

A photograph of several sailboats racing on the ocean. The sails are large and feature bold, geometric patterns in yellow, blue, and white. The boats are moving quickly, creating white spray in the water. The sky is clear and blue.

weygandt
kimmel
kieso

team for success

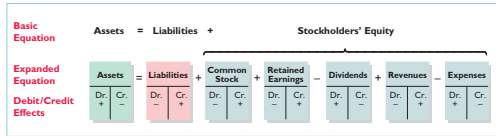
FINANCIAL ACCOUNTING

SEVENTH EDITION

RAPID REVIEW

Chapter Content

BASIC ACCOUNTING EQUATION (Chapter 2)



ADJUSTING ENTRIES (Chapter 3)

Type	Adjusting Entry		
Deferrals	1. Prepaid expenses	Dr. Expenses	Cr. Assets
	2. Unearned revenues	Dr. Liabilities	Cr. Revenues
Accruals	1. Accrued revenues	Dr. Assets	Cr. Revenues
	2. Accrued expenses	Dr. Expenses	Cr. Liabilities

Note: Each adjusting entry will affect one or more income statement accounts and one or more balance sheet accounts.

Interest Computation

Interest = Face value of note × Annual interest rate × Time in terms of one year

CLOSING ENTRIES (Chapter 4)

Purpose: (1) Update the Retained Earnings account in the ledger by transferring net income (loss) and dividends to retained earnings. (2) Prepare the temporary accounts (revenue, expense, dividends) for the next period's postings by reducing their balances to zero.

Process

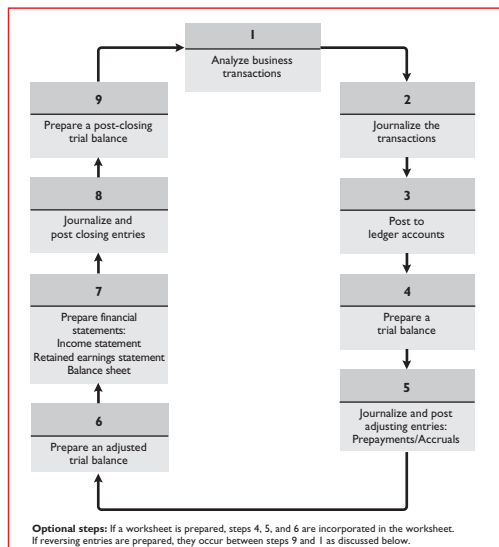
- Debit each revenue account for its balance (assuming normal balances), and credit Income Summary for total revenues.
- Debit Income Summary for total expenses, and credit each expense account for its balance (assuming normal balances).

STOP AND CHECK: Does the balance in your Income Summary Account equal the net income (loss) reported in the income statement?

- Debit (credit) Income Summary, and credit (debit) Retained Earnings for the amount of net income (loss).
- Debit Retained Earnings for the balance in the Dividends account and credit Dividends for the same amount.

STOP AND CHECK: Does the balance in your Retained Earnings account equal the ending balance reported in the balance sheet and the retained earnings statement? Are all of your temporary account balances zero?

ACCOUNTING CYCLE (Chapter 4)



INVENTORY (Chapters 5 and 6)

Ownership

Freight Terms	Ownership of goods on public carrier resides with:	Who pays freight costs:
FOB shipping point	Buyer	Buyer
FOB destination	Seller	Seller

Perpetual vs. Periodic Journal Entries

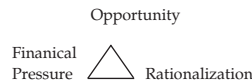
Event	Perpetual	Periodic*
Purchase of goods	Inventory Cash (A/P)	Purchases Cash (A/P)
Freight (shipping point)	Inventory Cash	Freight-In Cash
Return of goods	Cash (or A/P) Inventory	Cash (or A/P) Purchase Returns and Allowances
Sale of goods	Cash (or A/R) Sales Cost of Goods Sold Inventory	Cash (or A/R) Sales No entry
End of period	No entry	Closing or adjusting entry required

Cost Flow Methods

- Specific identification
- First-in, first-out (FIFO)
- Weighted-average
- Last-in, first-out (LIFO)

FRAUD, INTERNAL CONTROL, AND CASH (Chapter 7)

The Fraud Triangle



Principles of Internal Control Activities

- Establishment of responsibility
- Segregation of duties
- Documentation procedures
- Physical controls
- Independent internal verification
- Human resource controls

Bank Reconciliation

Bank	Books
Balance per bank statement	Balance per books
Add: Deposit in transit	Add: Unrecorded credit memoranda from bank statement
Deduct: Outstanding checks	Deduct: Unrecorded debit memoranda from bank statement
Adjusted cash balance	Adjusted cash balance

- Note: 1. Errors should be offset (added or deducted) on the side that made the error.
2. Adjusting journal entries should only be made on the books.

RECEIVABLES (Chapter 8)

Methods to Account for Uncollectible Accounts

Direct write-off method	Record bad debts expense when the company determines a particular account to be uncollectible.
Allowance methods: Percentage-of-sales	At the end of each period estimate the amount of credit sales uncollectible. Debit Bad Debts Expense and credit Allowance for Doubtful Accounts for this amount. As specific accounts become uncollectible, debit Allowance for Doubtful Accounts and credit Accounts Receivable.
Percentage-of-receivables	At the end of each period estimate the amount of uncollectible receivables. Debit Bad Debts Expense and credit Allowance for Doubtful Accounts in an amount that results in a balance in the allowance account equal to the estimate of uncollectibles. As specific accounts become uncollectible, debit Allowance for Doubtful Accounts and credit Accounts Receivable.

RAPID REVIEW

Chapter Content

PLANT ASSETS (Chapter 9)

Presentation

Tangible Assets	Intangible Assets
Property, plant, and equipment	Intangible assets (patents, copyrights, trademarks, franchises, goodwill)
Natural resources	

Computation of Annual Depreciation Expense

Straight-line	$\frac{\text{Cost} - \text{Salvage value}}{\text{Useful life (in years)}}$
Units-of-activity	$\frac{\text{Depreciable cost}}{\text{Useful life (in units)}} \times \text{Units of activity during year}$
Declining-balance	Book value at beginning of year \times Declining balance rate* *Declining-balance rate = $1 \div \text{Useful life (in years)}$

Note: If depreciation is calculated for partial periods, the straight-line and declining-balance methods must be adjusted for the relevant proportion of the year. Multiply the annual depreciation expense by the number of months expired in the year divided by 12 months.

BONDS (Chapter 10)

Premium	Market interest rate < Contractual interest rate
Face Value	Market interest rate = Contractual interest rate
Discount	Market interest rate > Contractual interest rate

Computation of Annual Bond Interest Expense

Interest expense = Interest paid (payable) + Amortization of discount
(OR - Amortization of premium)

Straight-line amortization	$\frac{\text{Bond discount (premium)}}{\text{Number of interest periods}}$	
Effective-interest amortization (preferred method)	Bond interest expense	Bond interest paid
	Carrying value of bonds at beginning of period \times Effective interest rate	Face amount of bonds \times Contractual interest rate

STOCKHOLDERS' EQUITY (Chapter 11)

No-Par Value vs. Par Value Stock Journal Entries

No-Par Value	Par Value
Cash Common Stock	Cash Common Stock (par value) Paid-in Capital in Excess of Par Value

Comparison of Dividend Effects

	Cash	Common Stock	Retained Earnings
Cash dividend	↓	No effect	↓
Stock dividend	No effect	↑	↓
Stock split	No effect	No effect	No effect

Debits and Credits to Retained Earnings

Retained Earnings	
Debits (Decreases)	Credits (Increases)
1. Net loss 2. Prior period adjustments for overstatement of net income 3. Cash dividends and stock dividends 4. Some disposals of treasury stock	1. Net income 2. Prior period adjustments for understatement of net income

INVESTMENTS (Chapter 12)

Comparison of Long-Term Bond Investment and Liability Journal Entries

Event	Investor	Investee
Purchase / issue of bonds	Debt Investments Cash	Cash Bonds Payable
Interest receipt / payment	Cash Interest Revenue	Interest Expense Cash

Comparison of Cost and Equity Methods of Accounting for Long-Term Stock Investments

Event	Cost	Equity
Acquisition	Stock Investments Cash	Stock Investments Cash
Investee reports earnings	No entry	Stock Investments Investment Revenue
Investee pays dividends	Cash Dividend Revenue	Cash Stock Investments

Trading and Available-for-Sale Securities

Trading	Report at fair value with changes reported in net income.
Available-for-sale	Report at fair value with changes reported in the stockholders' equity section.

STATEMENT OF CASH FLOWS (Chapter 13)

Cash flows from operating activities (indirect method)

Net income		
Add:	Losses on disposals of assets	\$ X
	Amortization and depreciation	X
	Decreases in noncash current assets	X
	Increases in current liabilities	X
Deduct:	Gains on disposals of assets	(X)
	Increases in noncash current assets	(X)
	Decreases in current liabilities	(X)
Net cash provided (used) by operating activities		\$ X

Cash flows from operating activities (direct method)

Cash receipts		
(Examples: from sales of goods and services to customers, from receipts of interest and dividends on loans and investments)		\$ X
Cash payments		
(Examples: to suppliers, for operating expenses, for interest, for taxes)	(X)	
Cash provided (used) by operating activities		\$ X

PRESENTATION OF NON-TYPICAL ITEMS (Chapter 14)

Prior period adjustments (Chapter 11)	Statement of retained earnings (adjustment of beginning retained earnings)
Discontinued operations	Income statement (presented separately after "Income from continuing operations")
Extraordinary items	Income statement (presented separately after "Income before extraordinary items")
Changes in accounting principle	In most instances, use the new method in current period and restate previous years results using new method. For changes in depreciation and amortization methods, use the new method in the current period, but do not restate previous periods.



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Jerry J. Weygandt PhD, CPA; Paul D. Kimmel, PhD, CPA;
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weygandt
kimmel
kieso
team for success

Jerry J. Weygandt PhD, CPA

University of Wisconsin—Madison
Madison, Wisconsin

Paul D. Kimmel PhD, CPA

University of Wisconsin—Milwaukee
Milwaukee, Wisconsin

Donald E. Kieso PhD, CPA

Northern Illinois University
DeKalb, Illinois



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the concepts.”

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Santa Clara University

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Jerry Weygandt

Jerry J. Weygandt, PhD, CPA, is Arthur Andersen Alumni Professor of Accounting at the University of Wisconsin—Madison. He holds a Ph.D. in accounting from the University of Illinois. Articles by Professor Weygandt have appeared in the *Accounting Review*, *Journal of Accounting Research*, *Accounting Horizons*, *Journal of Accountancy*, and other academic and professional journals. These articles have examined such financial reporting issues as accounting for price-level adjustments, pensions, convertible securities, stock option contracts, and interim reports. Professor Weygandt is author of other accounting and financial reporting books and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Wisconsin Society of Certified Public Accountants. He has served on numerous committees of the American Accounting Association and as a member of the editorial board of the *Accounting Review*; he also has served as President and Secretary-Treasurer of the American Accounting Association. In addition, he has been actively involved with the American Institute of Certified Public Accountants and has been a member of the Accounting Standards Executive Committee (AcSEC) of that organization. He has served on the FASB task force that examined the reporting issues related to accounting for income taxes and served as a trustee of the Financial Accounting Foundation. Professor Weygandt has received the Chancellor's Award for Excellence in Teaching and the Beta Gamma Sigma Dean's Teaching Award. He is on the board of directors of M & I Bank of Southern Wisconsin. He is the recipient of the Wisconsin Institute of CPA's Outstanding Educator's Award and the Lifetime Achievement Award. In 2001 he received the American Accounting Association's Outstanding Educator Award.



Paul Kimmel

Paul D. Kimmel, PhD, CPA, received his bachelor's degree from the University of Minnesota and his doctorate in accounting from the University of Wisconsin. He is an Associate Professor at the University of Wisconsin—Milwaukee, and has public accounting experience with Deloitte & Touche (Minneapolis). He was the recipient of the UWM School of Business Advisory Council Teaching Award, the Reggie Taite Excellence in Teaching Award and a three-time winner of the Outstanding Teaching Assistant Award at the University of Wisconsin. He is also a recipient of the Elijah Watts Sells Award for Honorary Distinction for his results on the CPA exam. He is a member of the American Accounting Association and the Institute of Management Accountants and has published articles in *Accounting Review*, *Accounting Horizons*, *Advances in Management Accounting*, *Managerial Finance*, *Issues in Accounting Education*, *Journal of Accounting Education*, as well as other journals. His research interests include accounting for financial instruments and innovation in accounting education. He has published papers and given numerous talks on incorporating critical thinking into accounting education, and helped prepare a catalog of critical thinking resources for the Federated Schools of Accountancy.



Don Kieso

Donald E. Kieso, PhD, CPA, received his bachelor's degree from Aurora University and his doctorate in accounting from the University of Illinois. He has served as chairman of the Department of Accountancy and is currently the KPMG Emeritus Professor of Accountancy at Northern Illinois University. He has public accounting experience with Price Waterhouse & Co. (San Francisco and Chicago) and Arthur Andersen & Co. (Chicago) and research experience with the Research Division of the American Institute of Certified Public Accountants (New York). He has done post doctorate work as a Visiting Scholar at the University of California at Berkeley and is a recipient of NIU's Teaching Excellence Award and four Golden Apple Teaching Awards. Professor Kieso is the author of other accounting and business books and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Illinois CPA Society. He has served as a member of the Board of Directors of the Illinois CPA Society, then AACSB's Accounting Accreditation Committees, the State of Illinois Comptroller's Commission, as Secretary-Treasurer of the Federation of Schools of Accountancy, and as Secretary-Treasurer of the American Accounting Association. Professor Kieso is currently serving on the Board of Trustees and Executive Committee of Aurora University, as a member of the Board of Directors of Kishwaukee Community Hospital, and as Treasurer and Director of Valley West Community Hospital. From 1989 to 1993 he served as a charter member of the national Accounting Education Change Commission. He is the recipient of the Outstanding Accounting Educator Award from the Illinois CPA Society, the FSA's Joseph A. Silvano Award of Merit, the NIU Foundation's Humanitarian Award for Service to Higher Education, a Distinguished Service Award from the Illinois CPA Society, and in 2003 an honorary doctorate from Aurora University.

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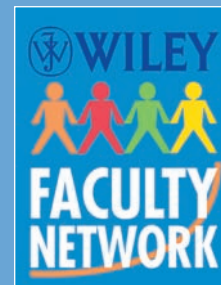
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Enhanced Homework Material

In each chapter we have expanded the number of Self-Study Questions, added three to four additional new Exercises, and revised the Brief Exercises and Problems. New *Challenge Problems* are available online at www.wiley.com/college/wegandt and offer another resource for students to practice chapter concepts. Financial analysis and reporting problems have been updated in accordance with the new **PepsiCo** and **Coca-Cola Company** financial statements.

Chapter Content Updates

Chapter One now subdivides owner's equity into Capital Drawing, Revenue, and Expense accounts. The transaction analyses use this expanded accounting equation to show the cause for the differing effects on owner's equity.

Chapter Seven's fraud and internal control section has been completely reworked to better explain what fraud is and why fraud occurs. A series of case vignettes are provided to highlight specific real-world frauds and explain how use of the proper internal control activities might have prevented or allowed for earlier fraud detection.

Online Chapter

In order to ensure the most current material on GAAP available, we have placed the previous chapter on *Accounting Principles*, now Chapter Fifteen, on the book's companion website (www.wiley.com/college/wegandt).

Updated International Financial Reporting Standards (IFRS) Content

As we continue to strive to reflect the constant changes in the accounting environment, we have added new material on International Financial Reporting Standards (IFRS). At the end of this Preface, we have included an introduction and overview of the similarities and differences between IFRS and U.S. generally accepted accounting principles (GAAP). A new appendix that analyzes the impact of IFRS on the individual chapters of this textbook, including specific page references, has also been added to the end of the textbook. For additional information, visit www.wileyifrs.com. Finally, new FASB Codification Activities now appear at the end of every chapter and offer students experience in using this system.

This edition was also subject to an overall, comprehensive revision to ensure that it is technically accurate, relevant, and up-to-date. A chapter-by-chapter summary of content changes is provided in the chart on the next page.

Chapter 1 Accounting in Action

- New section on GAAP
- New *International Note* on IFRS
- 4 New *Do it!* boxes and Review Exercises
- 1 New Comprehensive Problem
- 5 New Self-Study Questions

Chapter 2 The Recording Process

- New *International Note* on Double Entry Accounting System
- 4 New *Do it!* boxes and Review Exercises
- 1 New Comprehensive Problem
- 5 New Self-Study Questions

Chapter 3 Adjusting the Accounts

- Updated real-company classified balance sheet presentations
- New *International Note*
- 4 New *Do it!* boxes and Review Exercises
- 1 New Comprehensive Problem
- 5 New Self-Study Questions

Chapter 4 Completing the Accounting Cycle

- Updated real-company classified balance sheet presentations
- New *International Note*
- 4 New *Do it!* boxes and Review Exercises
- 1 New Comprehensive Problem
- 5 New Self-Study Questions

Chapter 5 Accounting for Merchandising Operations

- New section on “Flow of Costs”
- New “Shipping Terms” illustration
- New journal entry in “Adjusting Entries” section
- New *International Note*
- 4 New *Do it!* boxes and Review Exercises
- 1 New Comprehensive Problem
- 2 New Self-Study Questions

Chapter 6 Inventories

- 4 New *Do it!* boxes and Review Exercises
- 2 New Comprehensive Problems
- 4 New Self-Study Questions

Chapter 7 Fraud, Internal Control, and Cash

- New section on “Fraud”
- Revised section on “Internal Control”
- 4 New *Do it!* boxes and Review Exercises
- 1 New Comprehensive Problem
- 5 New Self-Study Questions

Chapter 8 Accounting for Receivables

- 4 New *Do it!* boxes and Review Exercises
- 1 New Comprehensive Problem
- 5 New Self-Study Questions

Chapter 9 Plant Assets, Natural Resources, and Intangible Assets

- 4 New *Do it!* boxes and Review Exercises
- 2 New Comprehensive Problems
- 5 New Self-Study Questions

Chapter 10 Liabilities

- 5 New *Do it!* boxes and Review Exercises
- 2 New Comprehensive Problems
- 5 New Self-Study Questions

Chapter 11 Corporations: Organizations, Stock Transactions, Dividends, and Retained Earnings

- Updated *Investor Insight* box
- 8 New *Do it!* boxes and Review Exercises
- 1 New Comprehensive Problem
- 4 New Self-Study Questions

Chapter 12 Investments

- New *Ethics* and *International Notes*
- Updated *Accounting Across the Organization* box
- 4 New *Do it!* boxes and Review Exercises
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- 5 New Self-Study Questions

Chapter 13 Statement of Cash Flows

- 5 New *Do it!* boxes and Review Exercises
- 2 New Comprehensive Problems
- 5 New Self-Study Questions

Chapter 14 Financial Statement Analysis

- New Feature Story
- New *Ethics* and *International Notes*
- 4 New *Do it!* boxes and Review Exercises
- 1 New Comprehensive Problem
- 5 New Self-Study Questions

Chapter 15 Accounting Principles

(available online at www.wiley.com/college/weygandt)

- Content updated with the most current FASB pronouncements concerning GAAP

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Reviewers and Virtual Focus Group Participants

John Ahmad
Northern Virginia Community College—Annandale

Colin Battle
Beverly Beatty
Jaswinder Bhargal
Leroy Bugger
Ann Cardozo
Kimberly Charland
Lisa Cole
Kathy Crusto-Way
Robin D'Agati
Karl E. Dahlberg
Tony Dellarte
Pam Donahue
Kathy Dunne
Dora Estes
Mary Falkey
Lori Grady
Joyce Griffin
Lester Hall
Becky Hancock
Audrey Hunter
Donna Johnston-Blair
Naomi Karolinski
Kenneth Koerber
Sandra Lang
Cathy Xanthaky Larsen
David Laurel
Michael Lawrence
Pamela Legner
Suneel Maheshwari
Lori Major
Jim Martin
Evelyn McDowell
Glenn Pate
Yvonne Phang
Mike Prockton
Jessica Rakow
Richard Sarkisian
Mark Savitskie
Beth Secrest
William Serafin
Walter Silva
Lois Slutsky
Frank Stangota
Dennis Stovall
Shafi Ullah
Broward Community College
Broward Community College
Anne Arundel Community College
Chabot College
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Wayne State University
Walsh University
Community College of Allegheny County
Massachusetts Bay Community College
Broward Community College
Rutgers State University
Grand Valley State University
Broward Community College

Patricia Walczack
Kenton Walker
Patricia Wall
Xiao-Jun Zhang
Lansing Community College
University of Wyoming
Middle Tennessee State University
UC Berkley

Ancillary Authors, Contributors, and Proofers

LuAnn Bean, *Florida Institute of Technology*
accuracy review

Cynthia Birk, *University of Nevada, Reno*
accuracy review

Jack Borke, *University of Wisconsin—Platteville*
challenge exercise author

Kimberly Brickler, *Lindenwood University*
accuracy review

Larry Falcetto, *Emporia State University*
instructor manual, test bank author,
accuracy review

Lance Fisher, *Oklahoma State University*
accuracy review

Mark Gleason, *Metropolitan State University*
online quizzing

Coby Harmon, *University of California—Santa Barbara*
PowerPoint

Douglas Kieso, *Aura University*
Study Guide

Kirk Lynch, *Sandhills Community College*
accuracy review

Laura McNally
WileyPLUS author

Jill Misuraca, *Central Connecticut State University*
accuracy review

Patricia Mounce, *University of Central Arkansas*
accuracy review

Barbara Muller, *Arizona State University*
accuracy review

Rex Schildhouse, *San Diego Community College—Miramar*—Excel workbook, accuracy review

Lynn Stallworth, *Appalachian State University*
accuracy review

Dick Wasson, *San Diego State University*
working papers author, accuracy review

Andrea Weickgennant, *Xavier University*
accuracy review

Bernie Weinrich, *Lindenwood University*
accuracy review

Melanie Yon
WileyPLUS author

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Jerry J. Weygandt
Madison, Wisconsin

Paul D. Kimmel
Milwaukee, Wisconsin

Donald E. Kieso
DeKalb, Illinois



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What TYPE of learner are you?

