions of financial accounting.

Accounting is "the language of business." It's the language companies use to tell their financial story. More precisely, **accounting** is a system of maintaining records of a company's operations and communicating that information to decision makers. The earliest use of such systematic recordkeeping dates back thousands of years to when records were kept of delivered agricultural products. Using accounting to maintain a record of multiple transactions allowed for better exchange among individuals and aided in the development of more complex societies.¹ In this book, you'll learn how to read, interpret, and communicate a company's financial story using the language of business.

Millions of people every day must make informed decisions about companies. Illustration 1-1 identifies some of those people and examples of decisions they make about the companies.

ILLUSTRATION 1-1

Decisions People Make About Companies



1. **Investors** decide whether to invest in stock.
2. **Creditors** decide whether to lend money.
3. **Customers** decide whether to purchase products.
4. **Suppliers** decide the customer's ability to pay for supplies.
5. **Managers** decide production and expansion.
6. **Employees** decide employment opportunities.
7. **Competitors** decide market share and profitability.
8. **Regulators** decide on social welfare.
9. **Tax authorities** decide on taxation policies.
10. **Local communities** decide on environmental issues.

To make the decisions outlined in Illustration 1-1, these people need information. This is where accounting plays a key role. As Illustration 1-2 shows, accountants **measure the activities of the company and communicate those measurements to others**.

Accounting information that is provided for *internal* users (managers) is referred to as **managerial accounting**; that provided to *external* users is referred to as **financial accounting**. In this book, we focus on financial accounting. Formally defined, the two functions of **financial accounting** are to measure business activities of a company and then to communicate those measurements to *external* parties for decision-making purposes.

As you study the business activities discussed in this book, it is important for you to keep in mind this "framework" for financial accounting. For each activity, ask yourself

1. How is the business activity being measured?
2. How is the business activity being communicated?

¹S. Basu and G. Waymire. 2006. Recordkeeping and Human Evolution. *Accounting Horizons* 20 (3): 201-229.

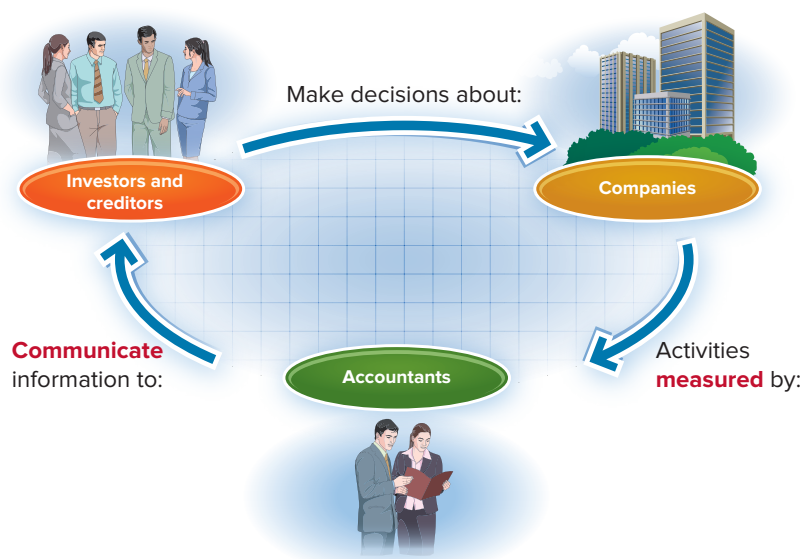


ILLUSTRATION 1-2
Framework for
Financial Accounting



These are the two functions of financial accounting. You'll better understand *why* this process exists by thinking about *how* the measurements being communicated help people make better decisions.

For example, **investors** want to make good decisions related to buying and selling their shares of the company's stock: Will the company's stock increase or decrease in value? The value of a stock is tied directly to the company's ability to make a profit, so what activities reflect the company's profitability? How should those activities be measured, and how should they be communicated in formal accounting reports?

As another example, **creditors** make decisions related to lending money to the company: Will the company be able to repay its debt and interest when they come due? How can debt activity be measured and how can it be communicated so that creditors better understand the ability of the company to have sufficient cash to repay debt and interest in the short term and the long term?



KEY POINT

The two primary functions of financial accounting are to measure business activities of a company and to communicate information about those activities to investors and creditors and other outside users for decision-making purposes.

