FINANCIAL ACCOUNTING

NINTH EDITION

LIBBY / LIBBY / HODGE

DECK 63.32

LUV 36.92

CMG 717.99

FIZZ 25.56

AMZN 514.75

AAPL 112.11

HOG 56.43

SBUX 55.41

WFM 32.84

Mc Graw Hill Education

NINTH EDITION

Financial Accounting

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Cornell University

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Ithaca College

Frank Hodge
University of Washington

McGraw Hill Education

To: Herman and Doris Hargenrater
Oscar and Selma Libby
Laura Libby and Brian Plummer
Abby, Grace, and Claire Hodge

For more than 30 years, Dan Short has been an exceptional teacher, administrator, and textbook author. We have worked with Dan on *Financial Accounting* for more than 20 years. Over that period, he has been our mentor, trusted advisor, and coauthor. In fact, without Dan, we would never have completed our first edition. Dan is a truly gifted writer, has a great sense of humor, and we are proud to call him our friend. We wish Dan a well-earned and joyous retirement.

Mc Graw Hill Education

FINANCIAL ACCOUNTING, NINTH EDITION

This book is printed on acid-free paper.

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ISBN 978-1-259-22213-9
MHID 1-259-22213-6

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Compositor: *SPi Global*
Printer: *R. R. Donnelley*

Library of Congress Cataloging-in-Publication Data

Names: Libby, Robert, author. | Libby, Patricia A., author. | Hodge, Frank, 1965- author.
Title: Financial accounting / Robert Libby, Patricia A. Libby, Frank Hodge.
Description: Ninth edition. | New York, NY : McGraw-Hill Education, 2017.
Identifiers: LCCN 2015036286 | ISBN 9781259222139 (alk. paper)
Subjects: LCSH: Accounting. | Corporations—Accounting. | Financial statements.
Classification: LCC HF5636 .L53 2017 | DDC 657—dc23 LC record available at http://lccn.loc.gov/2015036286

mheducation.com/highered

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Bob was selected as the AAA Outstanding Educator in 2000 and received the AAA Outstanding Service Award in 2006 and the AAA Notable Contributions to the Literature Award in 1985 and 1996. He has received the Core Faculty Teaching Award multiple times at Cornell. Bob is a widely published author and researcher specializing in behavioral accounting. He has published numerous articles in *The Accounting Review; Journal of Accounting Research; Accounting, Organizations, and Society;* and other accounting journals. He has held a variety of offices, including vice president, in the American Accounting Association, and he is a member of the American Institute of CPAs and the editorial boards of *The Accounting Review* and *Accounting, Organizations, and Society.*

PATRICIA A. LIBBY

Patricia Libby is associate professor of accounting at Ithaca College, where she teaches the undergraduate financial accounting course. She previously taught graduate and undergraduate financial accounting at Eastern Michigan University and the University of Texas. Before entering academia, she was an auditor with Price Waterhouse (now PricewaterhouseCoopers) and a financial administrator at the University of Chicago. She is also faculty advisor to Beta Alpha Psi and Ithaca College Accounting Association. She received her BS from Pennsylvania State University, her MBA from DePaul University, and her PhD from the University of Michigan; she also successfully completed the CPA exam (Illinois).

Pat conducts research on using cases in the introductory course and other parts of the accounting curriculum. She has published articles in *The Accounting Review, Issues in Accounting Education,* and *The Michigan CPA.*

FRANK HODGE

Frank Hodge is the chair of the Accounting Department and the Harrington Family Endowed Professor at the University of Washington's Foster School of Business. Frank also serves in the President's Office as the University of Washington's Faculty Athletics Representative to the PAC-12 Conference and the National Collegiate Athletic Association.

Frank joined the faculty at the University of Washington in 2000. He earned his MBA and PhD degrees from Indiana University. Frank teaches financial accounting and financial statement analysis to undergraduate students, full-time MBA students, executive MBA students, and intercollegiate athletic administrators. Frank's research focuses on how individuals use accounting information to make investment decisions and how technology influences their information choices. Frank was one of six members of the Financial Accounting Standards Research Initiative team and has presented his research at the Securities and Exchange Commission. Frank is on the editorial boards of *The Accounting Review; Contemporary Accounting Research; and Accounting, Behavior and Organizations.* He also has published articles in *The Accounting Review; Contemporary Accounting Research; Accounting, Organizations, and Society*; *Accounting Horizons;* and several other journals. Frank lives in Seattle with his wife and two daughters.

A TRUSTED LEADER FOR

New author Frank Hodge joins the award-winning author team of Bob Libby and Pat Libby to continue *Financial Accounting*'s best-selling tradition of helping the instructor and student become partners in learning. Libby/Libby/Hodge uses a remarkable learning approach that keeps students engaged and involved in the material from the first day of class.

Libby/Libby/Hodge's *Financial Accounting* maintains its leadership by focusing on three key attributes:

THE PIONEERING FOCUS COMPANY APPROACH

The Libby/Libby/Hodge authors' trademark focus company approach is the best method for helping students understand financial statements and the real-world implications of financial accounting for future managers. **This approach shows that accounting is relevant and motivates students by explaining accounting in a real-world context.** Throughout each chapter, the material is integrated around a familiar focus company, its decisions, and its financial statements. This provides the perfect setting for discussing the importance of accounting and how businesses use accounting information.

A BUILDING-BLOCK APPROACH TO TEACHING TRANSACTION ANALYSIS

Faculty agree the accounting cycle is the most critical concept to learn and master for students studying financial accounting. Libby/Libby/Hodge believes students struggle with the accounting cycle when transaction analysis is covered in one chapter. If students are exposed to the accounting equation, journal entries, and T-accounts for both balance sheet and income statement accounts in a single chapter, many are left behind and are unable to grasp material in the next chapter, which typically covers adjustments and financial statement preparation.

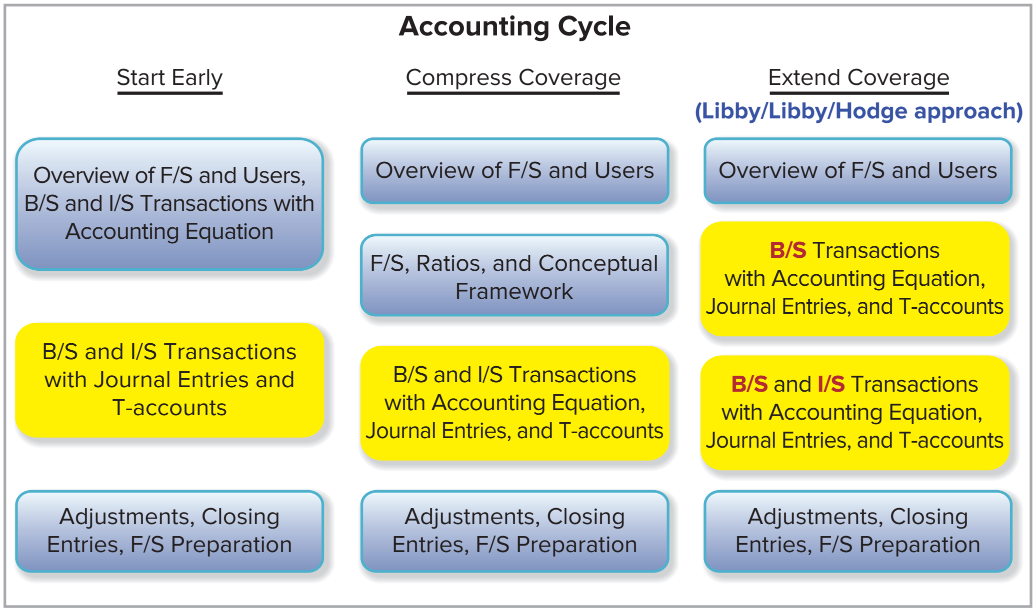
"The book does an excellent job of using real-world examples to highlight the importance of understanding financial accounting to students who may or may not be interested in pursuing accounting careers. I think this book will hold students' attention, without sacrificing the technical information that provides the foundation for further accounting coursework. ***Exceptionally well-written and nicely organized.****"*

—Paul Hribar, University of Iowa

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

STUDENTS AND INSTRUCTORS

provides students with the opportunity to learn the basic structure and tools used in accounting in a simpler setting. In Chapter 3, students are exposed to more complex operating transactions that also affect income statement accounts. **By slowing down the introduction of transactions and giving students time to practice and gain mastery, this building-block approach leads to greater student success in their study of later topics in financial accounting such as adjusting entries.** After the students have developed an understanding of the complete accounting cycle and the resulting statements, Chapter 5 takes students through the corporate reporting and analysis process.



This graphic shows a detailed comparison of the Libby/Libby/Hodge approach to the accounting cycle chapters compared to the approach taken by other financial accounting texts.

The authors' approach to introducing the accounting cycle has been tested in peer-reviewed, published research studies. One of these award-winning studies has shown that the accounting cycle approach used in this textbook yields learning gains that outpace approaches used in other textbooks by a significant margin.

> *"[Libby, Libby, Hodge] does a **great job explaining financial accounting concepts to college students on an introductory level.**"*
>
> *—Peggy O'Kelly, Northeastern University*

POWERFUL TECHNOLOGY FOR TEACHING AND STUDY

Students have different learning styles and conflicting time commitments, so they want technology tools that will help them study more efficiently and effectively. The ninth edition includes the best technology available with Connect's latest features—SmartBook, Connect Insight, and new study, practice, and assessment materials.

