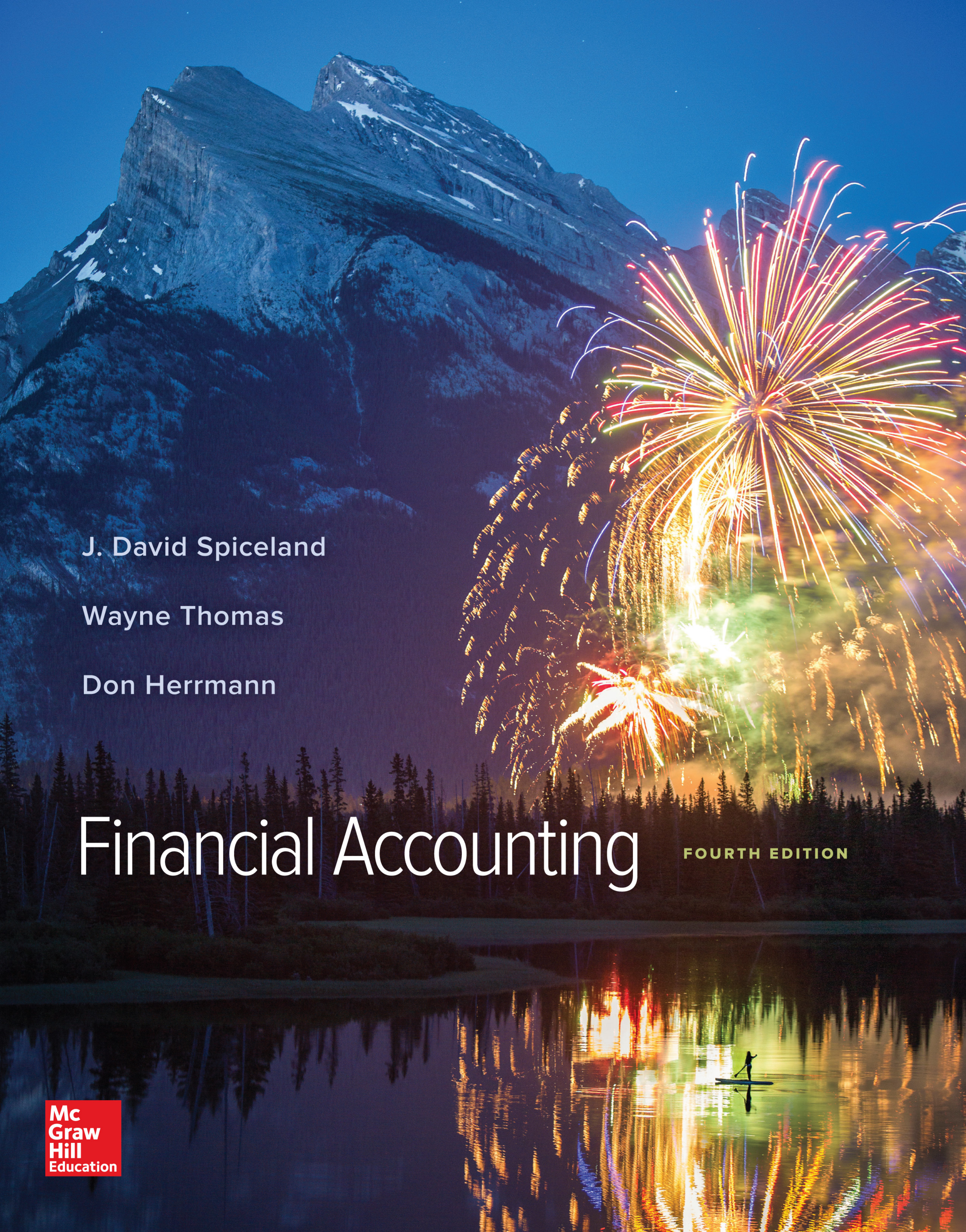

J. David Spiceland

Wayne Thomas

Don Herrmann

Financial Accounting

FOURTH EDITION

Mc Graw Hill Education

Financial Accounting

FOURTH EDITION

J. DAVID SPICELAND
University of Memphis

WAYNE THOMAS
University of Oklahoma

DON HERRMANN
Oklahoma State University

McGraw Hill Education

Dedicated to

David's wife Charlene, daughters Denise and Jessica, and three sons Michael David, Michael, and David

Wayne's wife Julee, daughter Olivia, and three sons Jake, Eli, and Luke

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

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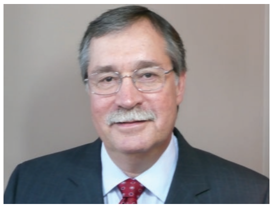


David Spiceland is professor of accounting at the University of Memphis, where he teaches intermediate accounting and other financial accounting courses at the undergraduate and master's levels. He received his BS degree in finance from the University of Tennessee, his MBA from Southern Illinois University, and his PhD in accounting from the University of Arkansas.

Professor Spiceland's primary research interests are in earnings management and educational research. He has published articles in a variety of journals including *The Accounting Review, Accounting and Business Research, Journal of Financial Research,* and *Journal of Accounting Education.* David has received university and college awards and recognition for his teaching, research, and technological innovations in the classroom. David is lead author of McGraw-Hill's best-selling *Intermediate Accounting* text.

David is the Memphis Tigers' No. 1 basketball fan. He enjoys playing basketball, is a former all-state linebacker, and an avid fisherman. Cooking is a passion for David, who served as sous chef for Paula Deen at a Mid-South Fair cooking demonstration.

WAYNE THOMAS

Wayne Thomas is the John T. Steed Chair in Accounting at the University of Oklahoma, where he teaches introductory financial accounting to nearly 600 students per year. He received his bachelor's degree in accounting from Southwestern Oklahoma State University, and his master's and PhD in accounting from Oklahoma State University.

Professor Thomas's primary research interests are in markets-based accounting research, financial disclosures, financial statement analysis, and international accounting issues. He previously served as an editor of *The Accounting Review* and has published articles in a variety of journals including *The Accounting Review, Journal of Accounting and Economics, Journal of Accounting Research, Review of Accounting Studies,* and *Contemporary Accounting Research.* He has won several research awards, including the American Accounting Association's Competitive Manuscript Award. Professor Thomas has won teaching awards at the university, college, and departmental levels, and has received the Outstanding Educator Award from the Oklahoma Society of CPAs. Wayne is a co-author on McGraw-Hill's best-selling *Intermediate Accounting,* with David Spiceland.

Wayne enjoys playing sports (basketball, tennis, golf, and ping pong), solving crossword puzzles, and coaching little league sports. He has participated in several adventure races, like you'll read about in the Great Adventures continuing problem at the end of each chapter.

DON HERRMANN

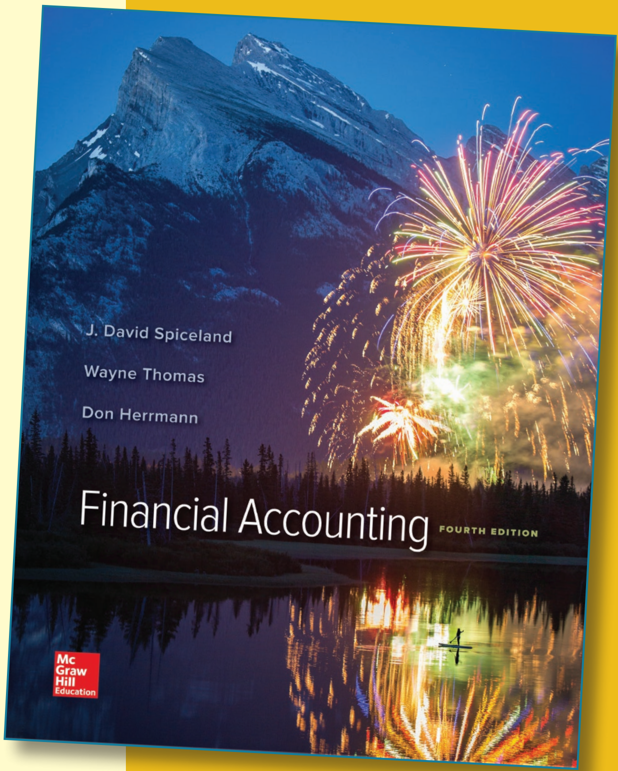
Don Herrmann is the Deloitte Professor of Accounting at Oklahoma State University, where he teaches financial accounting and intermediate accounting, and is director of the doctoral program. He received his bachelor's degree in business from John Brown University, his master's degree in accounting from Kansas State University, and his PhD in accounting from Oklahoma State University.