Understanding each of these basic learning styles enables the authors to engage students' minds and motivate them to do their best work, ultimately improving the experience for both students and faculty.

	Intake: To take in the information	To make a study package	Text features that may help you the most	Output: To do well on exams
VISUAL	<ul style="list-style-type: none"> • Pay close attention to charts, drawings, and handouts your instructors use. • Underline. • Use different colors. • Use symbols, flow charts, graphs, different arrangements on the page, white spaces. 	<p>Convert your lecture notes into "page pictures."</p> <p>To do this:</p> <ul style="list-style-type: none"> • Use the "Intake" strategies. • Reconstruct images in different ways. • Redraw pages from memory. • Replace words with symbols and initials. • Look at your pages. 	<p>The Navigator/Feature Story/Preview Infographics/Illustrations Accounting equation analyses Highlighted words Graph in All About You Comprehensive Do it! Problem/ Action Plan Questions/Exercises/Problems Financial Reporting Problem Comparative Analysis Problem Exploring the Web</p>	<ul style="list-style-type: none"> • Recall your "page pictures." • Draw diagrams where appropriate. • Practice turning your visuals back into words.
AURAL	<ul style="list-style-type: none"> • Attend lectures and tutorials. • Discuss topics with students and instructors. • Explain new ideas to other people. • Use a tape recorder. • Leave spaces in your lecture notes for later recall. • Describe overheads, pictures, and visuals to somebody who was not in class. 	<p>You may take poor notes because you prefer to listen. Therefore:</p> <ul style="list-style-type: none"> • Expand your notes by talking with others and with information from your textbook. • Tape-record summarized notes and listen. • Read summarized notes out loud. • Explain your notes to another "aural" person. 	<p>Preview Insight Boxes Do it! Action Plan "What Do You Think?" in All About You Summary of Study Objectives Glossary Comprehensive Do it! Problem/Action Plan Self-Study Questions Questions/Exercises/Problems Financial Reporting Problem Comparative Analysis Problem Exploring the Web Decision Making Across the Organization</p>	<p>Communication Activity Ethics Case</p> <ul style="list-style-type: none"> • Talk with the instructor. • Spend time in quiet places recalling the ideas. • Practice writing answers to old exam questions. • Say your answers out loud.
READING/ WRITING	<ul style="list-style-type: none"> • Use lists and headings. • Use dictionaries, glossaries, and definitions. • Read handouts, textbooks, and supplementary library readings. • Use lecture notes. 	<ul style="list-style-type: none"> • Write out words again and again. • Reread notes silently. • Rewrite ideas and principles into other words. • Turn charts, diagrams, and other illustrations into statements. 	<p>The Navigator/Feature Story/Study Objectives/Preview Do it! Action Plan Summary of Study Objectives Glossary/Self-Study Questions Questions/Exercises/Problems Writing Problems Financial Reporting Problem Comparative Analysis Problem "All About You" Activity Exploring the Web Decision Making Across the Organization Communication Activity</p>	<ul style="list-style-type: none"> • Write exam answers. • Practice with multiple-choice questions. • Write paragraphs, beginnings and endings. • Write your lists in outline form. • Arrange your words into hierarchies and points.
KINESTHETIC	<ul style="list-style-type: none"> • Use all your senses. • Go to labs, take field trips. • Listen to real-life examples. • Pay attention to applications. • Use hands-on approaches. • Use trial-and-error methods. 	<p>You may take poor notes because topics do not seem concrete or relevant. Therefore:</p> <ul style="list-style-type: none"> • Put examples in your summaries. • Use case studies and applications to help with principles and abstract concepts. • Talk about your notes with another "kinesthetic" person. • Use pictures and photographs that illustrate an idea. 	<p>The Navigator/Feature Story/Preview Infographics/Illustrations Do it! Action Plan Summary of Study Objectives Comprehensive Do it! Problem/ Action Plan Self-Study Questions Questions/Exercises/Problems Financial Reporting Problem Comparative Analysis Problem Exploring the Web Decision Making Across the Organization Communication Activity "All About You" Activity</p>	<ul style="list-style-type: none"> • Write practice answers. • Role-play the exam situation.

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The Instructor's Resource CD (IRCD) contains an electronic version of all instructor supplements. The IRCD gives you the flexibility to access and prepare instructional materials based on your individual needs.

Solutions Manual.

The Solutions Manual contains detailed solutions to all questions, brief exercises, exercises, and problems in the textbook as well as suggested answers to the questions and cases.

Solution Transparencies.

The solution transparencies feature detailed solutions to brief exercises, exercises, problems, and "Broadening Your Perspectives" activities. Transparencies can be easily ordered from the Instructor's Book Companion Site at www.wiley.com/college/veygandt.

Instructor's Manual.

Included in each chapter are lecture outlines with teaching tips, chapter reviews, illustrations, and review quizzes.

Teaching Transparencies.

The teaching transparencies are 4-color acetate images of the illustrations found in the Instructor's Manual. Transparencies can be easily ordered from the Instructor's Book Companion Site at www.wiley.com/college/veygandt.

Test Bank.

With over 400 new questions, the test bank allows instructors to tailor examinations according to study objectives and Bloom's taxonomy. Achievement tests, comprehensive examinations, and a final exam are included.

Algorithmic Computerized Test Bank.

The algorithmic feature of the new computerized test bank allows instructors to assign different values to a particular question, add questions, scramble the order of questions, and scramble the order of possible answers in multiple-choice questions.

PowerPoint™ Presentation Material.

The new PowerPoint™ presentations contain a combination of key concepts, images and problems from the textbook. Review exercises and "All About You" summaries are included in each chapter to encourage classroom participation.

WebCT and Desire2Learn.

WebCT or Desire2Learn offer an integrated set of course management tools that enable instructors to easily design, develop, and manage Web-based and Web-enhanced courses.

For Students

Book Companion Site

The *Financial Accounting* student website provides a wealth of support materials that will help students develop their conceptual understanding of class material and increase their ability to solve problems. On this website students will find Excel templates, PowerPoint presentations, web quizzing, and other resources. In addition, students can access the new B Exercises, Challenge Exercises, and C Problems at this site. Finally, full versions of the Waterways Continuing Problem are included at the student website. Besides showing the data needed to complete these exercises, the website offers Excel templates that encourage completion of the Waterways problem tasks.

Active-Learning Aids

The *Financial Accounting* Website.

The book's website at www.wiley.com/college/wegandt provides a wealth of materials that will help you develop a conceptual understanding and increase your ability to solve problems. For example, you will find PowerPoint™ presentations and web quizzing.

Working Papers.

Working papers are partially completed accounting forms (templates) for all end-of-chapter brief exercises, exercises, problems, and cases. They are a convenient resource for organizing and completing homework assignments, and they demonstrate how to correctly set up solution formats. Also available on CD-ROM and within WileyPLUS is an electronic version of the print working papers, which are Excel-formatted templates that will help you learn to properly format and present end-of-chapter textbook solutions.

Study Guide.

The Study Guide is a comprehensive review of accounting. It guides you through chapter content, tied to study objectives. Each chapter of the Study Guide includes a chapter review (20 to 30 key points); a demonstration problem; and for extra practice, true/false, multiple-choice, and matching questions, and additional exercises, with solutions. The Study Guide is an excellent tool for use on a regular basis during the course and also when preparing for exams.

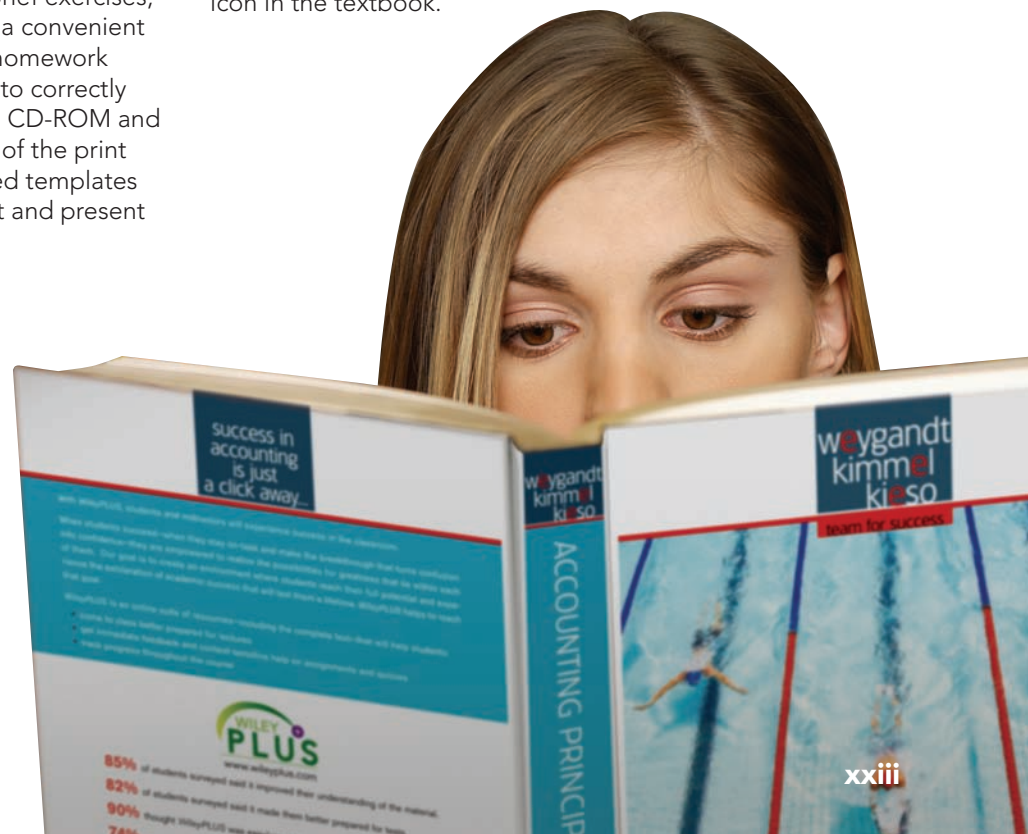
Problem-Solving Survival Guide.

This tutorial is designed to improve your success rates in solving homework assignments and exam questions. Each chapter includes an overview of key topics; a purpose statement and link to study objectives for each homework assignment; numerous review tips to alert you to common pitfalls and misconceptions; and reminders to concepts and principles. Multiple-choice exercises and cases similar to common homework assignments or exam questions enhance your problem-solving proficiency. Solutions not only explain answers but also discuss an approach to similar types of accounting problems.

Solving Managerial

Accounting Problems Using Excel.

This online manual and collection of Excel templates allow students to complete select end-of-chapter exercises and problems identified by a spreadsheet icon in the textbook.



Student Owner's Manual

How to Use the Study Aids in This Book

Helpful Hints in the margins further clarify concepts being discussed. They are like having an instructor with you as you read.

Fair Value Principle. The **fair value principle** indicates that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability). Fair value information may be more useful than historical cost for certain types of assets and liabilities. For example, certain investment securities are reported at fair value because market value information is often readily available for these types of assets. In choosing between cost and fair value, the FASB uses two qualities that make accounting information useful for decision making—relevance and faithful representation. In determining which measurement principle to use, the FASB weighs the factual nature of cost figures versus the relevance of fair value. In general, the FASB indicates that most assets must follow the cost principle because market values are not representationally faithful. Only in situations where assets are actively traded, such as investment securities, is the fair value principle applied.

Helpful Hints further clarify concepts being discussed.

HELPFUL HINT
Relevance and faithful representation are two primary qualities that make accounting information useful for decision making.

10 Chapter 1 Accounting in Action

This assumption prevents the inclusion of some relevant information in the accounting records. For example, the health of a company's owner, the quality of service, and the morale of employees are not included. The reason: Companies cannot quantify this information in money terms. Though this information is important, companies record only events that can be measured in money.

ETHICS NOTE
The importance of the economic entity assumption is illustrated by scandals involving Adelphia. In this case, senior company employees entered into transactions that blurred the line between the employees' financial interests and those of the company. For example, Adelphia guaranteed over \$2 billion of loans to the founding family.

ECONOMIC ENTITY ASSUMPTION
An economic entity can be any organization or unit in society. It may be a company (such as Crocs, Inc.), a governmental unit (the state of Ohio), a municipality (Seattle), a school district (St. Louis District 48), or a church (Southern Baptist). The economic entity assumption requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other organizations. For example, the personal expenses of Sally's Boutique, must be kept separate from the Boutique's business expenses.

The Building Blocks of Accounting 9

INTERNATIONAL NOTE
Over 100 countries use international financial reporting standards (IFRS). For example, all companies in the European Union follow international standards. The differences between U.S. and international standards are not generally significant. In this book, we highlight any major differences using International Notes like this one. We provide an extensive discussion of how IFRS relates to accounting principles in the IFRS appendix at the end of the textbook.

Board (IASB) issues international financial reporting standards (IFRS) that have been adopted in many countries. The Board (IASB) issues international financial reporting standards (IFRS) that have been adopted in many countries. The Board (IASB) issues international financial reporting standards (IFRS) that have been adopted in many countries.

Assumptions

Ethics Notes and International Notes point out ethical and international points related to the nearby text discussion.

Insight examples give you more glimpses into how actual companies make decisions using accounting information. These high-interest boxes focus on various themes—ethics, international, and investor concerns.

A **critical thinking question** asks you to apply your accounting learning to the story in the example. *Guideline Answers* appear at the end of the chapter.

INVESTOR INSIGHT


How to Read Stock Quotes


The volume of trading on national and international exchanges is heavy. Shares in excess of a billion are often traded daily on the New York Stock Exchange (NYSE) alone. For each listed stock, the *Wall Street Journal* and other financial media report the total volume of stock traded for a given day, the high and low price for the day, the closing market price, and the net change for the day. A recent stock quote for PepsiCo, listed on the NYSE under the ticker symbol PEP, is shown below.

Stock	Volume	High	Low	Close	Net Change
PepsiCo	4,305,600	60.30	59.32	60.02	+0.41


These numbers indicate that PepsiCo's trading volume was 4,305,600 shares. The high, low, and closing prices for that date were \$60.30, \$59.32, and \$60.02, respectively. The net change for the day was an increase of \$0.41 per share.

? For stocks traded on organized stock exchanges, how are the dollar prices per share established? What factors might influence the price of shares in the marketplace?





ACCOUNTING ACROSS THE ORGANIZATION



Turning Gift Cards into Revenue

Those of you interested in marketing know that gift cards are among the hottest tools in merchandising today. Customers purchase gift cards and give them to someone for later use. In a recent year gift-card sales topped \$95 billion.

Although these programs are popular with marketing executives, they create accounting questions. Should revenue be recorded at the time the gift card is sold, or when it is used by the customer? How should expired gift cards be accounted for? In its 2008 balance sheet Best Buy reported unearned revenue related to gift cards of \$531 million.

Source: Robert Berner, "Gift Cards: No Gift to Investors," *Business Week* (March 14, 2005), p. 86.

? Suppose that Robert Jones purchases a \$100 gift card at Best Buy on December 24, 2011, and gives it to his wife, Devon, on December 25, 2011. On January 3, 2012, Devon uses the card to purchase \$100 worth of CDs. When do you think Best Buy should recognize revenue, and why?

Accounting Across the Organization examples show the use of accounting by people in non-accounting functions—such as finance, marketing, or management.

Guideline Answers to the critical thinking questions appear at the end of the chapter.

Brief **Do it!** exercises ask you to put to work your newly acquired knowledge. They outline an **Action Plan** necessary to complete the exercise, and they show a **Solution**.

before you go on...

Do it! Indicate whether each of the five statements presented below is true or false.

Basic Concepts

1. The three steps in the accounting process are identification, recording, and communication.
2. The two most common types of external users are investors and company officers.
3. Congress passed the Sarbanes-Oxley Act of 2002 to reduce unethical behavior and decrease the likelihood of future corporate scandals.
4. The primary accounting standard-setting body in the United States is the Financial Accounting Standards Board (FASB).
5. The cost principle dictates that companies record assets at their cost. In later periods, however, the fair value of the asset must be used if fair value is higher than its cost.

Action Plan

The Do it! exercises ask you to put newly acquired knowledge to work. They outline the Action Plan necessary to complete the exercise, and they show a Solution.

Comprehensive Do it! 541

Comprehensive Do it!

The Rolman Corporation is authorized to issue 1,000,000 shares of \$5 par value common stock. In its first year, the company has the following stock transactions.

Jan. 10 Issued 400,000 shares of stock at \$8 per share.
 July 1 Issued 100,000 shares of stock for land. The land had an asking price of \$900,000. The stock is currently selling on a national exchange at \$8.25 per share.
 Sept. 1 Purchased 10,000 shares of common stock for the treasury at \$9 per share.
 Dec. 1 Sold 4,000 shares of the treasury stock at \$10 per share.

Instructions

(a) Journalize the transactions.
 (b) Prepare the stockholders' equity section assuming the company had retained earnings of \$200,000 at December 31.

Solution to Comprehensive Do it!

(a) Jan. 10	Cash		3,200,000		
	Common Stock			2,000,000	
	Paid-in Capital in Excess of Par Value			1,200,000	
	(To record issuance of 400,000 shares of \$5 par value stock)				
July 1	Land				
	Common Stock				
	Paid-in Capital in Excess of Par Value				

Action Plan

- When common stock has a par value, credit Common Stock for par value.
- Use fair market value in a noncash transaction.
- Debit and credit the Treasury Stock account at cost.

Comprehensive Do it! Problem with **Action Plan** gives students an opportunity to see a detailed solution to a representative problem before they do their homework. Coincides with the Do it! problems within the chapter.

Do it! Review problems appear in the homework material and provide another way for students to determine whether they have mastered the content in the chapters.

Do it! Review

Do it! 1-1 Indicate whether each of the five statements presented below is true or false. *Review basic concepts. (SO 1, 2, 4)*

1. The three steps in the accounting process are identification, recording, and examination.
2. The two most common types of external users are investors and creditors.
3. Congress passed the Sarbanes-Oxley Act of 2002 to ensure that investors invest only in companies that will be profitable.
4. The primary accounting standard-setting body in the United States is the Securities and Exchange Commission.

Accounting equation analyses appear next to key journal entries. They will help students understand the impact of an accounting transaction on the components of the accounting equation, on the stockholders' equity accounts, and on the company's cash flows.

Pioneer Advertising Agency Inc. purchased advertising supplies costing \$2,500 on October 5. Pioneer recorded that transaction by increasing (debiting) the asset Advertising Supplies. This account shows a balance of \$2,500 in the October 31 trial balance. An inventory count at the close of business on October 31 reveals that \$1,000 of supplies are still on hand. Thus, the cost of supplies used is \$1,500 (\$2,500 - \$1,000). Pioneer makes the following adjusting entry.

	Oct. 31 Advertising Supplies Expense	1,500		1,500	
	Advertising Supplies				-1,500
	(To record supplies used)				

Equation analyses summarize the effects of the transaction on the elements of the accounting equation.

A	=	L	+	SE
				-1,500 Exp
				Cash Flows
				no effect

Illustration 11-21
Disclosure of unrestricted retained earnings

LOCKHEED MARTIN CORPORATION
Notes to the Financial Statements

At December 31, retained earnings were unrestricted and available for dividend payments.

In some cases, there may be **retained earnings restrictions**. These make a portion of the retained earnings balance currently unavailable for dividends. Restrictions result from one or more of the following causes.

