PORTER & NORTON

Financial Accounting

The Impact on Decision Makers

NINTH EDITION

Financial Accounting
The Impact on Decision Makers

9e

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Financial Accounting: The Impact on Decision Makers, 9th edition

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1 2 3 4 5 6 7 17 16 15 14 13

Brief Contents

Contents

To those who really ‘‘count’’
Melissa
Kathy, Amy, Andrew

In honor of editor extraordinaire
Craig Avery

Preface

Business Success Means Understanding Accounting

A Framework for Success

Student success in accounting goes beyond knowing how to complete procedures—it means ensuring that students have an understanding of what the numbers mean and how they can use accounting information in the real world to make better business decisions. Like learning anything, however, it's important to provide students with models to follow as they learn how to interpret real data to make good decisions.

In the previous editions of *Financial Accounting*, Gary Porter and Curt Norton focused on making the material more relevant and engaging to students. For this edition, to make the text more approachable and student-friendly, language has been streamlined and important points have been called out. In addition, a hallmark of this text has always been the use of financial statements and other data for real-world companies, from chapter openers to end-of-chapter material, giving students the opportunity to use that data to apply what they're learning. The hallmark real-world company focus is continued and amplified through its application within key learning models.

This edition features three key models that provide students with a more structured approach to understanding financial data and how it is used to make sound business decisions. The **Transaction Model** helps students see the effects an economic event has on the accounting equation and financial statements, the **Financial Decision Framework** focuses on ratio analysis and business decisions, and the **Ethical Decision Model** helps students employ ethical judgment when applying accounting principles. The first two models are now available in CengageNOW to provide an accompanying multimedia learning tool—more deeply engaging the students in utilizing these models.

Financial Accounting: The Impact on Decision Makers, 9th edition will help your students learn and understand complex accounting rules and procedures and will also give them a framework through which they can apply their knowledge to make effective business decisions.

Transaction Model helps students understand an accounting transaction in less time and with more clarity. **Journal Entry Analysis** shows both the journal entry and the transaction-effects equation in one clear, integrated notation. This model is extended into CengageNOW with questions that measure students' understanding of the effects of transactions they're asked to record.

Journal Entry Analysis				
	Jan. XX	Wage and Salary Expense	10,000	
		Cash		10,000
		To record payment of wages and salaries.		

Balance Sheet						Income Statement				
ASSETS		=	LIABILITIES	+	STOCKHOLDERS' EQUITY	REVENUES	−	EXPENSES	=	NET INCOME
Cash	(10,000)				(10,000)			Wage and Salary Expense 10,000		(10,000)

This form of notation has clear benefits for both students and instructors:

- It provides a clear view of how transactions affect the balance sheet.
- Its separation of balance sheet and income statement sides differentiates these two equations and shows how the income statement elements are affected.
- Its arrow format better communicates the relationship between net income and stockholders' equity.
- When a transaction includes a contra account, this form explains clearly the effect of this account on the equation.

Financial Decision Framework gives students a structured framework to guide them through the **Making Business Decisions** feature in selected chapters. Students will identify relevant financial information, analyze that information, and make better business decisions based on what they uncover.

The two-part Financial Decision Framework includes a **Ratio Analysis Model** (Part A) that guides students through formulating a question about a real company, and then calculating, comparing, and interpreting ratios.

RATIO ANALYSIS
BUSINESS DECISION MAKING

A. The Ratio Analysis Model

1. Formulate the Question
How liquid is Columbia Sportswear?

2. Gather the Information from the Financial Statements
The **current ratio** measures liquidity. To calculate a company's current ratio, it is essential to know its current assets and current liabilities. Current assets are the most liquid of all assets. Current liabilities are the debts that will be paid the soonest.

Current assets: From the balance sheet
Current liabilities: From the balance sheet

3. Calculate the Ratio

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Columbia Sportswear
Partial Balance Sheet (in thousands of dollars)
For the Year Ended December 31, 2011

Assets	
Total current assets	$ 1,049,526
Liabilities and Stockholders' Equity	
Total current liabilities	$ 267,002

$$\text{Current Ratio} = \frac{\$\ 1{,}049{,}526}{\$\ \ 267{,}002} = 3.93 \text{ to } 1$$

4. Compare the Ratio with Other Ratios
Ratios are of no use in a vacuum. It is necessary to compare them with prior years and with competitors.

CURRENT RATIO			
Columbia Sportswear		**Under Armour**	
12/31/11	**12/31/10**	**12/31/11**	**12/31/10**
3.93 to 1	3.94 to 1	3.76 to 1	3.73 to 1

5. Interpret the Ratios
In general, the higher the current ratio, the more liquid the company. Columbia Sportswear's ratio is virtually unchanged from the end of 2010 to the end of 2011. Also, the company's current ratio is very similar to that for its competitor, Under Armour. Columbia Sportswear's current ratio of 3.93 at the end of 2011 indicates a relative high degree of liquidity.

Moving a step beyond ratios, the Financial Decision Framework then guides students through the **Business Decision Model** (Part B), which leads them through asking a question as a user of financial information, gathering and analyzing the necessary information, making a decision, and then monitoring that decision. This framework, integrated throughout the text, provides students with models for honing their analysis and decision-making skills using real company information in a relevant, applicable context.

B. The Business Decision Model

1. Formulate the Question
If you were a banker, would you be willing to loan money to Columbia Sportswear?

2. Gather Information from the Financial Statements and Other Sources
This information will come from a variety of sources, not limited to but including:

- The balance sheet, which provides information about liquidity, the income statement regarding profitability, and the statement of cash flows on inflows and outflows of cash.
- The outlook for the sports apparel and footwear industry (consumer demand, labor issues, foreign competition, etc.).
- The outlook for the economy during the time the loan would be outstanding. Is inflation projected to increase or decrease during this time?
- Projections for interest rates for similar loans during the term of the loan.
- Alternative uses for the bank's money.

3. Analyze the Information Gathered

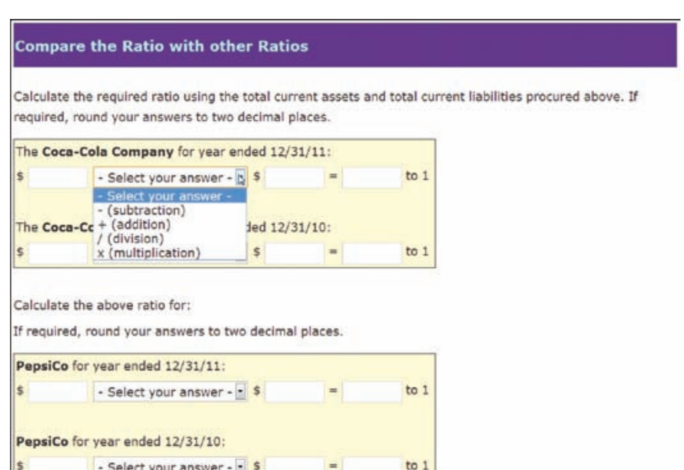
- Compare Columbia Sportswear's current ratio computed in A. above with Under Armour's as well as with industry averages.
- Look at trends over time in the current ratios.
- Review projections for economic outlook and interest rates.

4. Make the Decision
Taking into account all of the various sources of information, decide either to

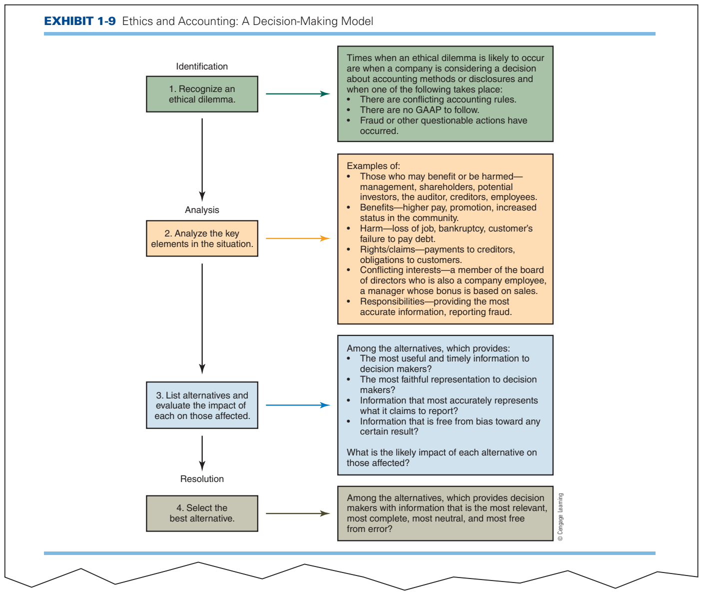
- Loan money to Columbia Sportswear or
- Find an alternative use for the money

5. Monitor Your Decision
If you decide to make the loan, you will need to monitor the loan periodically. During the time the loan is outstanding, you will want to assess the company's continuing liquidity as well as other factors you considered before making the loan.