User's Guide For learning objectives throughout this book, you will see boxed sections, like this one, titled *Key Point*. These boxed items will highlight the central focus of the learning objectives.

Measuring Business Activities

Let's first look at the typical activities of a start-up business. We'll do this with a simple example. Suppose you want to start a soccer academy. The "goal" of the academy is to provide lessons to develop junior players for top university programs and perhaps even one day to play in a professional league. Let's look at some initial activities of your new company, which you've decided to name **Eagle Soccer Academy**.

Let's assume you need about \$300,000 to get the business up and running. You don't have that amount of money to start the business, so you begin by looking for investors. With their money, **investors** buy ownership in the company and have the right to share in the company's profits. Each share of ownership is typically referred to as a share of common stock. You develop a business proposal, explaining your target customers, funds needed, expected profits, and benefits your company will bring to the community. You pitch your idea to

■ **LO1-2**

Understand the business activities that financial accounting measures.

several organizations around the city and sell 7,000 shares of common stock to investors for \$140,000 (\$20 per share). You sell 2,000 additional shares to your parents for \$40,000. You also purchase 1,000 of your own shares for \$20,000, giving you 10% ownership (1,000 shares/10,000 total shares issued). Your company has now received \$200,000 from investors.

To raise the remaining cash needed, you turn to **creditors**. Creditors lend money to a company, expecting to be paid back the loan amount plus interest. Impressed by your business proposal and ability to raise funding from investors, a local bank lends you \$100,000 with 12% annual interest, which you agree to repay within three years.

Now, with the \$300,000 of cash obtained from investors and creditors, your company buys equipment. This equipment costs \$120,000, leaving \$180,000 cash for future use. At this point, your company has the following resources that can be used for operations.

Cash	\$180,000	}	Resources
Equipment	<u>120,000</u>		
	<u><u>\$300,000</u></u>		

Who has the claims to the company's resources? Answer: The investors and creditors. Creditors have claims equal to the amount loaned to the company, \$100,000. In other words, \$100,000 of the company's resources are promised to the local bank. Investors have claims to all remaining resources, \$200,000.

Creditors (local bank)	\$100,000	}	Claims to Resources
Investors (common stock)	<u>200,000</u>		
	<u><u>\$300,000</u></u>		

We'll continue the example of Eagle Soccer Academy in more detail in a moment. For now, we can see that the company has engaged in financing and investing activities, and it will soon begin operating activities.

- **Financing activities** include transactions the company has with investors and creditors, such as issuing stock (\$200,000) and borrowing money from a local bank (\$100,000).
- **Investing activities** include transactions involving the purchase and sale of resources that are expected to benefit the company for several years, such as the purchase of equipment for \$120,000. With the necessary resources in place, the company is ready to begin operations.
- **Operating activities** will include transactions that relate to the primary operations of the company, such as providing products and services to customers and the associated costs of doing so, like rent, salaries, utilities, taxes, and advertising.

Types of Business Organizations Notice that you are both the manager and an investor of Eagle Soccer Academy. You manage the resources of the company on behalf of the owners (stockholders, in this case), while you are also an investor helping to align your interests with the other investors in the company. This is common in many start-up businesses. Mark Cuban, the owner of the Dallas Mavericks and a tech-savvy entrepreneur, refers to a manager who also owns shares in the company as having "skin in the game." Companies that issue shares of stock often form as corporations.

A **corporation** is a company that is legally separate from its owners. The advantage of being legally separate is that the stockholders have limited liability. **Limited liability** prevents stockholders from being held personally responsible for the financial obligations of the corporation. Stockholders of Eagle Soccer Academy can lose their investment of \$200,000 if the company fails, but they cannot lose any of their personal assets (such as homes, cars, computers, and furniture).

A **sole proprietorship** is a business owned by one person; a **partnership** is a business owned by two or more persons. If you had decided to start Eagle Soccer Academy without outside investors, you could have formed a sole proprietorship, or you and a friend could

have formed a partnership. However, because you did not have the necessary resources to start the business, being a sole proprietorship (or even one member of a partnership) was not a viable option. Thus, a disadvantage of selecting the sole proprietorship or partnership form of business is that owners must have sufficient personal funds to finance the business in addition to the ability to borrow money. Another disadvantage of being a sole proprietorship or partnership is that neither offers limited liability. Owners (and partners) are held personally responsible for the activities of the business.