Professor Herrmann's research interests are in earnings forecasts, segment reporting, financial statement analysis, and international accounting issues. He is past president of the American Accounting Association International Section and has served on the editorial and review board of the top research journal in the field of accounting, *The Accounting Review.* He has published articles in a variety of journals including *The Accounting Review, Journal of Accounting Research, Accounting Horizons, Journal of Business, Finance, and Accounting,* and the *Journal of Accounting and Public Policy.* Don Herrmann and Wayne Thomas often work together, having co-authored over 15 research articles. Professor Herrmann has received teaching awards at the department, college, and university levels, including Professor of the Year in the University Greek System.

Don, like his co-authors, is a big sports fan. He played tennis on scholarship in college and enjoys playing soccer, basketball, running, biking, and swimming. He also coaches soccer, basketball, and little league baseball in his hometown.

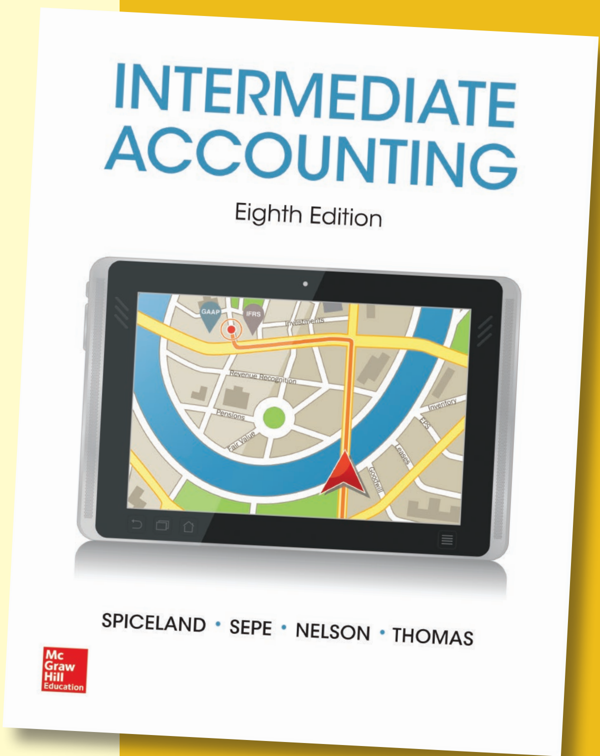
CELEBRATING STUDENT SUCCESS

Don't you love those moments in your course when students are fully engaged? When the "Aha!" revelations are bursting like fireworks? David Spiceland, Wayne Thomas, and Don Herrmann have developed a unique set of materials based directly on their collective years in the classroom. They've brought together best practices like highlighting Common Mistakes, offering frequent Let's Review exercises, integrating the course with a running Continuing Problem, demonstrating the relevance of the course with real-world companies and decision analysis, and communicating it all in a student-friendly conversational writing style. After the proven success of the first three editions of *Financial Accounting,* we are confident that the fourth edition will not only motivate, engage, and challenge students—it will illuminate the financial accounting course like never before.



Spiceland's Accounting Series

To allow *Financial Accounting* to be part of a complete learning system, authors David Spiceland and Wayne Thomas have teamed up with Jim Sepe and Mark Nelson to offer *Intermediate Accounting.* Now in its eighth edition, *Intermediate Accounting* uses the same approach that makes *Financial Accounting* a success—conversational writing style with a real-world focus, decision maker's perspective, innovative pedagogy, and author-prepared assignments and supplements. The Spiceland Accounting Series is fully integrated with McGraw-Hill's Connect, an educational platform that seamlessly joins Spiceland's superior content with enhanced digital tools to deliver precisely what a student needs, when and how they need it.



EDUCATION IS CHANGING . . .

At McGraw-Hill, the Spiceland: *Financial Accounting* authors recognize that teaching is **part art and part science** and have been mastering the art and science of teaching in their own classrooms for years. Based on this experience and their interactions with thousands of faculty members, students, and business owners who have shared their insight, this approach has been crafted, refined, and continues to evolve to embody successful teaching and learning strategies. While the importance of financial accounting to successful business management remains constant, the ways in which students learn and are motivated continue to evolve. In today's fast-paced technology age, students are engaged when they believe topics are relevant. The authors' targeted insight into the student experience is crafted through research in addition to the information our technology can share. Through the intuitive SmartBook technology, the authors are able to analyze data that shows where students are struggling and refine their pedagogy to provide additional focus in these areas. ***It is through understanding the science of what works and the art in how the teaching methodologies are executed, that Spiceland:* Financial Accounting *continues to build on its successful approach in this edition.***

SO ARE WE.

CREATING FUTURE BUSINESS LEADERS

From the first edition of *Financial Accounting,* the authors have been talking with standard setters, auditors, and business leaders across the country to ensure their materials are consistent with what's being practiced in the business world. For example, in the fourth edition, we now cover installment notes early in the chapter on long-term liabilities based on feedback that loans with monthly principle and interest payments are very common in the business world. Coverage of installment notes is also practical for students who may be considering a car loan or a home loan in the not so distant future.

The authors believe that the foundation students get in the first financial accounting course is paramount to their business success. In keeping with the feedback from business leaders and instructors, the authors have focused their approach on four key areas:

- **Building Student Interest**
- **Helping Students Become Better Problem Solvers**
- **Fostering Decision-Making and Analysis Skills**
- **Using Technology to Enhance Learning**

By honing in on these key areas, the result is a better-prepared student who has a greater potential to take a leadership role when he or she graduates and enters the business world.

Building Student Interest

The first step in student engagement is real-world relevance. The authors of *Financial Accounting* do this by making the course relevant to students by exposing them to interesting, real-world examples that are applicable to their lives and future careers, and by crafting their narrative and its supporting features in an approachable and straightforward style.

Helping Students Become Better Problem Solvers

Helping students understand each piece of the accounting cycle and then how it is interconnected is central to the financial accounting course. The authors have taken care to carefully organize and streamline the materials with features like in-chapter **Let's Review** problems for students to check their understanding and prepare them to successfully complete the assigned End-of-Chapter material. The **Common Mistakes** feature is a student favorite, as it helps them avoid mistakes commonly made in the homework. **General Ledger Problems** further review the accounting cycle and allow students to see the big picture of how information flows through the financial statements.

Fostering Decision-Making and Analysis Skills

Decision-making and analysis skills are key ingredients in creating future business leaders. In building a strong foundation in problem-solving, students are better equipped to expand their understanding into how financial information affects businesses. Students are given opportunities to explore real business decision-making practices in each chapter—**Decision Maker's Perspectives** and **Decision Points**—and employ decision making in their homework assignments using materials like the **Great Adventures** continuing case and the Analysis portion of most **General Ledger Problems**.

Using Technology to Enhance Learning

Many of today's students are visual learners and technology driven. Spiceland: *Financial Accounting* reinforces students' conceptual understanding with elements like SmartBook and with video-based instruction using **Interactive Illustrations** and **Interactive Presentations.** The end-of-chapter exercises are supplemented with video-driven **Guided Examples.** Connect brings this all together to facilitate an interactive and personalized learning environment.

NEW IN THE FOURTH EDITION

We have received an incredible amount of feedback from over 600 reviewers and focus group participants. The list of changes and improvements on the next few pages is testament to the many hours that reviewers spent thinking about and analyzing our earlier editions, helping us to make *Financial Accounting* the **best book of its kind.**

Overall Updates in the Fourth Edition

- **Updated content to reflect latest FASB pronouncements** including terminology related to the upcoming changes in Revenue Recognition and Inventory.
- **Usage data** from SmartBook and Connect were used in developing changes to the 4th Edition.
- **Revised illustrations** in the new edition to continue to offer clear and visual learning tools for students.
- **Feature stories, real-world examples, and ratio analyses** were updated to include the most recent year of company data available.
- **Added content and new illustrations in Chapters 1–3** to build students' understanding of the framework of financial accounting and the accounting cycle activities during the year versus the end of the year.
- **Revised Chapter 9 on long-term liabilities** to first discuss installment notes (like car loans or home loans), leases, and an overview of bonds for instructors that prefer less detailed coverage of bonds. A detailed coverage of bonds is also provided later in the chapter for instructors that prefer a more in-depth coverage of bonds payable.
- **Revised Chapter 12 to eliminate the discussion of extraordinary items** in accordance with a recent FASB standard.
- **Fifteen New General Ledger Problems** have been added to the current offering, including some Great Adventures questions in this format. General Ledger Problems that were previously in Connect only, are also now available in the text.
- **Additional Accounting Cycle Problems** were added to Chapter 3 and to the later topical Chapters 5–10. Students can see how more advanced transactions related to receivables, inventory, depreciable assets, current and long-term liabilities, and equities work through an entire accounting cycle.
- **New Excel Simulations** covering financial accounting topics are now available in Connect. These questions allow students to practice their Excel skills within their Connect assignments using relevant accounting functions and activities. Assistance is provided on Excel basics so that instructors don't have to teach students Excel, and activities are auto-graded and provide feedback to students.
- **Over 400 new test bank questions** were added, including both multiple choice and computational questions.
- **Instructional PowerPoint slides** now include Concept Checks to help test students' comprehension during the lecture.