The models are extended into the end-of-chapter material so students not only learn these models for making financial decisions, but they also have a chance to apply them in practice. Additionally, the models are available in CengageNOW, allowing students to complete the assignments on their own time. In CengageNOW, student submissions will be auto-graded and provide immediate feedback; so, students can learn from their mistakes.



Ethical Decision Model (introduced in Chapter 1) follows the stepped method to reach ethical decisions through identification, analysis, and resolution. Ethical issues are introduced within selected chapters, and end-of-chapter cases ask students to apply the model in order to evaluate the situation and learn how to make ethical decisions. Cases that ask students to use the Ethical Decision Model are noted with a special icon.



Hallmark Features to Help Students Learn Accounting

Chapter openers focus on the importance of accounting and the value of the topics covered in the chapter.

MAKING BUSINESS DECISIONS
CARNIVAL CORPORATION & PLC

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In these difficult economic times, all companies face challenges in generating revenues. This is certainly true of those that rely on consumer discretionary spending. The vacation and cruise business is a prime example. How do companies convince families to take cruises and spend money on board and, at the same time, hold down their own costs in this tough economy?

As the largest cruise company and one of the largest vacation companies in the world, **Carnival Corporation & PLC** (hereinafter referred to as ''Carnival'') presides over a vast fleet of ships operating under a number of recognizable brand names. Carnival Cruise Lines™, Princess™, Costa™, Holland America Line™, and Cunard™ are among the names on the company's fleet of 100 ships sailing around the world. As shown on the accompanying comparative income statements, revenues rose by over $1.3 billion in 2011 to $15.793 billion in total. Passenger tickets made up the vast majority of this revenue, increasing by nearly 10% in 2011 from the prior year.

As you know by now in your study of accounting, revenues are only one side of the equation in determining a company's profitability. Profit, or net income, is the result of deducting expenses from revenues. What do you suppose are some of the major expenses in running a cruise company? As the income statement reports, the largest of these is ''Commissions, transportation and other,'' which includes commissions paid to travel agents and other transportation-related costs. This expense increased by about 8%. With 91,000 employees worldwide, you can imagine that the company's payroll is one of its largest expenses, amounting to over $1.7 billion in 2011. However, Carnival was able to limit the increase in this critical cost to about 7% in 2011.

Another major cost in running a cruise business is the fuel needed to power a fleet of ships. Note the nearly $2.2 billion spent on fuel in 2011, a 35% increase from the prior year! Even with the $571 million increase in the cost of fuel, Carnival was able to report a bottom line of over $1.9 billion, a modest 3% decrease from the prior year. The company's ability to remain profitable in the future will certainly be impacted by the amount it has to pay for fuel.

In our study of accounting, we have not yet given any thought to how the numbers on an income statement (or on any of the other statements) got where they did. After all, before the information on the statements can be used for decision making, someone must decide how to record the various transactions that underlie the amounts reported. As a user of financial information, you will need to answer the following questions:

- What source documents are used as the necessary evidence to record transactions? (See p. 105.)
- What is the double-entry system of accounting? What is its role in the recording process? (See pp. 112–115.)
- What are some of the tools that accountants use to effectively and efficiently process the information that appears on financial statements? (See pp. 117–121.)

SPOTLIGHT interviews with business leaders in 9 of the 13 chapters show how actual managers, executives, accounting professionals, and analysts use accounting to get ahead in their careers. **Spotlights** profile real business professionals and their techniques, skills, business insights, and decisions to show how vital accounting is to their success.

SPOTLIGHT

Income Measurement, Accrual Accounting, and Ethics

In the construction industry, income measurement and accrual accounting are very important to the success of a company. Showing an accurate account balance and managing cash flow is critical when applying for credit, which is necessary within this very competitive industry. **James H. Kennedy**, CPA, specializes in providing accounting services to construction companies. A classically trained chef, he made a career change at 34 to return to accounting and become a CPA.

According to James, it is critical to get a balance between receivables and payables in this ever-changing industry. With the recent changes in the economy, construction customers are slower paying, with the average receivables taking close to 50 days to be paid. At the same time, payables are due within 30 days. Taking longer than 30 days to pay can negatively affect a company's ability to receive orders. Because of this, many companies are forced to make difficult decisions regarding pricing and payables.

When applying for a loan, James recommends that construction firms make sure that all receivables are classified as current or noncurrent assets and not understated; that current portions of long-term debt are properly recorded; and that accrued expenses are not overstated. These are all very important because they can greatly affect the ratios that many banks review before they lend money. He says that applying for a loan is like a first date. You only have one opportunity to make a good first impression.

While there can be pressure to adjust the financials to reflect a ''better'' picture, James makes clear that an accountant must accurately reflect a firm's income. Protect your integrity and your CPA license at all times, he says. James is a third-generation CPA, and his grandfather told him, ''All you ever really have is your reputation. You only get one CPA license and it's how you feed your family. It makes all the difference in the world.''

"Learn to communicate well. . . . Develop an excellent style of writing. It will differentiate you from your colleagues immediately. . . . Know your debits and credits cold, automatically, by heart, inside out, upside down, day or night."

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Name: James H. Kennedy, CPA
Education: B.S., Business Administration, Rowan University
College Major: Accounting
Occupation: CPA
Age: 53
Position: Founding partner of peer reviewed CPA firm that works closely with construction firms
Company Name: Kennedy & Associates, LLC CPA Services
See James Kennedy's interview clip in CNOW.

Additionally, **Spotlight interview videos** are featured in CengageNOW's Study Tools for *Financial Accounting* and also on the student companion web site.

LOOKING AHEAD features help prepare students for accounting changes to come. Whether changes are on the horizon for International Financial Reporting Standards, for new and challenging financial statement formats, or due to the global economic crisis, students need to be aware of how the future of business is affected. **Looking Ahead** features in selected chapters are a preview of trends and upcoming issues that will affect business and accounting.

LOOKING AHEAD

Whether LIFO survives in the United States is not only a matter of convergence with international standards. Because the method allows companies with rising inventory costs to report lower income, the White House and its supporters in Congress see the repeal of LIFO as one avenue for raising tax revenues and thus cutting into the ever-increasing federal deficit. Naturally, companies currently using the method are adamantly opposed to its elimination and are lobbying for its continuation. In addition to the budgetary implications, those in Congress who would like to see LIFO eliminated point to its prohibition under IFRS. This issue is a prime example of how accounting choices affect much more than a company's bottom line and can sometimes be at the center of national policy debates. Stay tuned.

Tetra Images/Getty Images

NEW ''FLAGSHIP'' COMPANIES: Financial Statements and Notes from Under Armour, Inc., and Columbia Sportswear Company bring the role of accounting and decision making in business into focus. Financial report excerpts from these competing companies encourage students' critical thinking and financial decision making skills.