> *"The text has **some of the best discussions that I have seen in introductory texts of statement of cash flows and financial statement analysis topics.**"*
>
> *—Marilyn Misch, Pepperdine University*

MARKET-LEADING PEDAGOGY

Financial Accounting, 9e, offers a host of pedagogical tools that complement the different ways you like to teach and the ways your students like to learn. Some offer information and tips that help you present a complex subject; others highlight issues relevant to what your students read online or see on television. Either way, *Financial Accounting*'s pedagogical support will make a real difference in your course and in your students' learning.

FINANCIAL ANALYSIS — Interpreting Assets, Liabilities, and Stockholders' Equity on the Balance Sheet

Assessment of **Le-Nature's** assets was important to its creditors, **Wells Fargo Bank** and others, and its ... resources

A QUESTION OF ETHICS — Ethics and the Need for Internal Control

Some people are bothered by the recommendation that all well-run companies should have strong inter- ... nt does not

KEY RATIO ANALYSIS — Net Profit Margin

? ANALYTICAL QUESTION

FOCUS ON CASH FLOWS — Working Capital and Cash Flows

Many working capital accounts have a direct relationship to income-producing activities. Accounts

INTERNATIONAL PERSPECTIVE — The International Accounting Standards Board and Global Convergence of Accounting Standards

Financial accounting standards and disclosure requirements are adopted by national regulatory agencies. Since 2002, there has been substantial movement toward the adoption of **International Financial Reporting Standards (IFRS)** issued by the **International Accounting Standards Board (IASB).** Examples of jurisdictions requiring the use of IFRS currently include:

FINANCIAL ANALYSIS BOXES—These features tie important chapter concepts to real-world decision-making examples. They also highlight alternative viewpoints and add to the critical-thinking and decision-making focus of the text.

A QUESTION OF ETHICS BOXES—These boxes appear throughout the text, conveying the importance and the consequences of acting responsibly in business practice.

> *"Excellent book with **very good and clear writing, coverage, illustrations** and overall very student friendly."*
>
> *—Kashi Balachandran, New York University*

AND CONTENT

FOCUS ON CASH FLOWS BOXES—Each of the first eleven chapters includes a discussion and analysis of changes in the cash flows of the focus company and explores the decisions that caused those changes.

Cash Flows from Operations, Net Income, and the Quality of Earnings

FOCUS ON CASH FLOWS

As presented in the previous chapters, the statement of cash flows explains the difference between the ending and beginning balances in the Cash account on the balance sheet during the accounting period. Put simply, the cash flow statement is a categorized list of all transactions of the period that affected the Cash account. The three categories are operating, investing, and financing activities. **Since no adjustments made in this chapter affected cash, the cash flow categories identified on the Cash T-account at the end of Chapter 3 remain the same.**

Many standard financial analysis texts warn analysts to look for unusual deferrals and accruals when they attempt to predict future periods' earnings. They often suggest that wide disparities between net income and cash flow from operations are a useful warning sign. For example, Subramanyan suggests the following:

> Accounting accruals determining net income rely on estimates, deferrals, allocations, and valuations. These considerations sometimes allow more subjectivity than do the factors determining cash flows. For this reason we often relate cash flows from operations to net income in assessing its quality.

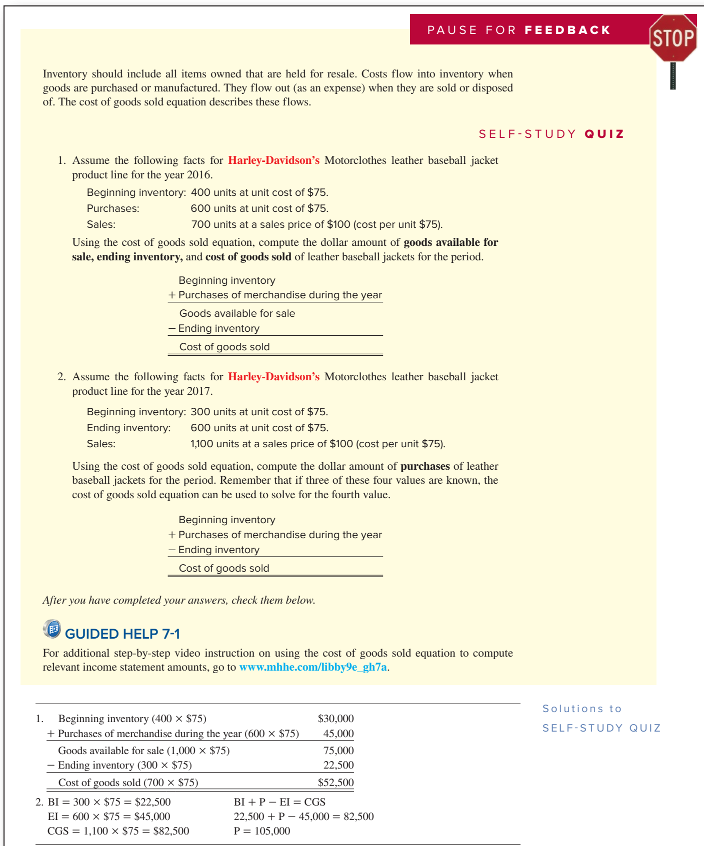
KEY RATIO ANALYSIS BOXES—Each box presents ratio analysis for the focus company in the chapter as well as for comparative companies. Cautions are also provided to help students understand the limitations of certain ratios.

INTERNATIONAL PERSPECTIVE BOXES—These boxes highlight the emergence of global accounting standards (IFRS) at a level appropriate for the introductory student.

> *"The textbook focuses on the key accounting concepts and is **written clearly so that it is easy for students to understand.**"*
>
> *—Rada Brooks, University of California Berkeley, Haas School of Business*

> *"The **real-life examples are an excellent way to draw in the student** and I thought that **the ethics components and IFRS components were an excellent addition.**"*
>
> *—Tammy Metzke, Milwaukee Area Technical College*

PRACTICE IS KEY TO SUCCESS


PAUSE FOR **FEEDBACK**

Inventory should include all items owned that are held for resale. Costs flow into inventory when goods are purchased or manufactured. They flow out (as an expense) when they are sold or disposed of. The cost of goods sold equation describes these flows.

SELF-STUDY **QUIZ**

1. Assume the following facts for **Harley-Davidson's** Motorclothes leather baseball jacket product line for the year 2016.

   Beginning inventory: 400 units at unit cost of $75.
   Purchases: 600 units at unit cost of $75.
   Sales: 700 units at a sales price of $100 (cost per unit $75).

   Using the cost of goods sold equation, compute the dollar amount of **goods available for sale, ending inventory,** and **cost of goods sold** of leather baseball jackets for the period.

   Beginning inventory
   \+ Purchases of merchandise during the year
   Goods available for sale
   − Ending inventory
   Cost of goods sold

2. Assume the following facts for **Harley-Davidson's** Motorclothes leather baseball jacket product line for the year 2017.

   Beginning inventory: 300 units at unit cost of $75.
   Ending inventory: 600 units at unit cost of $75.
   Sales: 1,100 units at a sales price of $100 (cost per unit $75).

   Using the cost of goods sold equation, compute the dollar amount of **purchases** of leather baseball jackets for the period. Remember that if three of these four values are known, the cost of goods sold equation can be used to solve for the fourth value.

   Beginning inventory
   \+ Purchases of merchandise during the year
   − Ending inventory
   Cost of goods sold

After you have completed your answers, check them below.

GUIDED HELP 7-1

For additional step-by-step video instruction on using the cost of goods sold equation to compute relevant income statement amounts, go to www.mhhe.com/libby9e_gh7a.

Solutions to SELF-STUDY QUIZ

1.	Beginning inventory (400 × $75)	$30,000
	+ Purchases of merchandise during the year (600 × $75)	45,000
	Goods available for sale (1,000 × $75)	75,000
	− Ending inventory (300 × $75)	22,500
	Cost of goods sold (700 × $75)	$52,500

2. BI = 300 × $75 = $22,500   BI + P − EI = CGS
EI = 600 × $75 = $45,000   22,500 + P − 45,000 = 82,500
CGS = 1,100 × $75 = $82,500   P = 105,000

PAUSE FOR FEEDBACK AND SELF-STUDY QUIZ

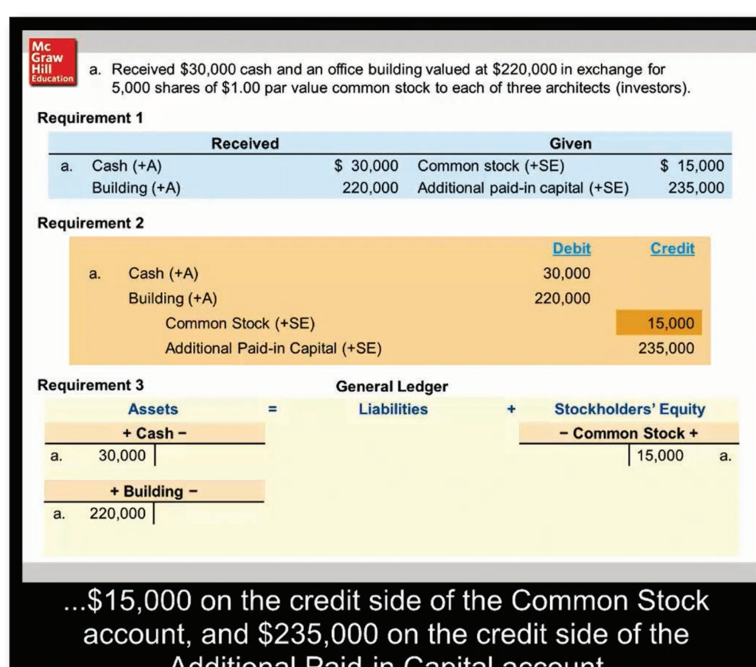
Research shows that students learn best when they are actively engaged in the learning process. This active learning feature engages the student, provides interactivity, and promotes efficient learning. These quizzes ask students to pause at strategic points throughout each chapter to ensure they understand key points before moving ahead.