CHAPTER 1

- Added discussion of the distinction between expenses and dividends.
- Revised **Illustration 1–4** to make relationship among measurement categories more evident.
- Revised discussion to explain the basic format of the income statement in **Illustration 1–5.**
- Revised discussion throughout to be consistent with the new revenue recognition standard (ASU 2014-09).
- Provided a reference to the role of the PCAOB when discussing the auditor's report.
- Updated **AP1–2, AP1–3,** and **AP1–4** for American Eagle and The Buckle's most recent financial information.

CHAPTER 2

- Redesigned **Illustration 2–1** to make the six-step process of measuring external transactions more apparent.
- Emphasized in a Key Point the distinction between steps (2) and (3) of the measurement process in **Illustrations 2–1.**
- Revised **Illustration 2-3** to make clear the components of the expanded accounting equation.
- Separated the discussion of transactions (6) and (7) and discussed new revenue recognition principle in both (ASU 2014-09).
- Added discussion of difference between recording an expense versus an asset at the end of transaction (9) in **Part A.**
- Revised **Illustration 2–5** to improve clarity of effects of debits and credits on the accounting equation.
- Revised **Illustration 2–6** to make clear the effects of debits and credits on the expanded accounting equation.
- Moved up coverage of the chart of accounts to **Learning Objective 2–4.**
- Revised **Illustration 2–10** to show basic format of a general ledger account.
- For transactions (1) and (2), demonstrated posting to the general ledger accounts.
- Changed the account title from Unearned Revenue to Deferred Revenue, consistent with ASU 2014-09.
- Moved the Let's Review to follow **LO2–5** and demonstrated posting to the Cash account.
- Updated **AP2–2, AP2–3,** and **AP2–4** for American Eagle and The Buckle's most recent financial information.

CHAPTER 3

- Revised the definition of the Revenue Recognition Principle to be consistent with the new revenue recognition standard (ASU 2014-09).
- Revised entire discussion in **Part A** to continue the example of Eagle Golf Academy from **Chapters 1** and **2.**
- Discussed the revenue recognition principle in relation to transactions (6), (7), and (8) of Eagle Golf Academy.
- Discussed expense recognition in relation to transactions (4), (5), and (9) of Eagle Golf Academy.
- Added new **Illustrations 3–1** and **3–2** to highlight differences between accrual-basis accounting and cash-basis accounting for Eagle Golf Academy.
- Added new **Illustration 3–4** to explain four types of adjusting entries.

- Eliminated mini-financial statements under each of the eight adjusting entries in **Part B.**
- Changed company to Federal Express in **Illustrations 3–6** and to Netflix in **Illustration 3–7.**
- Added adjusting entry for interest receivable to demonstrate the flip side of the adjusting entry for interest payable.
- Revised **Illustration 3–10** to show adjusted trial balance.
- Added new Decision Maker's Perspective for the classified balance sheet.
- Added new General Ledger/Accounting Cycle review **Exercise 3–21.**
- Added **Problems 3–9A** and **3–9B** to require completion of the full accounting cycle.
- Updated **AP3–2, AP3–3,** and **AP3–4** for American Eagle and The Buckle's most recent financial information.

CHAPTER 4

- Added **Illustration 4–1** to graphically depict the Fraud Triangle.
- Added **Illustration 4–7** to graphically depict the components of the balance of cash.
- Revised discussion of deposits outstanding and checks outstanding.
- Added illustration to help identify deposits outstanding in a bank reconciliation.
- Added illustration to help identify checks outstanding in a bank reconciliation.
- Added bullet-point discussion of items involved in reconciling the company's balance of cash (Step 2).
- Added **Illustration 4–11** to summarize items included in the bank reconciliation.
- Changed **Learning Objective 4–6** to reflect the broader concept of accounting for employee purchases (in addition to petty cash).
- Added discussion of internal controls over employee purchases in **Learning Objective 4–6.**
- Separated section on Statement of Cash Flows to a new **Part C,** and included brief discussion of the reporting of restricted cash in the balance sheet.
- Revised the Analysis section to include comparison of Regal Entertainment to Cinemark Holdings.
- Revised **Review Questions 25** and **26, Brief Exercise 4–13,** and **Exercises 4–12** and **4–13** for employee purchases.
- Revised **Review Questions 29** and **30, Brief Exercise 4–18,** and **Exercise 4–20** for cash analysis.
- Updated **AP4–2, AP4–3,** and **AP4–4** for American Eagle and The Buckle's most recent financial information.

CHAPTER 5

- In Part A, added discussion of the new revenue recognition rules (ASU No. 2014-09) related to sales discounts, sales returns, and sales allowances.
- Added new **Illustration 5–3** to demonstrate accounting for contra revenue transactions.
- Added discussion of **Illustration 5–6** explaining why accounts in the "Not Yet Due" column have a percentage uncollectible.
- Added discussion of role of subsidiary ledgers and control accounts to expand on **Illustrations 5–6** and **5–7.**
- Provided additional discussion of the use of two entries to record cash collection on accounts previously written off.
- Revised **Illustration 5–12** to make timing difference between Allowance Method and Direct Write-off Method more apparent.
- Revised analysis of Tenet Healthcare versus Lifepoint Hospitals to show impact of cash collections on profitability.
- Added new **Brief Exercises 5–12** and **5–13** for the direct write-off method and **Brief Exercise 5–19** for matching terms.
- Added new General Ledger/Accounting Cycle review **Exercise 5–21.**
- Updated **AP5–2, AP5–3,** and **AP5–4** for American Eagle and The Buckle's most recent financial information.

CHAPTER 6

- Revised **Illustration 6–1** to better demonstrate inventory differences between a manufacturing company versus a merchandising company.
- Revised **Illustration 6–4** to include actual titles in Best Buy's multiple-step income statement.
- Revised discussion of Best Buy's multiple-step income statement based on new illustration.
- Updated discussion of inventory to lower of cost and "net realizable value" (instead of "market"), based on the FASB's recent simplification project. Companies using LIFO or the retail inventory method are excluded from the change.
- Revised **Illustration 6–19** to better illustrate the concept of lower of cost and net realizable value.
- Updated inventory analysis section to include comparison of Best Buy and Tiffany's.
- Added new General Ledger/Accounting Cycle review **Exercise 6–21.**
- Updated **AP6–2, AP6–3,** and **AP6–4** for American Eagle and The Buckle's most recent financial information.

CHAPTER 7

- Updated the WorldCom feature story.
- Updated the Balance Sheet for Darden Restaurants(**Illustration 7–1**).
- Revised the **Illustration 7–5** on the world's top 10 brands.
- Expanded the discussion on the use of an Accumulated Depreciation account rather than simply crediting the asset account.
- Explained that most companies have separate Accumulated Depreciation accounts for each separate asset or asset class.
- Added an equation to calculate the depreciation rate under the double-declining-balance method.
- Added color borders to the depreciation schedules in the text to better identify the depreciation method used in the schedule.
- Briefly expanded the discussion on intangible assets.
- Added a new list describing that (1) companies purchase intangible assets and (2) companies create intangible assets internally.
- Clarified the calculation and recording of goodwill and revised the text example.

- Revised the discussion on intangible assets subject to amortization to better explain the use of service life and residual value in computing amortization for intangible assets.
- Added a footnote referring to the standard on nonmonetary transactions *(FASB ASC 846).*
- Expanded the analysis section to compare return on assets for Walmart vs. Costco (Target could no longer be used as they reported a loss in the most recent year).
- Revised and simplified the discussion on asset impairments.
- Added a new General Ledger/Accounting Cycle review **Exercise 7–21.**
- Changed **Problems 7–9A** and **7–9B** to allow instructors to assign algo versions of these analysis problems in Connect.
- Updated **AP7–2, AP7–3,** and **AP7–4** for American Eagle and The Buckle's most recent financial information.