EXHIBIT 1-8 Under Armour's Income Statement

Under Armour, Inc. and Subsidiaries
Consolidated Statements of Income
(In thousands, except per share amounts)

	Year Ended December 31,		
	2011	**2010**	**2009**
Net revenues	$1,472,684	$1,063,927	$856,411
Cost of goods sold	759,848	533,420	446,286
Gross profit	712,836	530,507	410,125
Selling, general and administrative expenses	550,069	418,152	324,852
Income from operations	162,767	112,355	85,273
Interest expense, net	(3,841)	(2,258)	(2,344)
Other expense, net	(2,064)	(1,178)	(511)
Income before income taxes	156,862	108,919	82,418
Provision for income taxes	59,943	40,442	35,633
Net income	$ 96,919	$ 68,477	$ 46,785
Net income available per common share			
Basic	$ 1.88	$ 1.35	$ 0.94
Diluted	$ 1.85	$ 1.34	$ 0.92
Weighted average common shares outstanding			
Basic	51,570	50,798	49,848
Diluted	52,526	51,282	50,650

See accompanying notes.

Net revenues reached about $1,473 million.

Costs of products sold were about $760 million.

Net income for the year was nearly $97 million.

Source: Under Armour Inc's Form 10-K for the Fiscal Year Ended December 31, 2011.

EXHIBIT 2-1 Comparative Balance Sheets for Columbia Sportswear Company

Columbia Sportswear Company
Consolidated Balance Sheets
(In thousands)

	December 31,	
	2011	**2010**
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 241,034	$ 234,257
Short-term investments	2,878	68,812
Accounts receivable, net (Note 4)	351,538	300,181
Inventories, net (Note 5)	365,199	314,298
Deferred income taxes (Note 10)	52,485	45,091
Prepaid expenses and other current assets	36,392	28,241
…urrent assets	1,049,526	990,880
[illegible]	[illegible]	221,813

UPDATED: Real-World Financial Information. The text's **balance sheet organization** uses well-known companies such as Under Armour, Inc., Columbia Sportswear, Carnival Corporation & PLC, Nordstrom Inc., Gap Inc., Sears Holdings, Apple, Nike, Starbucks, Coca-Cola, Southwest Airlines, Walgreen, and lululemon athletica to help apply accounting to the real world. Every chapter features a single company, complete with financial data and business strategy, along with assignments that ask students to dig deeper into the company's financials to develop their analytical skills.

UPDATED: Hot Topics boxes in all chapters dive deeper into the latest issues and challenges of the chapter-opening company.

HOT TOPICS
Keeping a Watchful Eye on Sales

© B.O'Kane/Alamy

All companies must pay close attention to their sales figures. Still, it is hard to imagine any segment of the economy more revenue conscious than retailers. Nordstrom is no exception. Like its competition, the company reports monthly to the financial press, as it did recently in announcing its December 2012 sales. Retailers report both total sales as well as what they call ''same-store sales,'' numbers that only include stores that operated in both the current and prior reporting periods. Analysts can more easily discern trends when sales at new stores are excluded.

Nordstom's investors should be encouraged by the recent announcement. Same-store sales for the five-week period ending December 29, 2012, increased by 8.6% over the comparable period in 2011. The company also tracks sales for its ''full line stores'' as compared to its discount ''rack stores.'' Both types of stores reported increases in same-store sales for the month of December of over 8% from the prior year. This is just the sort of information that is crucial in planning for the future as Nordstrom decides where to invest its valuable resources.

Source: Nordstrom news release, January 3, 2013; http://www.nordstrom.com.

UPDATED: Changes in Global Financial Standards. In addition to the Looking Ahead sections that preview upcoming regulatory, industry, and economic issues, **IFRS sections on selected topics** focus on global changes to specific financial accounting standards. International Financial Reporting Standards (**IFRS**) coverage in selected sections of the text, called out by an icon IFRS, provide a brief background for the upcoming changes in financial standards.

Inventory Valuation in Other Countries

The acceptable methods of valuing inventory differ considerably around the world. Although FIFO is the most popular method in the United States, LIFO continues to be widely used, as is the average cost method. Many countries prohibit the use of LIFO for tax or financial reporting purposes. Additionally, the IASB strictly prohibits the use of LIFO by companies that follow its standards. As GAAP in the United States come closer to converging with the international standards, it is still uncertain whether LIFO will survive as an acceptable inventory valuation method.

IFRS

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Exercise 5-25 Inventory Costing Methods—Periodic System

LO6 • 7
EXAMPLE 5-11, 5-12, 5-13, 5-14, 5-15

The following information is available concerning the inventory of Carter Inc.:

	Units	Unit Cost
Beginning inventory	200	$10
Purchases:		
March 5	300	11
June 12	400	12
August 23	250	13
October 2	150	15

During the year, Carter sold 1,000 units. It uses a periodic inventory system.

Required

1. Calculate ending inventory and cost of goods sold for each of the following three methods:
   a. Weighted average
   b. FIFO
   c. LIFO
2. Assume an estimated tax rate of 30%. How much more or less (indicate which) will Carter pay in taxes by using FIFO instead of LIFO? Explain your answer.
3. Assume that Carter prepares its financial statements in accordance with IFRS. Which costing method should it use to pay the least amount of taxes? Explain your answer.

IFRS

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UPDATED: IFRS Appendix A, "International Financial Reporting Standards" is a succinct overview of such topics as the reasons for a single set of standards, key differences between GAAP and IFRS, and the pace of change in the regulatory movement.

UPDATED: Daimler's balance sheet in Appendix A shows how financial statements for companies headquartered outside the United States sometimes differ in both the terminology used and the organization of the statements.

Review and Reinforcement Opportunities

Overview sections at the start of each major head provide students with a summary of the concepts to be presented in that section. Overviews provide a handy preview of concepts before studying the chapter, as well as an additional chance to review concepts before tackling homework or taking an exam.

Analyzing the Effects of Transactions on the Accounting Equation

OVERVIEW: Some transactions affect just the balance sheet, and others affect both the balance sheet and the income statement. Regardless, as transactions are recorded, the accounting equation must remain in balance:

Assets = Liabilities + Stockholders' Equity

Key Concept Highlights. More than ever before, the ninth edition highlights key concepts in the text using color, boldface, bulleting, and other design elements to help students zero in on key concepts they will need to know for homework and tests.

LO7 Determine which expenditures should be capitalized as asset costs and which should be treated as expenses.

Capital versus Revenue Expenditures

Accountants often must decide whether certain expenditures related to operating assets should be treated as an addition to the cost of the asset or as an expense. One of the most common examples involving this decision concerns repairs to an asset. Should the repairs constitute capital expenditures or revenue expenditures?

- **A capital expenditure is a cost that is added to the acquisition cost of an asset.**
- **A revenue expenditure is not treated as part of the cost of the asset, but as an expense on the income statement.**

Thus, the company must decide whether to treat an item as an asset (balance sheet) and depreciate its cost over its life or to treat it as an expense (income statement) of a single period.

The distinction between capital and revenue expenditures is a matter of judgment. Generally, the following guidelines should be followed:

- **When an expenditure *increases the life of the asset or its productivity,* it should be treated as a capital expenditure and added to the asset account.**
- **When an expenditure *simply maintains an asset in its normal operating condition,* however, it should be treated as an expense.**

The *materiality* of the expenditure must also be considered. Most companies establish a policy of treating an expenditure that is smaller than a specified amount as a revenue expenditure (an expense on the income statement).

Capital expenditure
A cost that improves the asset and is added to the asset account.
Alternate term: Item treated as asset.

Revenue expenditure
A cost that keeps an asset in its normal operating condition and is treated as an expense.
Alternate term: Item treated as an expense of the period.

Examples Teach Key Concepts and Skills. Students refer to examples in the text with the goal of solving the homework. Thus, Exercises and Brief Exercises at the back of every chapter refer to the many numbered, step-by-step examples in each chapter. Numbered examples of key procedures, activities, or processes will help students focus on learning the important skills they will need for completing the homework.

Example 3-2 Using a T Account

To illustrate a T account, we will look at the Cash account for Glengarry Health Club. The transactions recorded in the account can be traced to Exhibit 3-1.

Left side of an asset account shows increases.

Shows the account name

Right side of an asset account shows decreases.

Cash

Increases		Decreases	
Investment by owners	100,000	Wages and salaries	10,000
Court fees collected	5,000	Utilities	3,000
Accounts collected	4,000	Dividends	2,000
	109,000		15,000
Bal.	94,000		

The amounts $109,000 and $15,000 are called *footings.* They represent the totals of the amounts on each side of the account. Neither these amounts nor the balance of $94,000 represents transactions. They are simply shown to indicate the totals and the balance in the account.