1. **Legal restrictions.** Many states require a corporation to restrict retained earnings for the cost of treasury stock purchased. The restriction keeps intact the corporation's legal capital that is being temporarily held as treasury stock. When the company sells the treasury stock, the restriction is lifted.

Financial statements appear regularly. Those from actual companies are identified by a company logo or a photo.

An **All About You** feature links some aspect of the chapter topic to personal life, and often to some financial situation a student is likely to face now or in the near future. The authors offer their own opinions about the situation at the end of the chapter.

all about YOU

Ethics: Managing Personal Financial Reporting

When companies need money, they go to investors or creditors. Before investors or creditors will give a company cash, they want to know the company's financial position and performance. They want to see the company's financial statements—the balance sheet and the income statement. When students need money for school, they often apply for financial aid. When you apply for financial aid, you must submit your own version of a financial statement—the Free Application for Federal Student Aid (FAFSA) form.

The FAFSA form asks how much you make (based on your federal income tax return) and how much your parents make. The purpose is to find out how much you own and how much you owe. Why do the Department of Education and your school want this information? Simple: They want to know whether

The federal share of assistance is declining
Sources of financial aid as a percentage of total aid used to finance postsecondary expenses

Federal aid	Institutional grants	State grants
45%	15%	0%
30%		
15%		
0%		
1981-82	'85-'86	'90-'91
'95-'96	2001-'01	'05-'06

Exercises: Set B and Challenge Exercises are available online at www.wiley.com/college/wegandt.

In the book, two similar sets of **Problems—A and B**—are keyed to the same study objectives.

Selected problems, identified by this icon, can be solved using the **General Ledger Software (GLS)** package.

An icon identifies **Exercises and Problems** that can be solved using Excel templates at the student website.

EXERCISES: SET B AND CHALLENGE EXERCISES

Visit the book's companion website at www.wiley.com/college/wegandt, and choose the Student Companion site, to access Exercise Set B and a set of Challenge Exercises.

PROBLEMS: SET A

Journalize a series of transactions.
(SO 2, 4)

GLS

GLS

P2-1A Frontier Park was started on April 1 by C. J. Mendez and associates. The following selected events and transactions occurred during April.

Apr. 1 Stockholders invested \$40,000 cash in the business in exchange for common stock.
4 Purchased land costing \$30,000 for cash.
8 Incurred advertising expense of \$1,800 on account.
11 Paid salaries to employees \$1,500.
12 Hired park manager at a salary of \$4,000 per month, effective May 1.

Trial balance totals \$64,000
Prepare a correct trial balance.
(SO 7)

(e) Post the journal entries to the accounts in the ledger. (Add accounts as needed.)
(d) Prepare a trial balance as of January 31, 2011.

P2-4A The trial balance of the Sterling Company shown below does not balance.

STERLING COMPANY

Trial Balance
May 31, 2011

PROBLEMS: SET C

Visit the book's website at www.wiley.com/college/wegandt, and choose the Student Companion site, to access Problem Set C.

An additional parallel set of **C Problems** appears at the book's companion site.

The **Continuing Cookie Chronicle** exercise follows the continuing saga of accounting for a small business begun by an entrepreneurial student.

Broadening Your Perspective 45

CONTINUING COOKIE CHRONICLE

CCC1 Natalie Koebel spent much of her childhood learning the art of cookie-making from her grandmother. They passed many happy hours mastering every type of cookie imaginable and later creating new recipes that were both healthy and delicious. Now at the start of her second year in college, Natalie is investigating various possibilities for starting her own business as part of the requirements of the entrepreneurship program in which she is enrolled.
A long-time friend insists that Natalie has to somehow include cookies in her business plan. After a series of brainstorming sessions, Natalie settles on the idea of operating a cookie-making

The Continuing Cookie Chronicle starts in this chapter and continues in every chapter. You also can find this problem at the book's Student Companion site.

The **Broadening Your Perspective** section helps to pull together concepts from the chapter and apply them to real-world business situations.

BROADENING YOUR PERSPECTIVE

FINANCIAL REPORTING AND ANALYSIS

Financial Reporting Problem: PepsiCo, Inc.

BYP2-1 The financial statements of **PepsiCo, Inc.** are presented in Appendix A. The notes accompanying the statements contain the following selected accounts, stated in millions of dollars.

Accounts Payable	Income Taxes Payable
Accounts Receivable	Interest Expense
Property, Plant, and Equipment	Inventory

Instructions

(a) Answer the following questions.

(1) What is the increase and decrease side for each account?
(2) What is the normal balance for each account?

(b) Identify the probable other account in the transaction and the effect on that account when:

(1) Accounts Receivable is decreased.
(2) Accounts Payable is decreased.
(3) Inventory is increased.

The **Financial Reporting Problem** focuses on reading and understanding the financial statements of PepsiCo, Inc., which are printed in Appendix A.

A **Comparative Analysis Problem** compares and contrasts the financial reporting of PepsiCo with its competitor The Coca-Cola Company.

Comparative Analysis Problem: PepsiCo, Inc. vs. The Coca-Cola Company

BYP2-2 PepsiCo's financial statements are presented in Appendix A. Financial statements of The Coca-Cola Company are presented in Appendix B.

Instructions

(a) Based on the information contained in the financial statements, determine the normal balance of the listed accounts for each company.

Pepsi	Coca-Cola
1. Inventory	1. Accounts Receivable
2. Property, Plant, and Equipment	2. Cash and Cash Equivalents
3. Accounts Payable	3. Cost of Goods Sold (expense)
4. Interest Expense	4. Sales (revenue)

(b) Identify the other account ordinarily involved when:

(1) Accounts Receivable is increased.
(2) Wages Payable is decreased.
(3) Property, Plant, and Equipment is increased.
(4) Interest Expense is increased.

Exploring the Web

BYP2-3 Much information about specific companies is available on the World Wide Web. Such information includes basic descriptions of the company's location, activities, industry, financial health, and financial performance.

Address: biz.yahoo.com/i, or go to www.wiley.com/college/wegandt

Steps

1. Type in a company name, or use index to find company name.
2. Choose **Profile**. Perform instructions (a)-(c) on the next page.
3. Click on the company's specific industry to identify competitors. Perform instructions (d)-(g) on the next page.

Exploring the Web exercises guide students to websites where they can find and analyze information related to the chapter topic.

Decision Making Across the Organization



BYP2-4 Lisa Ortega operates Ortega Riding Academy. The academy's primary sources of revenue are riding fees and lesson fees, which are paid on a cash basis. Lisa also boards horses for owners, who are billed monthly for boarding fees. In a few cases, boarders pay in advance of expected use. For its revenue transactions, the academy maintains the following accounts: No. 1 Cash, No. 5 Boarding Accounts Receivable, No. 27 Unearned Boarding Revenue, No. 51 Riding Revenue, No. 52 Lesson Revenue, and No. 53 Boarding Revenue.

The academy owns 10 horses, a stable, a riding corral, riding equipment, and office equipment. These assets are accounted for in accounts No. 11 Horses, No. 12 Building, No. 13 Riding Corral, No. 14 Riding Equipment, and No. 15 Office Equipment.

For its expenses, the academy maintains the following accounts: No. 6 Hay and Feed Supplies, No. 7 Prepaid Insurance, No. 21 Accounts Payable, No. 60 Salaries Expense, No. 61 Advertising Expense, No. 62 Utilities Expense, No. 63 Veterinary Expense, No. 64 Hay and Feed Expense, and No. 65 Insurance Expense.

Ortega makes periodic payments of cash dividends to stockholders. To record stockholders' equity in the business and dividends, Ortega maintains three accounts: No. 50 Common Stock, No. 51 Retained Earnings, and No. 52 Dividends.

During the first month of operations an inexperienced bookkeeper was employed. Lisa Ortega asks you to review the following eight entries of the 50 entries made during the month. In each case, the explanation for the entry is correct.

May 1	Cash	18,000	18,000
	Common Stock (Invested \$18,000 cash in exchange for stock)		
5	Cash	250	250
	Riding Revenue (Received \$250 cash for lessons provided)		

Decision Making Across the Organization cases helps students build decision-making skills by analyzing accounting information in a less structured situation. These cases require teams of students to evaluate a manager's decision or lead to a decision among alternative courses of action.

Ethics Cases ask students to reflect on typical ethical dilemmas, analyze the stakeholders and the issues involved, and decide on an appropriate course of action.

Ethics Case

BYP2-6 Mary Jansen is the assistant chief accountant at Casey Company, a manufacturer of computer chips and cellular phones. The company presently has total sales of \$20 million. It is the end of the first quarter. Mary is hurriedly trying to prepare a general ledger trial balance so that quarterly financial statements can be prepared and released to management and the regulatory agencies. The total credits on the trial balance exceed the debits by \$1,000. In order to meet the 4 p.m. deadline, Mary decides to force the debits and credits into balance by adding the amount of the difference to the Equipment account. She chose Equipment because it is one of the larger account balances; percentage-wise, it will be the least misstated. Mary "plugs" the difference! She believes that the difference will not affect anyone's decisions. She wishes that she had another few days to find the error but realizes that the financial statements are

Understanding IFRS

In this textbook, both here and in the IFRS Appendix at the back of the book, we present the most recent information available on international financial accounting standards. In this section, we provide an overview of International Financial Reporting Standards (IFRS), as well as a summary table of similarities and differences between IFRS and generally accepted accounting principles (GAAP) by chapter. In the IFRS Appendix, we analyze the impact of IFRS on the individual chapters of this textbook, with specific page references to the textbook included.

Strong forces are in place to achieve a global set of accounting standards in the not-too-distant future. Currently, many companies find it costly to comply with the different reporting standards required by other countries. Likewise, investors, attempting to diversify their holdings and manage their risks, have become very interested in investing in foreign companies. Having one common set of accounting rules will make it easier for international investors to compare the financial results of companies from different countries. In this summary, we provide additional insight into the movement toward one set of international accounting standards, IFRS, to be used by all companies.

Pathway Toward Global Standards

Most agree that there is a need for one set of globalized accounting standards. Consider that today's companies view the entire world as their market. Some of the best-known corporations, such as **Coca-Cola**, **Intel**, and **McDonald's**, generate more than 50 percent of their sales outside the United States. As a result, these organizations no longer think of themselves as simply U.S. companies. In addition, the mergers by such international giants as **Budweiser** and **Vodafone/Mannesmann** are creating massive corporations that bridge countries and cultures. Consumer behavior is changing as well. As communication barriers continue to drop, companies and individuals in different countries and markets are becoming comfortable buying and selling goods and services from one another. Most notably, investors no longer confine themselves to the markets of their home country. Whether it is currency, equity securities (stocks), or bonds, active markets throughout the world are trading these types of financial instruments.

For many years, foreign companies that listed on the U.S. exchanges were required to use GAAP or provide a reconciliation between IFRS and GAAP. Recently, this requirement was dropped. Currently, U.S. companies that list their shares on foreign exchanges do not have to convert to IFRS. However, it is possible that foreign exchanges may begin requiring U.S. firms to convert or reconcile their financial statements to IFRS to list on foreign exchanges. In addition, to attract foreign investors, U.S. companies may need to provide additional information regarding how IFRS would affect their financial statements. As investors gain a better understanding of IFRS, they may demand this additional information from U.S. companies.

Regulatory Initiatives

In an effort to address this rapidly changing global environment, the Securities and Exchange Commission (SEC) recently proposed a road-map toward international accounting standards, whereby some large U.S. companies would have the option of reporting under IFRS as early as 2009. It is possible that all publicly traded U.S. companies would be required to report under IFRS no later than 2016. Many obstacles exist before these goals can be met, but it seems likely that given the potential

benefits of switching to international standards, and the risks of not switching, U.S. regulators will make every effort to overcome the obstacles.

In recent years, the FASB and the international accounting standard-setter, the International Accounting Standards Board (IASB), have worked diligently to narrow the differences between U.S. and international accounting standards. This effort is referred to as *convergence*. International accounting standards converge when differences between international and U.S. standards are eliminated. The elimination of differences between GAAP and IFRS that results from convergence will make an eventual switch to IFRS by U.S. companies that much easier.

Differences Between IFRS and GAAP

The differences between IFRS and GAAP may provide certain companies with a competitive advantage. For example, international standards that are more permissive for reporting the results of individual business segments of a company may lead to a presentation that appears more favorable but in reality is misleading. Conversely, the U.S. standards may force a U.S. company to disclose more segment information. Understanding this difference may be important in judging the competing companies. Here are two examples of such differences (other differences are highlighted in the *International Notes* throughout the textbook):

- IFRS permits companies to value property, plant, and equipment at fair value using appraisals. In the United States, this practice is not allowed.
- IFRS prohibits use of LIFO costing for inventories. In the United States, a significant number of companies use LIFO to cost some, if not their entire, inventory.

The fact that there are differences should not be surprising because standard-setters worldwide have developed standards in response to different user needs. In some countries, the primary users of financial statements are private investors; in others, the primary users are tax authorities or central government planners. In the United States, capital market participants (investors and creditors) have driven accounting standard formulation.

Standard-Setting Environment

As discussed in the textbook, the FASB has the primary responsibility for establishing accounting standards in the United States. As a governmental agency, the SEC has the authority to delegate standard-setting responsibility to the FASB and to ensure that companies follow these standards appropriately. Both of these organizations have strongly supported the movement toward one set of international standards.

The primary organization involved in developing IFRS is the IASB. The IASB is a privately funded accounting standard-setter based in London, United Kingdom. Its members currently come from nine countries. The IASB is committed to developing, in the public interest, a single set of high-quality, understandable, and enforceable global accounting standards. The IASB cooperates with national accounting standard-setters to achieve convergence in accounting standards around the world. Because it is a private organization, the IASB has no regulatory mandate and therefore no enforcement mechanism in place. In other words, unlike the U.S.'s standard-setting procedures, there is no SEC to enforce the use of IASB standards. Use of IFRS is completely voluntary unless mandated by an authorized regulator. For example, effective January 1, 2005, the European Union (EU) required member country companies that list on EU securities exchanges to use IFRS.

As noted above, the FASB and the IASB are working together toward the goal of a single set of high-quality accounting standards that will be used both domestically

and internationally. To achieve this goal, the FASB and IASB are undertaking several joint projects. One joint project is the development of a common conceptual framework for financial accounting and reporting. The goal of this project is to build a framework that both the FASB and the IASB can use when developing new and revised accounting standards. Other joint efforts involve developing new standards on major topics. Presently, the FASB and IASB are working on such major projects as leasing, revenue recognition, and reporting on financial performance.

The FASB and IASB have also eliminated or narrowed differences through short-term convergence projects. This approach has been quite successful so far. For example, the FASB has issued standards that mirror present IASB standards on such reporting issues as exchanges of nonmonetary assets and accounting changes. The goal of this collaboration is to select the better standard and move forward with it.

As often stated, “the devil is in the details.” Both groups are working hard to ensure that not only are the broad conceptual approaches the same, but also the methods of applying them. Thus, the FASB and IASB are not looking for mutual recognition of each other’s standards. Rather, they want the same standards, interpretations, and language. Regarding the FASB and convergence, Bob Herz, present chair of the FASB, has taken a position he calls “killing three birds with one stone.” That is, he hopes that new standards will (1) improve U.S. reporting, (2) simplify U.S. standards and standard-setting, and (3) provide international convergence.

There are many challenges to convergence. Presently, domestic and international accounting parties are often starting from different places. Not only are the FASB and the IASB involved, but also numerous national standard-setters are in the mix. There are significant cultural differences among countries and regions of the world. In the United States, the FASB is faced with a litigious society and therefore is often encouraged to write detailed standards. In addition, there are often institutional or legal barriers to change. For example, any time a standard is issued that affects debt-versus-equity classifications, loan covenants may have to be changed. In some countries, changing loan covenants is very difficult.

Financial statements prepared according to GAAP have been the standard for communicating financial information internationally. Regulators from around the world have readily accepted these financial statements when a company has chosen to list on an exchange. In 2005, however, the IASB standards became the common financial statement language for over 7,000 listed companies in the European Union and in over 100 countries around the world. There are still many bumps in the road to the establishment of one set of worldwide standards, but the progress to date is remarkable. We are optimistic that the goal of worldwide standards can be achieved, which will be of value to all.

Be sure to read
the following
Summary Table
and the
IFRS Appendix
at the end of this book,
for more information on
how IFRS relates to the
accounting principles
discussed in the
textbook.

Summary Table of International Accounting Issues

Presented below are key similarities and differences between GAAP and international accounting standards (referred to hereafter as IFRS), as they relate to introductory financial accounting. As you will note, there are many similarities in the two systems. The Securities and Exchange Commission (SEC) has proposed a roadmap for publicly traded U.S. companies to adopt international accounting standards. While some smaller U.S. companies will not be required to switch until as late as 2016, some large companies will be allowed to adopt international standards (IFRS) as early as 2009. As they arise, additional international accounting developments that relate to introductory financial accounting are provided at the Student Companion portion of the book's website.

Topic	Similarities	Differences
Chapter 1		
Financial Statements	The primary types of financial statements required by international accounting standards (IFRS) and U.S. accounting standards (GAAP) are the same.	In practice, some format differences do exist in presentations commonly employed by IFRS companies compared to GAAP companies.
Standard Setting Environment	<p>IFRS includes the standards developed by the IASB. GAAP includes primarily FASB standards.</p> <p>The Boards have similar processes for creating new standards. In recent years they have worked closely together on reducing differences in existing standards and on creating new accounting standards jointly.</p> <p><i>Looking to the future:</i> The SEC eliminated a rule that required foreign companies that trade shares in U.S. markets to reconcile their accounting with GAAP. The SEC also is seeking comment on a proposal to allow some large U.S. companies to prepare financial statements using IFRS as early as 2009, and to require all publicly traded U.S. companies to use IFRS no later than 2016.</p>	<p>In many IFRS countries, the primary users of financial statements are private investors, tax authorities, or central government planners. In the United States, capital market participants (investors and creditors) have driven accounting standard formulation.</p> <p>IFRS tends to be simpler and less stringent (principle-based) in its accounting and disclosure requirements. GAAP is more detailed (rule-based).</p>
Conceptual Framework	<p>IASB and FASB frameworks are very similar: both frameworks are organized using the same concepts (objectives, elements, qualitative characteristics, etc.)</p> <p><i>Looking to the future:</i> The IASB and the FASB have a joint project to develop a common conceptual framework. This framework is based on the existing IASB framework and the FASB's conceptual framework.</p>	The IFRS conceptual framework puts more emphasis on accountability (referred to as stewardship) than does the GAAP conceptual framework.
Chapter 2		
Recording Process	Both IFRS and GAAP rely on the same double entry system to record transactions	GAAP is supported by much more detailed and stringent internal control rules that are designed to ensure the accuracy and reliability of the recording and reporting process.
Chapter 3		
Revenue Recognition	The general concepts and principles used for revenue recognition are similar between GAAP and IFRS. A specific standard exists for revenue recognition under IFRS.	IFRS defines revenue to include both revenues and gains. GAAP provides separate definitions for revenues and gains. GAAP has a much more detailed collection of standards on revenue recognition than IFRS.
<i>Looking to the future:</i> The FASB and IASB are working on a joint project to develop new revenue recognition standards.		
Chapter 4		
Balance Sheet	GAAP and IFRS both require a balance sheet. The content and presentation of an IFRS balance sheet is similar to the one used for GAAP.	IFRS statements may report property, plant, and equipment first in the balance sheet. Some companies report the subtotal "net assets," which equals total assets minus total liabilities.
<i>Looking to the future:</i> The IASB and the FASB are working on a project to converge their standards related to financial statement presentation. A key feature of the proposed framework for financial statement presentation is that each of the statements will be organized in the same format—to separate an entity's financing activities from its operating and other (investing) activities, and to further separate financing activities.		
Chapter 5		
Income Statement	<p>The IFRS and GAAP accounting systems (perpetual and periodic) are essentially the same in recording sale transactions. GAAP and IFRS both require a statement of income.</p> <p>The content and presentation of an IFRS income statement is similar to the one used for GAAP.</p> <p><i>Looking to the future:</i> As indicated earlier, the IASB and FASB are working on a project that would rework the structure of the financial statements. This structure would use three categories mentioned earlier (operating, investing, and financing) consistently across the statements.</p>	Unlike GAAP, IFRS does not follow a single-step or multiple-step approach.

