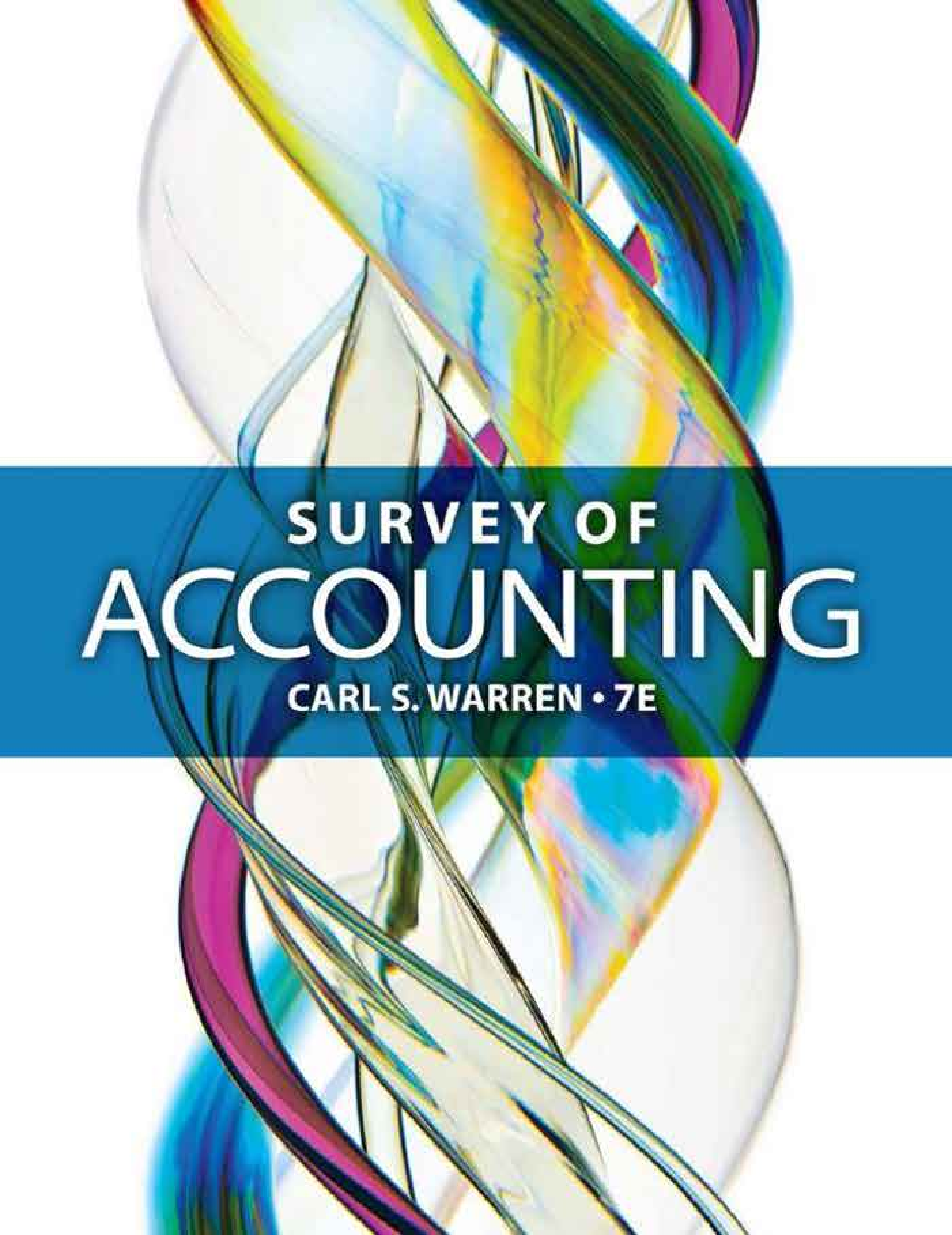

SURVEY OF ACCOUNTING

CARL S. WARREN • 7E

SURVEY OF ACCOUNTING

SEVENTH EDITION

CARL S. WARREN

Professor Emeritus of Accounting

University of Georgia, Athens

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Survey of Accounting, Seventh Edition

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PREFACE

Survey of Accounting, Seventh Edition, is designed for a one-term introductory accounting course. Written for students who have no prior knowledge of accounting, this text emphasizes how managers, investors, and other business stakeholders use accounting reports. It provides an overview of the basic topics in financial and managerial accounting, without the extraneous accounting principles topics that must be skipped or otherwise modified to fit into a one-term course.