NEW: Key Points Review in the end-of-chapter section highlights the key concepts covered in the chapter.

KEY POINTS REVIEW

LO1 Explain the difference between external and internal events.

- Both of these different types of events affect an entity and are usually recorded in the accounting system as a transaction.
  - External events are interactions between an entity and its environment.
  - Internal events are interactions entirely within an entity.

Alternative Terms. In the study of accounting, as in the world of business, terms and terminology are very important. The text presents **Alternate Terms** at the end of each chapter that illustrate variations in financial accounting terminology that students may encounter.

Personalized Study Plan. Students can master key concepts and prepare for exams with CengageNOW's Personalized Study Plan—a diagnostic tool plus study plan—preloaded with an Integrated eBook and other multimedia resources to make learning more engaging. The Pre-Test can be used to determine what students already know. Based on the results of the Pre-Test, the personalized study plan will automatically generate resources to help students focus on the areas where they need the most help. Finally, with the Post-Test, students can assess what they actually learned.

Assessment Tools

Homework Shows Cross-References to Key Examples beside the Exercises and Brief Exercises to help students review the related example material before completing the homework items.

Exercise 3-10 Journal Entries Recorded Directly in T Accounts

LO3 • 4 • 5
EXAMPLE 3-2, 3-4, 3-5

Record each of the following transactions directly in T accounts using the numbers preceding the transactions to identify them in the accounts. Each account needs a separate T account.

1. Received contribution of $6,500 from each of the three principal owners of We-Go Delivery Service in exchange for shares of stock.
2. Purchased office supplies for cash of $130.
3. Purchased a van for $15,000 on an open account. The company has 25 days to pay for the van.
4. Provided delivery services to residential customers for cash of $125.
5. Billed a local business $200 for delivery services. The customer is to pay the bill within 15 days.
6. Paid the amount due on the van.
7. Received the amount due from the local business billed in (5).

Brief Exercises, tied to a single learning outcome, allow students to confirm what they have learned and develop the skills and confidence needed to effectively work more complex exercises and problems.

LO5
EXAMPLE 2-6, 2-7

Brief Exercise 2-5 Multiple- versus Single-Step Income Statement

A retailer is considering whether to prepare a multiple- or single-step income statement. Provide three lines that appear on a multiple-step statement that do not appear on a single-step statement.

LO6
EXAMPLE 2-8

Brief Exercise 2-6 Profit Margin

A company reported sales of $100,000; cost of goods sold of $60,000; selling, general, and administrative expenses of $15,000; and income tax expense of $10,000. Compute the company's profit margin.

LO7
EXAMPLE 2-9

Brief Exercise 2-7 Retained Earnings

A company started the year with retained earnings of $200,000. During the year, it reported net income of $80,000 and paid dividends of $50,000. Compute the company's ending retained earnings.

Brief Exercise walk-through videos are now available to assist students completing their homework in CengageNOW. These videos, designed for the visual-learner, provide step-by-step guidance on how to complete the exercise. Students can then translate this knowledge back to the textbook examples to complete the cycle of learning.

Working-backward exercises generally give students a "result"—either journal entries, account balances, balance sheet or income statement presentations/amounts, or ratios. With this information, they are then asked to work backward to solve for the missing information in the exercise. **This type of problem solving is a test of their ability to think critically about key accounting concepts**.

Exercise 4-9 Working Backward: Depreciation LO5 EXAMPLE 4-5

Polk Corp. purchased new store fixtures for $55,000 on January 31, 2012. Polk depreciates assets using the straight-line method and estimated a salvage value for the machine of $5,000. On its December 31, 2014, balance sheet, Polk reported the following:

Property, plant, and equipment:		
Store fixtures	$55,000	
Less: Accumulated depreciation	15,000	$40,000

Required

1. What is the yearly amount of depreciation expense for the store fixtures?
2. What is the estimated useful life in years for the store fixtures? Explain your answer.

Blueprint Problems and Connections in CengageNOW are assignable teaching problems that require students to think through the problem solving process.

- Blueprint Problems cover primary learning objectives and help students understand the fundamental accounting concepts and their associated building blocks—not just memorizing formulas or journal entries required for a single concept.
- Blueprint Connections build upon concepts covered and introduced within the Blueprint Problems. These are scenario-based exercises that help students strengthen their analytical skills.
- Both can be used in class as part of the lecture, as a group activity, as a homework assignment, or for study and review.
- Both Blueprint Problems and Connections include feedback and explanations to enhance the learning experience.

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Chapter-by-Chapter Changes

Chapter 1

- Introduced one of two new flagship companies, Under Armour, Inc., as the focus company for Chapter 1.
- Revised Exhibits 1-1, 1-7, and 1-8 to reflect new flagship company, Under Armour, Inc.
- Revised Hot Topics feature to describe sale of stock by the founder of Under Armour, Inc.
- Updated end-of-chapter material: E1-9, E1-16, P1-8, P1-9, P1-8A, P1-9A, DC1-2, and DC1-3.
- Revised DC1-1 and DC1-2 to reflect new flagship company, Under Armour, Inc.
- Revised DC1-3 to reflect new flagship companies, Under Armour, Inc., and Columbia Sportswear Company.
- Revised DC1-6 to integrate the concept of ethics in accounting with the practice of modeling ethical decision making.

Chapter 2

- Introduced one of two new flagship companies, Columbia Sportswear Company, as the focus company for Chapter 2.
- Revised Exhibits 2-1, 2-2, and 2-3 to reflect new flagship company, Columbia Sportswear Company.
- Revised the Hot Topics feature to highlight Columbia Sportswear Company's dividend decision.
- Replaced Ratio Decision Model for the Current Ratio with new two-part Business Decision Model, consisting of Ratio Analysis and Business Decision portions.
- Replaced Ratio Decision Model for the Profit Margin with new two-part Business Decision Model, consisting of Ratio Analysis and Business Decision portions.
- Updated Looking Ahead feature for status of the FASB/IASB joint project on the format and presentation of financial statements.
- Revised P2-10 and P2-10A to integrate the new two-part Business Decision Model.
- Revised DC2-1 to reflect new flagship companies, Under Armour, Inc., and Columbia Sportswear Company.
- Revised DC2-2 to reflect new flagship company, Columbia Sportswear Company.
- Revised DC2-6 to integrate the concept of ethics in accounting with the practice of modeling ethical decision making.

Chapter 3

- Updated the chapter opener with the most current information available and replaced the financial statements from Carnival Corporation as the focus company for Chapter 3.
- Revised Hot Topics feature to highlight Holland America Line's selection on world's most ethical companies list.
- Revised DC3-1 to reflect new flagship companies, Under Armour, Inc., and Columbia Sportswear Company.
- Revised DC3-2 to reflect new flagship company, Under Armour, Inc.
- Updated end-of-chapter material: DC3-3.
- Revised DC3-6 to integrate the concept of ethics in accounting with the practice of modeling ethical decision making.

Chapter 4

- Updated the chapter opener with the most current information available and replaced the financial statements from Nordstrom as the focus company for Chapter 4.

- Updated the Hot Topics feature to highlight Nordstrom's same store sales reporting.
- Revised Exhibit 4-11 to illustrate a standard journal entry format.
- Updated end-of-chapter material: E4-31, DC4-2, and DC4-3.
- Revised DC3-1 to reflect new flagship companies, Under Armour, Inc., and Columbia Sportswear Company.
- Revised DC4-6 to integrate the concept of ethics in accounting with the practice of modeling ethical decision making.