Summary Table of International Accounting Issues (continued)

Topic	Similarities	Differences
Chapter 6		
Inventories	<p>Under IFRS and GAAP, who owns the goods—goods in transit, consigned goods—as well as the costs to include in inventory are essentially accounted for the same.</p> <p>FIFO and average-cost are the only two acceptable cost flow assumptions permitted under IFRS. Both sets of GAAP permit specific identification where appropriate.</p>	<p>GAAP permits the use of LIFO for inventory valuation. IFRS prohibits the use of LIFO.</p> <p>In the lower-of-cost-or-market test for inventory valuation, IFRS defines <i>market</i> in a different way than GAAP.</p> <p>In GAAP, if inventory is written down it cannot be written up if it subsequently increases in value. Under IFRS, the write-down may be reversed.</p>
<p><i>Looking to the future:</i> One convergence issue that will be difficult to resolve relates to the use of the LIFO cost flow assumption. As indicated, IFRS specifically prohibits its use. Conversely, LIFO is widely used in the United States because of its favorable tax advantages. In addition, many argue that from a financial reporting point of view, LIFO provides a better matching of current costs against revenue and therefore enables companies to compute a more realistic income.</p>		
Chapter 7		
Cash	<p>The accounting and reporting related to cash is essentially the same under both IFRS and GAAP. In addition, the definition used for cash equivalents is essentially the same as well.</p>	
Internal Control	<p>All companies, whether preparing statements under GAAP or IFRS, need good internal controls.</p>	<p>Recently passed Sarbanes-Oxley (SOX) internal control standards apply only to large public companies listed on U.S. exchanges. There is continuing debate over whether foreign issuers should have to comply with this extra layer of regulation.</p>
<p><i>Looking to the future:</i> Some critics of the SOX provisions attribute a decline in initial public offerings (IPOs) to the increased cost of complying with the internal control rules. Others argue that growth in non-U.S. markets is a natural consequence of general globalization of capital flows. In any event, the movement toward international accounting standards will necessitate increased international cooperation regarding internal control regulations and auditing standards.</p>		
Chapter 8		
Receivables	<p>The basic accounting for receivables, such as the use of allowance accounts, how to record discounts, and factoring are essentially the same between IFRS and GAAP.</p> <p>Both IFRS and GAAP allow a so called “fair value option” which gives companies the choice of reporting certain financial instruments, such as receivables, at fair value.</p>	<p>IFRS and GAAP for the fair value option are similar but not identical. For example, there are differences in qualifying criteria and in the financial instruments covered.</p>
<p><i>Looking to the future:</i> Both the IASB and the FASB have indicated that they believe that financial statements would be more useful if companies reported all financial instruments, such as receivables, at fair value. The fair value option for recording financial instruments is an important step in moving closer to fair value accounting.</p>		
Chapter 9		
Property, Plant, and Equipment	<p>IFRS views depreciation as an allocation of cost over an asset’s life and permits the same depreciation methods (straight-line, accelerated, units-of-production) as GAAP.</p>	<p>IFRS permits in certain situations that property, plant, and equipment can be written up to fair value, which is not permitted by GAAP.</p> <p>IFRS allows “component depreciation” where significant parts of a fixed asset can be depreciated using different estimated lives.</p>
<p><i>Looking to the future:</i> The IFRS provision allowing asset revaluations and the issues related to the use of fair value for the measurement of long-lived assets represent major obstacles to convergence.</p>		
Intangible Assets	<p>Under IFRS, as in GAAP, the costs associated with research and development are segregated into the two components. Costs in the research phase are always expensed under both IFRS and GAAP.</p>	<p>While both GAAP and IFRS require that research costs be expensed, under IFRS, costs in the development phase are capitalized once certain technical conditions are met.</p> <p>There are differences in how the amount of a loss due to the impairment of an asset is determined.</p> <p>IFRS allows reversal of impairment losses when there has been a change in economic conditions or in the expected use of the asset. Under GAAP, impairment losses cannot be reversed.</p>
<p><i>Looking to the future:</i> IFRS permits more recognition of intangibles compared to GAAP. Thus, it will be challenging to develop converged standards for intangible assets, given the long-standing prohibition in GAAP on capitalizing development costs.</p>		

Summary Table of International Accounting Issues (continued)

<i>Topic</i>	<i>Similarities</i>	<i>Differences</i>
Chapter 10		
Liabilities	<p>IFRS and GAAP require that companies present current and noncurrent liabilities on the face of the balance sheet, with current liabilities generally presented in order of liquidity.</p> <p><i>Looking to the future:</i> The IASB and FASB are working on a conceptual framework project, part of which will examine the definition of a liability.</p>	
Leases	<p>Both GAAP and IFRS have the objective of recording leases by lessees and lessors according to their economic substance—that is, according to the definitions of assets and liabilities.</p> <p><i>Looking to the future:</i> The FASB and IASB boards have added a joint project on lease accounting to their agendas.</p>	<p>GAAP for leases is much more “rules-based,” with specific bright-line criteria to determine if a lease arrangement transfers the risks and rewards of ownership. IFRS is more general in its provisions.</p>
Chapter 11		
Stockholders’ Equity	<p>Under both GAAP and IFRS, the costs associated with issuing stock reduce the proceeds from the issuance and reduce paid-in capital.</p> <p>The accounting for par, no par, and stated value are the same under both sets of standards.</p> <p><i>Looking to the future:</i> The differences in reporting stockholders’ equity between GAAP and IFRS are being addressed in the joint financial statement presentation project.</p>	<p>Under IFRS, stockholders’ equity is classified as contributed capital and reserves. <i>Reserves</i> mean all stockholders’ equity items other than amounts directly contributed by stockholders. The term <i>reserve</i> is not used in GAAP, because it is considered misleading.</p>
Chapter 12		
Investments	<p>The accounting for trading, available-for-sale, and held-to-maturity securities is essentially the same between IFRS and GAAP.</p> <p>Both IFRS and GAAP use the same test to determine whether the equity method of accounting should be used, that is, significant influence, with a general guide of over 20% ownership.</p> <p><i>Looking to the future:</i> As noted earlier, both the FASB and IASB have indicated that they believe that all financial instruments should be reported at fair value and that changes in fair value should be reported as part of net income. It seems likely that as more companies choose the fair value option for financial instruments, accounting will eventually arrive at fair value measurement for <i>all</i> financial instruments.</p>	<p>IFRS uses the term <i>associate investment</i> rather than <i>equity investment</i> to describe its investment under the equity method.</p> <p>GAAP does not permit the reversal of an impairment charge related to available-for-sale securities. IFRS follows the same approach but does permit reversal for certain debt securities.</p>
Chapter 13		
Statement of Cash Flows	<p>Both IFRS and GAAP require that the statement of cash flows have three major sections—operating, investing, and financing—along with changes in cash and cash equivalents, and both permit use of the indirect or direct method.</p> <p><i>Looking to the future:</i> The FASB is of the view that operating cash flows be presented on a statement of cash flows using the direct method only. However, the majority of IASB boardmembers express a preference for not requiring use of the direct method of reporting operating cash flows. The two Boards will have to resolve their differences in this area in order to issue a converged standard for the statement of cash flows.</p>	<p>IFRS requires that noncash investing and financing activities be excluded from the statement of cash flows. Instead these noncash activities should be reported elsewhere (in the notes). Under GAAP, companies may present this information in the cash flow statement.</p>
Chapter 14		
Accounting Changes and Irregular Items	<p>The accounting and reporting for changes in accounting principles, changes in estimates, discontinued operations, and errors is very consistent between GAAP and IFRS.</p> <p><i>Looking to the future:</i> The treatment of extraordinary items will have to be resolved. In recent years, the types of items allowed to be reported as extraordinary has been significantly restricted under GAAP.</p>	<p>IFRS and GAAP differ in how to report corrections of errors in previously issued financial statements. IFRS is more flexible as the IFRS sometimes allows it to be reported in the current period.</p> <p>GAAP requires companies to report an item as extraordinary if it is unusual in nature and infrequent in occurrence. Extraordinary items are prohibited under IFRS.</p>



FINANCIAL ACCOUNTING

SEVENTH EDITION



Accounting in Action

STUDY OBJECTIVES

After studying this chapter, you should be able to:

- 1 Explain what accounting is.
- 2 Identify the users and uses of accounting.
- 3 Understand why ethics is a fundamental business concept.
- 4 Explain generally accepted accounting principles and the measurement principles.
- 5 Explain the monetary unit assumption and the economic entity assumption.
- 6 State the accounting equation, and define its components.
- 7 Analyze the effects of business transactions on the accounting equation.
- 8 Understand the four financial statements and how they are prepared.



The Navigator

Scan Study Objectives	■
Read Feature Story	■
Read Preview	■
Read text and answer Do it! p. 11 ■ p. 14 ■ p. 21 ■ p. 25 ■	■
Work Comprehensive Do it! p. 27	■
Review Summary of Study Objectives	■
Answer Self-Study Questions	■
Complete Assignments	■

The Navigator is a learning system designed to prompt you to use the learning aids in the chapter and set priorities as you study.

Study Objectives give you a framework for learning the specific concepts covered in the chapter.

Feature Story

KNOWING THE NUMBERS

Consider this quote from Harold Geneen, the former chairman of **IT&T**: "To be good at your business, you have to know the numbers—cold." Success in any business comes back to the numbers. You will rely on them to make decisions, and managers will use them to evaluate your performance. That is true whether your job involves marketing, production, management, or information systems.

In business, accounting and financial statements are the means for communicating the numbers. If you don't know how to read financial statements, you can't really know your business.

When Jack Stack and 11 other managers purchased **Springfield ReManufacturing Corporation (SRC)** (www.screman.com) for 10 cents a share, it was a failing

division of **International Harvester**. Stack had 119 employees who were counting on him for their livelihood, and he knew that the company was on the verge of financial failure.

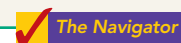
Stack decided that the company's only chance of survival was to encourage every employee to think like a businessperson and to act like an owner. To accomplish this, all employees at SRC took basic accounting courses and participated in weekly reviews of the company's financial statements. SRC survived, and eventually thrived. To this day, every employee (now numbering more than 1,000) undergoes this same training.

Many other companies have adopted this approach, which is called "open-book management." Even in companies that do not practice open-book management, employers generally assume that managers in all areas of the company are "financially literate."

Taking this course will go a long way toward making you financially literate. In this book you will learn how to read and prepare financial statements, and how to use basic tools to evaluate financial results. Appendices A and B provide real financial statements of two well-known companies, **PepsiCo, Inc.** and **The Coca-Cola Company**. Throughout this textbook we attempt to increase your familiarity with financial reporting by providing numerous references, questions, and exercises that encourage you to explore these financial statements.



The Feature Story helps you picture how the chapter topic relates to the real world of accounting and business. You will find references to the story throughout the chapter.



Inside Chapter 1...

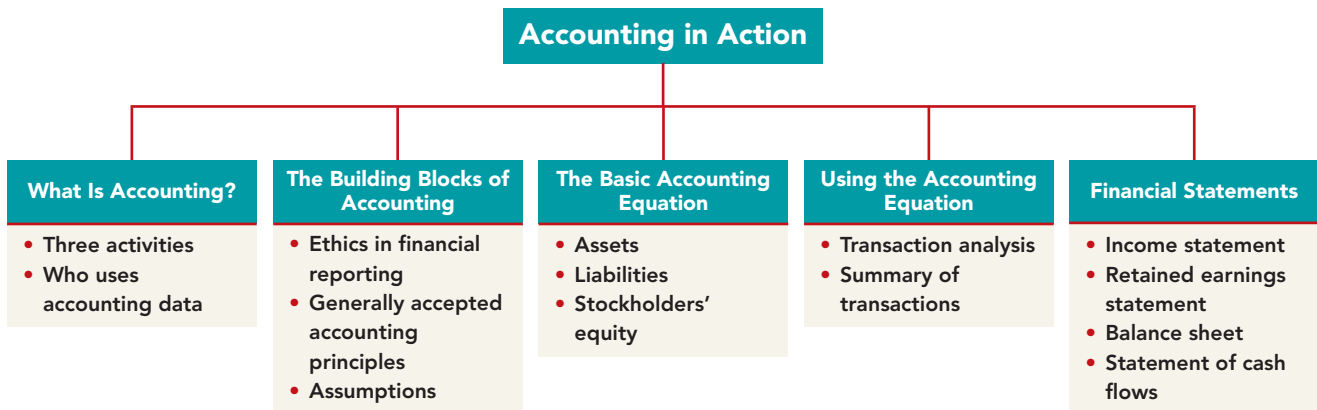
- **How Will Accounting Help Me?** (p. 11)
- **What Do General Mills, Walt Disney, and Dunkin' Donuts Have in Common?** (p. 24)
- **All About You: Ethics: Managing Personal Financial Reporting** (p. 26)

"Inside Chapter x" lists boxes in the chapter that should be of special interest to you.

Preview of Chapter 1

The opening story about **Springfield ReManufacturing Corporation** highlights the importance of having good financial information to make effective business decisions. Whatever one's pursuits or occupation, the need for financial information is inescapable. You cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or dispensing financial information. Good decision making depends on good information.

The purpose of this chapter is to show you that accounting is the system used to provide useful financial information. The content and organization of Chapter 1 are as follows.



The **Preview** describes and outlines the major topics and subtopics you will see in the chapter.

WHAT IS ACCOUNTING?

STUDY OBJECTIVE 1

Explain what accounting is.

Why is accounting so popular? What consistently ranks as one of the top career opportunities in business? What frequently rates among the most popular majors on campus? What was the undergraduate degree chosen by **Nike** founder Phil Knight, **Home Depot** co-founder Arthur Blank, former acting director of the **Federal Bureau of Investigation (FBI)** Thomas Pickard, and numerous members of Congress? Accounting.¹ Why did these people choose accounting? They wanted to understand what was happening financially to their organizations. Accounting is the financial information system that provides these insights. In short, to understand your organization, you have to know the numbers.

Accounting consists of three basic activities—it **identifies**, **records**, and **communicates** the economic events of an organization to interested users. Let's take a closer look at these three activities.

Three Activities

To **identify** economic events, a company selects the **economic events relevant to its business**. Examples of economic events are the sale of snack chips by **PepsiCo**, providing of telephone services by **AT&T**, and payment of wages by **Ford Motor Company**.

¹The appendix to this chapter describes job opportunities for accounting majors and explains why accounting is such a popular major.

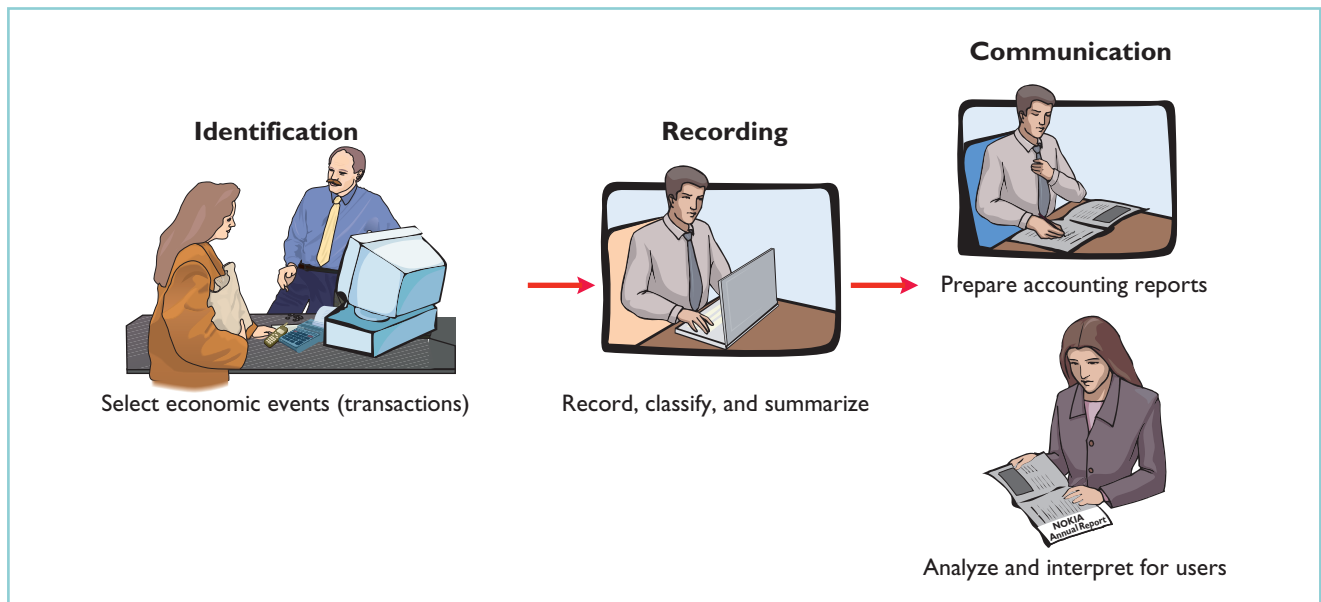
Once a company like PepsiCo identifies economic events, it **records** those events in order to provide a history of its financial activities. Recording consists of keeping a **systematic, chronological diary of events**, measured in dollars and cents. In recording, PepsiCo also classifies and summarizes economic events.

Finally, PepsiCo **communicates** the collected information to interested users by means of **accounting reports**. The most common of these reports are called **financial statements**. To make the reported financial information meaningful, PepsiCo reports the recorded data in a standardized way. It accumulates information resulting from similar transactions. For example, PepsiCo accumulates all sales transactions over a certain period of time and reports the data as one amount in the company's financial statements. Such data are said to be reported **in the aggregate**. By presenting the recorded data in the aggregate, the accounting process simplifies a multitude of transactions and makes a series of activities understandable and meaningful.

A vital element in communicating economic events is the accountant's ability to **analyze and interpret** the reported information. Analysis involves use of ratios, percentages, graphs, and charts to highlight significant financial trends and relationships. Interpretation involves **explaining the uses, meaning, and limitations of reported data**. Appendix A of this textbook shows the financial statements of **PepsiCo, Inc.**; Appendix B illustrates the financial statements of **The Coca-Cola Company**. We refer to these statements at various places throughout the text. At this point, they probably strike you as complex and confusing. By the end of this course, you'll be surprised at your ability to understand, analyze, and interpret them.

Illustration 1-1 summarizes the activities of the accounting process.

Illustration 1-1
The activities of the accounting process



You should understand that the accounting process **includes** the bookkeeping function. **Bookkeeping** usually involves **only** the recording of economic events. It is therefore just one part of the accounting process. In total, accounting involves **the entire process of identifying, recording, and communicating economic events**.²

Essential terms are printed in blue when they first appear, and are defined in the end-of-chapter glossary.

²The origins of accounting are generally attributed to the work of Luca Pacioli, an Italian Renaissance mathematician. Pacioli was a close friend and tutor to Leonardo da Vinci and a contemporary of Christopher Columbus. In his 1494 text *Summa de Arithmetica, Geometria, Proportione et Proportionalite*, Pacioli described a system to ensure that financial information was recorded efficiently and accurately.

Who Uses Accounting Data

STUDY OBJECTIVE 2

Identify the users and uses of accounting.

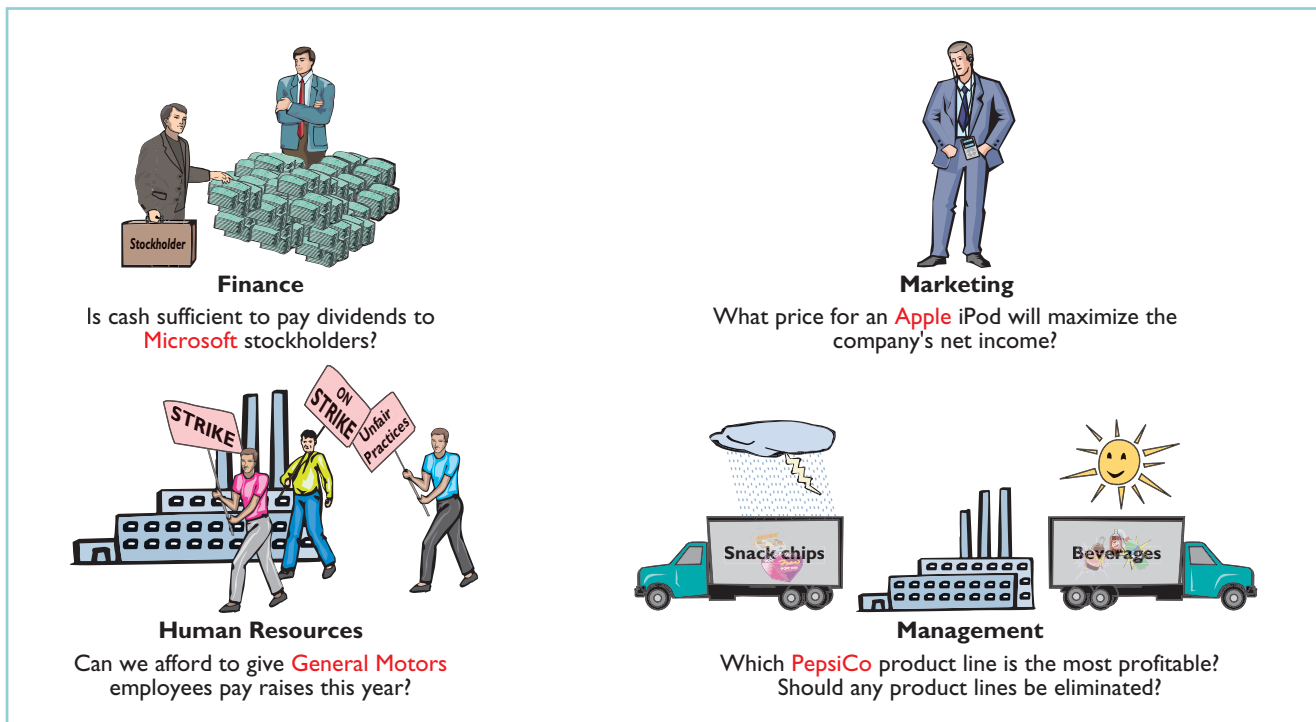
The information that a user of financial information needs depends upon the kinds of decisions the user makes. There are two broad groups of users of financial information: internal users and external users.