A potential disadvantage of a corporation is *double taxation*: (1) the company first pays corporate income taxes on income it earns and (2) stockholders then pay personal income taxes when the company distributes that income as dividends to them. There are many complexities in tax laws, and these laws are subject to change. For certain types of corporations and in certain instances, corporations may pay a higher or lower overall tax rate compared to partnerships and sole proprietorships.

Because most of the largest companies in the United States are corporations, in this book we focus primarily on accounting from a corporation's perspective. Focusing on corporations also highlights the importance of financial accounting—to measure and communicate activities of a company for investors (stockholders) and creditors (lenders, such as a local bank). (A more detailed discussion of the advantages and disadvantages of a corporation is provided in Chapter 10.)

ASSETS, LIABILITIES, AND STOCKHOLDERS' EQUITY

What information would Eagle's investors and creditors be interested in knowing to determine whether their investment in the company was a good decision? **Ultimately, investors and creditors want to know about the company's resources and their claims to those resources.** Accounting uses some conventional names to describe such resources and claims.

Assets are the total resources of a company. At this point, Eagle Soccer Academy has two assets—cash of \$180,000 and equipment of \$120,000—equaling total resources of \$300,000. Of course, there are many other possible resources that a company can have, such as supplies, inventory for sale to customers, buildings, land, and investments. You'll learn about these and many other assets throughout this book.

Liabilities are amounts owed to creditors. Eagle Soccer Academy has a liability of \$100,000 to the local bank. Other examples of liabilities would be amounts owed to suppliers, employees, utility companies, and the government (in the form of taxes). Liabilities typically include claims that must be paid by a specified date.

Stockholders' equity represents the owners' claims to resources. These claims arise from two primary sources: (1) contributions by the owners themselves and (2) net resources generated by company operations. To this point, Eagle Soccer Academy has contributions from owners of \$200,000.

The **accounting equation** in Illustration 1-3 shows the relationship among the three measurement categories. The equation shows that a company's assets equal its liabilities plus stockholders' equity. Alternatively, a company's resources equal creditors' and owners' claims to those resources.

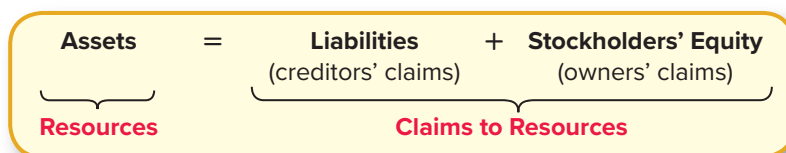


ILLUSTRATION 1-3

The Accounting Equation

The accounting equation for Eagle Soccer Academy would be

Assets	=	Liabilities	+	Stockholders' Equity
(resources)		(creditors' claims)		(owners' claims)
\$300,000	=	\$100,000	+	\$200,000

The accounting equation illustrates a fundamental model of business valuation.

The value of a company to its owners equals total resources of the company minus amounts owed to creditors. Creditors expect to receive only resources equal to the amount owed them. Stockholders, on the other hand, can claim all of the company's resources in excess of the amount owed to creditors.

REVENUES, EXPENSES, AND DIVIDENDS

Of course, all owners hope their claims to the company's resources increase over time. This increase occurs when the company makes a profit. Stockholders claim all resources in excess of amounts owed to creditors; thus, profits of the company are claimed solely by stockholders. We calculate a company's profits by comparing its revenues and expenses.

Revenues are the amounts recognized when the company sells products or provides services to customers. For example, when you or one of your employees provides soccer training to a customer, the company recognizes revenue. However, as you've probably heard, "It takes money to make money." To operate the academy, you'll encounter many costs.

Expenses are the costs of providing products and services and other business activities during the current period. For example, to operate the soccer academy, you'll have costs related to salaries, rent, supplies, and utilities. These are typical expenses of most companies.

Net income is the difference between revenues and expenses. All businesses want revenues to be greater than expenses, producing a positive net income and adding to stockholders' equity in the business. However, if expenses exceed revenues, as happens from time to time, the difference between them is a negative amount—a **net loss**.

You'll notice the use of the term *net* to describe a company's profitability. In business, the term *net* is used often to describe the difference between two amounts. Here, we measure revenues *net* of (or minus) expenses, to calculate the net income or net loss. If we assume that by the end of the first month of operations Eagle Soccer Academy has total revenues of \$72,000 and total expenses of \$58,000, then we would say that the company has *net income* of \$14,000 for the month.