Chapter 5

- Updated the chapter opener with the most current information available and replaced the financial statements from Gap as the focus company for Chapter 5.
- Updated the Hot Topics feature on Gap's international expansion.
- Updated Example 5-15 for Winnebago Industries' LIFO reserve.
- Revised Exhibit 5-11, substituting a partial statement of cash flows for Under Armour, Inc.
- Replaced Ratio Decision Model for the Gross Profit Ratio with new two-part Business Decision Model, consisting of Ratio Analysis and Business Decision portions.
- Replaced Ratio Decision Model for the Inventory Turnover Ratio with new two-part Business Decision Model, consisting of Ratio Analysis and Business Decision portions.
- Revised P5-2, P5-5, P5-2A, and P5-5A to integrate the new two-part Business Decision Model.
- Updated end-of-chapter material: E5-16, P5-8, P5-14, P5-8A, P5-14A, DC5-2, and DC5-3.
- Revised DC5-1 to reflect new flagship companies, Under Armour, Inc., and Columbia Sportswear Company.
- Revised DC5-9 to integrate the concept of ethics in accounting with the practice of modeling ethical decision making.

Chapter 6

- Updated the chapter opener with the most current information available and replaced the financial statements from Sears Holdings as the focus company for Chapter 6.
- Updated the Hot Topics feature to highlight Sears Holdings' strategy to finance operating cash needs.
- Updated Exhibits 6-1, 6-4, and 6-5 for new Sears Holdings' statements and reports.
- Revised DC6-1 to reflect new flagship companies, Under Armour, Inc., and Columbia Sportswear Company.
- Updated end-of-chapter material: DC6-2.
- Revised DC6-4 to integrate the concept of ethics in accounting with the practice of modeling ethical decision making.

Chapter 7

- Updated the chapter opener with the most current information available and replaced the financial statements from Apple Inc. as the focus company for Chapter 7.
- Updated the Hot Topics feature on Apple's quarterly report filed with the SEC.
- Updated Looking Ahead feature for status of possible changes in the statement of cash flows under the joint FASB/IASB project.
- Replaced Ratio Decision Model for the Accounts Receivable Turnover Ratio with new two-part Business Decision Model, consisting of Ratio Analysis and Business Decision portions.
- Updated end-of-chapter material: E7-5 and DC7-2.
- Revised P7-3 and P7-3A to integrate the new two-part Business Decision Model.

- Revised DC7-1, substituting amounts for 3M Company.
- Revised DC7-3 to reflect new flagship companies, Under Armour, Inc., and Columbia Sportswear Company.
- Revised DC7-5 to integrate the concept of ethics in accounting with the practice of modeling ethical decision making.

Chapter 8

- Updated the chapter opener with the most current information available and replaced the financial statements from Nike as the focus company for Chapter 8.
- Updated the Hot Topics feature to highlight Nike's intangible branding.
- Replaced Ratio Decision Model with new two-part Business Decision Model, consisting of Ratio Analysis and Business Decision portions.
- Updated end-of-chapter material DC8-1 features Columbia Sportswear Company and DC8-2 reflects Under Armour, Inc., and Columbia Sportswear Company; uses Ratio Analysis Model and Business Decision Model; DC8-5 uses the Ethical Decision Model.

Chapter 9

- Updated the chapter opener with the most current information available and replaced the financial statements from Starbucks as the focus company for Chapter 9.
- Updated the Hot Topics feature to highlight Starbucks' liability for products.
- Added sentences about calculating the balance of warranty liability.
- Updated end-of-chapter material P9-2, P9-3, P9-2A, P9-3A, DC9-2, DC9-3, and DC9-4.
- Changed DC9-1 to Columbia Sportswear Company and Under Armour, Inc.

Chapter 10

- Updated the chapter opener with the most current information available and replaced the financial statements from Coca-Cola and Pepsi as the focus companies for Chapter 10.
- Replaced Ratio Decision Model with new two-part Business Decision Model, consisting of Ratio Analysis and Business Decision portions.
- Updated end-of-chapter material: P10-9, P10-9A, and DC10-3
- DC10-1 features Columbia Sportswear Company and DC10-2 reflects Columbia Sportswear Company and Under Armour, Inc. DC10-2 uses Ratio Analysis Model and Business Decision Model. DC10-6 uses the Ethical Decision Model.

Chapter 11

- Updated the chapter opener with the most current information available and replaced the financial statements from Southwest Airlines as the focus company for Chapter 11.
- Updated end-of-chapter material: P11-7, P11-7A, and DC11-3
- DC11-1 features Columbia Sportswear Company and Under Armour, Inc., and DC11-2 highlights Columbia Sportswear Company. DC11-5 uses the Ethical Decision Model.

Chapter 12

- Introduced Walgreen Company as the new focus company for Chapter 12.
- Revised Exhibit 12-1 to illustrate cash flow and net income differences.
- Revised the Hot Topics feature to illustrate Walgreen Company's strategy for returning cash to stockholders.

- Updated Looking Ahead feature for status of possible changes in the statement of cash flows under a joint FASB/IASB project.
- Replaced Ratio Decision Model for the Cash Flow Adequacy Ratio with new two-part Business Decision Model, consisting of Ratio Analysis and Business Decision portions.
- Updated end-of-chapter material: E12-4.
- Revised DC12-1 to reflect new flagship companies, Under Armour, Inc., and Columbia Sportswear Company.
- Revised DC12-2 to integrate the new two-part Business Decision Model.
- Revised DC12-3 to substitute Walgreen Company.
- Revised DC12-6 to integrate the concept of ethics in accounting with the practice of modeling ethical decision making.

Chapter 13

- Introduced lululemon athletica, inc., as the new focus company for Chapter 13.
- Revised Exhibit 13-1, substituting financial information for lululemon athletica, inc.
- Revised the Hot Topics feature to highlight lululemon athletica, inc.'s quarterly disclosures.
- Updated Looking Ahead feature for status of joint FASB/IASB project on the format and presentation of financial statements.
- Revised Review Problem for new focus company.
- Updated end-of-chapter material: E13-7.
- Revised E13-5, E13-6, E13-8, and E13-11 for new companies.
- Revised DC13-1 and DC13-2 to reflect new flagship company, Under Armour, Inc.
- Revised DC13-3 to reflect new flagship companies, Under Armour, Inc., and Columbia Sportswear Company.
- Revised DC13-4 to reflect new flagship company, Columbia Sportswear Company.
- Revised DC13-7 to integrate the concept of ethics in accounting with the practice of modeling ethical decision making.

Additional Instructor and Student Supplements

Instructor's Manual

The Instructor's Manual, by Sandra Augustine (Hilbert College), contains detailed lecture outlines, lecture topics, and suggestions for classroom activities. The chapter activities in the Instructor's Manual have been analyzed and assigned the same set of outcomes that are used in the Solutions Manual and the Test Bank (available on the Instructor Companion web site).

Solutions Manual

The Solutions Manual, by the text authors, consists of solutions to all the end-of-chapter material keyed to learning outcomes and using the Journal Entry Analysis form of transaction notation for journal entries found in the text. (Available in print, ISBN-13: 978-1-285-18299-5. Also available on the Instructor Companion web site.)

Test Bank

The Test Bank, by LuAnn Bean (Florida Institute of Technology), contains a comprehensive set of test items to meet every assessment need from brief exercises to problems and decision cases. The Test Bank will now be offered in Cognero.

Cengage Learning Testing Powered by Cognero is a flexible, online system that allows instructors to:

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Excel® Templates

Selected problems in each chapter may be solved on a Microsoft Excel spreadsheet to increase awareness of basic software applications. Just download the Excel spreadsheets for homework items that are identified by icons in the text. (Excel templates are available on the Student Resources page of the product web site. Password-protected Instructor solutions are available on the Instructor Companion web site.)

PowerPoint® Slides

Student PowerPoint Slides, a smaller version of the Instructor PowerPoint Lectures, allow students to get ready for upcoming lectures, quizzes, homework, and exams with core material needed for chapter study. (Student PowerPoint Slides are available on the Student Resources page of the product web site. More detailed, password-protected Instructor PowerPoint Slides are available on the Instructor Companion web site.)

Student Web Resources

Chapter-by-chapter quizzes, topical discussions, updates on IFRS integration, and more are available. These items help reinforce and shed light on text topics. Discover more by logging into the text web site. Visit www.cengagebrain.com.