INTERNAL USERS

Internal users of accounting information are those individuals inside a company who plan, organize, and run the business. These include marketing managers, production supervisors, finance directors, and company officers. In running a business, internal users must answer many important questions, as shown in Illustration 1-2.

Illustration 1-2

Questions asked by internal users



To answer these and other questions, internal users need detailed information on a timely basis. **Managerial accounting** provides internal reports to help users make decisions about their companies. Examples are financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year.

EXTERNAL USERS

External users are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors. **Investors** (owners) use accounting information to make decisions to buy, hold, or sell ownership shares of a company. **Creditors** (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money. Illustration 1-3 (page 7) shows some questions that investors and creditors may ask.

Financial accounting answers these questions. It provides economic and financial information for investors, creditors, and other external users. The information needs of external users vary considerably. **Taxing authorities** (such as the Internal Revenue Service) want to know whether the company complies with tax laws.

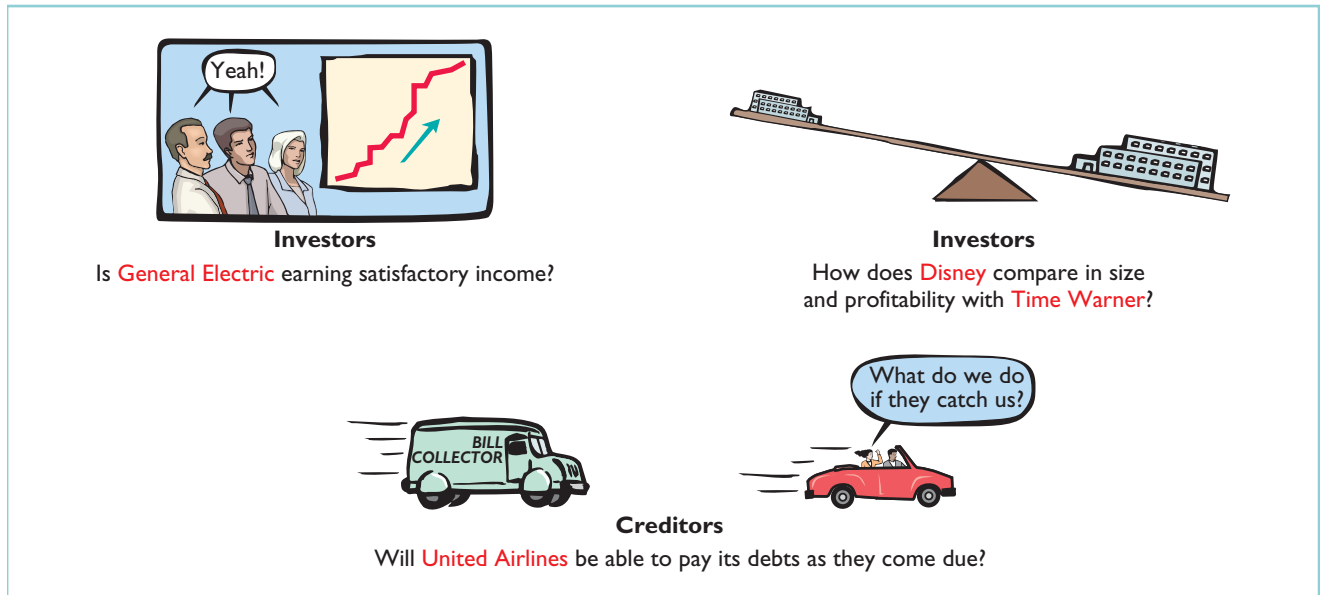


Illustration 1-3
Questions asked by
external users

Regulatory agencies, such as the Securities and Exchange Commission and the Federal Trade Commission, want to know whether the company is operating within prescribed rules. **Customers** are interested in whether a company like **General Motors** will continue to honor product warranties and support its product lines. **Labor unions** such as the Major League Baseball Players Association want to know whether the owners can pay increased wages and benefits.

THE BUILDING BLOCKS OF ACCOUNTING

A doctor follows certain standards in treating a patient's illness. An architect follows certain standards in designing a building. An accountant follows certain standards in reporting financial information. For these standards to work, a fundamental business concept must be at work—ethical behavior.

Ethics in Financial Reporting

People won't gamble in a casino if they think it is rigged. Similarly, people won't play the stock market if they think stock prices are rigged. In recent years the financial press has been full of articles about financial scandals at **Enron**, **WorldCom**, **HealthSouth**, **AIG**, and others.

As the scandals came to light, mistrust of financial reporting in general grew. One article in the *Wall Street Journal* noted that "repeated disclosures about questionable accounting practices have bruised investors' faith in the reliability of earnings reports, which in turn has sent stock prices tumbling."³ Imagine trying to carry on a business or invest money if you could not depend on the financial statements to be honestly prepared. Information would have no credibility. There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

United States regulators and lawmakers were very concerned that the economy would suffer if investors lost confidence in corporate accounting because of unethical financial reporting. In response, Congress passed the **Sarbanes-Oxley Act of 2002**

STUDY OBJECTIVE 3

Understand why ethics is a fundamental business concept.

³"U.S. Share Prices Slump," *Wall Street Journal*, February 21, 2002.

Ethics Notes help sensitize you to some of the ethical issues in accounting.



ETHICS NOTE

Circus-founder P.T. Barnum is alleged to have said, "Trust everyone, but cut the deck." What Sarbanes-Oxley does is to provide measures that (like cutting the deck of playing cards) help ensure that fraud will not occur.

(SOX, or Sarbox). Its intent is to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals. As a result of SOX, top management must now certify the accuracy of financial information. In addition, top management now faces much more severe penalties for fraudulent financial activity. Also, SOX calls for increased independence of the outside auditors who review the accuracy of corporate financial statements and increased responsibility of boards of directors in their oversight role.

The standards of conduct by which one's actions are judged as right or wrong, honest or dishonest, fair or not fair, are **ethics**. Effective financial reporting depends on sound ethical behavior. To sensitize you to ethical situations in business and to give you practice at solving ethical dilemmas, we address ethics in a number of ways in this book:

1. A number of the *Feature Stories* and other parts of the text discuss the central importance of ethical behavior to financial reporting.
2. *Ethics Insight* boxes and marginal *Ethics Notes* highlight ethics situations and issues in actual business settings.
3. Many of the *All About You* boxes (near the chapter Summary; see page 26, for example) focus on ethical issues you may face in your college and early-career years.
4. At the end of the chapter, an *Ethics Case* simulates a business situation and asks you to put yourself in the position of a decision maker in that case.

When analyzing these various ethics cases, as well as experiences in your own life, it is useful to apply the three steps outlined in Illustration 1-4.

Illustration 1-4

Steps in analyzing ethics cases and situations



1. Recognize an ethical situation and the ethical issues involved.

Use your personal ethics to identify ethical situations and issues. Some businesses and professional organizations provide written codes of ethics for guidance in some business situations.

2. Identify and analyze the principal elements in the situation.

Identify the *stakeholders*—persons or groups who may be harmed or benefited. Ask the question: What are the responsibilities and obligations of the parties involved?

3. Identify the alternatives, and weigh the impact of each alternative on various stakeholders.

Select the most ethical alternative, considering all the consequences. Sometimes there will be one right answer. Other situations involve more than one right solution; these situations require an evaluation of each and a selection of the best alternative.

Generally Accepted Accounting Principles

STUDY OBJECTIVE 4

Explain generally accepted accounting principles and the measurement principles.

The accounting profession has developed standards that are generally accepted and universally practiced. This common set of standards is called **generally accepted accounting principles (GAAP)**. These standards indicate how to report economic events.

Various standard-setting bodies, in consultation with the accounting profession and the business community, determine these guidelines:

The **Securities and Exchange Commission (SEC)** is the agency of the U.S. government that oversees U.S. financial markets and accounting standard-setting bodies.

The **Public Company Accounting Oversight Board (PCAOB)** determines auditing standards and reviews auditing firms.

The **Financial Accounting Standards Board (FASB)** is the primary accounting standard-setting body in the United States.

The **International Accounting Standards Board (IASB)** issues international financial reporting standards (IFRS) that have been adopted by many countries outside of the United States.

The FASB and IASB have worked closely to try to minimize the differences in their standards. Recently the SEC announced that foreign companies that wish to have their shares traded on U.S. stock exchanges will no longer have to prepare reports that conform with U.S. accounting standards, as long as their reports conform with international accounting standards. Also, the SEC indicated that it will allow some U.S. companies to adopt IFRS as early as 2009. The SEC also laid out a roadmap by which all U.S. companies will be required to switch to IFRS by 2016. The adoption of IFRS by U.S. companies would make it easier for investors to compare U.S. and foreign companies, as well as for U.S. companies to raise capital in international markets.

MEASUREMENT PRINCIPLES

GAAP generally uses one of two measurement principles, the cost principle or the fair value principle. Selection of which principle to follow generally relates to trade-offs between relevance and faithful representation. **Relevance** means that financial information is capable of making a difference in a decision. **Faithful representation** means that the numbers and descriptions match what really existed or happened—it is factual.

Cost Principle. The **cost principle** (or historical cost principle) dictates that companies record assets at their cost. This is true not only at the time the asset is purchased, but also over the time the asset is held. For example, if **Best Buy** purchases land for \$30,000, the company initially reports it in its accounting records at \$30,000. But what does Best Buy do if, by the end of the next year, the fair value of the land has increased to \$40,000? Under the cost principle it continues to report the land at \$30,000.

Fair Value Principle. The **fair value principle** indicates that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability). Fair value information may be more useful than historical cost for certain types of assets and liabilities. For example, certain investment securities are reported at fair value because market value information is often readily available for these types of assets. In choosing between cost and fair value, the FASB uses two qualities that make accounting information useful for decision making—relevance and faithful representation. In determining which measurement principle to use, the FASB weighs the factual nature of cost figures versus the relevance of fair value. In general, the FASB indicates that most assets must follow the cost principle because market values are not representationally faithful. Only in situations where assets are actively traded, such as investment securities, is the fair value principle applied.

Assumptions

Assumptions provide a foundation for the accounting process. Two main assumptions are the **monetary unit assumption** and the **economic entity assumption**.

MONETARY UNIT ASSUMPTION

The **monetary unit assumption** requires that companies include in the accounting records only transaction data that can be expressed in money terms. This assumption enables accounting to quantify (measure) economic events. The monetary unit assumption is vital to applying the measurement principles.



INTERNATIONAL NOTE

Over 100 countries use international financial reporting standards (IFRS). For example, all companies in the European Union follow international standards. The differences between U.S. and international standards are not generally significant. In this book, we highlight any major differences using International Notes like this one. We provide an extensive discussion of how IFRS relates to accounting principles in the IFRS appendix at the end of the textbook.

International Notes highlight differences between U.S. and international accounting standards.

Helpful Hints further clarify concepts being discussed.

HELPFUL HINT

Relevance and faithful representation are two primary qualities that make accounting information useful for decision making.

STUDY OBJECTIVE 5

Explain the monetary unit assumption and the economic entity assumption.

This assumption prevents the inclusion of some relevant information in the accounting records. For example, the health of a company's owner, the quality of service, and the morale of employees are not included. The reason: Companies cannot quantify this information in money terms. Though this information is important, companies record only events that can be measured in money.



ETHICS NOTE

The importance of the economic entity assumption is illustrated by scandals involving **Adelphia**. In this case, senior company employees entered into transactions that blurred the line between the employees' financial interests and those of the company. For example, Adelphia guaranteed over \$2 billion of loans to the founding family.

ECONOMIC ENTITY ASSUMPTION

An economic entity can be any organization or unit in society. It may be a company (such as **Crocs, Inc.**), a governmental unit (the state of Ohio), a municipality (Seattle), a school district (St. Louis District 48), or a church (Southern Baptist). The **economic entity assumption** requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities. To illustrate, Sally Rider, owner of Sally's Boutique, must keep her personal living costs separate from the expenses of the Boutique. Similarly, **McDonald's**, **Coca-Cola**, and **Cadbury-Schweppes** are segregated into separate economic entities for accounting purposes.

Proprietorship. A business owned by one person is generally a **proprietorship**. The owner is often the manager/operator of the business. Small service-type businesses (plumbing companies, beauty salons, and auto repair shops), farms, and small retail stores (antique shops, clothing stores, and used-book stores) are often proprietorships. **Usually only a relatively small amount of money (capital) is necessary to start in business as a proprietorship. The owner (proprietor) receives any profits, suffers any losses, and is personally liable for all debts of the business.** There is no legal distinction between the business as an economic unit and the owner, but the accounting records of the business activities are kept separate from the personal records and activities of the owner.

Partnership. A business owned by two or more persons associated as partners is a **partnership**. In most respects a partnership is like a proprietorship except that more than one owner is involved. Typically a partnership agreement (written or oral) sets forth such terms as initial investment, duties of each partner, division of net income (or net loss), and settlement to be made upon death or withdrawal of a partner. Each partner generally has unlimited personal liability for the debts of the partnership. **Like a proprietorship, for accounting purposes the partnership transactions must be kept separate from the personal activities of the partners.** Partnerships are often used to organize retail and service-type businesses, including professional practices (lawyers, doctors, architects, and certified public accountants).

Corporation. A business organized as a separate legal entity under state corporation law and having ownership divided into transferable shares of stock is a **corporation**. The holders of the shares (stockholders) **enjoy limited liability**; that is, they are not personally liable for the debts of the corporate entity. Stockholders **may transfer all or part of their ownership shares to other investors at any time** (i.e., sell their shares). The ease with which ownership can change adds to the attractiveness of investing in a corporation. Because ownership can be transferred without dissolving the corporation, the corporation **enjoys an unlimited life**.

Although the combined number of proprietorships and partnerships in the United States is more than five times the number of corporations, the revenue produced by corporations is eight times greater. Most of the largest enterprises in the United States—for example, **ExxonMobil**, **General Motors**, **Wal-Mart**, **Citigroup**, and **Microsoft**—are corporations.

Do it!

Indicate whether each of the five statements presented below is true or false.

1. The three steps in the accounting process are identification, recording, and communication.
2. The two most common types of external users are investors and company officers.
3. Congress passed the Sarbanes-Oxley Act of 2002 to reduce unethical behavior and decrease the likelihood of future corporate scandals.
4. The primary accounting standard-setting body in the United States is the Financial Accounting Standards Board (FASB).
5. The cost principle dictates that companies record assets at their cost. In later periods, however, the fair value of the asset must be used if fair value is higher than its cost.

Solution

1. True 2. False. The two most common types of external users are investors and creditors.
3. True. 4. True. 5. False. The cost principle dictates that companies record assets at their cost. Under the cost principle, the company must also use cost in later periods as well.

Related exercise material: **E1-1, E1-2, E1-3, E1-4**, and **Do it! 1-1**.

before you go on...

Basic Concepts

The Do it! exercises ask you to put newly acquired knowledge to work. They outline the Action Plan necessary to complete the exercise, and they show a Solution.

Action Plan

- Review the basic concepts learned to date.
- Develop an understanding of the key terms used.



ACCOUNTING ACROSS THE ORGANIZATION



How Will Accounting Help Me?

One question that students frequently ask is, “How will the study of accounting help me?” It should help you a great deal, because a working knowledge of accounting is desirable for virtually every *field* of endeavor. Some examples of how accounting is used in other careers include:

General management: Imagine running **Ford Motors**, **Massachusetts General Hospital**, **Northern Virginia Community College**, a **Subway** franchise, a **Trek** bike shop. All general managers need to understand where the enterprise’s cash comes from and where it goes in order to make wise business decisions.

Marketing: A marketing specialist at a company like **Procter & Gamble** develops strategies to help the sales force be successful. But making a sale is meaningless unless it is a profitable sale. Marketing people must be sensitive to costs and benefits, which accounting helps them quantify and understand.

Finance: Do you want to be a banker for **Bank of America**, an investment analyst for **Goldman Sachs**, a stock broker for **Merrill Lynch**? These fields rely heavily on accounting. In all of them you will regularly examine and analyze financial statements. In fact, it is difficult to get a good finance job without two or three courses in accounting.

Real estate: Are you interested in being a real estate broker for **Prudential Real Estate**? Because a third party—the bank—is almost always involved in financing a real estate transaction, brokers must understand the numbers involved: Can the buyer afford to make the payments to the bank? Does the cash flow from an industrial property justify the purchase price? What are the tax benefits of the purchase?



How might accounting help you?



Accounting Across the Organization boxes demonstrate applications of accounting information in various business functions. Guideline answers are provided on the last page of the chapter.

THE BASIC ACCOUNTING EQUATION

STUDY OBJECTIVE 6

State the accounting equation, and define its components.

The two basic elements of a business are what it owns and what it owes. **Assets** are the resources a business owns. For example, **Google** has total assets of approximately \$18.4 billion. Liabilities and owner's equity are the rights or claims against these resources. Thus, Google has \$18.4 billion of claims against its \$18.4 billion of assets. Claims of those to whom the company owes money (creditors) are called **liabilities**. Claims of owners are called **stockholders' equity**. Google has liabilities of \$1.4 billion and stockholders' equity of \$17 billion.

We can express the relationship of assets, liabilities, and stockholders' equity as an equation, as shown in Illustration 1-5.

Illustration 1-5

The basic accounting equation

Assets	=	Liabilities	+	Stockholders' Equity
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This relationship is the **basic accounting equation**. Assets must equal the sum of liabilities and stockholders' equity. Liabilities appear before stockholders' equity in the basic accounting equation because they are paid first if a business is liquidated.

The accounting equation applies to all **economic entities** regardless of size, nature of business, or form of business organization. It applies to a small proprietorship such as a corner grocery store as well as to a giant corporation such as **PepsiCo**. The equation provides the **underlying framework** for recording and summarizing economic events.

Let's look in more detail at the categories in the basic accounting equation.

Assets

As noted above, **assets** are resources a business owns. The business uses its assets in carrying out such activities as production and sales. The common characteristic possessed by all assets is **the capacity to provide future services or benefits**. In a business, that service potential or future economic benefit eventually results in cash inflows (receipts). For example, Campus Pizza owns a delivery truck that provides economic benefits from delivering pizzas. Other assets of Campus Pizza are tables, chairs, jukebox, cash register, oven, tableware, and, of course, cash.

Liabilities

Liabilities are claims against assets—that is, existing debts and obligations. Businesses of all sizes usually borrow money and purchase merchandise on credit. These economic activities result in payables of various sorts:

- Campus Pizza, for instance, purchases cheese, sausage, flour, and beverages on credit from suppliers. These obligations are called **accounts payable**.
- Campus Pizza also has a **note payable** to First National Bank for the money borrowed to purchase the delivery truck.
- Campus Pizza may also have **wages payable** to employees and **sales and real estate taxes payable** to the local government.

All of these persons or entities to whom Campus Pizza owes money are its **creditors**.

Creditors may legally force the liquidation of a business that does not pay its debts. In that case, the law requires that creditor claims be paid **before** ownership claims.

Stockholders' Equity

The ownership claim on total assets is **stockholders' equity**. It is equal to total assets minus total liabilities. Here is why: The assets of a business are claimed by either creditors or stockholders. To find out what belongs to stockholders, we subtract creditors' claims (the liabilities) from the assets. The remainder is the stockholders' claim on the assets—stockholders' equity. It is often referred to as **residual equity**—that is, the equity “left over” after creditors' claims are satisfied.

The stockholders' equity section of a corporation's balance sheet generally consists of (1) common stock and (2) retained earnings.

COMMON STOCK

A corporation may obtain funds by selling shares of stock to investors. **Common stock** is the term used to describe the total amount paid in by stockholders for the shares they purchase.

RETAINED EARNINGS

The **retained earnings** section of the balance sheet is determined by three items: revenues, expenses, and dividends.

Revenues. **Revenues** are the gross increases in stockholders' equity resulting from business activities entered into for the purpose of earning income. Generally, revenues result from selling merchandise, performing services, renting property, and lending money.