*"The **Pause for Feedback and Self-Study Quizzes give the student the opportunity to test their understanding of the material before moving forward** and also assist in breaking up the chapter into manageable sections."*

—Betty P. David, Francis Marion University

GUIDED HELP

Today's students have a wide variety of time commitments. And research shows that when they have difficulty understanding a key concept, they benefit most when help is available immediately. **Our unique Guided Help feature provides a narrated, animated, step-by-step walk-through of select topics covered in the Self-Study Quiz that students can view at any time through their mobile device or online. It also saves office hour time!**



IN FINANCIAL ACCOUNTING

CHAPTER TAKE-AWAYS

End-of-chapter summaries complement the learning objectives outlined at the beginning of the chapter.

CHAPTER **TAKE-AWAYS**

7-1. Apply the cost principle to identify the amounts that should be included in inventory and the expense matching principle to determine cost of goods sold for typical retailers, wholesalers, and manufacturers. p. 335

Inventory should include all items owned that are held for resale. Costs flow into inventory when goods are purchased or manufactured. They flow out (as an expense) when they are sold or disposed of. In conformity with the expense matching principle, the total cost of the goods sold during the period must be matched with the sales revenue earned during the period. A company can keep track of the ending inventory and cost of goods sold for the period using (1) the perpetual inventory system, which is based on the maintenance of detailed and continuous inventory records, and (2) the periodic inventory system, which is based on a physical count of ending inventory and use of the cost of goods sold equation to determine cost of goods sold.

7-2. Report inventory and cost of goods sold using the four inventory costing methods. p. 340

The chapter discussed four different inventory costing methods used to allocate costs between the units remaining in inventory and the units sold and their applications in different economic circumstances. The methods discussed were specific identification, FIFO, LIFO, and average cost. Each of the inventory costing methods conforms to GAAP. Public companies using LIFO must provide note disclosures that allow conversion of inventory and cost of goods sold to FIFO amounts. Remember that the cost flow assumption need not match the physical flow of inventory.

COMPREHENSIVE PROBLEMS

Selected chapters include problems that cover topics from earlier chapters to refresh, reinforce, and build an integrative understanding of the course material.

COMPREHENSIVE **PROBLEM (CHAPTERS 6–8)**

COMP8-1 **Complete the requirements for each of the following independent cases:**

Case A. Dr Pepper Snapple Group, Inc., is a leading integrated brand owner, bottler, and distributor of nonalcoholic beverages in the United States, Canada, and Mexico. Key brands include Dr. Pepper, Snapple, 7-UP, Mott's juices, A&W root beer, Canada Dry ginger ale, Schweppes ginger ale, and Hawaiian Punch, among others.

The following represents selected data from recent financial statements of Dr Pepper Snapple Group (dollars in millions):

DR PEPPER SNAPPLE GROUP, INC.
Consolidated Balance Sheets (partial)

(in millions)	December 31, 2014	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$237	$153
Accounts receivable (net of allowances of $2 and $3, respectively)	61	58

Consolidated Statements of Income (partial)

	For the Year Ended December 31		
(in millions)	2014	2013	2012
Net sales	$6,121	$5,997	$5,995
…			
Net income	$ 703	$ 624	$ 629

CASES **AND PROJECTS** connect

Annual Report Cases

CP1-1 **Finding Financial Information**
LO1-1

Refer to the financial statements of **American Eagle Outfitters** in Appendix B at the end of this book.

Required:
Skim the annual report. Look at the income statement, balance sheet, and cash flow statement closely and attempt to infer what kinds of information they report. Then answer the following questions based on the report.

1. What types of products does American Eagle Outfitters sell?
2. On what date does American Eagle Outfitters's most recent reporting year end?
3. For how many years does it present complete
   a. Balance sheets?
   b. Income statements?
   c. Cash flow statements?
4. Are its financial statements audited by independent CPAs? How do you know?
5. Did its total assets increase or decrease over the last year?
6. How much inventory (in dollars) did the company have as of January 31, 2015 (accountants would call this the ending balance)?
7. Write out the basic accounting (balance sheet) equation and provide the values in dollars reported by the company as of January 31, 2015.

CP1-2 **Finding Financial Information**
LO1-1

Refer to the financial statements of **Urban Outfitters** in Appendix C at the end of this book.

CASES AND PROJECTS

This section includes annual report cases, financial reporting and analysis cases, critical thinking cases, and financial reporting and analysis team projects. The real-world company analysis theme is continued in this section, giving students practice comparing American Eagle and Urban Outfitters among other relevant companies. **New** for the ninth edition: several of these Cases and Projects are now in Connect as auto-graded assignment option.

CONTINUING **PROBLEM** connect

CON1-1 **Financial Statements for a New Business Plan**

Penny Cassidy is considering forming her own pool service and supply company, Penny's Pool Service & Supply, Inc. (PPSS). She has decided to incorporate the business to limit her legal liability. She expects to invest $20,000 of her own savings and receive 1,000 shares of common stock. Her plan for the first year of operations forecasts the following amounts at December 31, the end of the current year: Cash in bank, $2,900; amounts due from customers for services rendered, $2,300; pool supplies inventory, $4,600; equipment, $28,000; amounts owed to **Pool Corporation, Inc.**, a pool supply wholesaler, $3,500; note payable to the bank, $5,000. Penny forecasts first-year sales of $60,000, wages of $24,000, cost of supplies used of $8,200, other administrative expenses of $4,500, and income tax expense of $4,000. She expects to pay herself a $10,000 dividend as the sole stockholder of the company.

Required:
If Penny's estimates are correct, what would the following first-year financial statements look like for Penny's Pool Service & Supply (use Exhibits 1.2, 1.3, and 1.4 as models)?

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

CONTINUING PROBLEM

The continuing case revolves around Penny's Pool Service & Supply, Inc., and its largest supplier, Pool Corporation, Inc. In the first five chapters, the continuing case follows the establishment, operations, and financial reporting for Penny's. In Chapter 5, Pool Corporation, a real publicly traded corporation, is also introduced in more detail. The Pool Corporation example is then extended to encompass each new topic in the remaining chapters.

"This is an excellent book that can be used for both an introductory course as well as an MBA class. The book has a simple, conversational and easy-to-understand writing style. The book is also very well organized and has a lot of end-of-chapter material. ***This is one of the best financial accounting books that I have come across.*** *It is a must for a financial accounting course."*

—Syed Hasan, George Mason University

WHAT'S NEW IN THE 9th EDITION?

In response to feedback and guidance from numerous financial accounting faculty, the authors have made many important changes to the ninth edition of *Financial Accounting,* including the following:

- Integrated **new focus companies** including **Amazon**, the world's largest Internet retailer; **Whole Foods Market**, a supermarket chain specializing in organic food; and **Graham Holdings Company**, a company that expands primarily through investing in other companies, including **Kaplan, Inc.**
- **Detailed edit of Chapters 9, 10, and 11** to use consistent terminology throughout each chapter and more closely link content to other chapters.
- **Expanded the number of Guided Help features** in the text to provide more of these narrated, animated, step-by-step examinations of select topics in the Self-Study Quizzes in each chapter.
- Reviewed, updated, and introduced new end-of-chapter material in each chapter to support new topics and learning objectives. In addition, other **new McGraw-Hill Connect® problem formats** include **General Ledger Problems** that auto-post from journal entries to T-accounts to trial balances, **Excel Simulations,** and **Interactive Presentations.**
- Added **new Annual Report Cases that can be auto-graded in Connect.** In addition, the **Cases and Projects** content from the book is also now available in Connect as either auto-graded or manually graded questions.

Chapter 1

Focus Company: Le-Nature's Inc.

- Chapter 1 is written around a recent accounting fraud that is exciting, yet simple. Students are introduced to the structure, content, and use of the four basic financial statements through the story of two brothers who founded **Le-Nature's Inc.,** a natural beverage company. Le-Nature's financial statements are used to support increases in borrowing for expansion. When actual sales do not live up to expectations, the brothers turn to financial statement fraud to cover up their failure, which emphasizes the importance of controls, responsible ethical conduct, and accurate financial reporting.
- **GUIDED HELP** feature provides all users of the text with free access to step-by-step video instruction on preparing a simple balance sheet, income statement, and statement of stockholders' equity for **LaCrosse Footwear**, a leading outdoor footwear company.
- More algorithmic exercises included in Connect®.
- ***New*** **CONTINUING PROBLEM** added to the end-of-chapter problems based on the activities of Penny's Pool Service & Supply and its supplier, **Pool Corporation**. These companies provide a consistent context for summarizing the key points emphasized in each chapter. In Chapter 1, students prepare a basic income statement, statement of stockholders' equity, and balance sheet based on Penny's estimates for the first year.
- *New* Annual Report Case that can be graded through Connect.
- New and updated real companies in end-of-chapter exercises, problems, and cases.