CHAPTER 8

- Updated the feature story.
- Updated the partial balance sheet for Southwest Airlines (**Illustration 8–2**).
- Added a summary reconciling gross monthly pay to net monthly pay.
- Removed footnote about temporary payroll tax holiday in 2011 and 2012.
- Updated FICA base salary amount to $118,500 in 2015 in the text and EOC.
- Updated the section on unearned revenues to instead use the term deferred revenues consistent with the terminology used in the new revenue recognition standard.
- Added a new Common Mistake that some students think "Deferred Revenue" is a revenue account.
- Simplified the recording of Sales Tax Payable by removing the alternative method.
- Updated **Illustration 8–6,** Southwest Airlines disclosure of the current portion of long-term debt and long-term debt.
- Revised the example for recording the estimated warranty liability and actual warranty work.
- Updated the liquidity analysis comparing United Airlines and American Airlines.
- Added **Illustration 8–10** to summarize the effects of changes in current assets and current liabilities on the liquidity ratios.
- Added a new General Ledger/Accounting Cycle review **Exercise 8–16.**
- Changed **Problems 8–9A** and **8–9B** to allow instructors to assign algo versions of these analysis problems in Connect.
- Updated **AP8–2, AP8–3,** and **AP8–4** for American Eagle and The Buckle's most recent financial information.

CHAPTER 9

- Redesigned the chapter to provide instructors greater flexibility in the coverage of long-term liabilities. Instructors that prefer an overview of long-term liabilities including installment notes, leases, and bonds can just cover **Part A.** Instructors that prefer a detailed coverage of bonds can also cover **Part B** (Pricing a Bond) and/or **Part C** (Recording Bonds Payable).
- Moved the discussion of installment notes and leases early in the chapter.
- Revised the discussion of the amortization schedule for an installment note.
- Moved the Decision Maker's Perspective describing why some companies lease rather than buy to the beginning of the section on leases.
- Updated the footnote disclosure of minimum lease payments for Six Flags, Inc.
- Added clarification next to the **Part B** heading to indicate that **Part B** is designed as a stand-alone section and can be omitted without loss of understanding of the remaining topics in the chapter.
- Revised **Illustration 9-12** (differences among stated rate, market rate, and bond issue price) for greater clarity.
- Updated the comparison of Coca-Cola vs. PepsiCo in the analysis section.
- Revised the discussion of the times interest earned ratio.
- Changed the order of the end of chapter material to match the redesign of the chapter text.
- Added a new General Ledger/Accounting Cycle review **Exercise 9-19.**
- Changed **Problems 9-7A** and **9-7B** to allow instructors to assign algo versions of these analysis problems in Connect.
- Updated **AP9-2, AP9-3,** and **AP9-4** for American Eagle and The Buckle's most recent financial information.

CHAPTER 10

- Revised the feature story.
- Updated **Illustration 10–1** for American Eagle.
- Added a reference to Ali Baba, the largest technology IPO ever.
- Simplified the equations below **Illustration 10–6** relating to authorized and issued shares.
- Added an equation to help students better identify retained earnings.
- Added **Illustration 10–13** to help students understand how net income, net losses, and dividends impact the balance in retained earnings over time.
- Added a new decision point on retained earnings.
- Added a new common mistake related to students incorrectly paying dividends on treasury stock.

- Revised the discussion on the stockholders' equity section for American Eagle in **LO10–7.**
- Moved the decision maker's perspective entitled "Why Doesn't Stockholders' Equity Equal the Market Value of Equity?" from the analysis section to Part C on reporting stockholders' equity.
- Revised the equity analysis section to compare Ralph Lauren with Abercrombie.
- Added the dividend yield as a new ratio in the equity analysis section and updated all EOC material.
- Added new General Ledger/Accounting Cycle review **Exercise 10–17.**
- Changed **Problems 10–7A** and **10–7B** to allow instructors to assign algo versions of these analysis problems in Connect.
- Updated **AP10–2, AP10–3,** and **AP10–4** for American Eagle and The Buckle's most recent financial information.

CHAPTER 11

- Updated the feature story.
- Added a definition of cash inflows and cash outflows at the beginning of **part A.**
- Reformatted **Illustration 11–2** to make it easier for students to read and use as a guide for homework.
- Updated **Illustration 11–7** to better show the basic format for the statement of cash flows.
- Deleted the two summary journal entries in the chapter to provide more concise explanations of items reconciling net income to operating cash flows.
- Moved **Illustration 11-8** to the beginning of the operating section providing a helpful summary of increases and decreases in adjusting net income to operating cash flows.
- Added an additional box to better demonstrate how an increase in accounts receivable causes sales revenue to be higher than cash inflows.
- Added a Let's Review following the operating activities section.
- Added a new introduction to the investing activities section to give students an overall sense of investing activities before going into more detail.
- Added a new introduction to the financing activities section to give students an overall sense of financing activities before going into more detail.
- Revised the cash flow analysis to compare Apple vs. Google. (Dell is now a private firm with data no longer publicly available.)
- Revised the introduction to the direct method to emphasize that the only difference between the indirect and direct methods is in the operating section.
- Changed **Problems 11–4A** and **11–4B** to allow instructors to assign algo versions of these analysis problems in Connect.
- Updated **AP11–2, AP11–3,** and **AP11–4** for American Eagle and The Buckle's most recent financial information.

CHAPTER 12

- Revised the feature story to list some of the top professional athletes sponsored by Under Armour.
- Updated all data and discussion for the vertical and horizontal analysis of Under Armour and Nike.
- Updated all the risk ratios and discussion in comparing Under Armour with Nike.
- Updated the list of companies held by Berkshire Hathaway to include company names that students can better recognize.
- Updated all the profitability ratios and discussion in comparing Under Armour and Nike.
- Revised the discussion and definition of discontinued operations based on the FASBs new guidelines.
- Added a new example of discontinued operations for Nike related to the Sale of Cole Hann (footwear, handbags, and accessories).
- Eliminated the discussion of extraordinary items based on the FASB's new guidelines.
- Revised the IFRS box titled "Do International Standards Influence the FASB?"
- Updated **Illustration 12–26** to account for the FASB's new guidelines eliminating the reporting of extraordinary items.
- In discussing "other revenues and expenses", deleted the example of Marie Callendar's and replaced it with an example for Nike.
- Added a summary to the final section that accounting is not just black and white. There are many gray areas in accounting requiring management judgment.
- Updated all EOC material to eliminate the recording of extraordinary items.
- Added a new internet research project using yahoo finance (**AP12–6**).

BUILDING STUDENT INTEREST

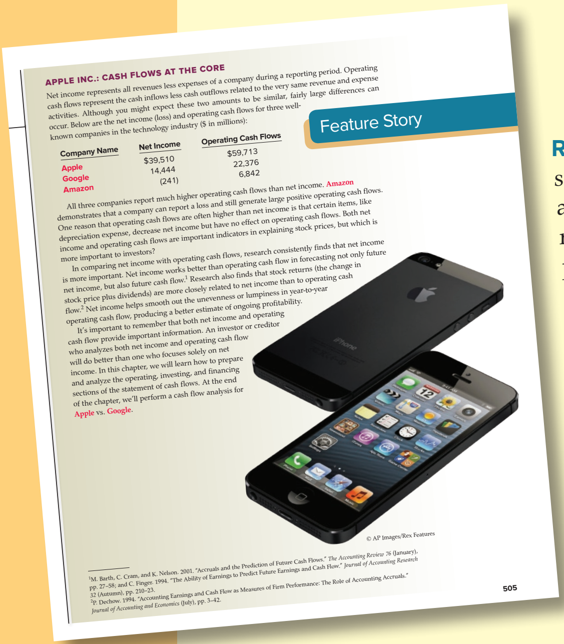
With a wide variety of students enrolled in the financial accounting course, getting them interested in the content and making it enjoyable to learn can be challenging. Spiceland: *Financial Accounting* achieves this by using relevant examples and context that relate well to students, making the content both approachable and easy to digest.

Part of the unique art in how the authors of Spiceland: *Financial Accounting* approach the material is through their signature **Conversational Writing Style.** The authors took special care to write chapters that foster a friendly dialogue between the text and each individual student. The tone of the presentation is intentionally conversational—creating the impression of ***speaking with* the student,** as opposed to *speaking at* the student. This conversational writing style has been a proven success with Spiceland's *Intermediate Accounting* (now in its eighth edition), and that same approach has led to the success of Spiceland: *Financial Accounting.*

> **This text has a logical layout and incorporates tools** to keep the student's attention. It makes the student think about the impact on the financials based upon the different principles and estimates selected.
>
> — Victor Stanton, *University of California–Berkeley*

Layered in with the conversational tone, the authors' infusion of relevant examples from real companies that flow throughout each chapter's content, provide a compelling reason for students to take interest in the material.