Revenues usually result in an increase in an asset. They may arise from different sources and are called various names depending on the nature of the business. Campus Pizza, for instance, has two categories of sales revenues—pizza sales and beverage sales. Other titles for and sources of revenue common to many businesses are: sales, fees, services, commissions, interest, dividends, royalties, and rent.

Expenses. **Expenses** are the cost of assets consumed or services used in the process of earning revenue. **They are decreases in stockholders' equity that result from operating the business.** Like revenues, expenses take many forms and are called various names depending on the type of asset consumed or service used. For example, Campus Pizza recognizes the following types of expenses: cost of ingredients (flour, cheese, tomato paste, meat, mushrooms, etc.); cost of beverages; wages expense; utilities expense (electric, gas, and water expense); telephone expense; delivery expense (gasoline, repairs, licenses, etc.); supplies expense (napkins, detergents, aprons, etc.); rent expense; interest expense; and property tax expense.

Dividends. Net income represents an increase in net assets which are then available to distribute to stockholders. The distribution of cash or other assets to stockholders is called a **dividend**. Dividends reduce retained earnings. However, dividends are **not an expense**. A corporation first determines its revenues and expenses and then computes net income or net loss. If it has net income, and decides it has no better use for that income, a corporation may decide to distribute a dividend to its owners (the stockholders).

In summary, the principal sources (increases) of stockholders' equity are investments by stockholders and revenues from business operations. In contrast, reductions (decreases) in stockholders' equity result from expenses and dividends. These relationships are shown in Illustration 1-6 (page 14).

HELPFUL HINT

In some situations accountants use the term *owner's equity* and in others *owners' equity*. *Owner's* refers to one owner (the case with a sole proprietorship), and *owners'* refers to multiple owners (the case with partnerships). The term *stockholders' equity* refers to ownership in corporations.

HELPFUL HINT

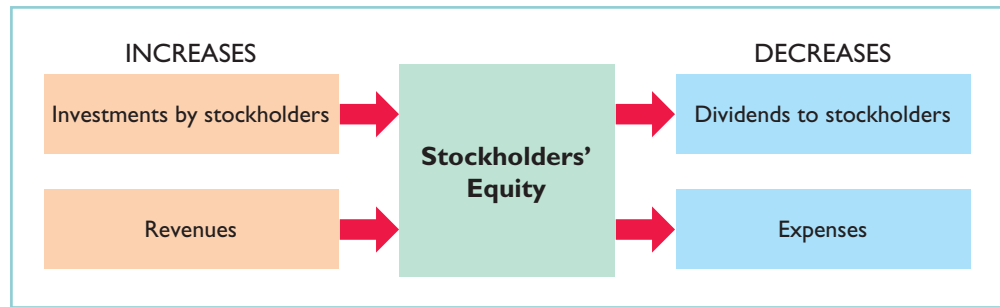
The effect of revenues is positive—an increase in stockholders' equity coupled with an increase in assets or a decrease in liabilities.

HELPFUL HINT

The effect of expenses is negative—a decrease in stockholders' equity coupled with a decrease in assets or an increase in liabilities.

Illustration 1-6

Increases and decreases
in stockholders' equity



before you go on...

Stockholders' Equity Effects**Action Plan**

- Understand the sources of revenue.
- Understand what causes expenses.
- Review the rules for changes in stockholders' equity: Investments and revenues increase stockholders' equity. Expenses and dividends decrease stockholders' equity.
- Recognize that dividends are distributions of cash or other assets to stockholders.

Do it!

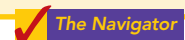
Classify the following items as issuance of stock (I), dividends (D), revenues (R), or expenses (E). Then indicate whether each item increases or decreases stockholders' equity.

- | | |
|---------------------|----------------------|
| (1) Rent Expense | (3) Dividends |
| (2) Service Revenue | (4) Salaries Expense |

Solution

1. Rent Expense is an expense (E); it decreases stockholders' equity. 2. Service Revenue is a revenue (R); it increases stockholders' equity. 3. Dividends is a distribution to stockholders (D); it decreases stockholders' equity. 4. Salaries Expense is an expense (E); it decreases stockholders' equity.

Related exercise material: **BE1-1, BE1-2, BE1-3, BE1-4, BE1-5, E1-5, E1-6, E1-7**, and **Do it! 1-2**.



USING THE ACCOUNTING EQUATION

STUDY OBJECTIVE 7

Analyze the effects of business transactions on the accounting equation.

Transactions (business transactions) are a business's economic events recorded by accountants. Companies carry on many activities that do not represent business transactions. Examples are hiring employees, answering the telephone, talking with customers, and placing merchandise orders. Some of these activities may lead to business transactions: Employees will earn wages, and suppliers will deliver ordered merchandise. The company must analyze each event to find out if it affects the components of the accounting equation. If it does, the company will record the transaction. Illustration 1-7 (page 15) demonstrates the transaction-identification process.

Each transaction must have a dual effect on the accounting equation. For example, if an asset is increased, there must be a corresponding: (1) decrease in another asset, or (2) increase in a specific liability, or (3) increase in stockholders' equity.

Two or more items could be affected. For example, as one asset is increased \$10,000, another asset could decrease \$6,000 and a liability could increase \$4,000. Any change in a liability or ownership claim is subject to similar analysis.

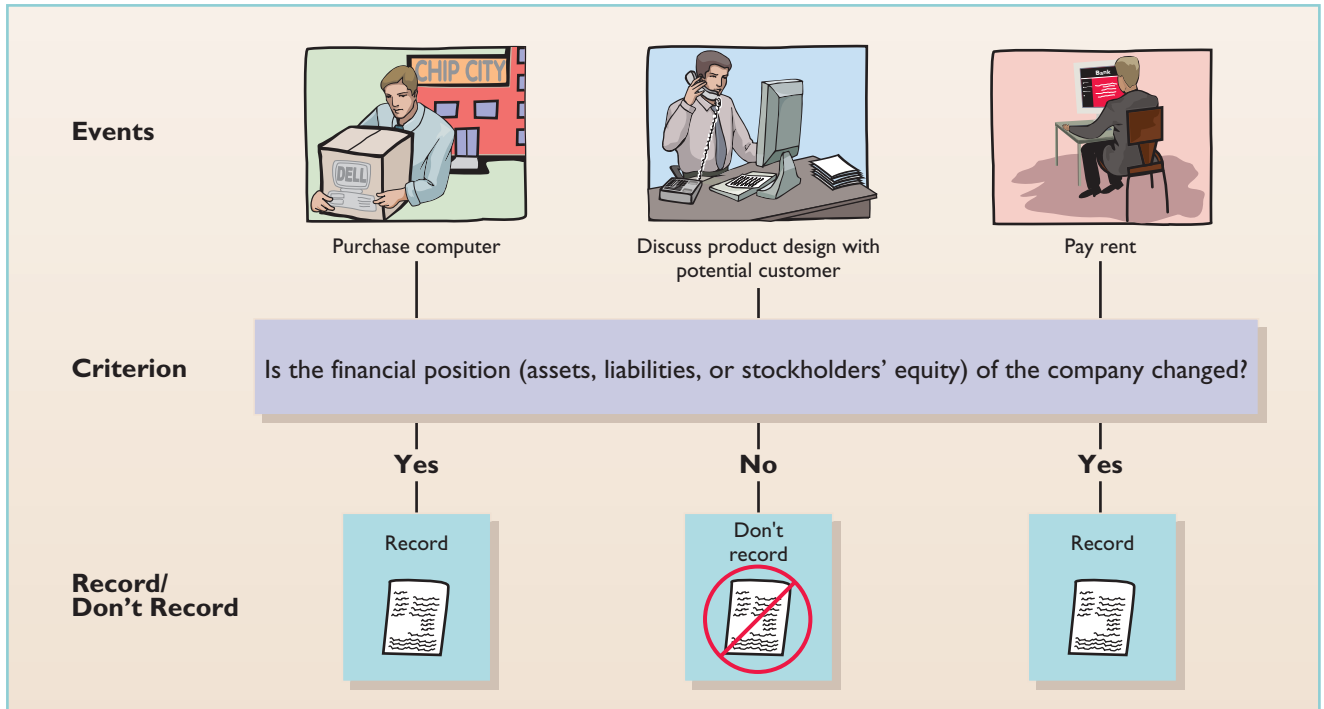
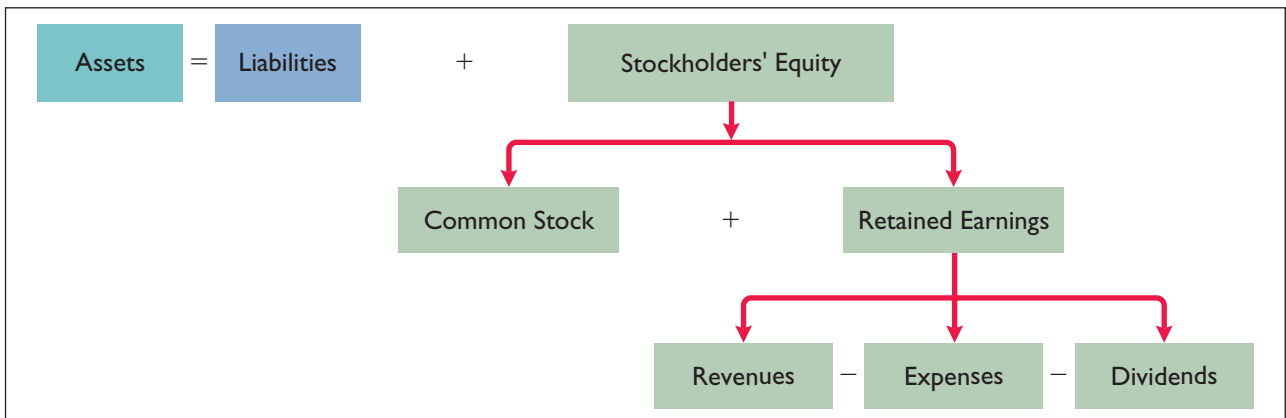


Illustration 1-7
Transaction-identification process

Transaction Analysis

In order to analyze transactions, we will examine a computer programming business (Softbyte Inc.) during its first month of operations. As part of this analysis, we will expand the basic accounting equation. This will allow us to better illustrate the impact of transactions on stockholders' equity. Recall that stockholders' equity is comprised of two parts: common stock and retained earnings. Common stock is affected when the company issues new shares of stock in exchange for cash. Retained earnings is affected when the company earns revenue, incurs expenses, or pays dividends. Illustration 1-8 shows the expanded equation.

Illustration 1-8
Expanded accounting equation



HELPFUL HINT

You will want to study these transactions until you are sure you understand them. They are not difficult, but understanding them is important to your success in this course. The ability to analyze transactions in terms of the basic accounting equation is essential in accounting.

If you are tempted to skip ahead after you've read a few of the following transaction analyses, don't do it. Each has something unique to teach, something you'll need later. (We assure you that we've kept them to the minimum needed!)

Transaction 1. Investment by Stockholders. Ray and Barbara Neal decide to open a computer programming company that they incorporate as Softbyte Inc. On September 1, 2011, they invest \$15,000 cash in the business in exchange for \$15,000 of common stock. The common stock indicates the ownership interest that the Neals have in Softbyte Inc. This transaction results in an equal increase in both assets and stockholders' equity. The asset Cash increases \$15,000, as does Common Stock. The effect of this transaction on the basic equation is:

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
	Cash	=			Common Stock
(1)	+\$15,000	=			+\$15,000 Issued Stock

Observe that the equality of the basic equation has been maintained. Note also that the source of the increase in stockholders' equity (in this case, Issued Stock) is indicated. Why does this matter? Because investments by stockholders do not represent revenues, and they are excluded in determining net income. Therefore, it is necessary to make clear that the increase is an investment rather than revenue from operations. Additional investments (i.e., investments made by stockholders after the corporation has been initially formed) have the same effect on stockholders' equity as the initial investment.

Transaction 2. Purchase of Equipment for Cash. Softbyte Inc. purchases computer equipment for \$7,000 cash. This transaction results in an equal increase and decrease in total assets, though the composition of assets changes: Cash decreases \$7,000, and the asset Equipment increases \$7,000. The specific effect of this transaction and the cumulative effect of the first two transactions are:

	<u>Assets</u>		=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
	Cash	+ Equipment	=			Common Stock
Old Bal.	\$15,000					\$15,000
(2)	-7,000	+7,000				
New Bal.	\$ 8,000	\$7,000	=			\$15,000
	\$15,000					

Observe that total assets are still \$15,000. Common stock also remains at \$15,000, the amount of the original investment.

Transaction 3. Purchase of Supplies on Credit. Softbyte Inc. purchases for \$1,600 from Acme Supply Company computer paper and other supplies expected to last several months. Acme agrees to allow Softbyte to pay this bill in October. This transaction is a purchase on account (a credit purchase). Assets increase because of the expected future benefits of using the paper and supplies, and liabilities increase by the amount due Acme Company. The asset Supplies increases \$1,600,

and the liability Accounts Payable increases by the same amount. The effect on the equation is:

		Assets			=	Liabilities	+	Stockholders' Equity		
		Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock
(3)	Old Bal.	\$8,000				\$7,000	=			\$15,000
	New Bal.	\$8,000	+	+\$1,600	+	\$7,000	=	+\$1,600	+	\$15,000
		\$16,600						\$16,600		

Total assets are now \$16,600. This total is matched by a \$1,600 creditor's claim and a \$15,000 ownership claim.

Transaction 4. Services Provided for Cash. Softbyte Inc. receives \$1,200 cash from customers for programming services it has provided. This transaction represents Softbyte's principal revenue-producing activity. Recall that **revenue increases stockholders' equity**. In this transaction, Cash increases \$1,200, and revenues (specifically Service Revenue) increase \$1,200. The new balances in the equation are:

		Assets			=	Liabilities	+	Stockholders' Equity										
		Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+	Retained Earnings						
												Rev.	-	Exp.	-	Div.		
(4)	Old Bal.	\$8,000		\$1,600		\$7,000	=	\$1,600		\$15,000								
	New Bal.	+\$1,200		\$1,600		\$7,000	=	\$1,600		\$15,000		+\$1,200						
		\$17,800						\$17,800										Service Revenue

The two sides of the equation balance at \$17,800. Note that stockholders' equity increases when revenues are earned. The title Service Revenue indicates the source of the increase in stockholders' equity. Service Revenue is included in determining Softbyte Inc.'s net income.

Transaction 5. Purchase of Advertising on Credit. Softbyte Inc. receives a bill for \$250 from the *Daily News* for advertising the opening of its business but postpones payment of the bill until a later date. This transaction results in an increase in liabilities and a decrease in stockholders' equity. The specific items involved are Accounts Payable and Advertising Expense. The effect on the equation is:

		Assets			=	Liabilities	+	Stockholders' Equity										
		Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+	Retained Earnings						
												Rev.	-	Exp.	-	Div.		
(5)	Old Bal.	\$9,200		\$1,600		\$7,000	=	\$1,600		\$15,000		\$1,200						
	New Bal.	\$9,200		\$1,600		\$7,000	=	+\$250		\$15,000		\$1,200		-\$250				
		\$17,800						\$17,800										Advertising Expense

The two sides of the equation still balance at \$17,800. Retained Earnings decreases when Softbyte incurs the expense. In addition, the specific cause of the decrease (advertising expense) is noted. Expenses do not have to be paid in cash at the time they are incurred. When Softbyte pays at a later date, the liability Accounts Payable will decrease and the asset Cash will decrease [see Transaction (8)]. The cost of advertising is an expense (rather than an asset) because Softbyte has used the benefits. Advertising Expense is included in determining net income.

Transaction 6. Services Rendered for Cash and Credit. Softbyte Inc. provides \$3,500 of programming services for customers. The company receives cash of \$1,500 from customers, and it bills the balance of \$2,000 on account. This transaction results in an equal increase in assets and stockholders' equity. Three specific items are affected: Cash increases \$1,500; Accounts Receivable increases \$2,000; and Service Revenue increases \$3,500. The new balances are as follows.

	Assets				=	Liabilities	+	Stockholders' Equity									
	Cash	+	Accounts Receivable	+				Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+	Retained Earnings	
													Rev.	-	Exp.	-	Div.
Old Bal.	\$ 9,200					\$1,850		\$15,000		\$1,200			\$250				
(6)	+1,500		+2,000							+3,500							
New Bal.	\$10,700	+	\$2,000	+	\$1,600	+	\$7,000	=	\$1,850	+	\$15,000	+	\$4,700	-	\$250		
	\$21,300										\$21,300						

Why increase Service Revenue by \$3,500 when Softbyte has collected only \$1,500? We do so because the inflow of assets resulting from the earning of revenues does not have to be in the form of cash. Remember that stockholders' equity increases when revenues are earned. Softbyte earns revenues when it provides the service. When it later receives collections on account, Softbyte will increase Cash and will decrease Accounts Receivable [see Transaction (9)].

Transaction 7. Payment of Expenses. Softbyte pays the following expenses in cash for September: store rent \$600, salaries of employees \$900, and utilities \$200. These payments result in an equal decrease in assets and stockholders' equity. Cash decreases \$1,700 and Retained Earnings decreases by the same amount. The effect of these payments on the equation is:

	Assets				=	Liabilities	+	Stockholders' Equity									
	Cash	+	Accounts Receivable	+				Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+	Retained Earnings	
													Rev.	-	Exp.	-	Div.
Old Bal.	\$10,700		\$2,000		\$1,600		\$7,000	=	\$1,850		\$15,000		\$4,700		\$250		
(7)	-1,700														-600		
															-900		
															-200		
New Bal.	\$ 9,000	+	\$2,000	+	\$1,600	+	\$7,000	=	\$1,850	+	\$15,000	+	\$4,700	-	\$1,950		
	\$19,600										\$19,600						

The two sides of the equation now balance at \$19,600. Three lines are required in the analysis to indicate the different types of expenses that have been incurred.

Transaction 8. Payment of Accounts Payable. Softbyte Inc. pays its *Daily News* advertising bill of \$250 in cash. The company previously (in Transaction 5) recorded the bill as an increase in Accounts Payable and a decrease in Retained Earnings. This payment “on account” decreases the asset Cash by \$250 and also decreases the liability Accounts Payable by \$250. The effect of this transaction on the equation is:

	Assets				=	Liabilities	+	Stockholders' Equity											
	Cash	+	Accounts Receivable	+		Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+	Retained Earnings	Rev.	-	Exp.	-	Div.
Old Bal.	\$9,000		\$2,000		\$1,600		\$7,000	=	\$1,850		\$15,000		\$4,700		\$1,950				
(8)	-250								-250										
New Bal.	\$8,750	+	\$2,000	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	\$4,700	-	\$1,950				
	\$19,350								\$19,350										

Observe that the payment of a liability related to an expense that has previously been recorded does not affect stockholders' equity. Softbyte recorded the expense (in Transaction 5) and should not record it again. Neither Common Stock nor Retained Earnings changes as a result of this transaction.

Transaction 9. Receipt of Cash on Account. Softbyte receives the sum of \$600 in cash from customers who had previously been billed for services (in Transaction 6). This transaction does not change total assets, but it changes the composition of those assets. Cash increases \$600 and Accounts Receivable decreases \$600. The new balances are:

	Assets				=	Liabilities	+	Stockholders' Equity											
	Cash	+	Accounts Receivable	+		Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+	Retained Earnings	Rev.	-	Exp.	-	Div.
Old Bal.	\$8,750		\$2,000		\$1,600		\$7,000	=	\$1,600		\$15,000		\$4,700		\$1,950				
(9)	+600		-600																
New Bal.	\$9,350	+	\$1,400	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	\$4,700	-	\$1,950				
	\$19,350								\$19,350										

Note that the collection of an account receivable for services previously billed and recorded does not affect stockholders' equity. Softbyte already recorded this revenue (in Transaction 6) and should not record it again.

Transaction 10. Dividends. The corporation pays a dividend of \$1,300 in cash to Ray and Barbara Neal, the stockholders of Softbyte Inc. This transaction results in an equal decrease in assets and stockholders' equity. Both Cash and Retained Earnings decrease \$1,300, as shown on the next page.

	Assets				=	Liabilities	+	Stockholders' Equity			
	Cash	Accounts Receivable	Supplies	Equipment				Accounts Payable	Common Stock	Retained Earnings	
								Rev.	Exp.	Div.	
Old Bal.	\$9,350	\$1,400	\$1,600	\$7,000	=	\$1,600	+	\$15,000	\$4,700	\$1,950	
(10)	-1,300				=						-1,300 Dividends
New Bal.	\$8,050	\$1,400	\$1,600	\$7,000	=	\$1,600	+	\$15,000	\$4,700	\$1,950	\$1,300
	\$18,050					\$18,050					

Note that the dividend reduces retained earnings, which is part of stockholders' equity. **Dividends are not expenses.** Like stockholders' investments, dividends are excluded in determining net income.