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Gary A. Porter
Curtis L. Norton
August 2013

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Gary A. Porter is currently a Distinguished Lecturer at Drake University. He earned Ph.D. and M.B.A. degrees from the University of Colorado and his B.S.B.A. from Drake University. As Professor of Accounting, Dr. Porter served as Department Chair and taught at numerous universities. He has published in the *Journal of Accounting Education, Journal of Accounting, Auditing & Finance,* and *Journal of Accountancy,* among others, and has conducted numerous workshops on the subjects of introductory accounting education and corporate financial reporting.

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Financial Accounting

The Impact on Decision Makers

9e

Accounting as a Form of Communication

1

AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:

LO1 Explain what business is about.

LO2 Distinguish among the forms of organization.

LO3 Describe the various types of business activities.

LO4 Define accounting and identify the primary users of accounting information and their needs.

LO5 Explain the purpose of each of the financial statements and the relationships among them and prepare a set of simple statements.

LO6 Identify and explain the primary assumptions made in preparing financial statements.

LO7 Identify the various groups involved in setting accounting standards and the role of auditors in determining whether the standards are followed.

LO8 Explain the critical role that ethics plays in providing useful financial information.

STUDY LINKS

A Look at This Chapter Business is the foundation upon which accounting rests. After a brief introduction to business, we begin the study of accounting by considering what accounting is and who uses the information it provides. We will see that accounting is an important form of communication and that financial statements are the medium that accountants use to communicate with those who have some interest in the financial affairs of a company.

A Look at Upcoming Chapters Chapter 1 introduces accounting and financial statements. Chapter 2 looks in more detail at the composition of the statements and the conceptual framework that supports the work of an accountant. Chapter 3 steps back from financial statements and examines how companies process economic events as a basis for preparing the statements. Chapter 4 completes the introduction to the accounting model by considering the importance of accrual accounting in this communication process.

MAKING BUSINESS DECISIONS
UNDER ARMOUR, INC.

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Why is learning financial accounting important? Why should you care about learning to read the financial statements of a company?

To be frank, it's because successful companies generate jobs, and struggling companies shed jobs—and jobs affect the economy, which affects your future—how you live, learn, and work.

Also, the more you know about how successful companies work, the better are your chances of doing well in your chosen field. Whatever you plan to do, your knowledge of business and accounting helps you compete whether you invest, work for a company, or go into business for yourself.

Consider **Under Armour, Inc.**, a company that got its start in 1995 when a collegiate football player noticed that the cotton t-shirt underneath his pads was always soaked with sweat. This observation led Kevin Plank to develop a microfiber shirt that wicked moisture and kept athletes cool and dry. The young entrepreneur maxed out his credit cards, set up a company in his grandmother's basement, and began his quest to revolutionize the sports apparel business. Within a year, Georgia Tech became his first customer, with other collegiate and NFL teams following close behind. In 1999, Plank landed a contract with **Warner Brothers** to outfit the actors in two upcoming football movies.

All successful companies are continually faced with key strategic decisions. Like so many startups, Under Armour faced one of the most important of these decisions in 2005 when it decided to sell stock to the public. At that point, the company was generating less than $300 million in annual sales with 600 employees. Another key decision followed the next year when the company added footwear to its product line. In 2011, Under Armour opened its first store in China, recognizing the need to tap into new fast-growing international markets to continue growing at a rapid pace.

How does management stockholders, and others interested in the financial well-being of a company know if the company is making good business decisions? Was it a wise decision to take the company public, to expand into footwear, and to look to markets outside the United States? The numbers produced by an accounting system go a long way in assessing a company's financial performance. Consider the Selected Financial Data shown on the next page as they appeared in Under Armour's 2011 Form 10-K, the annual report filed with the Securities and Exchange Commission:

- Beginning in 2008, the company's revenues have increased each year, topping $1 billion for the first time in 2010 and growing by another 38% in 2011.
- The company's ''bottom line'' performance, its net income, has also been impressive, increasing in each of the last three years and reaching nearly $100 million in 2011.

Companies use this financial information in making decisions. When a stockbroker decides whether to recommend to a client the purchase of stock in a company, the broker needs information about the company's profits and any payment of dividends. When deciding whether to loan money to a company, a banker must consider the company's current debts.

Why do you need to study this chapter? Learning how accountants and other businesspeople assess a company's performance can work for you too as you prepare for your own competitive future:

- What is business? (See pp. 5–6.)
- What forms of organization carry on business activities? (See pp. 5–7.)
- In what types of business activities do those organizations engage? (See pp. 7–9.)
- What is revenue? How is it measured? (See p. 8.)
- What is net income? How is it measured? (See p. 14.)
- How do revenue and net income relate to a company's assets? (See pp. 13–14.)
- Where do the various items appear on a company's financial statements? (See pp. 13–16.)

Learning the answers to these questions—learning how accountants think and communicate—is just plain smart for everyone in today's job market.

	Year Ended December 31,				
(In thousands, except per share amounts)	**2011**	**2010**	**2009**	**2008**	**2007**
Net revenues	$1,472,684	$1,063,927	$856,411	$725,244	$606,561
Cost of goods sold	759,848	533,420	446,286	372,203	302,083
Gross profit	712,836	530,507	410,125	353,041	304,478
Selling, general and administrative expenses	550,069	418,152	324,852	276,116	218,213
Income from operations	162,767	112,355	85,273	76,925	86,265
Interest income (expense), net	(3,841)	(2,258)	(2,344)	(850)	749
Other income (expense), net	(2,064)	(1,178)	(511)	(6,175)	2,029
Income before income taxes	156,862	108,919	82,418	69,900	89,043
Provision for income taxes	59,943	40,442	35,633	31,671	36,485
Net income	$ 96,919	$ 68,477	$ 46,785	$ 38,229	$ 52,558

Source: Under Armour's web site and Under Armour Inc's Form 10-K for the Fiscal Year Ended December 31, 2011.

What Is Business?

LO1 Explain what business is about.

Business
All of the activities necessary to provide the members of an economic system with goods and services.

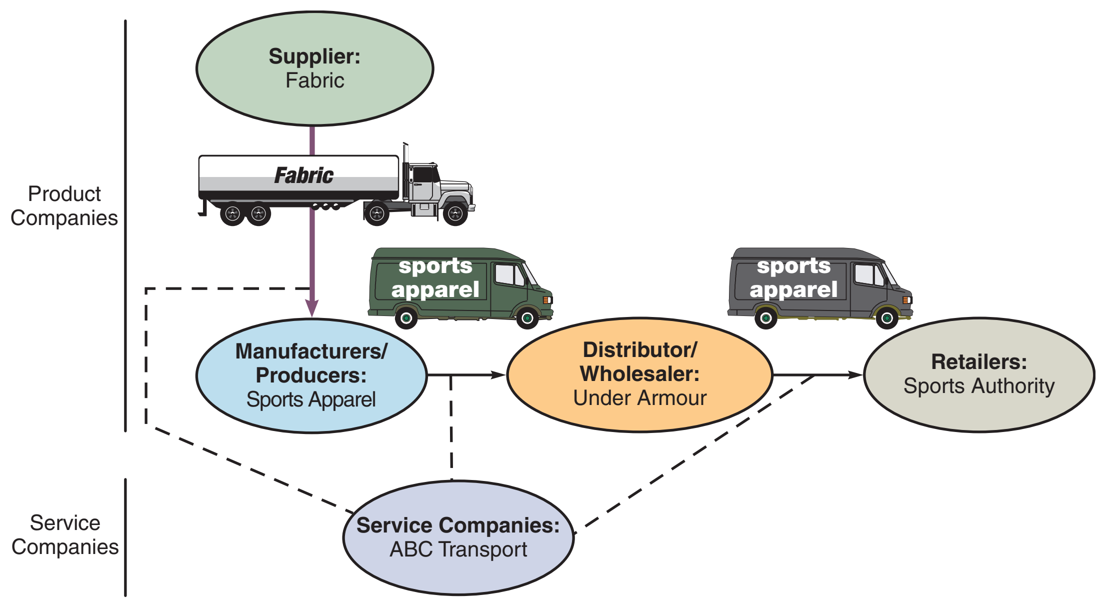
OVERVIEW: Businesses exist to provide members of society with goods and services. Product companies include manufacturers/producers, wholesalers, and retailers. Service providers are becoming increasingly important in today's economy.