> The text is very detailed, but **not overly technical.** It is written at a level and in a way that is highly user friendly.
>
> —PeterWoodlock, *Youngstown State University*



APPLE INC.: CASH FLOWS AT THE CORE

Feature Story

Net income represents all revenues less expenses of a company during a reporting period. Operating cash flows represent the cash inflows less cash outflows related to the very same revenue and expense activities. Although you might expect these two amounts to be similar, fairly large differences can occur. Below are the net income (loss) and operating cash flows for three well-known companies in the technology industry ($ in millions):

Company Name	Net Income	Operating Cash Flows
Apple	$39,510	$59,713
Google	14,444	22,376
Amazon	(241)	6,842

All three companies report much higher operating cash flows than net income. Amazon demonstrates that a company can report a loss and still generate large positive operating cash flows. One reason that operating cash flows are often higher than net income is that certain items, like depreciation expense, decrease net income but have no effect on operating cash flows. Both net income and operating cash flows are important indicators in explaining stock prices, but which is more important to investors?

In comparing net income with operating cash flows, research consistently finds that net income is more important. Net income works better than operating cash flow in forecasting not only future net income, but also future cash flow.[1] Research also finds that stock returns (the change in stock price plus dividends) are more closely related to net income than to operating cash flow.[2] Net income helps smooth out the unevenness or lumpiness in year-to-year operating cash flow, producing a better estimate of ongoing profitability.

It's important to remember that both net income and operating cash flow provide important information. An investor or creditor who analyzes both net income and operating cash flow will do better than one who focuses solely on net income. In this chapter, we will learn how to prepare and analyze the operating, investing, and financing sections of the statement of cash flows. At the end of the chapter, we'll perform a cash flow analysis for Apple vs. Google.

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[1]M. Barth, C. Cram, and K. Nelson. 2001. "Accruals and the Prediction of Future Cash Flows." *The Accounting Review* 76 (January), pp. 27–58; and C. Finger. 1994. "The Ability of Earnings to Predict Future Earnings and Cash Flow." *Journal of Accounting Research* 32 (Autumn), pp. 210–23.
[2]P. Dechow. 1994. "Accounting Earnings and Cash Flow as Measures of Firm Performance: The Role of Accounting Accruals." *Journal of Accounting and Economics* (July), pp. 3–42.

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Real-World Focus Students are able to retain more information when they see how concepts are applied in the real world. Each chapter begins with a **Feature Story** that involves real companies and offers business insights related to the material in the chapter. As the chapter's topics are being presented, reference back to the companies in the Feature Story and other related companies are introduced to help keep the subject feeling real. The authors understand that students are engaged best when the discussion involves real companies that students find interesting and whose products or services are familiar, such as **Apple, American Eagle Outfitters, Best Buy, Six Flags, Regal Entertainment,** and **Google.** In **Chapter 12,** full financial statement analysis is provided for **Nike** versus **Under Armour.**

This focus is also carried into areas of the end-of-chapter material, where students can demonstrate their analysis and understanding of real-world situations.

> Most importantly, it **offers opportunities for students to have insights into accounting careers** via Career Corners.
>
> —Chuo-Hsuan Lee, *SUNY–Plattsburgh*

To help students be forward-thinking about their careers, discussions are included to bring the business world front and center. The **Career Corner** boxes highlight the relevance of accounting by showing how a particular topic in the chapter relates to a business career. This feature is intended to increase the relevance of the material for both accounting *majors* and *nonmajors.*

HELPING STUDENTS BECOME BETTER PROBLEM SOLVERS

This text is very well written and offers a set of end-of-chapter problems that **progressively challenges students** and directs them to **build problem-solving skills.** —Gregg S. Woodruff, *Western Illinois University*

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

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

Easy to read, love the Key Points and Common Mistakes—**these sound like me talking to my students** and are exactly the points I make in class! Really!

—Christa Morgan, *Georgia Perimeter College*

Key Points provide quick synopses of the critical pieces of information presented throughout each chapter. Key Points within each chapter's Learning Objectives are also summarized at the end of each chapter, providing students with a convenient study guide.

Very easy to read!!! I like the Key Points and Common Mistakes segments in each chapter. These features would really help my students as they read the text and study for exams. I also like the **simplicity of each chapter.**

— David Juriga, *St. Louis Community College*

Common Mistakes made by financial accounting students are highlighted throughout each of the chapters. With greater awareness of the pitfalls the average student will find in a first accounting class, students can avoid making the same mistakes and gain a deeper understanding of the chapter material.

COMMON MISTAKE

Dividends represent the payment of cash but are not considered an expense in running the business. Students sometimes mistakenly include the amount of dividends as an expense in the income statement, rather than as a distribution of net income in the statement of stockholders' equity.

The "Flip Side" and "Common Mistakes" sections are outstanding and are **likely to be among the favorite parts of the content** for students.

— Christian Wurst, *Temple University*

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

FOSTERING DECISION-MAKING & ANALYSIS SKILLS

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

> **Decision Maker's Perspective**
>
> **Investors Understand One-Time Gains**
>
> Investors typically take a close look at the components of a company's profits. For example, **Ford Motor Company** announced that it had earned a net income for the fourth quarter (the final three months of the year) of $13.6 billion. Analysts had expected Ford to earn only $1.7 to $2.0 billion for that period. The day that Ford announced this earnings news, its stock price *fell* about 4.5%.
>
> Why would Ford's stock price fall on a day when the company reported these seemingly high profits? A closer inspection of Ford's income statement shows that it included a one-time gain of $12.4 billion for the fourth quarter. After subtracting this one-time gain, Ford actually earned only about $1.2 billion from normal operations, easily missing analysts' expectations. This disappointing earnings performance is the reason the company's stock price fell.

Analysis sections are offered at the end of topical chapters (4–11). These sections analyze the ratios of two real companies related to that chapter's theme. Students are able to see how companies' different business strategies affect their financial ratios. The **Financial Statement Analysis** chapter (12) allows students to take a deep dive into these concepts by analyzing the financial statements of Nike and Under Armour.

General Ledger Problems have students demonstrate their understanding of Ratio Analysis based on a list of transactions and subsequent financial statements. In addition, multiple other opportunities are available for students to practice decision-making and analysis skills in Connect and in the text itself.

The **Additional Perspectives** section of each chapter offers cases and activities designed to allow students to apply the knowledge and skills they've learned to real, realistic, or provocative situations. Students are placed in the role of decision maker, presented with a set of information, and asked to draw conclusions that test their understanding of the issues discussed in the chapters. Each chapter offers an engaging mix of activities and opportunities to perform real-world financial accounting analysis, conduct internet research, understand earnings management, address ethical dilemma, and practice written communication.

The Great Adventures Continuing Problem progresses from chapter to chapter, encompassing the accounting issues of each new chapter as the story unfolds. This problem allows students to see how each chapter's topics can be integrated into the operations of a single company. This problem is also available in McGraw-Hill Connect.

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

USING TECHNOLOGY TO ENHANCE LEARNING

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

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

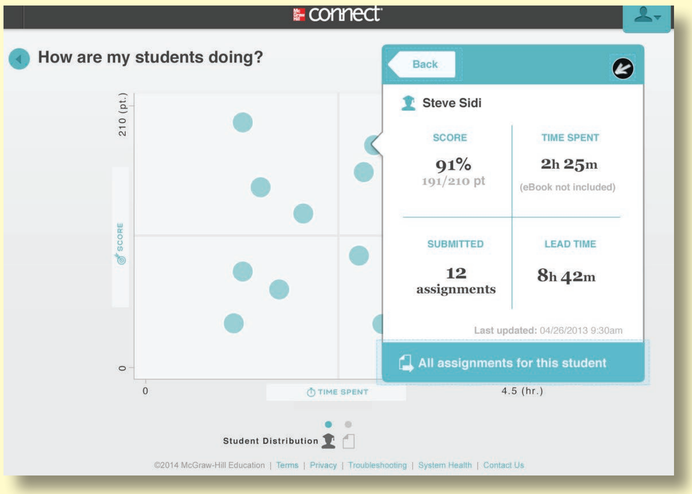
Additional algorithms and a greatly expanded test bank have been added as well, allowing students more practice and you more opportunities for students to demonstrate their understanding.