Dividends are cash payments to stockholders. We just saw that the first month of operations of Eagle Soccer Academy generated net income of \$14,000. From these profits, let's suppose the company decides to make a cash payment of \$4,000 to stockholders. The remaining \$10,000 of profits are retained in the company to help grow future operations. Thus, when Eagle has net income of \$14,000, stockholders receive a total benefit of \$14,000, equal to \$4,000 of dividends received and \$10,000 retained in the company they own.

Dividends Are Not an Expense. Recall earlier we defined expenses as the costs necessary to run the business to produce revenues. Dividends, on the other hand, are not costs related to providing products and services to *customers*; dividends are distributions (most often cash) to the *owners* of the company—the stockholders.

Common Terms
Other common names for net income include *earnings* or *profit*.

Let's Review

Match the term with the appropriate definition.

- | | |
|-------------------------------|--|
| 1. _____ Assets | a. Costs of selling products or services. |
| 2. _____ Liabilities | b. Sales of products or services to customers. |
| 3. _____ Stockholders' Equity | c. Amounts owed. |
| 4. _____ Dividends | d. Distributions to stockholders. |
| 5. _____ Revenues | e. Owners' claims to resources. |
| 6. _____ Expenses | f. Resources of a company. |

Solution:

1. f; 2. c; 3. e; 4. d; 5. b; 6. a

User's Guide *Let's Review* exercises test your comprehension of key concepts covered in the chapter text.

Suggested Homework:

BE1–4;
E1–2, E1–3;
P1–2A&B

In summary, the measurement role of accounting is to create a record of the activities of a company. To make this possible, a company must maintain an accurate record of its assets, liabilities, stockholders' equity, revenues, expenses, and dividends. Be sure you understand the meaning of these items. We will refer to them throughout this book. Illustration 1-4 summarizes the business activities and the categories that measure them.

Activities Related to:	Measurement Category	Relationship
<ul style="list-style-type: none"> Resources of the company Amounts owed Stockholders' investment 	<ul style="list-style-type: none"> Assets Liabilities Stockholders' equity 	Accounting Equation $(A = L + SE)$
<ul style="list-style-type: none"> Distributions to stockholders 	<ul style="list-style-type: none"> Dividends 	
<ul style="list-style-type: none"> Sales of products or services Costs of providing sales 	<ul style="list-style-type: none"> Revenues Expenses 	Net Income $(R - E = NI)$

ILLUSTRATION 1-4
 Business Activities and Their Measurement



KEY POINT

The measurement role of accounting is to create a record of the activities of a company. To make this possible, a company must maintain an accurate record of its assets, liabilities, stockholders' equity, revenues, expenses, and dividends.

As you learn to measure business activities, you will often find it helpful to consider both sides of the transaction: When someone pays cash, someone else receives cash; when someone borrows money, another lends money. Likewise, an expense for one company can be a revenue for another company; one company's asset can be another company's liability. Throughout this book, you will find discussions of the "flip side" of certain transactions, indicated by the icon you see here. In addition, certain homework problems, also marked by the icon, will ask you specifically to address the "flip side" in your computations. (See Exercise 1-2 and its flip side in Exercise 1-3 for the first such example.)



Flip Side

Communicating through Financial Statements

We've discussed that different business activities produce assets, liabilities, stockholders' equity, dividends, revenues, and expenses, and that the first important role of financial accounting is to *measure* the relevant transactions of a company. Its second vital role is to *communicate* these business activities to those outside the company. The primary means of communicating business activities is through financial statements.

Financial statements are periodic reports published by the company for the purpose of providing information to external users. There are four primary financial statements:

1. Income statement
2. Statement of stockholders' equity
3. Balance sheet
4. Statement of cash flows

These financial statements give investors and creditors the key information they need when making decisions about a company: Should I buy the company's stock? Should I lend money to the company? Is management efficiently operating the company? **Without these financial statements, it would be difficult for those outside the company to see what's going on inside.**

Let's go through a simple set of financial statements to see what they look like. We'll continue with our example of Eagle Soccer Academy. Actual companies' financial statements often report items you haven't yet encountered. However, because actual companies'

■ **LO1-3**
 Determine how financial accounting information is communicated through financial statements.