Chapter 2

Focus Company: Chipotle Mexican Grill

- Chapter 2 introduces the accounting cycle for **Chipotle Mexican Grill,** a trendy, yet relatively simple company. The chapter integrates financial information for investing and financing activities for the first quarter of 2015, resulting in the company's actual quarterly balance sheet (with a few simplifications). This fast-casual restaurant does not utilize franchising, thus reducing the complexities found with most other competitors and allowing focused emphasis on transaction analysis, journal entries, T-accounts, and the structure of the balance sheet.
- Focus and contrast company data updated.
- Update of the conceptual framework to reflect the new definitions from the FASB.
- Simplified account titles that relate more closely to end-of-chapter material.
- T-accounts now follow each transaction to illustrate posting the effects, while marginal notes have been deleted for a cleaner visual approach.
- ***New*** additional **GUIDED HELP** feature provides free access to step-by-step video instruction applying transaction analysis to identify accounts and effects on the accounting equation. This is in addition to the existing Guided Help for recording, posting, and classifying accounts for financing and investing activities.

- ***New* CONTINUING PROBLEM** added to the end-of-chapter problems based on the activities of Penny's Pool Service & Supply and its supplier, **Pool Corporation**. These companies provide a consistent context for summarizing the key points emphasized in each chapter. In Chapter 2, students prepare journal entries, post to T-accounts, prepare a trial balance and classified balance sheet, identify investing and financing activities affecting cash flows, and compute and interpret the current ratio based on the balance sheet for Penny's Pool Service & Supply.
- ***New and updated real companies***, as well as additional exercises on key concepts, in end-of-chapter exercises, problems, and cases.
- ***New*** Annual Report Case that can be graded through Connect.

Chapter 3

Focus Company: Chipotle Mexican Grill

- Chapter 3 builds on Chapter 2 by explaining and illustrating transaction analysis for operating activities for the first quarter of 2015 for **Chipotle Mexican Grill.** Students apply their knowledge of accounting concepts by preparing journal entries and posting to T-accounts using Chapter 2 transactions involving revenues and expenses.
- Focus and contrast company data updated.
- ***New*** concepts based on the FASB's Accounting Standards Updates for revenue recognition and expense recognition are incorporated in the chapter and end-of-chapter material.
- ***New*** additional **GUIDED HELP** feature provides free access to step-by-step video instruction applying transaction analysis to identify accounts and effects on the accounting equation. This is in addition to the existing Guided Help for identifying revenue and expense account titles and amounts for a given period.
- ***New* CONTINUING PROBLEM** added to the end-of-chapter problems based on the activities of Penny's Pool Service & Supply and its supplier, **Pool Corporation**. These companies provide a consistent context for summarizing the key points emphasized in each chapter. In Chapter 3, students prepare journal entries, create a classified income statement, and calculate and analyze the net profit margin for Penny's Pool Service & Supply.
- ***New and updated real companies***, as well as additional exercises on key concepts, in end-of-chapter exercises, problems, and cases.
- ***New*** Annual Report Case that can be graded through Connect.

Chapter 4

Focus Company: Chipotle Mexican Grill

- Chapter 4 builds on Chapters 2 and 3 by explaining and illustrating end-of-period adjustments, financial statements, and closing the records for the first quarter of 2015 for **Chipotle Mexican Grill.**
- Focus and contrast company data updated.
- The process for identifying and recording an adjustment at the end of the period has been modified to provide a logical progression—with the journal entry followed by the effects on the accounting equation, followed by posting the effects in the T-accounts—with less marginal clutter.
- ***New*** additional **GUIDED HELP** feature provides free access to step-by-step video instruction on recording a closing entry. This is in addition to the existing Guided Help for recording adjusting entries.
- ***New* CONTINUING PROBLEM** added to the end-of-chapter problems based on the activities of Penny's Pool Service & Supply and its supplier, **Pool Corporation**. These companies provide a consistent context for summarizing the key points emphasized in each chapter. In Chapter 4, students prepare adjusting journal entries for Penny's Pool Service & Supply.
- ***New and updated real companies***, as well as additional exercises on key concepts, in end-of-chapter exercises, problems, and cases.
- ***New*** Annual Report Case that can be graded through Connect.

Chapter 5

Focus Company: Apple Inc.

- Chapter 5 has been rewritten around the most recent financial statements and corporate governance and disclosure processes of **Apple Inc.,** students' favorite technology company.
- Focus and contrast company data updated.
- Focus of the chapter has been narrowed to three topics: details of the corporate governance and disclosure process; financial statement formats and important subtotals, totals, and additional disclosures; and the analysis of financial statements through gross profit, net profit, total asset turnover, and return on assets analysis.
- Fraud triangle provides the basis for the corporate governance discussion.
- ***New*** section on the effects of transactions on key ratios added to tie in the chapter to material in Chapters 2, 3, and 4.
- **GUIDED HELP** feature provides free access to step-by-step video instruction on preparing a detailed classified income statement and balance sheet from a trial balance for **Amazon.com**, the world's largest online retailer.
- More algorithmic exercises included in Connect.
- ***Two new* CONTINUING PROBLEMS** added to the end-of-chapter problems. The first asks students to evaluate the effects of key transactions on important statement subtotals and financial ratios

for Penny's Pool Service & Supply. The second introduces Penny's supplier, **Pool Corporation**, a public company, and asks students to prepare a detailed classified income statement and balance sheet and compute the gross profit percentage and return on assets ratios.

- ***New*** Annual Report Case that can be graded through Connect.
- ***New and updated real companies*** in end-of-chapter exercises, problems, and cases.

Chapter 6

Focus Company: Deckers Brands

- Focus and contrast company data updated.
- Content narrowed to three related topics: determinants of net sales, receivables valuation, and control of cash.
- Exhibits reorganized to better reflect the chapter flow.
- Coverage of bad debt recoveries increased.
- Coverage of electronic banking increased.
- ***Two New*** **GUIDED HELP** features provide free access to step-by-step video instruction on (1) preparing entries related to bad debts and determining their financial statement effects and (2) using aging to estimate bad debt expense.
- More algorithmic exercises included in Connect.
- ***New*** **CONTINUING PROBLEM** added to the end-of-chapter problems. Students are asked to make summary entries for bad debts and compute the amount to be reported as net sales for **Pool Corporation**, a public company.
- ***New*** Annual Report Case that can be graded through Connect.
- ***New and updated real companies*** in end-of-chapter exercises, problems, and cases.

Chapter 7

Focus Company: Harley-Davidson, Inc.

- Focus and contrast company data updated.
- Coverage of perpetual versus periodic inventory systems moved to section on cost of goods sold near the beginning of the chapter.
- *New* rules for applying lower-of-cost-or-market to inventories covered at an appropriate level for the introductory course.
- ***Two New*** **GUIDED HELP** features provide free access to step-by-step video instruction on (1) computation of goods available for sale and cost of goods sold and (2) computing cost of goods sold and ending inventory under FIFO and LIFO costing methods.
- Exhibits 7.4 and 7.5 revised to make it easier to see the effects of FIFO, LIFO, and average costing methods on the financial statements.
- **Supplement B** added to demonstrate the effects of determining FIFO and LIFO cost of goods sold under periodic versus perpetual inventory systems.
- More algorithmic exercises included in Connect.
- ***New*** **CONTINUING PROBLEM** added to the end-of-chapter problems. Students are asked to compute the effects of the LIFO/FIFO choice for inventory items with increasing and decreasing costs for **Pool Corporation**, a public company.
- ***New*** Annual Report Case that can be graded through Connect.
- ***New and updated real companies*** in end-of-chapter exercises, problems, and cases.

Chapter 8

Focus Company: Southwest Airlines

- Chapter 8 illustrates the acquisition, use, repair and improvement, and disposal of property, plant, and equipment, followed by an illustration of accounting and reporting for intangible assets and natural resources, at several companies including **Cisco Systems**, **Walt Disney Company**, **Papa John's International**, and **International Paper**, among others.
- Focus and contrast company data updated.
- ***New*** additional **GUIDED HELP** feature provides free access to step-by-step video instruction on recording a disposal of an asset. This is in addition to the existing Guided Help for determining cost and creating depreciation schedules under straight-line, units-of-production, and declining-balance methods.
- ***New*** **CONTINUING PROBLEM** added to the end-of-chapter problems. Based on the activities of **Pool Corporation**, students are asked to determine cost; create depreciation schedules under straight-line, units-of-production, and declining-balance methods; and dispose of an asset.
- ***New and updated real companies***, as well as additional exercises on key concepts, in end-of-chapter exercises, problems, and cases.
- ***New*** Annual Report Case that can be graded through Connect.

Chapter 9

Focus Company: Starbucks

- Focus company data updated. New contrast companies added.
- Complete revision of chapter content to more closely link content to other chapters and to use consistent terminology throughout the chapter.
- Updated present value discussion and graphics for both single amounts and annuities. Chapter now includes descriptions of how to calculate present values using tables, calculators, and Excel.
- ***New*** **GUIDED HELP** features teach students the steps required to compute present values using two popular calculator models (HP 10BII+ and HP 12C) and Excel.
- ***New*** **Supplement A** uses vivid graphics to display the steps required to compute

present values using two popular calculator models (HP 10BII+ and HP 12C) and Excel.