Extensive End-Of-Chapter Questions are available in the text and Connect:

- Brief Exercises
- Exercises (A & B set)
- Problems (A & B set)
- Great Adventures Continuing Problem
- Comprehensive Problems spanning multiple chapters

Available within Connect, **SmartBook** makes study time as productive and efficient as possible. It identifies and closes knowledge gaps through a continually adapting reading experience that provides personalized learning resources at the precise moment of need. This ensures that every minute spent with SmartBook is returned to the student as the most value-added minute possible. The result? More confidence, better grades, and greater success

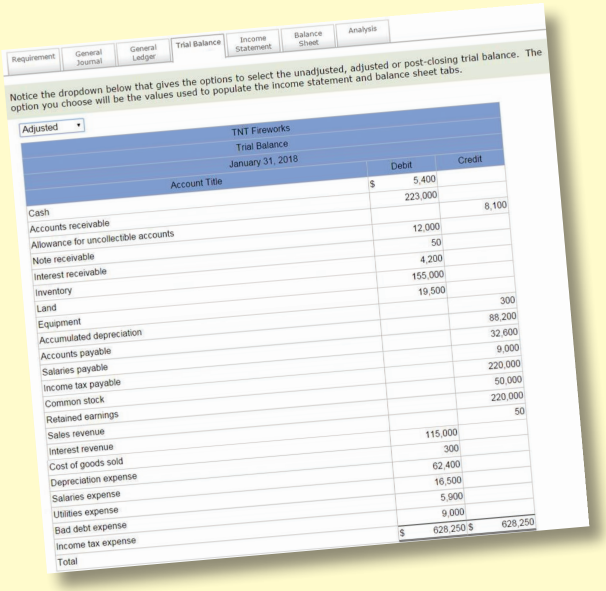
Connect Insight offers instructors and students with a highly visual analytics dashboard designed to provide valuable insights into what is occurring in the course. For instructors, Insight identifies areas in which groups of students are struggling and succeeding in their section(s). The analytics dashboard then allows instructors to view individual strengths and weaknesses, which can provide the blueprint for student success in the course. For students, Insight identifies individual strengths and weaknesses, as well as providing prescriptive advice on actions the student can take to shore up knowledge gaps. Connect Insight is a key differentiator in McGraw-Hill's technology offer!



TWO NEW CONNECT PROBLEM TYPES:

General Ledger Problems

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



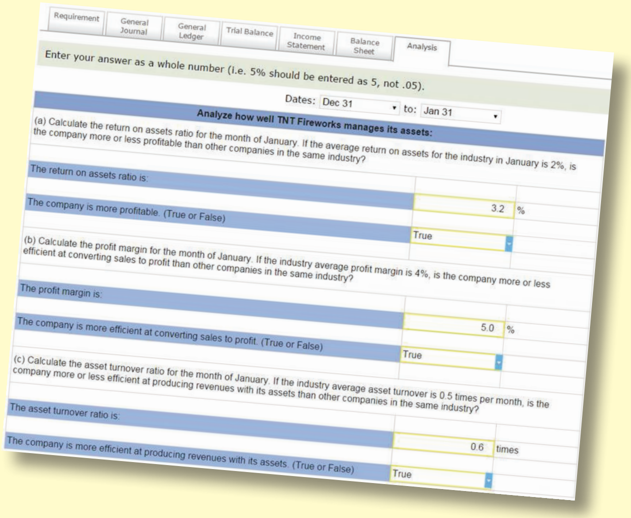
Requirement | General Journal | General Ledger | Trial Balance | Income Statement | Balance Sheet | Analysis

Notice the dropdown below that gives the options to select the unadjusted, adjusted or post-closing trial balance. The option you choose will be the values used to populate the income statement and balance sheet tabs.

Adjusted

TNT Fireworks
Trial Balance
January 31, 2018

Account Title	Debit	Credit
Cash	$ 5,400	
Accounts receivable	223,000	
Allowance for uncollectible accounts		8,100
Note receivable	12,000	
Interest receivable	50	
Inventory	4,200	
Land	155,000	
Equipment	19,500	
Accumulated depreciation		300
Accounts payable		88,200
Salaries payable		32,600
Income tax payable		9,000
Common stock		220,000
Retained earnings		50,000
Sales revenue		220,000
Interest revenue		50
Cost of goods sold	115,000	
Depreciation expense	300	
Salaries expense	62,400	
Utilities expense	16,500	
Bad debt expense	5,900	
Income tax expense	9,000	
Total	$ 628,250	$ 628,250



Requirement | General Journal | General Ledger | Trial Balance | Income Statement | Balance Sheet | Analysis

Enter your answer as a whole number (i.e. 5% should be entered as 5, not .05).

Dates: Dec 31 to: Jan 31

Analyze how well TNT Fireworks manages its assets:

(a) Calculate the return on assets ratio for the month of January. If the average return on assets for the industry in January is 2%, is the company more or less profitable than other companies in the same industry?

The return on assets ratio is:	3.2	%
The company is more profitable. (True or False)	True	

(b) Calculate the profit margin for the month of January. If the industry average profit margin is 4%, is the company more or less efficient at converting sales to profit than other companies in the same industry?

The profit margin is:	5.0	%
The company is more efficient at converting sales to profit. (True or False)	True	

(c) Calculate the asset turnover ratio for the month of January. If the industry average asset turnover is 0.5 times per month, is the company more or less efficient at producing revenues with its assets than other companies in the same industry?

The asset turnover ratio is:	0.6	times
The company is more efficient at producing revenues with its assets. (True or False)	True	

Excel Simulations

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

ADDITIONAL VIDEO-BASED INSTRUCTION:

Guided Examples

Guided Examples provide narrated, animated, and step-by-step walkthroughs of algorithmic versions of assigned exercises in Connect, allowing the student to identify, review, or reinforce the concepts and activities covered in class. Guided Examples provide immediate feedback and focus on the areas where students need the most guidance.

Interactive Presentations

The Interactive Presentations provide engaging narratives of all chapter learning objectives in an assignable, interactive online format. They follow the structure of the text and are organized to match the specific learning objectives within each chapter of *Financial Accounting.* While the interactive presentations are not meant to replace the textbook, they provide additional explanation and enhancement of material from the text chapter, allowing students to learn, study, and practice with instant feedback at their own pace.

Interactive Illustrations

Interactive Illustrations provide video-based explanations of key illustrations in the chapter, walking students step-by-step through the illustration, to deepen students' understanding of the concepts or the calculations shown.

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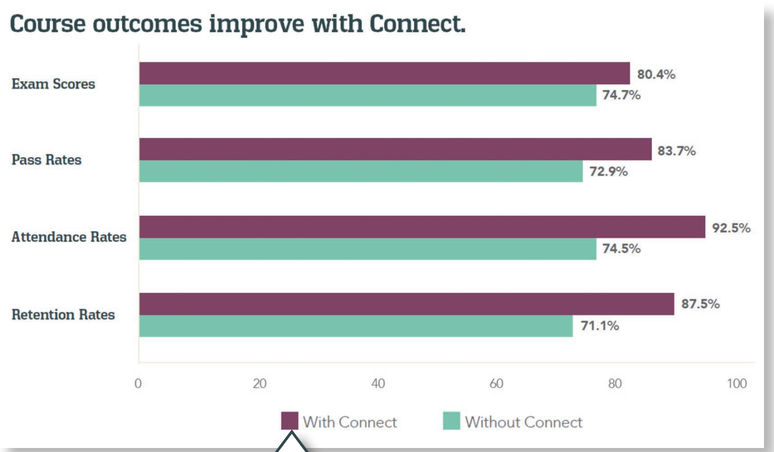

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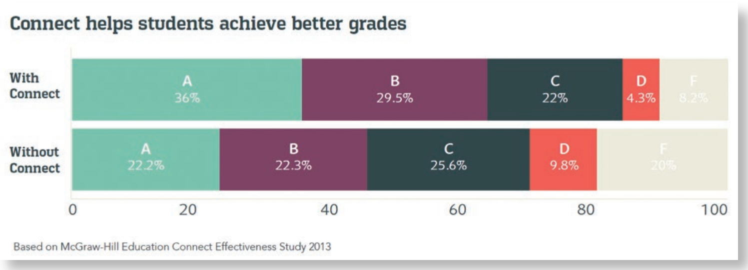

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Connect Insight is Connect's new one-of-a-kind visual analytics dashboard—now available for both instructors and students—that provides at-a-glance information regarding student performance, which is immediately actionable. By presenting assignment, assessment, and topical performance results together with a time metric that is easily visible for aggregate or individual results, Connect Insight gives the user the ability to take a just-in-time approach to teaching and learning, which was never before available. Connect Insight presents data that empowers students and helps instructors improve class performance in a way that is efficient and effective.

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*Findings based on a 2015 focus group survey at Pellissippi State Community College administered by McGraw-Hill Education

A HEARTFELT THANKS TO THE MANY VOICES . . .