Summary of Transactions

Illustration 1-9 summarizes the September transactions of Softbyte Inc. to show their cumulative effect on the basic accounting equation. It also indicates the transaction number and the specific effects of each transaction.

Illustration 1-9

Tabular summary of Softbyte Inc. transactions

Transaction	Assets				=	Liabilities	+	Stockholders' Equity			
	Cash	Accounts Receivable	Supplies	Equipment				Accounts Payable	Common Stock	Retained Earnings	
								Rev.	Exp.	Div.	
(1)	+15,000						+	\$15,000			Issued Stock
(2)	-7,000			+7,000							
(3)			+1,600		+1,600						
(4)	+1,200							+1,200			Service Revenue
(5)					+250				-250		Advert. Expense
(6)	+1,500	+2,000						+3,500			Service Revenue
(7)	-1,700								-600		Rent Expense
									-900		Salaries Expense
									-200		Utilities Expense
(8)	-250				-250						
(9)	+600	-600									
(10)	-1,300										-1,300 Dividends
	\$ 8,050	\$1,400	\$1,600	\$7,000	=	\$1,600	+	\$15,000	\$4,700	\$1,950	\$1,300
	\$18,050					\$18,050					

Illustration 1-9 demonstrates a number of significant facts:

- Each transaction must be analyzed in terms of its effect on:
 - the three components of the basic accounting equation.
 - specific types (kinds) of items within each component.
- The two sides of the equation must always be equal.
- The Common Stock and Retained Earnings columns indicate the causes of each change in the stockholders' claim on assets.

There! You made it through transaction analysis. If you feel a bit shaky on any of the transactions, it might be a good idea at this point to get up, take a short break, and come back again for a brief (10- to 15-minute) review of the transactions, to make sure you understand them before you go on to the next section.

before you go on...

Do it!

Transactions made by Virmari & Co., a public accounting firm, for the month of August are shown below. Prepare a tabular analysis which shows the effects of these transactions on the expanded accounting equation, similar to that shown in Illustration 1-9.

1. Stockholders purchased shares of stock for \$25,000 cash.
2. The company purchased \$7,000 of office equipment on credit.
3. The company received \$8,000 cash in exchange for services performed.
4. The company paid \$850 for this month's rent.
5. The company paid a dividend of \$1,000 in cash to stockholders.

Solution

Transaction	Assets		=	Liabilities	+	Stockholders' Equity					
	Cash	+ Office Equipment	=	Accounts Payable	+	Common Stock	+ Retained Earnings	Rev.	- Exp.	- Div.	
(1)	+\$25,000					+\$25,000					
(2)		+\$7,000		+\$7,000							
(3)	+8,000						+8,000				
(4)	-850								-850		
(5)	-1,000									-\$1,000	
	<u>\$31,150</u>	<u>+ \$7,000</u>	=	<u>\$7,000</u>	+	<u>\$25,000</u>	<u>+ \$8,000</u>	<u>- \$850</u>		<u>-\$1,000</u>	
	\$38,150			\$38,150							

Service Revenue
Rent Expense
Dividends

Related exercise material: BE1-6, BE1-7, BE1-8, BE1-9, E1-6, E1-7, E1-8, E1-10, and Do it! 1-3.



FINANCIAL STATEMENTS

Companies prepare four financial statements from the summarized accounting data:

1. An **income statement** presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time.
2. A **retained earnings statement** summarizes the changes in retained earnings for a specific period of time.
3. A **balance sheet** reports the assets, liabilities, and stockholders' equity of a company at a specific date.
4. A **statement of cash flows** summarizes information concerning the cash inflows (receipts) and outflows (payments) for a specific period of time.

STUDY OBJECTIVE 8
Understand the four financial statements and how they are prepared.

Each statement provides relevant financial data for internal and external users.

Illustration 1-10 (page 22) shows the financial statements of Softbyte Inc. Note that the statements are interrelated:

1. Net income of \$2,750 shown on the income statement is added to the beginning balance of retained earnings in the retained earnings statement.
2. Retained earnings of \$1,450 at the end of the reporting period shown in the retained earnings statement is reported on the balance sheet.
3. Cash of \$8,050 on the balance sheet is reported on the statement of cash flows.

HELPFUL HINT
The income statement, retained earnings statement, and statement of cash flows are all for a *period* of time. The balance sheet is for a *point* in time.

Illustration 1-10

Financial statements and their interrelationships

HELPFUL HINT

The heading of each statement identifies the company, the type of statement, and the specific date or time period covered by the statement.

HELPFUL HINT

The four financial statements are prepared in the sequence shown, for the following reasons:

- Net income is computed first and is needed to determine the ending balance in retained earnings.
- The ending balance in retained earnings is needed in preparing the balance sheet.
- The cash shown on the balance sheet is needed in preparing the statement of cash flows.

HELPFUL HINT

Note that final sums are double-underlined, and negative amounts are presented in parentheses.

SOFTBYTE INC.
Income Statement
For the Month Ended September 30, 2011

Revenues		
Service revenue		\$4,700
Expenses		
Salaries expense	\$900	
Rent expense	600	
Advertising expense	250	
Utilities expense	<u>200</u>	
Total expenses		<u>1,950</u>
Net income		<u>\$2,750</u>

SOFTBYTE INC.
Retained Earnings Statement
For the Month Ended September 30, 2011

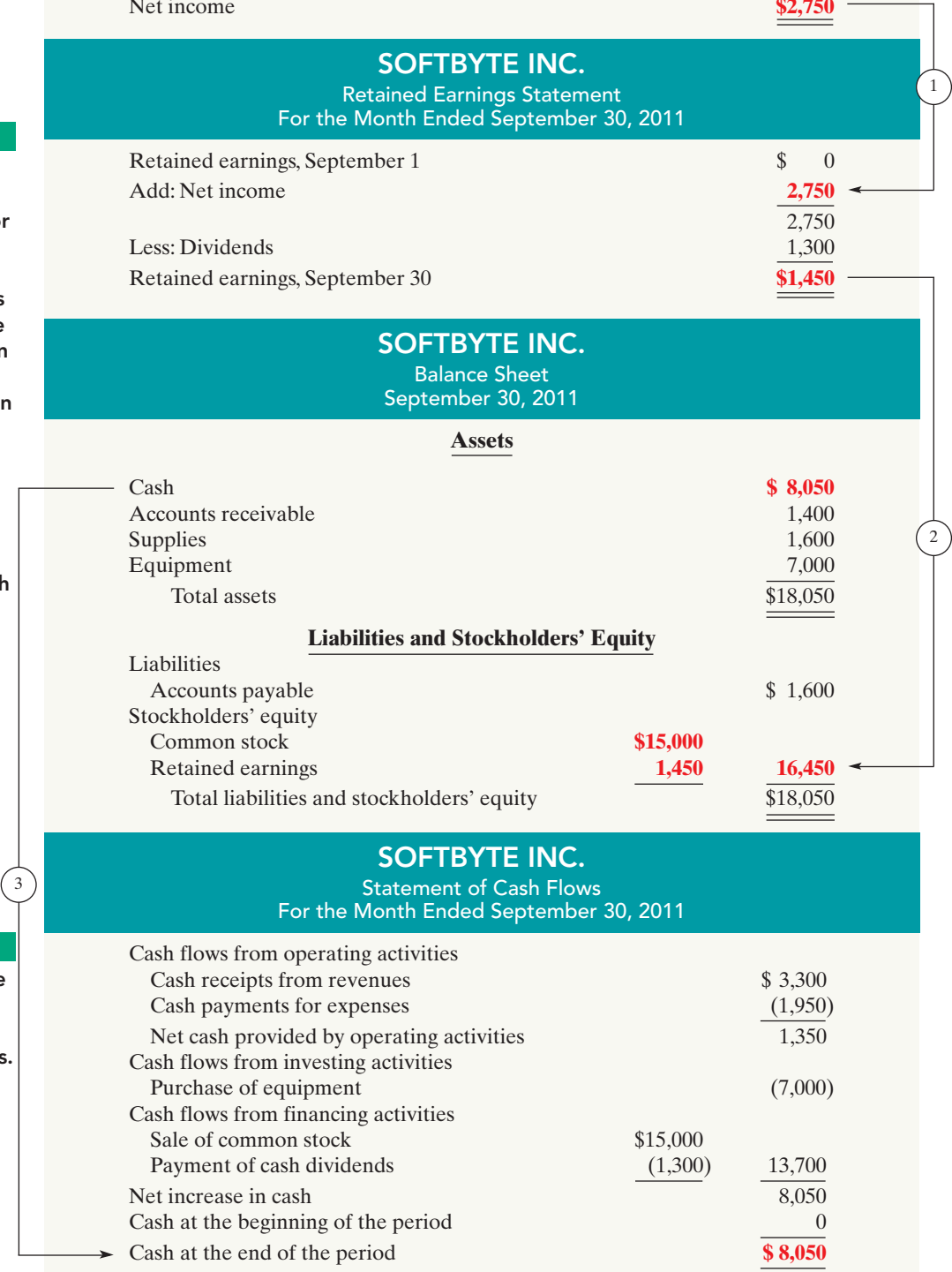
Retained earnings, September 1	\$ 0
Add: Net income	<u>2,750</u>
	2,750
Less: Dividends	<u>1,300</u>
Retained earnings, September 30	<u>\$1,450</u>

SOFTBYTE INC.
Balance Sheet
September 30, 2011

<u>Assets</u>		
Cash		\$ 8,050
Accounts receivable		1,400
Supplies		1,600
Equipment		<u>7,000</u>
Total assets		<u>\$18,050</u>
<u>Liabilities and Stockholders' Equity</u>		
Liabilities		
Accounts payable		\$ 1,600
Stockholders' equity		
Common stock	\$15,000	
Retained earnings	<u>1,450</u>	<u>16,450</u>
Total liabilities and stockholders' equity		<u>\$18,050</u>

SOFTBYTE INC.
Statement of Cash Flows
For the Month Ended September 30, 2011

Cash flows from operating activities		
Cash receipts from revenues		\$ 3,300
Cash payments for expenses		<u>(1,950)</u>
Net cash provided by operating activities		1,350
Cash flows from investing activities		
Purchase of equipment		(7,000)
Cash flows from financing activities		
Sale of common stock	\$15,000	
Payment of cash dividends	<u>(1,300)</u>	<u>13,700</u>
Net increase in cash		8,050
Cash at the beginning of the period		<u>0</u>
Cash at the end of the period		<u>\$ 8,050</u>



Also, explanatory notes and supporting schedules are an integral part of every set of financial statements. We illustrate examples of these notes and schedules in later chapters of this textbook.

Be sure to carefully examine the format and content of each statement in Illustration 1-10. We describe the essential features of each in the following sections.

HELPFUL HINT

There is only one group of notes for the whole set of financial statements, rather than separate sets of notes for each financial statement.

Income Statement

The income statement reports the success or profitability of the company's operations over a specific period of time. For example, Softbyte Inc.'s income statement is dated "For the Month Ended September 30, 2011." It is prepared from the data appearing in the revenue and expense columns of Illustration 1-9 (page 20). The heading of the statement identifies the company, the type of statement, and the time period covered by the statement.

The income statement lists revenues first, followed by expenses. Finally, the statement shows net income (or net loss). When revenues exceed expenses, **net income** results. When expenses exceed revenues, a **net loss** results.

Although practice varies, we have chosen in our illustrations and homework solutions to list expenses in order of magnitude. (We will consider alternative formats for the income statement in later chapters.)

Note that the income statement does not include investment and dividend transactions between the stockholders and the business in measuring net income. For example, as explained earlier, the cash dividend from Softbyte Inc. was not regarded as a business expense. This type of transaction is considered a reduction of retained earnings, which causes a decrease in stockholders' equity.

ALTERNATIVE TERMINOLOGY

The income statement is sometimes referred to as the *statement of operations*, *earnings statement*, or *profit and loss statement*.

Alternative Terminology notes present synonymous terms that you may come across in practice.

Retained Earnings Statement

Softbyte Inc.'s retained earnings statement reports the changes in retained earnings for a specific period of time. The time period is the same as that covered by the income statement ("For the Month Ended September 30, 2011"). Data for the preparation of the retained earnings statement come from the retained earnings columns of the tabular summary (Illustration 1-9) and from the income statement (Illustration 1-10).

The first line of the statement shows the beginning retained earnings amount. Then come net income and dividends. The retained earnings ending balance is the final amount on the statement. The information provided by this statement indicates the reasons why retained earnings increased or decreased during the period. If there is a net loss, it is deducted with dividends in the retained earnings statement.

Balance Sheet

Softbyte Inc.'s balance sheet reports the assets, liabilities, and stockholders' equity at a specific date (September 30, 2011). The company prepares the balance sheet from the column headings and the month-end data shown in the last line of the tabular summary (Illustration 1-9).

Observe that the balance sheet lists assets at the top, followed by liabilities and stockholders' equity. Total assets must equal total liabilities and stockholders' equity. Softbyte Inc. reports only one liability, accounts payable, on its balance sheet. In most cases, there will be more than one liability. When two or more liabilities are involved, a customary way of listing is as shown in Illustration 1-11 (page 24).

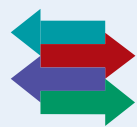
Illustration 1-11

Presentation of liabilities

<u>Liabilities</u>	
Notes payable	\$10,000
Accounts payable	63,000
Salaries payable	<u>18,000</u>
Total liabilities	\$91,000

The balance sheet is like a snapshot of the company's financial condition at a specific moment in time (usually the month-end or year-end).

ACCOUNTING ACROSS THE ORGANIZATION



What Do General Mills, Walt Disney, and Dunkin' Donuts Have in Common?

Not every company uses December 31 as the accounting year-end. Some companies whose year-ends differ from December 31 are **General Mills**, May 27; **Walt Disney Productions**, September 30; and **Dunkin' Donuts Inc.**, October 31. Why do companies choose the particular year-ends that they do? Many choose to end the accounting year when inventory or operations are at a low. Compiling accounting information requires much time and effort by managers, so companies would rather do it when they aren't as busy operating the business. Also, inventory is easier and less costly to count when it is low.



What year-end would you likely use if you owned a ski resort and ski rental business? What if you owned a college bookstore? Why choose those year-ends?

HELPFUL HINT

Investing activities pertain to investments made by the company, not investments made by the owner.

Statement of Cash Flows

The statement of cash flows provides information on the cash receipts and payments for a specific period of time. The statement of cash flows reports (1) the cash effects of a company's operations during a period, (2) its investing transactions, (3) its financing transactions, (4) the net increase or decrease in cash during the period, and (5) the cash amount at the end of the period.

Reporting the sources, uses, and change in cash is useful because investors, creditors, and others want to know what is happening to a company's most liquid resource. The statement of cash flows provides answers to the following simple but important questions.

1. Where did cash come from during the period?
2. What was cash used for during the period?
3. What was the change in the cash balance during the period?

As shown in Softbyte Inc.'s statement of cash flows in Illustration 1-10, cash increased \$8,050 during the period. Net cash flow provided from operating activities increased cash \$1,350. Cash flow from investing transactions decreased cash \$7,000. And cash flow from financing transactions increased cash \$13,700. At this time, you need not be concerned with how these amounts are determined. Chapter 14 will examine in detail how the statement is prepared.

before you go on...

Do it!

Presented below is selected information related to Flanagan Corporation at December 31, 2011. Flanagan reports financial information monthly.

Financial Statement Items

Office Equipment	\$10,000	Utilities Expense	\$ 4,000
Cash	8,000	Accounts Receivable	9,000
Service Revenue	36,000	Wages Expense	7,000
Rent Expense	11,000	Notes Payable	16,500
Accounts Payable	2,000	Dividends	5,000

- (a) Determine the total assets of Flanagan Corporation at December 31, 2011.
- (b) Determine the net income that Flanagan Corporation reported for December 2011.
- (c) Determine the stockholders' equity of Flanagan Corporation at December 31, 2011.

Solution

- (a) The total assets are \$27,000, comprised of Cash \$8,000, Accounts Receivable \$9,000, and Office Equipment \$10,000.
- (b) Net income is \$14,000, computed as follows:

Revenues			
Service revenue			\$36,000
Expenses			
Rent expense	\$11,000		
Wages expense	7,000		
Utilities expense	<u>4,000</u>		
Total expenses			<u>22,000</u>
Net income			<u>\$14,000</u>

- (c) The ending stockholders' equity of Flanagan Corporation is \$8,500. By rewriting the accounting equation, we can compute stockholders' equity as assets minus liabilities, as follows:

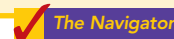
Total assets [as computed in (a)]		\$27,000
Less: Liabilities		
Notes payable	\$16,500	
Accounts payable	<u>2,000</u>	<u>18,500</u>
Stockholders' equity		<u>\$ 8,500</u>

Note that it is not possible to determine the corporation's stockholders' equity in any other way because the beginning total for stockholders' equity is not provided.

Action Plan

- Remember the basic accounting equation: assets must equal liabilities plus stockholders' equity.
- Review previous financial statements to determine how total assets, net income, and stockholders' equity are computed.

Related exercise material: **BE1-10, BE1-11, E1-8, E1-10, E1-11, and Do it! 1-4.**



Be sure to read
all about YOU
**Ethics: Managing
 Personal Financial
 Reporting**
 on page 26 for
 information on how topics
 in this chapter apply to
 your personal life.

Ethics: Managing Personal Financial Reporting

When companies need money, they go to investors or creditors. Before investors or creditors will give a company cash, they want to know the company's financial position and performance. They want to see the company's financial statements—the balance sheet and the income statement. When students need money for school, they often apply for financial aid. When you apply for financial aid, you must submit your own version of a financial statement—the Free Application for Federal Student Aid (FAFSA) form.

The FAFSA form asks how much you make (based on your federal income tax return) and how much your parents make. The purpose is to find out how much you own and how much you owe. Why do the Department of Education and your school want this information? Simple: They want to know whether you really need the money. Schools and government-loan funds have limited resources, and they want to make sure that the money goes to those who need it the most. The bottom line is: The worse off you look financially, the more likely you are to get money.

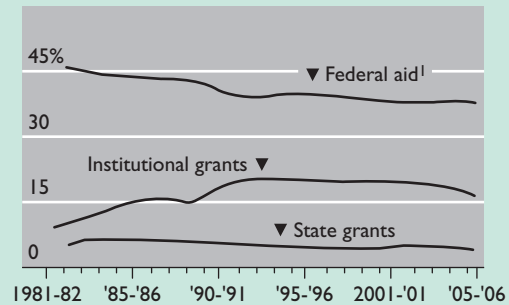
The question is: Should you intentionally make yourself look worse off than you are?

Some Facts

- * After adjusting for inflation, private-college tuition and fees have increased 37% over the past decade; public-college tuition has risen 54%.
- * Two-thirds (65.6%) of undergraduate students graduate with some debt.
- * Among graduating seniors, the average debt load is \$19,202, according to an analysis of data from the Department of Education's National Postsecondary Student Aid Study. That does not include any debt that their parents might incur.
- * Colleges are required to audit the FAFSA forms of at least one-third of their students; some audit 100%. (Compare that to the IRS, which audits a very small percentage of tax returns.) Thus, if you lie on your financial aid forms, there's a very good chance you'll get caught.

Additional information regarding scholarships and loans is available at www.finaid.org. You might find especially interesting the section that discusses how to maximize your chances of obtaining financial aid at www.finaid.org/fafsa/maximize.phtml.

The federal share of assistance is declining
Sources of financial aid as a percentage of total aid used to finance postsecondary expenses



Source for graph: College Board, *Princeton Review*, as reported in "College Admissions: Is Gate Open or Closed?," *Wall Street Journal*, March 25, 2006, p. A7.

What Do You Think?

Consider the following and decide what action you would take:

Suppose you have \$4,000 in cash and \$4,000 in credit card bills. The more cash and other assets that you have, the less likely you are to get financial aid. Also, if you have a lot of consumer debt (credit card bills), schools are not more likely to loan you money. To increase your chances of receiving aid, should you use the cash to pay off your credit card bills, and therefore make yourself look "worse off" to the financial aid decision makers?

YES: You are playing within the rules. You are not hiding assets. You are simply restructuring your assets and liabilities to best conform with the preferences that are built into the federal aid formulas.

NO: You are engaging in a transaction solely to take advantage of a loophole in the federal aid rules. In doing so, you are potentially depriving someone who is actually worse off than you from receiving aid.

Sources: "College Admissions: Is Gate Open or Closed?," *Wall Street Journal*, March 25, 2006, P. A7; www.finaid.org.



Comprehensive Do it!

Legal Services Inc. was incorporated on July 1, 2011. During the first month of operations, the following transactions occurred.