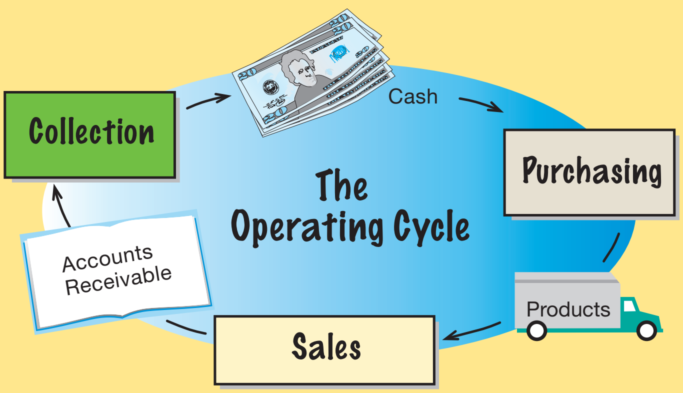
Hallmark Features

The seventh edition of this text continues to emphasize elements designed to help instructors and enhance the learning experience of students. These features include the following:

- **Integrated Financial Statement Framework** shows how transactions impact each of the three primary financial statements and stresses the integrated nature of accounting.
- **Infographic art** examples help students visualize important accounting concepts within the chapter.

The Operating Cycle

The operations of a merchandising business involve the purchase of merchandise for sale (purchasing), the sale of the products to customers (sales), and the receipt of cash from customers (collection). This overall process is referred to as the operating cycle. Thus, the operating cycle begins with spending cash, and it ends with receiving cash from customers. The operating cycle for a merchandising business is shown to the right. Operating cycles for retailers are usually shorter than they are for manufacturers because retailers purchase goods in a form ready for sale to the customer. Of course, some retailers will have shorter operating cycles than others because of the nature of their products. For example, a jewelry store or an automobile dealer normally has a longer operating cycle than a consumer electronics store or a grocery store. Businesses with longer operating cycles normally have higher profit margins on their products than businesses with shorter operating cycles. For example, it is not unusual for jewelry stores to price their jewelry at 30%–50% above cost. In contrast, grocery stores operate on very small profit margins, often below 5%. Grocery stores make up the difference by selling their products more quickly.



- **Illustrative Problems** help students apply what they learn by walking them through problems that cover the most important concepts addressed within the chapter.

Illustrative Problem

McCollum Company, a furniture wholesaler, acquired new equipment at a cost of $150,000 at the beginning of the fiscal year. The equipment has an estimated life of five years and an estimated residual value of $12,000. Ellen McCollum, the president, has requested information regarding alternative depreciation methods.

Instructions

Determine the annual depreciation for each of the five years of estimated useful life of the equipment, the accumulated depreciation at the end of each year, and the book value of the equipment at the end of each year by (a) the straight-line method and (b) the double-declining-balance method.

Solution

	Year	Depreciation Expense	Accumulated Depreciation, End of Year	Book Value, End of Year
a.	1	$27,600*	$ 27,600	$122,400
	2	27,600	55,200	94,800
	3	27,600	82,800	67,200
	4	27,600	110,400	39,600
	5	27,600	138,000	12,000

*$27,600 = ($150,000 − $12,000) ÷ 5

	Year	Depreciation Expense	Accumulated Depreciation, End of Year	Book Value, End of Year
b.	1	$60,000**	$ 60,000	$ 90,000
	2	36,000	96,000	54,000
	3	21,600	117,600	32,400
	4	12,960	130,560	19,440
	5	7,440***	138,000	12,000

**$60,000 = $150,000 × 40%
***The asset is not depreciated below the estimated residual value of $12,000.

- **"Integrity, Objectivity, and Ethics in Business"** features describe real-world dilemmas, helping students apply accounting concepts within an ethical context, using integrity and objectivity.

Integrity, Objectivity, and Ethics in Business

WHERE'S THE BONUS?