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

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CHAPTER 1

A Framework for Financial Accounting

Learning Objectives

AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:

- **LO1–1** Describe the two primary functions of financial accounting.
- **LO1–2** Understand the business activities that financial accounting measures.
- **LO1–3** Determine how financial accounting information is communicated through financial statements.
- **LO1–4** Describe the role that financial accounting plays in the decision-making process.
- **LO1–5** Explain the term generally accepted accounting principles (GAAP) and describe the role of GAAP in financial accounting.
- **LO1–6** Identify career opportunities in accounting.

Appendix

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

Ebook

BERKSHIRE HATHAWAY: SPEAKING THE LANGUAGE OF BUSINESS

"You have to understand accounting and you have to understand the nuances of accounting. It's the language of business and it's an imperfect language, but unless you are willing to put in the effort to learn accounting—how to read and interpret financial statements—you really shouldn't select stocks yourself." —Warren Buffett

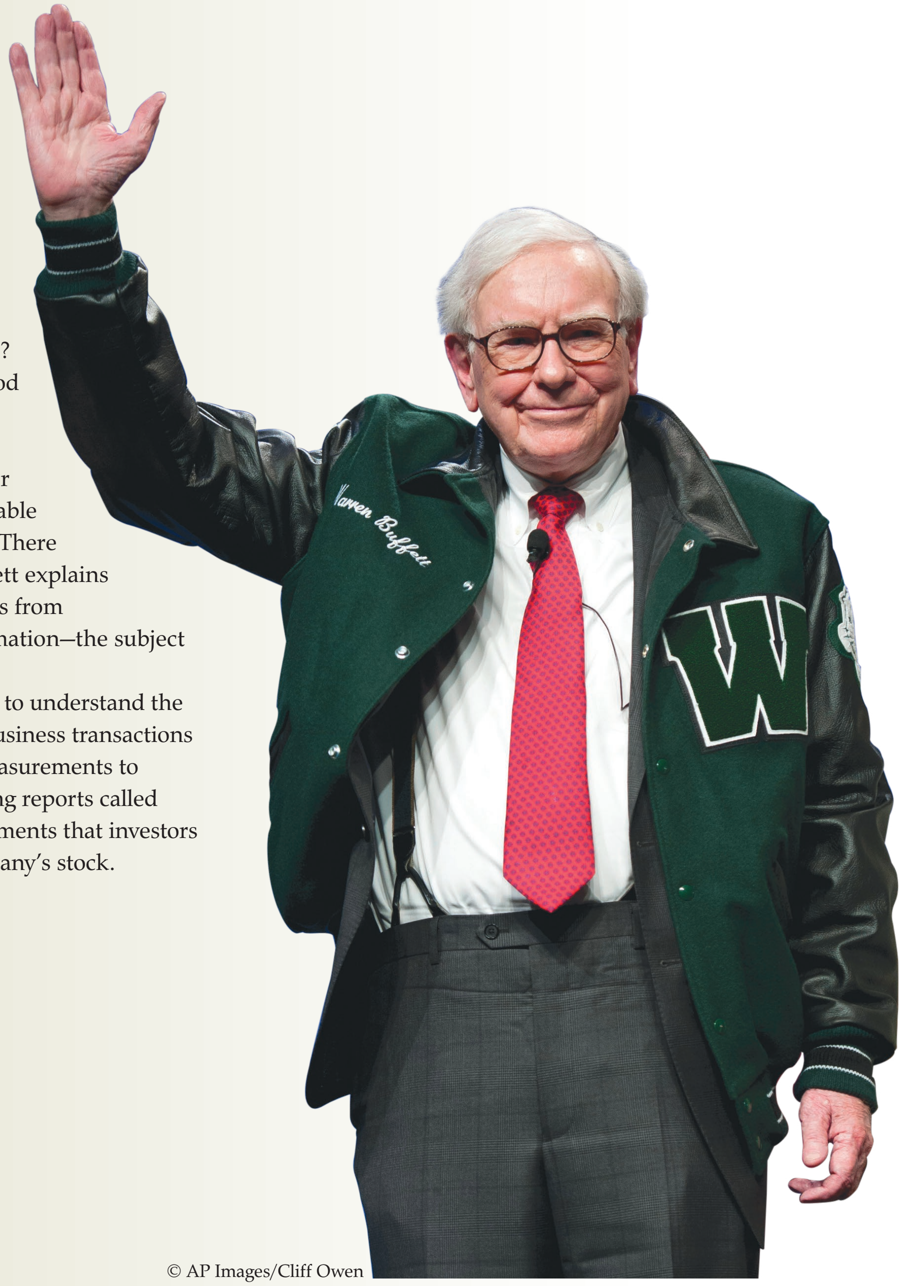
Feature Story

Warren Buffett is the chairman and CEO of **Berkshire Hathaway**, a holding company that invests billions of dollars in other companies. In 1965, Warren Buffet acquired control of Berkshire Hathaway, and the company's stock has returned an amazing 1,826,163% over the 50-year period from 1965–2014. That means anyone investing $1,000 in Berkshire Hathaway's stock in 1965 would have watched their investment grow to nearly $20,000,000 by the end of 2014. By 2014, Buffett's personal net worth had grown to $72 billion, making him one of the richest people in the world according to *Forbes* magazine.

Some of Buffett's more famous investments have included companies such as Coca-Cola, Dairy Queen, American Express, Gillette, GEICO, and Heinz. How did he decide which stocks to purchase? Over ten thousand company stocks are available in the United States and thousands more on stock exchanges around the world. How did he separate the successful companies from the unsuccessful ones?

Buffett explains that the key to identifying good stocks is to look for companies having a durable competitive advantage. In other words, look for companies that are expected to produce *profits* for a long time because they have achieved a sustainable advantage over their rivals. How do you do this? There are, of course, many factors to consider, but Buffett explains that the primary source of this information comes from analyzing companies' financial accounting information—the subject of this book.

As you read through the chapters, you'll begin to understand the purpose of financial accounting to measure the business transactions of a company and then to communicate those measurements to investors, like Warren Buffett, in formal accounting reports called *financial statements.* It is from these financial statements that investors base their decisions on buying and selling a company's stock.



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PART A

ACCOUNTING AS A MEASUREMENT/ COMMUNICATION PROCESS

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

Defining Accounting

■ **LO1–1**
Describe the two primary functions of financial accounting.

Accounting is "the language of business." More precisely, **accounting** is a system of maintaining records of a company's operations and communicating that information to decision makers. Perhaps the earliest use of such systematic recordkeeping dates back thousands of years to ancient Mesopotamia (present-day Iraq), where records were kept of delivered agricultural products. Using accounting to maintain a record of multiple transactions allowed for better exchange among individuals and aided in the development of more complex societies.[1] In this class, you'll learn how to read, interpret, and communicate using the language of business.

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

ILLUSTRATION 1–1
Decisions People Make About Companies

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

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

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

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

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

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

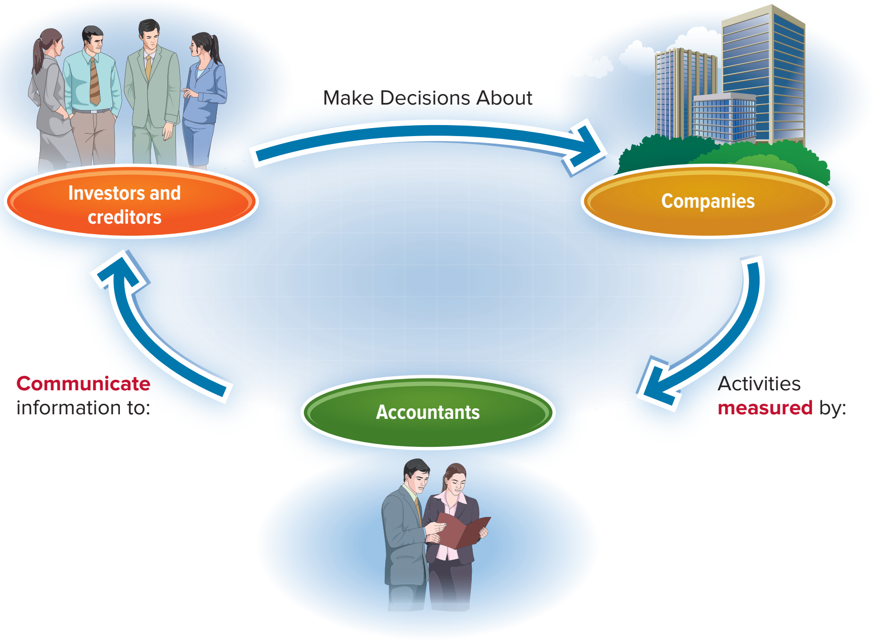

ILLUSTRATION 1–2
Framework for Financial Accounting

mhhe.com/4fa1

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

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

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

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

KEY POINT

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

Measuring Business Activities

■ LO1–2
Understand the business activities that financial accounting measures.