- ***New*** **CONTINUING PROBLEM** added to the end-of-chapter problems. Students are asked to record transactions that affect the liabilities section of the balance sheet for **Pool Corporation**, a public company.
- ***New*** Annual Report Case that can be graded through Connect.
- ***New and updated real companies*** in end-of-chapter exercises, problems, and cases.
- End-of-chapter material completely updated to seamlessly match the content of the chapter.

Chapter 10

Focus Company: Amazon

- ***New*** focus company and new contrast companies.
- Complete revision of chapter content to more closely link content to other chapters and to use consistent terminology throughout the chapter.
- ***New*** graphics that visually help students understand the timing of bond payments and the accounting for bonds.
- ***New*** **FINANCIAL ANALYSIS** feature describes bond ratings and bond rating agencies.
- Revised structure allows instructors to seamlessly assign accounting for bonds with or without the use of discount and premium accounts.
- ***New*** **GUIDED HELP** features walk students through (1) how to calculate the present value of a bond issued at a premium and (2) how to account for the bond over its life.
- ***New*** discussion of accounting for bond issuance costs.
- ***New*** **CONTINUING PROBLEM** added to the end-of-chapter problems. Students are asked to record bond transactions for **Pool Corporation**, a public company.
- ***New*** Annual Report Case that can be graded through Connect.
- ***New and updated real companies*** in end-of-chapter exercises, problems, and cases.
- End-of-chapter material completely updated to seamlessly match the content of the chapter.

Chapter 11

Focus Company: Whole Foods Market

- ***New*** focus company and new contrast companies.
- Complete revision of chapter content to more closely link content to other chapters and to use consistent terminology throughout the chapter.
- ***New*** discussion of stock splits effected in the form of a stock dividend.
- ***New*** **FINANCIAL ANALYSIS** feature on preferred stock.
- ***New*** **CONTINUING PROBLEM** added to the end-of-chapter problems. Students are asked to record transactions that affect the equity section of the balance sheet for **Pool Corporation**, a public company.
- ***New*** Annual Report Case that can be graded through Connect.
- ***New and updated real companies*** in end-of-chapter exercises, problems, and cases.
- End-of-chapter material completely updated to seamlessly match the content of the chapter.

Chapter 12

Focus Company: National Beverage Corporation

- Focus and contrast company data updated.
- ***Two New*** **GUIDED HELP** features provide free access to step-by-step video instruction on (1) preparing the operating section of the statement of cash flows using the indirect method and (2) preparing the investing and financing sections of the statement of cash flows.
- **Supplement C** and related problem material illustrate preparation of the complete statement of cash flows using the T-account approach.
- More algorithmic exercises included in Connect.
- ***New*** **CONTINUING PROBLEM** added to the end-of-chapter problems. Students are asked to prepare a complete statement of cash flows for **Pool Corporation**, a public company.
- ***New*** Annual Report Case that can be graded through Connect.
- ***New and updated real companies*** in end-of-chapter exercises, problems, and cases.

Chapter 13

Focus Company: The Home Depot

- Focus company data updated.
- Complete revision of chapter content to more closely link content to other chapters and to use consistent terminology throughout the chapter.
- ***New*** discussion of DuPont analysis.
- Ratio formulas in chapter updated to be consistent with formulas provided in previous chapters.
- ***New*** **CONTINUING PROBLEM** added to the end-of-chapter problems. Students are asked to download the latest financial statements for **Pool Corporation**, a public company, and compute various ratios discussed in the chapter.
- ***New*** Annual Report Case that can be graded through Connect.
- ***New and updated real companies*** in end-of-chapter exercises, problems, and cases.
- End-of-chapter material completely updated to seamlessly match the content of the chapter.

Appendix A

Focus Company: Graham Holdings Company

- ***New focus company***, **Graham Holdings Company,** a company that expands primarily through investing in other companies, including **Kaplan, Inc.** (top admissions test preparation organization). Accounting and reporting are discussed and illustrated for: (1) debt securities held to maturity, (2) passive investments using the fair value method, (3) investments involving significant influence using the equity method, and (4) investments in controlling interests.

- Focus and contrast company data updated.
- **GUIDED HELP** feature provides free access to step-by-step video instruction on accounting for and reporting available-for-sale securities as investments at fair value.
- ***New*** **CONTINUING PROBLEM** added to the end-of-chapter problems. Using the activities of **Pool Corporation**, students are asked to record passive investments as trading securities and as available-for-sale securities over a three-year period.
- ***New and updated real companies***, as well as additional exercises on key concepts, in end-of-chapter exercises, problems, and cases.
- ***New*** Annual Report Case that can be graded through Connect.

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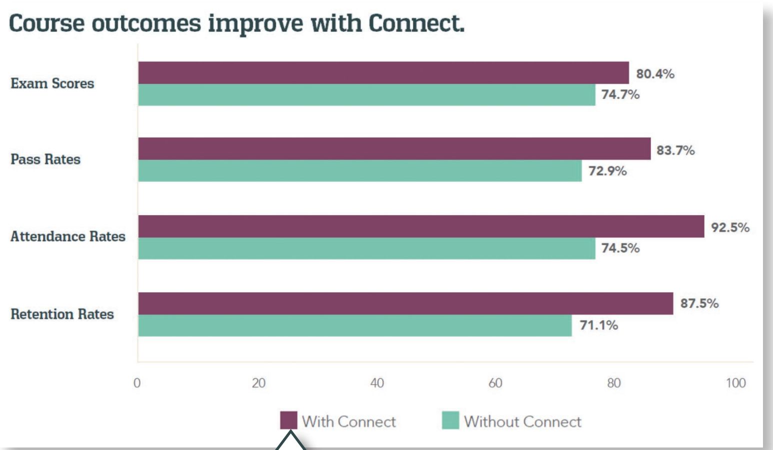

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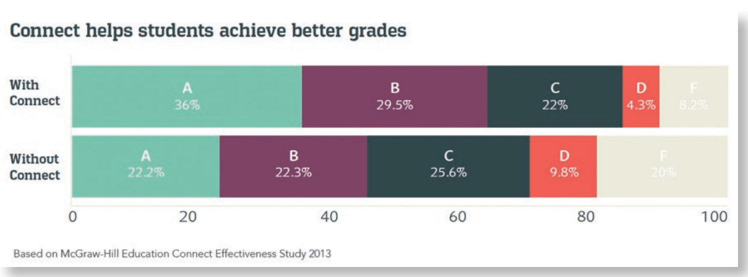

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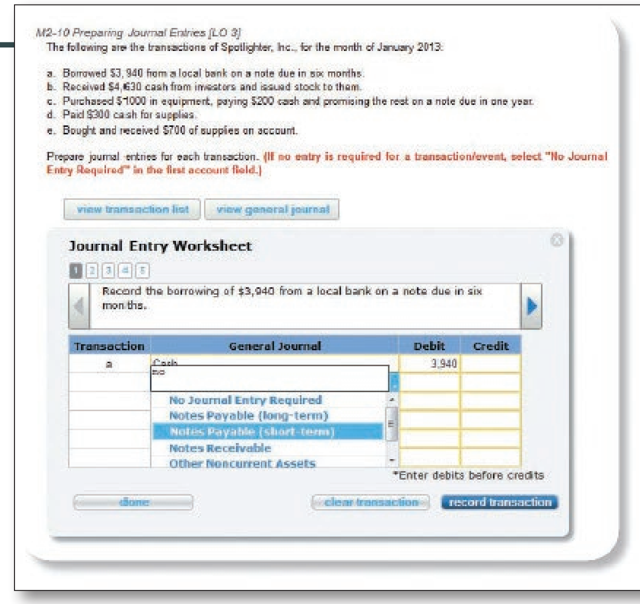

Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. Connect grades homework automatically and gives immediate feedback on any questions students may have missed. The extensive assignable, gradable end-of-chapter content includes a general journal application that looks and feels more like what you would find in a general ledger software package. Also, select questions have been redesigned to test students' knowledge more fully. They now include tables for students to work through rather than requiring that all calculations be done offline.

End-of-chapter questions in Connect include:

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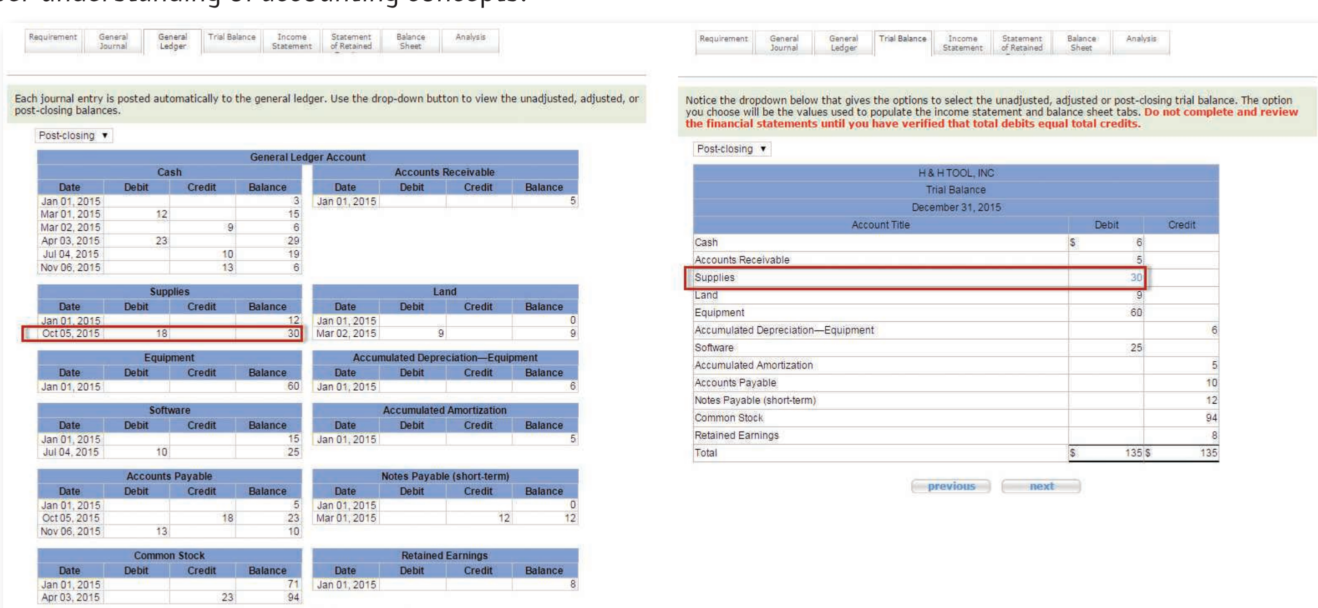
New **General Ledger Problems** provide a much-improved student experience when working with accounting cycle questions, offering improved navigation and less scrolling. Students can audit their mistakes by easily linking back to their original entries and can see how the numbers flow through the various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



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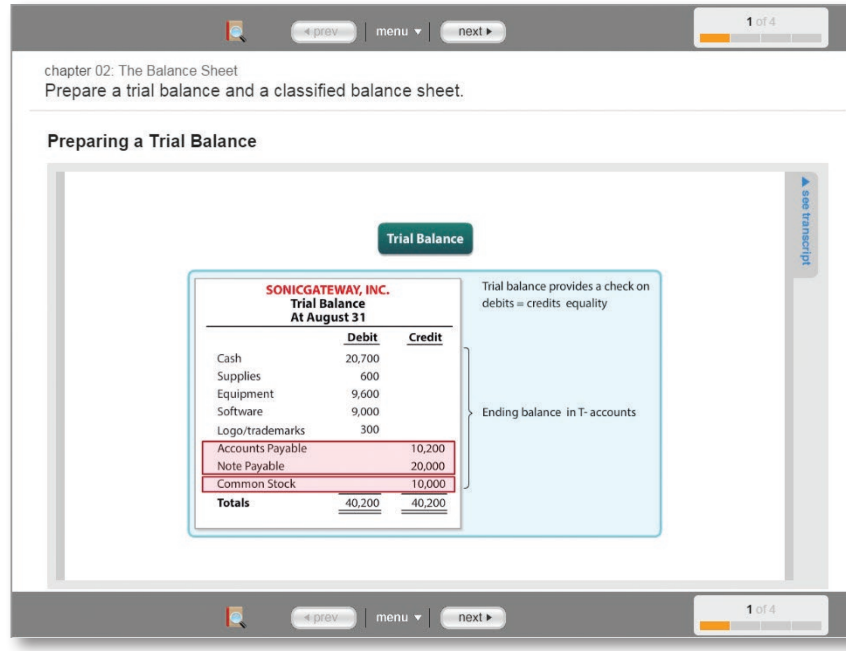
The **Interactive Presentations** provide engaging narratives of all chapter learning objectives in an assignable and interactive online format. They follow the structure of the text and are organized to match the specific learning objectives within each chapter of *Financial Accounting*. The interactive presentations provide additional explanation and enhancement of material from the text chapter, allowing students to learn, study, and practice with instant feedback, at their own pace.



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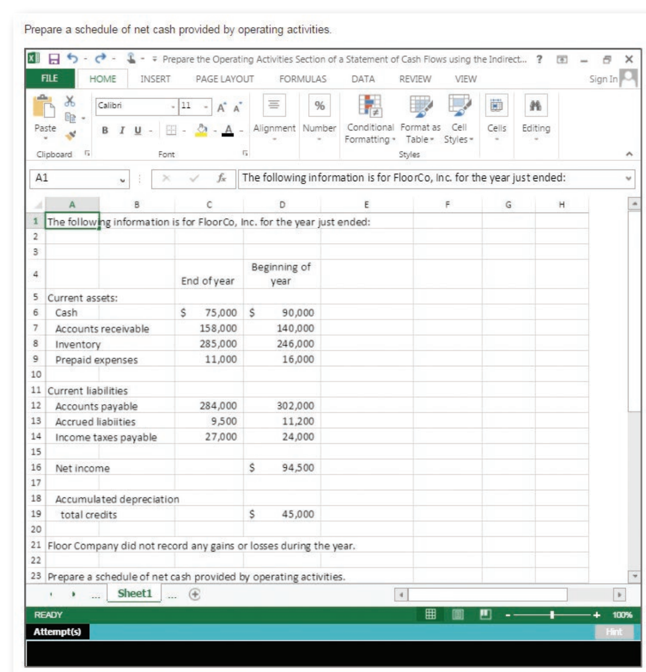

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The **Guided Examples** in Connect provide a narrated, animated, step-by-step walk-through of select exercises similar to those assigned. These short presentations can be turned on or off by instructors and provide reinforcement when students need it most.

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—Jennah Epstein Kraus, Student, Bunker Hill Community College

ACKNOWLEDGMENTS

Many dedicated instructors have devoted their time and effort to help us make each edition better. We would like to acknowledge and thank all of our colleagues who have helped guide our development decisions for this and previous editions. This text would not be the success it is without the help of all of you.

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We are grateful to the following individuals who helped develop, critique, and shape the extensive ancillary package: LuAnn Bean, Florida Institute of Technology; Jeannie Folk, College of DuPage; Julie Head, Indiana University; Shondra Johnson, Bradley University; Sara Kern, Gonzaga University; Nancy Lynch, West Virginia University; Mark McCarthy, East Carolina University; Barbara Muller, Arizona State University; Kristine Palmer, Longwood College; Ilene Leopold Persoff, Long Island University Post; Kevin Smith, Utah Valley University; Beth Woods, Accuracy Counts; and Teri Zuccaro, Clarke University.

We also have received invaluable input and support through the years from present and former colleagues and students. We also appreciate the additional comments, suggestions, and support of our students and our colleagues at Cornell University, Ithaca College, and University of Washington.

Last, we applaud the extraordinary efforts of a talented group of individuals at McGraw-Hill who made all of this come together. We would especially like to thank Tim Vertovec, our managing director; Natalie King, our senior brand manager; Rebecca Mann, our senior product developer; Kyle Burdette, our marketing manager; Daryl Horrocks, our program manager; Lori Koetters and Angela Norris, our project managers; Debra Kubiak, our designer; Susan Culbertson, our buyer; and Melissa Homer and Beth Thole, our content licensing specialists.

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Patricia A. Libby
Frank Hodge

CONTENTS IN BRIEF

CONTENTS

Financial Accounting

Financial Statements and Business Decisions

Le-Nature's Inc. designed its business strategy to ride the growing wave of interest in noncarbonated beverages. And apparently its strategy was a huge success: Its financial statements reported growth in sales from $156 to $275 million in just three years. How did this small family-run business compete with the likes of Coke and Pepsi in this growing market? The business press suggested the first key to its success was manufacturing a broad range of products that fit into the fastest growing "healthy" segments: flavored waters, teas, and fruit drinks. Founder and CEO Gregory Podlucky said that an obsessive drive for quality and efficiency was just as critical. Matching customers' concerns for the environment and healthy living, Le-Nature's was praised as one of the first companies to switch to environmentally friendlier PET plastic bottles and to employ safe in-bottle pasteurization. Its 21st-century manufacturing operation in Latrobe, Pennsylvania, produced everything that goes into its products, from the injection-molded PET bottles to the final packaging. Complete control over the whole process assures quality and provides the flexibility to respond quickly to changes in customers' demands. When convenience stores moved to larger-sized drinks or school cafeterias switched from carbonated beverages to healthier drinks, Le-Nature's could change its production to meet the customers' needs. In August, the company opened a second new state-of-the-art manufacturing facility in Arizona to meet the apparent growing demand.

But here is the twist: Just three short months later, investigators discovered that Le-Nature's phenomenal sales growth was more fiction than fact. How could this seeming success story portrayed in the financial statements really be one of the most remarkable frauds in history?

Chapter 1 concentrates on the key financial statements that businesspeople rely upon when they evaluate a company's performance as well as the importance of accurate financial statements in making our economic system work. We discuss these issues in the context of Le-Nature's rise and fall.

Accounting knowledge will be valuable to you only if you can apply it in the real world. Learning is also easier when it takes place in real contexts. So at the beginning of each chapter we always provide some background about the business that will provide the context for the chapter discussion.

Learning Objectives

After studying this chapter, you should be able to:

1-1 Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers).

1-2 Identify the role of generally accepted accounting principles (GAAP) in determining financial statement content and how companies ensure the accuracy of their financial statements.

chapter 1

FOCUS COMPANY:

Le-Nature's Inc.