1. Stockholders invested \$10,000 in cash in exchange for common stock of Legal Services Inc.
2. Paid \$800 for July rent on office space.
3. Purchased office equipment on account \$3,000.
4. Provided legal services to clients for cash \$1,500.
5. Borrowed \$700 cash from a bank on a note payable.
6. Performed legal services for client on account \$2,000.
7. Paid monthly expenses: salaries \$500, utilities \$300, and telephone \$100.

The Comprehensive Do it! is a final review of the chapter. The Action Plan gives tips about how to approach the problem, and the Solution demonstrates both the form and content of complete answers.

Instructions

- (a) Prepare a tabular summary of the transactions.
- (b) Prepare the income statement, retained earnings statement, and balance sheet at July 31 for Legal Services Inc.

Solution to Comprehensive Do it!

Trans- action	Assets			=	Liabilities		+	Stockholders' Equity				
	Cash	+ Accounts Receivable	+ Equipment	=	Note Payable	+ Accounts Payable	+	Common Stock	+ Retained Earnings Rev.	- Exp.	- Div.	
(1)	+\$10,000			=				+\$10,000				Issued Stock
(2)	-800			=						-800		Rent Expense
(3)			+\$3,000	=		+\$3,000						
(4)	+1,500			=					+\$1,500			Service Revenue
(5)	+700			=	+\$700							
(6)		+\$2,000		=					+\$2,000			Service Revenue
(7)	-500			=						-500		Salaries Expense
	-300			=						-300		Utilities Expense
	-100			=						-100		Telephone Expense
	<u>\$10,500</u>	+ <u>\$2,000</u>	+ <u>\$3,000</u>	=	<u>\$700</u>	+ <u>\$3,000</u>	+ <u>\$10,000</u>	+ <u>\$3,500</u>	- <u>\$1,700</u>			
	\$15,500				\$15,500							

(b)

LEGAL SERVICES INC. INCOME STATEMENT For the Month Ended July 31, 2011		
Revenues		
Service revenue		\$3,500
Expenses		
Rent expense	\$800	
Salaries expense	500	
Utilities expense	300	
Telephone expense	100	
Total expenses		<u>1,700</u>
Net income		<u>\$1,800</u>

Action Plan

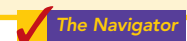
- Make sure that assets equal liabilities plus stockholders' equity after each transaction.
- Investments and revenues increase stockholders' equity. Dividends and expenses decrease stockholders' equity.
- Prepare the financial statements in the order listed.
- The income statement shows revenues and expenses for a period of time.
- The retained earnings statement shows the changes in retained earnings for the same period of time as the income statement.
- The balance sheet reports assets, liabilities, and stockholders' equity at a specific date.

LEGAL SERVICES INC.
RETAINED EARNINGS STATEMENT
 For the Month Ended July 31, 2011

Retained earnings, July 1	\$ -0-
Add: Net income	1,800
Retained earnings, July 31	<u>1,800</u>

LEGAL SERVICES INC.
BALANCE SHEET
 July 31, 2011

<u>Assets</u>	
Cash	\$10,500
Accounts receivable	2,000
Equipment	3,000
Total assets	<u>\$15,500</u>
<u>Liabilities and Stockholders' Equity</u>	
Liabilities	
Notes payable	\$ 700
Accounts payable	<u>3,000</u>
Total liabilities	3,700
Stockholders' equity	
Common stock	\$10,000
Retained earnings	<u>1,800</u>
Total liabilities and stockholders' equity	<u>\$15,500</u>



SUMMARY OF STUDY OBJECTIVES



- 1 **Explain what accounting is.** Accounting is an information system that identifies, records, and communicates the economic events of an organization to interested users.
- 2 **Identify the users and uses of accounting.** The major users and uses of accounting are as follows: (a) Management uses accounting information in planning, controlling, and evaluating business operations. (b) Investors (owners) decide whether to buy, hold, or sell their financial interests on the basis of accounting data. (c) Creditors (suppliers and bankers) evaluate the risks of granting credit or lending money on the basis of accounting information. Other groups that use accounting information are taxing authorities, regulatory agencies, customers, labor unions, and economic planners.
- 3 **Understand why ethics is a fundamental business concept.** Ethics are the standards of conduct by which actions are judged as right or wrong. If you cannot depend on the honesty of the individuals you deal with, effective communication and economic activity would be impossible, and information would have no credibility.
- 4 **Explain generally accepted accounting principles and the measurement principles.** Generally accepted accounting principles are a common set of standards used by accountants. GAAP generally uses one of two measurement principles, the cost principle or the fair value principle. Selection of which principle to follow generally relates to trade-offs between relevance and faithful representation.
- 5 **Explain the monetary unit assumption and the economic entity assumption.** The monetary unit assumption requires that companies include in the accounting records only transaction data that can be expressed in terms of money. The economic entity assumption requires that the activities of each economic entity be kept separate from the activities of its owner and other economic entities.

- 6 State the accounting equation, and define its components.** The basic accounting equation is:

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

Assets are resources owned by a business. Liabilities are creditorship claims on total assets. Stockholders' equity is the ownership claim on total assets.

- 7 Analyze the effects of business transactions on the accounting equation.** Each business transaction must have a dual effect on the accounting equation. For example, if an individual asset increases, there must be a corresponding (1) decrease in another asset, or (2) increase in a specific liability, or (3) increase in stockholders' equity.

- 8 Understand the four financial statements and how they are prepared.** An income statement presents the revenues and expenses of a company for a specified period of time. A retained earnings statement summarizes the changes in retained earnings that have occurred for a specific period of time. A balance sheet reports the assets, liabilities, and stockholders' equity of a business at a specific date. A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.



GLOSSARY



Accounting The information system that identifies, records, and communicates the economic events of an organization to interested users. (p. 4).

Assets Resources a business owns. (p. 12).

Balance sheet A financial statement that reports the assets, liabilities, and owner's equity at a specific date. (p. 21).

Basic accounting equation $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$. (p. 12).

Bookkeeping A part of accounting that involves only the recording of economic events. (p. 5).

Common stock Term used to describe the total amount paid in by stockholders for the shares they purchase. (p. 13).

Corporation A business organized as a separate legal entity under state corporation law, having ownership divided into transferable shares of stock. (p. 10).

Cost principle An accounting principle that states that companies should record assets at their cost. (p. 9).

Dividend A distribution by a corporation to its stockholders on a pro rata (equal) basis. (p. 13).

Economic entity assumption An assumption that requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities. (p. 10).

Ethics The standards of conduct by which one's actions are judged as right or wrong, honest or dishonest, fair or not fair. (p. 8).

Expenses The cost of assets consumed or services used in the process of earning revenue. (p. 13).

Fair value principle An accounting principle that states that companies should record assets at their fair value. (p. 9).

Faithful representation It means that the numbers and descriptions of financial information match what really existed or happened—it is factual. (p. 9).

Financial accounting The field of accounting that provides economic and financial information for investors, creditors, and other external users. (p. 6).

Financial Accounting Standards Board (FASB) A private organization that establishes generally accepted accounting principles (GAAP). (p. 9).

Generally accepted accounting principles (GAAP) Common standards that indicate how to report economic events. (p. 8).

Income statement A financial statement that presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time. (p. 21).

International Accounting Standards Board (IASB) An accounting standard-setting body that issues standards adopted by many countries outside of the United States. (p. 9).

Liabilities Creditor claims on total assets. (p. 12).

Managerial accounting The field of accounting that provides internal reports to help users make decisions about their companies. (p. 6).

Monetary unit assumption An assumption stating that companies include in the accounting records only transaction data that can be expressed in terms of money. (p. 9).

Net income The amount by which revenues exceed expenses. (p. 23).

Net loss The amount by which expenses exceed revenues. (p. 23).

Partnership A business owned by two or more persons associated as partners. (p. 10).

Proprietorship A business owned by one person. (p. 10).

Public Company Accounting Oversight Board (PCAOB) It determines auditing standards and reviews auditing firms. (p. 8).

Relevance It means that financial information is capable of making a difference in a decision. (p. 9).

Retained earnings statement A financial statement that summarizes the changes in retained earnings for a specific period of time. (p. 21).

Revenues The gross increase in stockholders' equity resulting from business activities entered into for the purpose of earning income. (p. 13).

Sarbanes-Oxley Act of 2002 (SOX) Law passed by Congress in 2002 intended to reduce unethical corporate behavior. (p. 7).

Securities and Exchange Commission (SEC) A governmental agency that requires companies to file financial reports in accordance with generally accepted accounting principles. (p. 8).

Statement of cash flows A financial statement that summarizes information about the cash inflows (receipts) and cash outflows (payments) for a specific period of time. (p. 21).

Stockholders' equity The ownership claim on a corporation's total assets. (p. 13).

Transactions The economic events of a business that are recorded by accountants. (p. 14).

APPENDIX Accounting Career Opportunities

STUDY OBJECTIVE 9

Explain the career opportunities in accounting.

Why is accounting such a popular major and career choice? First, there are a lot of jobs. In many cities in recent years, the demand for accountants exceeded the supply. Not only are there a lot of jobs, but there are a wide array of opportunities. As observed by one accounting organization, “accounting is one degree with 360 degrees of opportunity.”

Accounting is also hot because it is obvious that accounting matters. Interest in accounting has increased, ironically, because of the attention caused by the accounting failures of companies such as **Enron** and **WorldCom** and the turmoil over toxic assets at many financial institutions. These widely publicized scandals revealed the important role that accounting plays in society. Most people want to make a difference, and an accounting career provides many opportunities to contribute to society. Finally, the Sarbanes-Oxley Act of 2002 (see page 7) significantly increased the accounting and internal control requirements for corporations. This dramatically increased demand for professionals with accounting training.

As the following discussion reveals, the job options of people with accounting degrees are virtually unlimited.

Public Accounting

Individuals in **public accounting** offer expert service to the general public, in much the same way that doctors serve patients and lawyers serve clients. A major portion of public accounting involves **auditing**. In auditing, a certified public accountant (CPA) examines company financial statements and provides an opinion as to how accurately the financial statements present the company's results and financial position. Analysts, investors, and creditors rely heavily on these “audit opinions,” which CPAs have the exclusive authority to issue.

Taxation is another major area of public accounting. The work that tax specialists perform includes tax advice and planning, preparing tax returns, and representing clients before governmental agencies such as the Internal Revenue Service.

A third area in public accounting is **management consulting**. It ranges from installing accounting software or complex enterprise resource planning systems, to providing support services for marketing projects or merger activities.

Many CPAs are entrepreneurs. They form small- or medium-sized practices that frequently specialize in tax or consulting services.

Private Accounting

Instead of working in public accounting, you might choose to be an employee of a for-profit company such as **Starbucks**, **Google**, or **Kellogg**. In **private** (or **managerial**) **accounting**, you would be involved in activities such as cost accounting (finding the cost of producing specific products), budgeting, accounting information

system design and support, or tax planning and preparation. You might also be a member of your company's internal audit team. In response to SOX, the internal auditors' job of reviewing the company's operations to ensure compliance with company policies and to increase efficiency has taken on increased importance.

Alternatively, many accountants work for not-for-profit organizations such as the **Red Cross** or the **Bill and Melinda Gates Foundation**.

Opportunities in Government

Another option is to pursue one of the many accounting opportunities in governmental agencies. For example, the Internal Revenue Service (IRS), Federal Bureau of Investigation (FBI), and the Securities and Exchange Commission (SEC) all employ accountants. The FBI has a stated goal that at least 15% of its new agents should be CPAs. There is also a very high demand for accounting educators at public colleges and universities and in state and local governments.

Forensic Accounting

Forensic accounting uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. It is listed among the top 20 career paths of the future. The job of forensic accountants is to catch the perpetrators of the estimated \$600 billion per year of theft and fraud occurring at U.S. companies. This includes tracing money-laundering and identity-theft activities as well as tax evasion. Insurance companies hire forensic accountants to detect insurance frauds such as arson, and law offices employ forensic accountants to identify marital assets in divorces.

"Show Me the Money"

How much can a new accountant make? Salary estimates are constantly changing, and salaries vary considerably across the country. At the time this text was written, the following general information was available from Robert Half and Co.

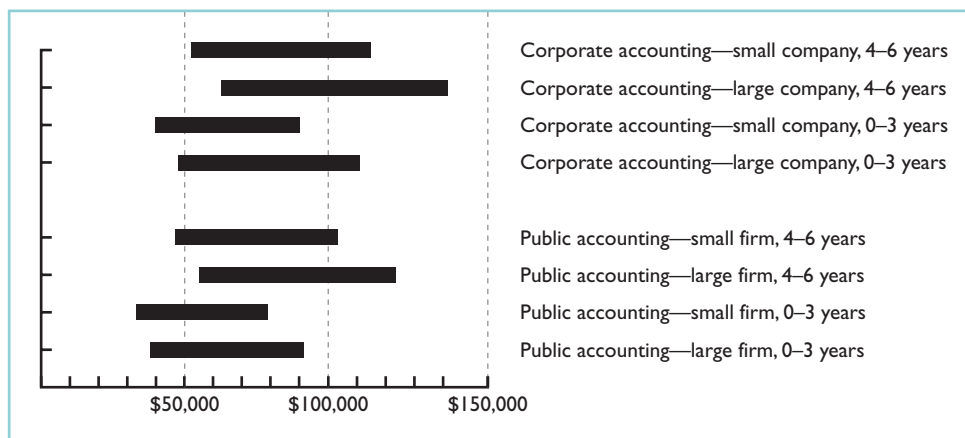


Illustration 1A-1
Salary estimates for jobs in public and corporate accounting

The average salary for a first-year partner in a CPA firm is close to \$130,000, with experienced partners often making substantially more. On the corporate side, controllers (the head accountant) can earn \$150,000, while chief financial officers can earn as much as \$350,000.

For up-to-date salary estimates, as well as a wealth of additional information regarding accounting as a career, check out www.startheregoplaces.com.

SUMMARY OF STUDY OBJECTIVE FOR APPENDIX

9 Explain the career opportunities in accounting.
Accounting offers many different jobs in fields such as public and private accounting, government, and forensic

accounting. Accounting is a popular major because there are many different types of jobs, with unlimited potential for career advancement.

GLOSSARY FOR APPENDIX

Auditing The examination of financial statements by a certified public accountant in order to express an opinion as to the fairness of presentation. (p. 30).

Forensic accounting An area of accounting that uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. (p. 31).

Management consulting An area of public accounting ranging from development of accounting and computer systems to support services for marketing projects and merger and acquisition activities. (p. 30).

Private (or managerial) accounting An area of accounting within a company that involves such activities as cost accounting, budgeting, design and support of accounting information systems, and tax planning and preparation. (p. 30).

Public accounting An area of accounting in which the accountant offers expert service to the general public. (p. 30).

Taxation An area of public accounting involving tax advice, tax planning, preparing tax returns, and representing clients before governmental agencies. (p. 30).

***Note:** All **asterisked** Questions, Exercises, and Problems relate to material in the appendix to the chapter.

SELF-STUDY QUESTIONS



Answers are at the end of the chapter.

- (SO 1) 1. Which of the following is *not* a step in the accounting process?
 a. identification. c. recording.
 b. verification. d. communication.
- (SO 2) 2. Which of the following statements about users of accounting information is *incorrect*?
 a. Management is an internal user.
 b. Taxing authorities are external users.
 c. Present creditors are external users.
 d. Regulatory authorities are internal users.
- (SO 4) 3. The cost principle states that:
 a. assets should be initially recorded at cost and adjusted when the market value changes.
 b. activities of an entity are to be kept separate and distinct from its owner.
 c. assets should be recorded at their cost.
 d. only transaction data capable of being expressed in terms of money be included in the accounting records.
- (SO 5) 4. Which of the following statements about basic assumptions is *correct*?
 a. Basic assumptions are the same as accounting principles.
 b. The economic entity assumption states that there should be a particular unit of accountability.
 c. The monetary unit assumption enables accounting to measure employee morale.
 d. Partnerships are not economic entities.
- (SO 5) 5. The three types of business entities are:
 a. proprietorships, small businesses, and partnerships.
 b. proprietorships, partnerships, and corporations.
 c. proprietorships, partnerships, and large businesses.
 d. financial, manufacturing, and service companies.
6. Net income will result during a time period when:
 a. assets exceed liabilities.
 b. assets exceed revenues.
 c. expenses exceed revenues.
 d. revenues exceed expenses.
7. Performing services on account will have the following effects on the components of the basic accounting equation:
 a. increase assets and decrease stockholders' equity.
 b. increase assets and increase stockholders' equity.
 c. increase assets and increase liabilities.
 d. increase liabilities and increase stockholders' equity.
8. As of December 31, 2011, Stoneland Company has assets of \$3,500 and stockholders' equity of \$2,000. What are the liabilities for Stoneland Company as of December 31, 2011?
 a. \$1,500. b. \$1,000. c. \$2,500. d. \$2,000.
9. Which of the following events is *not* recorded in the accounting records?
 a. Equipment is purchased on account.
 b. An employee is terminated.
 c. A cash investment is made into the business.
 d. The company pays a cash dividend.
10. During 2011, Gibson Company's assets decreased \$50,000 and its liabilities decreased \$90,000. Its stockholders' equity therefore:
 a. increased \$40,000.
 b. decreased \$140,000.
 c. decreased \$40,000.
 d. increased \$140,000.

- (SO 7) 11. Payment of an account payable affects the components of the accounting equation in the following way.
- Decreases stockholders' equity and decreases liabilities.
 - Increases assets and decreases liabilities.
 - Decreases assets and increases stockholders' equity.
 - Decreases assets and decreases liabilities.
- (SO 8) 12. Which of the following statements is *false*?
- A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.
 - A balance sheet reports the assets, liabilities, and stockholders' equity at a specific date.
 - An income statement presents the revenues, expenses, changes in stockholders' equity, and resulting net income or net loss for a specific period of time.
 - A retained earnings statement summarizes the changes in retained earnings for a specific period of time.
- (SO 8) 13. On the last day of the period, Jim Otto Company buys a \$900 machine on credit. This transaction will affect the:
- income statement only.
 - balance sheet only.
 - income statement and retained earnings statement only.
 - income statement, retained earnings statement, and balance sheet.
14. The financial statement that reports assets, liabilities, and stockholders' equity is the:
- income statement.
 - retained earnings statement.
 - balance sheet.
 - statement of cash flow.
- *15. Services provided by a public accountant include:
- auditing, taxation, and management consulting.
 - auditing, budgeting, and management consulting.
 - auditing, budgeting, and cost accounting.
 - internal auditing, budgeting, and management consulting.
- Go to the book's companion website, www.wiley.com/college/weygandt, for Additional Self-Study Questions.



QUESTIONS

- "Accounting is ingrained in our society and it is vital to our economic system." Do you agree? Explain.
- Identify and describe the steps in the accounting process.
- (a) Who are internal users of accounting data? (b) How does accounting provide relevant data to these users?
- What uses of financial accounting information are made by (a) investors and (b) creditors?
- "Bookkeeping and accounting are the same." Do you agree? Explain.
- Karen Sommers Travel Agency purchased land for \$90,000 cash on December 10, 2011. At December 31, 2011, the land's value has increased to \$93,000. What amount should be reported for land on Karen Sommers's balance sheet at December 31, 2011? Explain.
- What is the definition of the fair value principle?
- What is the monetary unit assumption?
- What is the economic entity assumption?
- What are the three basic forms of business organizations for profit-oriented enterprises?
- Maria Gonzalez is the owner of a successful printing shop. Recently her business has been increasing, and Maria has been thinking about changing the organization of her business from a proprietorship to a corporation. Discuss some of the advantages Maria would enjoy if she were to incorporate her business.
- What is the basic accounting equation?
- (a) Define the terms assets, liabilities, and stockholders' equity.
(b) What items affect stockholders' equity?
- Which of the following items are liabilities of Stanley Jewelry Stores?

(a) Cash.	(f) Equipment.
(b) Accounts payable.	(g) Salaries payable.
(c) Dividends.	(h) Service revenue.
(d) Accounts receivable.	(i) Rent expense.
(e) Supplies.	
- Can a business enter into a transaction in which only the left side of the basic accounting equation is affected? If so, give an example.
- Are the following events recorded in the accounting records? Explain your answer in each case.
 - The president of the company dies.
 - Supplies are purchased on account.
 - An employee is fired.
- Indicate how the following business transactions affect the basic accounting equation.
 - Paid cash for janitorial services.
 - Purchased equipment for cash.
 - Invested cash in the business for stock.
 - Paid accounts payable in full.
- Listed below are some items found in the financial statements of Alex Greenspan Co. Indicate in which financial statement(s) the following items would appear.

(a) Service revenue.	(d) Accounts receivable.
(b) Equipment.	(e) Retained earnings.
(c) Advertising expense.	(f) Wages payable.
- In February 2011, Paula King invested an additional \$10,000 in Hardy Company. Hardy's accountant, Lance Jones, recorded this receipt as an increase in cash and revenues. Is this treatment appropriate? Why or why not?