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

Let's assume you need about $35,000 to get the business up and going. You don't have that amount of money to start the business, so you begin by looking for investors. With their money, **investors** buy ownership in the company and have the right to share in the company's profits. Each share of ownership is typically referred to as a share of common stock. For your company, let's say you sell 1,000 shares of common stock for $25 each, receiving cash of $25,000 from investors. The 1,000 shares include 300 sold to your grandparents for $7,500, giving them 30% (= 300/1,000) ownership in the company. You also purchase 100 shares for $2,500, giving you 10% ownership. The remaining 600 shares include 300 to your parents, 200 to a friend, and 100 to your high school golf coach. You now have $25,000 from investors.

To raise the remaining cash needed, you borrow $10,000 from a local bank, which you agree to repay within three years. Thus, the bank is your **creditor.**

Now, with the $35,000 of cash obtained from investors and creditors, the company buys equipment. This equipment costs $24,000, leaving $11,000 cash for future use. At this point, your company has the following resources that can be used for operations.

Cash	$11,000	Resources
Equipment	24,000	
	$35,000	

Who has the claims to the company's resources? Answer: The investors and creditors. Creditors have claims equal to the amount loaned to the company, $10,000. In other words, $10,000 of the company's resources are promised to the local bank. Investors have claims to all remaining resources, $25,000.

Creditors (local bank)	$10,000	Claims to Resources
Investors (common stock)	25,000	
	$35,000	

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

Formally defined, a **corporation** is a company that is legally separate from its owners. The advantage of being legally separate is that the stockholders have limited liability. **Limited liability** prevents stockholders from being held personally responsible for the financial obligations of the corporation. Stockholders of Eagle Golf Academy can lose their investment of $25,000 if the company fails, but they cannot lose any of their personal assets (such as homes, cars, computers, and furniture).

Other common business forms include sole proprietorships and partnerships. A **sole proprietorship** is a business owned by one person; a **partnership** is a business owned by two or more persons. If you had decided to start Eagle Golf Academy without outside investors, you could have formed a sole proprietorship, or you and a friend could have formed a partnership. However, because you did not have the necessary resources to start the business, being a sole proprietorship (or even one member of a partnership) was not a viable option. Thus, a disadvantage of selecting the sole proprietorship or partnership form of business is that owners must have sufficient personal funds to finance the business in addition to the ability to borrow money. Another disadvantage of being a sole proprietorship or partnership is that neither offers limited liability. Owners (and partners) are held personally responsible for the activities of the business.

Sole proprietorships and partnerships do offer the advantage of lower taxes compared to corporations. Sole proprietorships and partnerships are taxed at the owner's personal income tax rate, which is typically lower than the corporate income tax rate. In addition, a corporation's income is taxed twice (known as *double taxation*): (1) the company first pays corporate income taxes on income it earns and (2) stockholders then pay personal income taxes when the company distributes that income as dividends to them.

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

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

- *Financing activities* include transactions the company has with investors and creditors, such as issuing stock ($25,000) and borrowing money from a local bank ($10,000).
- *Investing activities* include transactions involving the purchase and sale of resources that are expected to benefit the company for several years, such as the purchase of equipment for $24,000. With the necessary resources in place, the company is ready to begin operations.
- *Operating activities* will include transactions that relate to the primary operations of the company, such as providing products and services to customers and the associated costs of doing so, like rent, salaries, utilities, taxes, and advertising.

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

The resources of a company are referred to as **assets**. At this point, Eagle Golf Academy has two assets—cash and equipment. Of course, there are many other possible resources that a company can have, such as supplies, inventory for sale to customers, buildings, and land. You'll learn about these and many other assets throughout this book.

As discussed earlier, two parties have claims to the resources of the company—investors and creditors. Amounts owed to creditors are **liabilities**. Eagle Golf Academy has a liability of $10,000 to the local bank. Other examples of liabilities would be amounts owed to suppliers, employees, utility companies, and the government (in the form of taxes). Liabilities are claims that must be paid by a specified date.

Investors, or owners, have claims to any resources of the company not owed to creditors. In the case of Eagle Golf Academy, this amount is $25,000. We refer to owners' claims to resources as **stockholders' equity**, because stockholders are the owners.

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

ILLUSTRATION 1–3
The Accounting Equation

$$\underbrace{\textbf{Assets}}_{\text{Resources}} = \underbrace{\underset{\text{(creditors' claims)}}{\textbf{Liabilities}} + \underset{\text{(owners' claims)}}{\textbf{Stockholders' Equity}}}_{\text{Claims to Resources}}$$

As with any equation, we can move the components around. To isolate stockholders' equity, for example, we can subtract liabilities from both sides of the equal sign.

$$\underset{\text{(resources)}}{\textbf{Assets}} - \underset{\text{(creditors' claims)}}{\textbf{Liabilities}} = \underset{\text{(owners' claims)}}{\textbf{Stockholders' Equity}}$$

Eagle has assets of $35,000 and liabilities of $10,000. How much equity do stockholders have? They have $35,000 − $10,000, or $25,000.

The accounting equation illustrates a fundamental model of business valuation. The value of a company to its owners equals total resources of the company minus amounts owed to creditors. Creditors expect to receive only resources equal to the amount owed them. Stockholders, on the other hand, can claim all resources in excess of the amount owed to creditors.

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

We calculate a company's profits by comparing its revenues and expenses. **Revenues** are the amounts recorded when the company sells products or provides services to customers. For example, when you or one of your employees provides golf training to a customer, the company records revenue. However, as you've probably heard, "It takes money to make money." To operate the academy, you'll encounter many costs. For example, you'll have costs related to salaries, rent, supplies, and utilities. We record these amounts as expenses. **Expenses** are the costs of providing products and services.

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

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

You'll notice the use of the term *net* to describe a company's profitability. In business, the term *net* is used often to describe the difference between two amounts. Here, we measure revenues *net* of (or minus) expenses, to calculate the net income or net loss. If we assume that by the end of the first month of operations Eagle Golf Academy has total revenues of $7,200 and total expenses of $6,000, then we would say that the company has *net income* of $1,200 for the month. This amount of profit increases stockholders' claims to resources but has no effect on creditors' claims.

When a business has positive net income, it may either distribute those profits back to its stockholders or retain those profits to pay for future operations. Suppose you decide that because Eagle Golf Academy has net income of $1,200, a cash payment of $200 should be returned to stockholders at the end of the month. These cash payments to stockholders are called **dividends**.

The other $1,000 of net income adds to stockholders' equity of the company. Thus, when Eagle has net income of $1,200, stockholders receive a total benefit of $1,200, equal to $200 of dividends received plus $1,000 increase in stockholders' equity in the company they own.

Dividends are not an expense. Recall earlier we defined expenses as the costs necessary to run the business to produce revenues. Dividends, on the other hand, are not costs related to providing products and services to *customers;* dividends are cash returned to the *owners* of the company—the stockholders.

Let's Review

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

Suggested Homework:
BE1–4;
E1–2, E1–3;
P1–2A&B

Match the term with the appropriate definition.

1. _____ Assets	A. Costs of selling products or services.
2. _____ Liabilities	B. Sales of products or services to customers.
3. _____ Stockholders' Equity	C. Amounts owed.
4. _____ Dividends	D. Distributions to stockholders.
5. _____ Revenues	E. Owners' claims to resources.
6. _____ Expenses	F. Resources of a company.

Solution:

1. F; 2. C; 3. E; 4. D; 5. B; 6. A

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

ILLUSTRATION 1–4

Business Activities and Their Measurement

Activities Related to:	Measurement Category	Relationship
• Resources of the company • Amounts owed • Stockholders' investment	• Assets • Liabilities • Stockholders' equity	**Accounting Equation ($A = L + SE$)**
• Distributions to stockholders	• Dividends	
• Sales of products or services • Costs of providing sales	• Revenues • Expenses	**Net Income ($R - E = NI$)**

KEY POINT

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

Flip Side

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

Communicating through Financial Statements

■ LO1–3

Determine how financial accounting information is communicated through financial statements.

We've discussed that different business activities produce assets, liabilities, stockholders' equity, dividends, revenues, and expenses, and that the first important role of financial accounting is to *measure* the relevant transactions of a company. Its second vital role is to *communicate* these business activities to those outside the company. The primary means of communicating business activities is through financial statements. **Financial statements** are periodic reports published by the company for the purpose of providing information to external users. There are four primary financial statements:

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

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

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