Broadly defined, **business** consists of all activities necessary to provide the members of an economic system with goods and services. Certain business activities focus on providing goods or products such as ice cream, automobiles, and computers. Some of these companies produce or manufacture the products. Other companies are involved in the distribution of the goods, either as wholesalers (such as **Under Armour** who sells to retail outlets) or retailers (such as **Sports Authority** who sells to consumers). Other business activities, by their nature, are service-oriented. A broad range of service providers, such as **Walt Disney** and **United Airlines**, provide evidence of the growing importance of the service sector in the U.S. economy.

Example 1-1 Identifying Types of Businesses

To appreciate the kinds of enterprises in our economy, consider the various types of companies that have a stake in the delivery of an Under Armour shirt to a store. First, a *supplier* of raw material, such as the fabric used to make the shirt, must deliver the material to a *manufacturer*. The manufacturer uses the fabric along with other materials to produce the finished product. At this stage, the manufacturer sells the shirt to a *distributor* or *wholesaler*, Under Armour in this case, who in turn sells the shirt to a *retailer* such as **Sports Authority**. Additionally, *service companies* are involved, such as the transportation companies that deliver the materials and shirts to the various companies in the process.

EXHIBIT 1-1 Types of Businesses



Forms of Organization

OVERVIEW: Business entities are organized as sole proprietorships, partnerships, or corporations. Nonbusiness entities include government entities such as local, state, and federal governments and private organizations such as hospitals and universities.

LO2 Distinguish among the forms of organization.

One convenient way to categorize the many different types of organizations in our society is to distinguish between those that are organized to earn money and those that exist for some other purpose. Although the lines can become blurred, *business entities* such as Under Armour generally are organized to earn a profit, whereas *nonbusiness entities* generally exist to serve various segments of society. Both types are summarized in Exhibit 1-2.

Business Entities

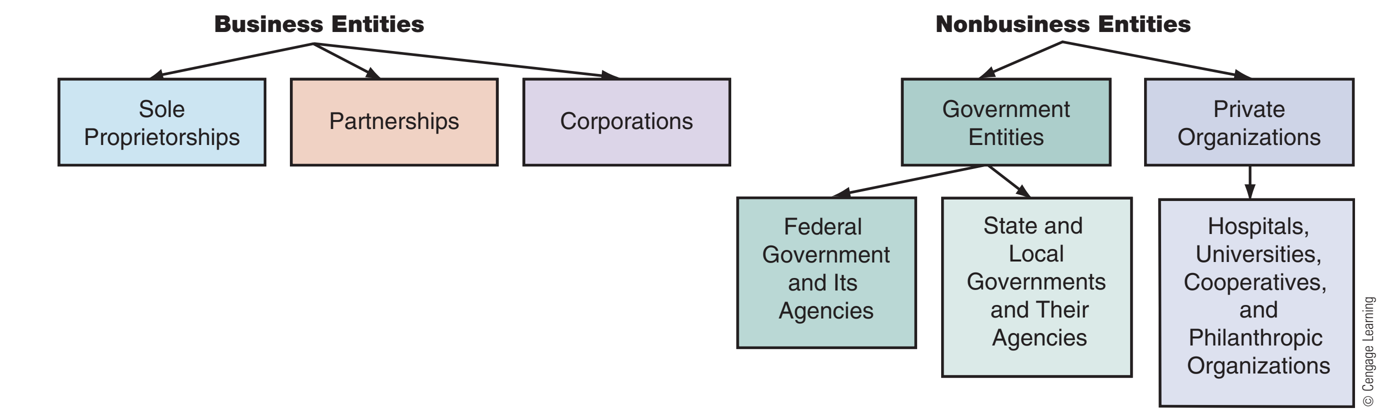
Business entities are organized to earn a profit. Legally, a profit-oriented company is one of three types: a sole proprietorship, a partnership, or a corporation.

Business entity
An organization operated to earn a profit.

Sole Proprietorships This form of organization is characterized by a single owner. Many small businesses are organized as **sole proprietorships**, often owned and operated by the same person. Because of the close relationship between the owner and

Sole proprietorship
A form of organization with a single owner.

EXHIBIT 1-2 Forms of Organization



the business, the affairs of the two must be kept separate. This is one example in accounting of the **economic entity concept**, which requires that a single, identifiable unit of organization be accounted for in all situations. For example, assume that Bernie Berg owns a neighborhood grocery store. In paying monthly bills such as utilities and supplies, Bernie must separate his personal costs from the costs associated with the grocery business. In turn, financial statements prepared for the business must not intermingle Bernie's personal affairs with the company affairs.

Economic entity concept
The assumption that a single, identifiable unit must be accounted for in all situations.

Unlike the distinction made for accounting purposes between an individual's personal and business affairs, the Internal Revenue Service (IRS) does not recognize the separate existence of a proprietorship from its owner. That is, a sole proprietorship is not a taxable entity; the business's profits are taxed on the individual's return.

Partnership
A business owned by two or more individuals; the organization form often used by accounting firms and law firms.

Partnerships A **partnership** is a business owned by two or more individuals. Many small businesses begin as partnerships. When two or more partners start out, they need an agreement as to how much each will contribute to the business and how they will divide any profits. This agreement may be an oral understanding between the partners, or it may be a formalized written document.

Public accounting firms, law firms, and other types of service companies are often organized as partnerships. Like a sole proprietorship, a partnership is not a taxable entity. Individual partners pay taxes on their proportionate shares of the business's profits.

Corporation
A form of entity organized under the laws of a particular state; ownership evidenced by shares of stock.

Share of stock
A certificate that acts as evidence of ownership in a corporation.

Corporations Although sole proprietorships and partnerships dominate in sheer number, corporations control a majority of the private resources in this country. A **corporation** is an entity organized under the laws of a particular state.

To start a corporation, articles of incorporation must be filed with the state. If the articles are approved by the state, a corporate charter is issued and the corporation can begin to issue stock. A **share of stock** is a certificate that acts as evidence of ownership in a corporation. Stocks of many corporations are traded on organized stock exchanges such as the New York Stock Exchange. Under Armour's stock is traded on the New York Stock Exchange.

What are the advantages of running a business as a corporation?

Bond
A certificate that represents a corporation's promise to repay a certain amount of money and interest in the future.

- **A corporation has the ability to raise large amounts of money in a relatively brief period of time.** This is what prompted Under Armour to eventually "go public." To raise money, the company sold a specific type of security: stock. Corporations may also issue bonds. A **bond** is different from a share of stock because it represents a promise by the company to repay a certain amount of money at a future date. In other words, if you were to buy a bond from a company, you would be lending it money. Interest on the bond is usually paid semiannually.

- **Ownership in a corporation is transferred easily.** If you hold shares of stock in a corporation whose stock is actively traded and you decide that you want out, you simply call your broker and put in an order to sell.
- **Stockholders have limited liability.** Generally, a stockholder is liable only for the amount contributed to the business. That is, if a company goes out of business, the most the stockholder stands to lose is the amount invested. On the other hand, both proprietors and general partners usually can be held personally liable for the debts of the business.

Nonbusiness Entities

Most **nonbusiness entities** are organized to serve the needs of various segments of society. For example, a hospital provides health care to its patients. A municipal government is operated for the benefit of its citizens. A local school district meets the educational needs of the community's youth.

Nonbusiness entity
An organization operated for some purpose other than to earn a profit.

None of these entities has an identifiable owner. The lack of an identifiable owner and of the profit motive changes the type of accounting used by nonbusiness entities. This type, called *fund accounting*, is discussed in advanced accounting courses. Regardless of the lack of a profit motive in nonbusiness entities, they still need the information provided by an accounting system. For example, a local government needs detailed cost breakdowns in order to levy taxes. A hospital may want to borrow money and will need financial statements to present to the prospective lender.