USING FINANCIAL STATEMENT INFORMATION TO MANAGE GROWTH

UNDERSTANDING THE BUSINESS

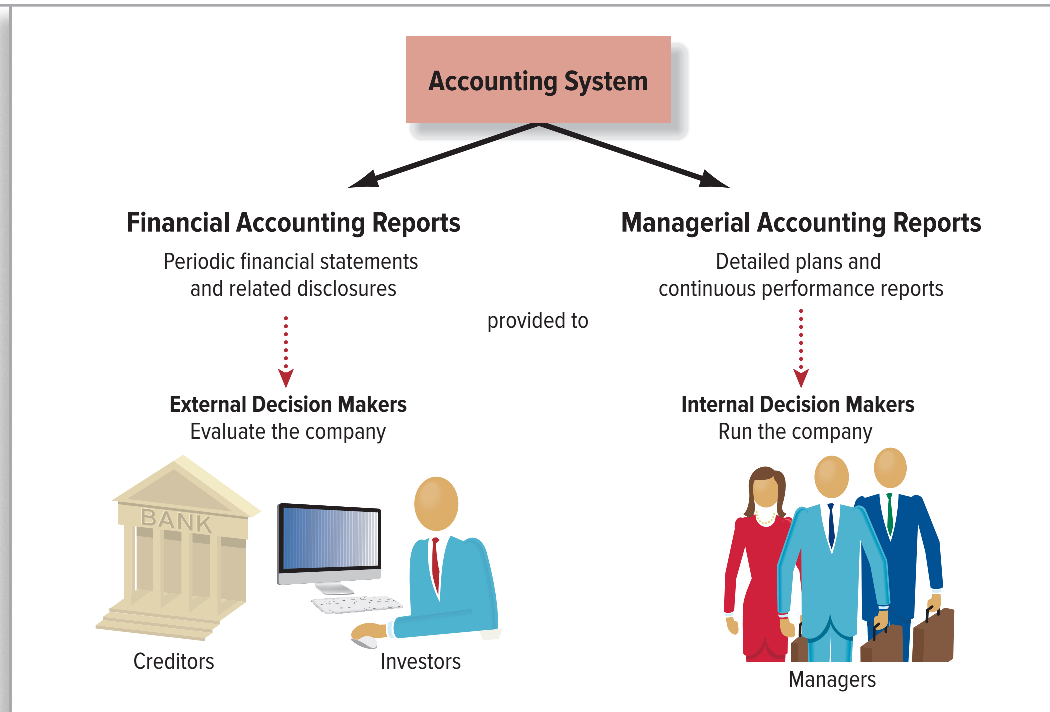
Le-Nature's Inc., our focus company for this chapter, was founded by Gregory Podlucky and his brother Jonathan, who initially were the sole owners or **stockholders** of the company. They were also the managers of the company. Using expertise gained working at their parents' brewery (**Stoney's Beer**), the brothers were early believers in the trend toward healthier, noncarbonated beverages. Like most entrepreneurs, their growth ambitions quickly outpaced their own financial resources. So they turned to banks, including **Wells Fargo Bank** and other lenders, to finance additional manufacturing facilities and equipment. Different units of Wells Fargo continued to arrange lending to Le-Nature's as the need arose, becoming its largest lender or **creditor.** Creditors make money on the loans by charging **interest.** The Podluckys also convinced others to buy stock in Le-Nature's. These individuals became part owners or stockholders along with the Podluckys. They hoped to receive a portion of what the company earned in the form of cash payments called **dividends** and to eventually sell their share of the company at a higher price than they paid. Creditors are more willing to lend and stock prices usually rise when creditors and investors expect the company to do well in the future. Both groups often judge future performance based on information in the company's financial statements.

The Accounting System

Managers (often called **internal decision makers**) need information about the company's business activities to manage the operating, investing, and financing activities of the firm. Stockholders and creditors (often called **external decision makers**) need information about these same business activities to assess whether

EXHIBIT 1.1

The Accounting System and Decision Makers



ACCOUNTING
A system that collects and processes (analyzes, measures, and records) financial information about an organization and reports that information to decision makers.

the company will be able to pay back its debts with interest and pay dividends. All businesses must have an **accounting** system that collects and processes financial information about an organization's business activities and reports that information to decision makers. **Le-Nature's business activities** included:

- **Financing Activities:** borrowing or paying back money to lenders and receiving additional funds from stockholders or paying them dividends.
- **Investing Activities:** buying or selling items such as plant and equipment used in the production of beverages.
- **Operating Activities:** the day-to-day process of purchasing raw tea and other ingredients from suppliers, manufacturing beverages, delivering them to customers, collecting cash from customers, and paying suppliers.

Exhibit 1.1 outlines the two parts of the accounting system. Internal managers typically require continuous, detailed information because they must plan and manage the day-to-day operations of the organization. Developing accounting information for internal decision makers, called **managerial** or **management accounting,** is the subject of a separate accounting course. The focus of this text is accounting for external decision makers, called **financial accounting,** and the four basic financial statements and related disclosures that are periodically produced by that system.

Why Study Financial Accounting?

No matter what your business career goals, you can't get away from financial accounting. You may want to work for an investment firm, a bank, or an accounting firm that would be involved in the financing of companies like **Le-Nature's**. We will focus much of our discussion on the perspectives of **investors, creditors,** and **preparers** of financial statements. However, you might not be aware that managers within the firm also make direct use of financial statements. For example, **marketing managers** and **credit managers** use customers' financial statements to decide whether to extend credit to their customers. **Supply chain managers** analyze suppliers' financial statements to see whether the suppliers have the resources to meet demand and invest in future development. Both the employees' unions and company **human resource managers** use financial statements as a basis for contract negotiations over pay rates. Financial statement figures even serve as a basis for calculating employee bonuses. Regardless of the functional area of management in which you are employed, you will use financial statement data.

We begin with a brief but comprehensive overview of the information reported in the four basic financial statements and the people and organizations involved in their preparation and use. This overview provides a context in which you can learn the more detailed material presented in the chapters that follow. Then we will discuss the parties that are responsible for the accuracy of financial statements as well as the consequences of misstated financial statements. Le-Nature's stockholders and creditors used its financial statements to learn more about the company before making their investment and lending decisions. In doing so, they assumed that the statements accurately represented Le-Nature's financial condition.

Your Goals for Chapter 1

To understand the way in which creditors and stockholders used **Le-Nature's** financial statements, we must first understand what specific information is presented in the four basic financial statements for a company such as Le-Nature's. **PLEASE NOTE: Rather than trying to memorize the definitions of every term used in this chapter, try to focus your attention on learning the general content, structure, and use of the statements. Specifically:**

- **Content:** the categories of items (often called **elements**) reported on each of the four statements.
- **Structure:** the **equation** that shows how the elements within the statement are organized and related.
- **Use:** how the information is **used** by stockholders and creditors to make investment and lending decisions.

The Pause for Feedback–Self-Study Quizzes at key points in the chapter will help you assess whether you have reached these goals. Remember that since this chapter is an overview, each concept discussed here will be discussed again in Chapters 2 through 5.

ORGANIZATION of the Chapter

The Four Basic Financial Statements: An Overview

- Balance Sheet
- Income Statement
- Statement of Stockholders' Equity
- Statement of Cash Flows
- Relationships Among the Statements
- Notes and Financial Statement Formats

Responsibilities for the Accounting Communication Process

- Generally Accepted Accounting Principles
- Ensuring the Accuracy of Financial Statements

LEARNING OBJECTIVE 1-1

Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers).

THE FOUR BASIC FINANCIAL STATEMENTS: AN OVERVIEW

Four financial statements are normally prepared by profit-making organizations for use by investors, creditors, and other external decision makers.

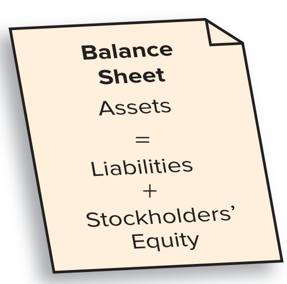
1. On its **balance sheet,** **Le-Nature's** reports the economic resources it owns and the sources of financing for those resources.
2. On its **income statement,** Le-Nature's reports its ability to sell goods for more than their cost to produce and sell.
3. On its **statement of stockholders' equity,** Le-Nature's reports additional contributions or payments to investors and the amount of income the company reinvested for future growth.
4. On its **statement of cash flows,** Le-Nature's reports its ability to generate cash and how it was used.

The four basic statements can be prepared at any point in time (such as the end of the year, quarter, or month) and can apply to any time span (such as one year, one quarter, or one month). Like most companies, Le-Nature's prepared financial statements for external users (investors and creditors) at the end of each quarter (known as **quarterly reports**) and at the end of the year (known as **annual reports**).

The Balance Sheet

BALANCE SHEET (STATEMENT OF FINANCIAL POSITION)

Reports the amount of assets, liabilities, and stockholders' equity of an accounting entity at a point in time.



The purpose of the **balance sheet** is to report the financial position (amount of assets, liabilities, and stockholders' equity) of an accounting entity at a particular point in time. We can learn a great deal about what the balance sheet reports just by reading the statement from the top. The balance sheet **Le-Nature's Inc.** presented to creditors and stockholders is shown in Exhibit 1.2.

Structure

Notice that the **heading** specifically identifies four significant items related to the statement:

1. **Name of the entity,** Le-Nature's Inc.
2. **Title of the statement,** Balance Sheet.
3. **Specific date of the statement,** At December 31, 2012.
4. **Unit of measure,** (in millions of dollars).

ACCOUNTING ENTITY

The organization for which financial data are to be collected.

The organization for which financial data are to be collected, called an **accounting entity**, must be precisely defined. On the balance sheet, the business entity itself, not the business owners, is viewed as owning the resources it uses and being responsible for its debts. The heading of each statement indicates the time dimension of the report. The balance sheet is like a financial snapshot indicating the entity's financial position at a specific point in time—in this case, December 31, 2012—which is stated clearly on the balance sheet. Financial reports are normally denominated in the currency of the country in which they are located. U.S. companies report in U.S. dollars, Canadian companies in Canadian dollars, and Mexican companies in Mexican pesos. Le-Nature's statements report in millions of dollars. That is, they round the last six digits to the nearest **million** dollars. The listing of Cash \$10.6 on Le-Nature's balance sheet actually means \$10,600,000.

BASIC ACCOUNTING EQUATION (BALANCE SHEET EQUATION)

Assets = Liabilities + Stockholders' Equity.

Notice that Le-Nature's balance sheet has three major captions: assets, liabilities, and stockholders' equity. The **basic accounting equation**, often called the balance sheet equation, explains their relationship:

Assets	=	**Liabilities**	+	**Stockholders' Equity**
Economic resources (e.g., cash, inventory, buildings)		Financing from creditors (e.g., amounts owed to suppliers, employees, banks)		Financing from stockholders (e.g., common stock, retained earnings)

EXHIBIT 1.2

Balance Sheet

LE-NATURE'S INC.* Balance Sheet At December 31, 2012 (in millions of dollars)		EXPLANATION
		Name of the entity
		Title of the statement
		Specific date of the statement
		Unit of measure
Assets:		***Resources controlled by the company***
Cash	$ 10.6	*Amount of cash in the company's bank accounts*
Accounts receivable	6.6	*Amounts owed by customers from prior sales*
Inventories	51.2	*Ingredients and beverages ready for sale*
Property, plant, and equipment	459.0	*Factories, production equipment, and land*
Total assets	**$527.4**	***Total amount of company's resources***
Liabilities and stockholders' equity:		***Sources of financing for company's resources***
Liabilities		*Financing supplied by creditors*
Accounts payable	$ 26.0	*Amounts owed to suppliers for prior purchases*
Notes payable to banks	381.7	*Amounts owed to banks on written debt contracts*
Total liabilities	407.7	
Stockholders' equity		*Financing provided by stockholders*
Common stock	55.7	*Amounts invested in the business by stockholders*
Retained earnings	64.0	*Past earnings not distributed to stockholders*
Total stockholders' equity	119.7	
Total liabilities and stockholders' equity	**$527.4**	***Total sources of financing for company's resources***

The notes are an integral part of these financial statements.

The basic accounting equation shows what we mean when we refer to a company's **financial position:** the economic resources that the company owns and the sources of financing for those resources.

Elements

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Assets are the economic resources owned by the entity. Le-Nature's lists four items under the category Assets. The exact items listed as assets on a company's balance sheet depend on the nature of its operations. But these are common names used by many companies. The four items listed by Le-Nature's are the economic resources needed to manufacture and sell beverages to retailers and vending companies. Each of these economic resources is expected to provide future benefits to the firm. To prepare to manufacture the beverages, Le-Nature's first needed cash to purchase land on which to build factories and install production machinery (property, plant, and equipment). Le-Nature's then began purchasing ingredients and producing beverages, which led to the balance assigned to inventories. When Le-Nature's sells its beverages to grocery stores and others, it sells them on credit and receives promises to pay called accounts receivable, which are collected in cash later.

Every asset on the balance sheet is initially measured at the total cost incurred to acquire it. Balance sheets do not generally show the amounts for which the assets could currently be sold.

Liabilities and stockholders' equity are the sources of financing for the company's economic resources. **Liabilities** indicate the amount of financing provided by creditors. They are the company's debts or obligations. Under the category Liabilities, Le-Nature's lists two items. The accounts payable arise from the purchase of goods

*Le-Nature's statements have been simplified for purposes of our discussion.

or services from suppliers on credit without a formal written contract (or a note). The notes payable to banks result from cash borrowings based on a formal written debt contract with banks.

Stockholders' equity indicates the amount of financing provided by owners of the business and reinvested earnings.[1] The investment of cash and other assets in the business by the stockholders is called common stock. The amount of earnings (profits) reinvested in the business (and thus not distributed to stockholders in the form of dividends) is called retained earnings.

In Exhibit 1.2, the Stockholders' Equity section reports two items. The founders and other stockholders' investment of $55.7 million is reported as common stock. Le-Nature's total earnings (or losses incurred) less all dividends paid to the stockholders since formation of the corporation equals $64 million and is reported as retained earnings. Total stockholders' equity is the sum of the common stock plus the retained earnings.

FINANCIAL ANALYSIS

Interpreting Assets, Liabilities, and Stockholders' Equity on the Balance Sheet

Assessment of **Le-Nature's** assets was important to its creditors, **Wells Fargo Bank** and others, and its stockholders because assets provide a basis for judging whether the company has sufficient resources available to operate. Assets are also important because they could be sold for cash in the event that Le-Nature's went out of business.

Le-Nature's debts are important because creditors and stockholders are concerned about whether the company has sufficient sources of cash to pay its debts. Le-Nature's debts were also relevant to Wells Fargo Bank's decision to lend money to the company because existing creditors share its claim against Le-Nature's assets. If a business does not pay its creditors, the creditors may force the sale of assets sufficient to meet their claims. The sale of assets often fails to cover all of a company's debts, and some creditors may take a loss.

Le-Nature's stockholders' equity is important to Wells Fargo Bank because creditors' claims legally come before those of owners. If Le-Nature's goes out of business and its assets are sold, the proceeds of that sale must be used to pay back creditors before the stockholders receive any money. Thus, creditors consider stockholders' equity a protective "cushion."

STOP

PAUSE FOR **FEEDBACK**

We just learned the **balance sheet** is a statement of financial position that reports dollar amounts for a company's assets, liabilities, and stockholders' equity at a specific point in time. These elements are related in the basic accounting equation: **Assets = Liabilities + Stockholders' Equity.** Before you move on, complete the following questions to test your understanding of these concepts.

SELF-STUDY **QUIZ**

1. **Le-Nature's** **assets** are listed in one section and **liabilities** and **stockholders' equity** in another. Notice that the two sections balance in conformity with the basic accounting

[1]A corporation is a business that is incorporated under the laws of a particular state. The owners are called **stockholders** or **shareholders.** Ownership is represented by shares of capital stock that usually can be bought and sold freely. The corporation operates as a separate legal entity, separate and apart from its owners. The stockholders enjoy limited liability; they are liable for the debts of the corporation only to the extent of their investments. Chapter Supplement A discusses forms of ownership in more detail.

equation. In the following chapters, you will learn that the basic accounting equation is the basic building block for the entire accounting process. Your task here is to verify that total assets ($527.4 million) is correct using the numbers for liabilities and stockholders' equity presented in Exhibit 1.2.

2. Learning which items belong in each of the balance sheet categories is an important first step in understanding their meaning. Without referring to Exhibit 1.2, mark each balance sheet item in the following list as an asset (A), a liability (L), or a stockholders' equity (SE) item.

______ Accounts payable	______ Property, plant, and equipment
______ Accounts receivable	______ Inventories
______ Cash	______ Notes payable
______ Common stock	______ Retained earnings

After you have completed your answers, check them below.

The Income Statement

Structure

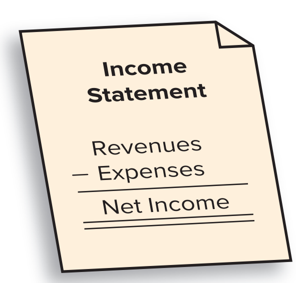
The **income statement** (statement of income, statement of earnings, statement of operations, statement of comprehensive income[2]) reports the accountant's primary measure of performance of a business, revenues less expenses during the accounting period. While the term *profit* is used widely for this measure of performance, accountants prefer to use the technical terms **net income** or net earnings. **Le-Nature's** net income measures its success in selling beverages for more than the cost to generate those sales.

A quick reading of Le-Nature's income statement (Exhibit 1.3) indicates a great deal about its purpose and content. The heading identifies the name of the entity, the title of the report, and the unit of measure used in the statement. Unlike the balance sheet, however, which reports as of a certain date, the income statement reports for a specified period of time (for the year ended December 31, 2012). The time period covered by the financial statements (one year in this case) is called an **accounting period**. Notice that Le-Nature's income statement has three major captions: revenues, expenses, and net income. The income statement equation that describes their relationship is:

Revenues	−	Expenses	=	Net Income
(Cash and promises received from delivery of goods and services)		(Resources used to earn period's revenues)		(Revenues earned minus expenses incurred)

INCOME STATEMENT (STATEMENT OF INCOME, STATEMENT OF EARNINGS, STATEMENT OF OPERATIONS, STATEMENT OF COMPREHENSIVE INCOME)
Reports the revenues less the expenses of the accounting period.

ACCOUNTING PERIOD
The time period covered by the financial statements.



Elements

Companies earn **revenues** from the sale of goods or services to customers (in Le-Nature's case, from the sale of beverages). Revenues normally are amounts expected to be received for goods or services that have been delivered to a customer, **whether or not the customer has paid for the goods or services.** Retail stores such as **Walmart** and **McDonald's** often receive cash from consumers at the time of sale. However, when Le-Nature's delivers its beverages to retail stores, it receives a promise of future payment called an account receivable, which later is

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

Solutions to SELF-STUDY QUIZ

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