Organizations and Social Responsibility

Although nonbusiness entities are organized specifically to serve members of society, U.S. business entities recognize the societal aspects of their overall mission and have established programs to meet these responsibilities. Some companies focus on local charities, while others donate to national or international causes.

The Nature of Business Activity

OVERVIEW: **Businesses engage in three types of activities: financing, investing, and operating. Financing is necessary to start a business, and funds are obtained from both stockholders and creditors. These funds are invested in the various assets needed to run a business. Once funds are obtained and investments made in productive assets, a business begins operations, which may consist of providing goods or services or both.**

LO3 Describe the various types of business activities.

Corporations engage in many different types of activities. However, these activities can be categorized into one of three types: financing, investing, or operating.

Financing Activities

All businesses must start with financing. Kevin Plank needed money in the 1990s to start his new company, Under Armour. The company needed additional financing later and thus made the decision in 2005 to sell stock to the public. Most companies not only sell stock to raise money but also borrow from various sources to finance their operations. These financing activities bring up two important accounting terms: *liabilities* and *capital stock*.

Example 1-2 Distinguishing Between Liabilities and Capital Stock

A liability is an obligation of a business. When a company borrows money at a bank, the liability is called a *note payable*. When a company sells bonds, the obligation is termed *bonds payable.* Amounts owed to the government for taxes are called taxes *payable*. When Under Armour buys apparel and the supplier gives Under Armour 30 days to pay the amount owed. Under Armour's obligation is called *accounts payable*.

Liability
An obligation of a business.

(*Continued*)

Capital stock
Indicates the owners' contributions to a corporation.

Stockholder
One of the owners of a corporation.
Alternate term: *Shareholder.*

Creditor
Someone to whom a company or person has a debt.
Alternate term: *Lender.*

Capital stock is the term used by accountants to indicate the dollar amount of stock sold to the public. Capital stock differs from liabilities in one very important respect. Those who buy stock in a corporation are not lending money to the business, as are those who buy bonds in the company or make a loan in some other form. One who buys stock in a company is called a **stockholder**, and that person is providing a permanent form of financing to the business. In other words, there is no due date when the stockholder must be repaid. Normally, the only way for a stockholder to get back his or her original investment from buying stock is to sell it to someone else. One who buys bonds in a company or in some other way makes a loan to it is called a **creditor**. A creditor does *not* provide a permanent form of financing to the business. That is, the creditor expects repayment of the amount loaned and, in many instances, payment of interest for the use of the money.

Investing Activities

Asset
A future economic benefit.

Once funds are generated from creditors and stockholders, money is available to invest in assets. **An asset is a future economic benefit to a business.** For example, cash is an asset to a company. To Under Amour, its buildings and equipment are assets, as is the inventory that is held for sale to customers. However, not all assets are tangible in nature, as are buildings, equipment, and inventory.

Example 1-3 Identifying Assets

Assume that a company acquires a patent that will give it the exclusive right to produce a certain product. The right to the future economic benefits from the patent is an asset. In summary, an asset is a valuable resource to the company that controls it.

Notice the tie between assets and liabilities. Although there are some exceptions, most liabilities are settled by transferring assets. The asset most often used to settle a liability is cash.

Operating Activities

Once funds are obtained from financing activities and investments are made in productive assets, a business is ready to begin operations. Every business is organized with a purpose in mind. The purpose of some businesses, such as Under Armour, is to sell a *product*. Other companies provide *services*. Service-oriented businesses are becoming an increasingly important sector of the U.S. economy. Some of the largest corporations in this country, such as banks and airlines, sell services rather than products.

Revenue
An inflow of assets resulting from the sale of goods and services.

Expense
An outflow of assets resulting from the sale of goods and services.

Revenue is the inflow of assets resulting from the sale of products and services. When a company makes a cash sale, the asset it receives is cash. When a sale is made on credit, the asset received is an account receivable. Revenue represents the dollar amount of sales of products and services for a specific period of time.

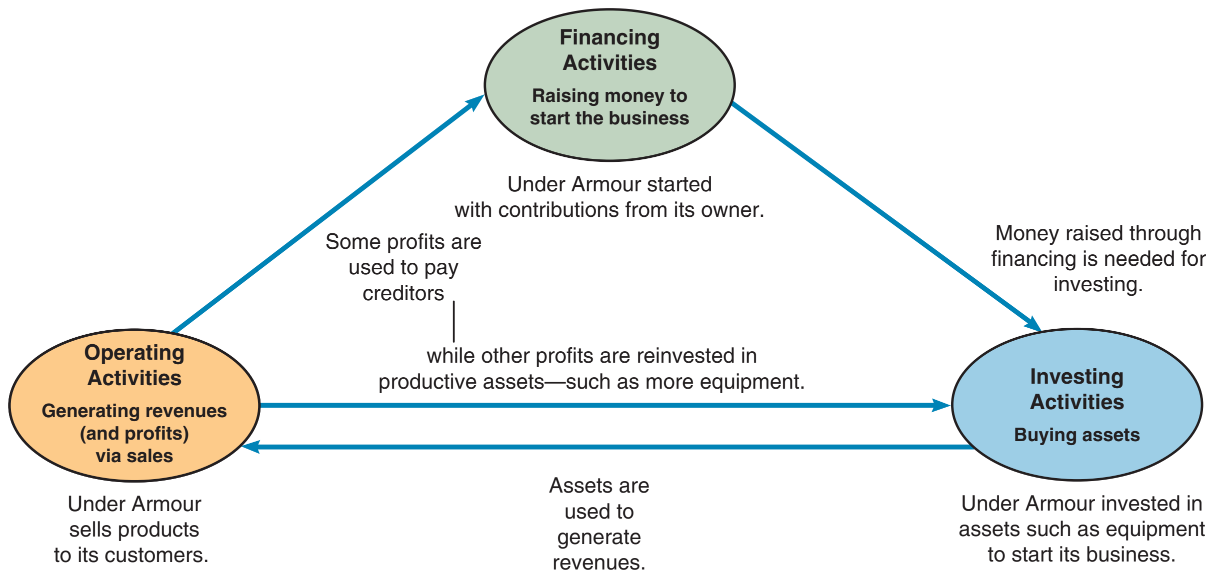
An **expense** is the outflow of assets resulting from the sale of goods and services. Expenses must be incurred to operate a business.

- Under Armour must pay its employees salaries and wages.
- Suppliers must be paid for purchases of inventory, and the utility company has to be paid for heat and electricity.
- The government must be paid the taxes owed it.

Summary of Business Activities

Exhibit 1-3 summarizes the three types of activities conducted by a business. A company obtains money from various types of financing activities, uses the money raised to invest in productive assets, and then provides goods and services to its customers. Actual businesses have many different financing, investing, and operating activities going on at any one time.

EXHIBIT 1-3 A Model of Business Activities



What Is Accounting, and What Information Do Users of Accounting Reports Need?

OVERVIEW: Accounting is the process of identifying, measuring, and communicating economic information to various users, including management of the company, stockholders, creditors, financial analysts, and government agencies.

LO4 Define accounting and identify the primary users of accounting information and their needs.

Accounting is often referred to as the language of business. In fact, **accounting** is "the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information."[1] Each of the three activities in this definition—*identifying*, *measuring*, and *communicating*—requires the judgment of a trained professional. Note that the definition refers to the users of economic information and the decisions they make.

Accounting The process of identifying, measuring, and communicating economic information to various users.

Users of Accounting Information and Their Needs

Internal users, primarily the managers of a company, are involved in the daily affairs of the business. All other groups are external users.

Internal Users The management of a company is in a position to obtain financial information in a way that best suits its needs. For example, if Under Armour's management wants to find out if the monthly payroll is more or less than the budgeted amount, a report can be generated to provide the answer. **Management accounting** is the branch of accounting concerned with providing internal users (management) with information to facilitate planning and control. The ability to produce management accounting reports is limited only by the extent of the data available and the cost involved in generating the information.

Management accounting The branch of accounting concerned with providing management with information to facilitate planning and control.

[1] American Accounting Association, *A Statement of Basic Accounting Theory* (Evanston, Ill.: American Accounting Association, 1966), p. 1.