Managers are often given bonuses based on reported earnings numbers. This can create a conflict. LIFO can improve the value of the company through lower taxes. However, in periods of rising costs (prices), LIFO also produces a lower earnings number and therefore lower management bonuses. Ethically, managers should select accounting procedures that will maximize the value of the firm, rather than their own compensation. Compensation specialists can help avoid this ethical dilemma by adjusting the bonus plan for the accounting procedure differences.

- **"How Businesses Make Money"** vignettes emphasize practical ways in which businesses apply accounting concepts when generating profit strategies.

HOW BUSINESSES MAKE MONEY

WHAT IS A PRODUCT?

A product is often thought of in terms beyond just its physical attributes. For example, why a customer buys a product usually impacts how a business markets the product. Other considerations, such as warranty needs, servicing needs, and perceived quality, also affect business strategies.

Consider the four different types of products listed below. For these products, the frequency of purchase, the profit per unit, and the number of retailers differ. As a result, the sales and marketing approach for each product differs.

Product	Type of Product	Frequency of Purchase	Profit per Unit	Number of Retailers	Sales/Marketing Approach
Snickers®	Convenience	Often	Low	Many	Mass advertising
Sony® TV	Shopping	Occasional	Moderate	Many	Mass advertising; personal selling
Diamond ring	Specialty	Seldom	High	Few	Personal selling
Prearranged funeral	Unsought	Rare	High	Few	Aggressive selling

- The **"International Connections"** feature, in select chapters, highlights key differences between international accounting standards and U.S. GAAP.

International Connection

DEVELOPMENT COSTS UNDER IFRS

In the United States, research and development costs must be expensed in the period in which they are incurred. IFRS, however, allow certain development costs to be recorded as an asset if specific criteria are met. Included in the criteria are the technical feasibility of completing the development of the intangible asset and whether the company intends to use or sell the asset. Whether development costs are recorded as an asset or expensed can have a significant impact on the financial statements. For example, Nokia Corporation reported €40 million of development costs as an asset on a recent balance sheet. [€ stands for the euro, the common currency of the European Economic Union.]

- **An attractive design** engages students and clearly presents the material. The Integrated Financial Statement Framework benefits from this pedagogically sound use of color, as each statement within the framework is shaded to reinforce the integrated nature of accounting.

Integrated Financial Statement (IFS) Approach

This framework clearly demonstrates the impact of transactions on the balance sheet, income statement, and the statement of cash flows and the corresponding relationship among these financial statements. The IFS framework moves the student from the simple to the complex and explains the how and why of financial statements.

Chapter 1 introduces students to this integration in the form of actual company financials from The Hershey Company, a well-known manufacturer of chocolates.

EXHIBIT 10

Integrated Financial Statements

The Hershey Company
Balance Sheet
December 31, 2012

Assets	=	Liabilities	+	Stockholders' Equity	
Cash $ 728		·		·	
·		·		·	
·		·		$5,028	Retained Earnings
$4,754	=	$3,706	+	$1,048	

$4,754
Total Liabilities + Stockholders' Equity

The Hershey Company
Statement of Cash Flows
For the Year Ended Dec. 31, 2012

Operating act.	$1,095
Investing act.	(473)
Financing act.	(587)
Increase in cash	$ 35
Cash, Jan. 1	693
Cash, Dec. 31	$ 728

3

The Hershey Company
Income Statement
For the Year Ended Dec. 31, 2012

Revenues	$ 6,644
Expenses	(5,983)
Net income	$ 661

1

The Hershey Company
Retained Earnings Statement
For the Year Ended Dec. 31, 2012

Retained earnings, Jan. 1		$4,708
Add: Net income	$ 661	
Less: Dividends	(341)	320
Retained earnings, Dec. 31		$5,028

2

Chapter 2 begins with an example format of the integrated framework used throughout the financial chapters. Early in the course, students will gain a greater understanding of how important trends or events can impact a company's financial statements, which add valuable insight into the financial condition of a business.

Integrated Financial Statement Framework **EXHIBIT 1**

Statement of Cash Flows	Balance Sheet				Income Statement
	Assets =	Liabilities +	Stockholders' Equity		
	Assets =	Liabilities +	Capital Stock +	Retained Earnings	
Transactions	XXX	XXX	XXX	XXX	
	XXX	XXX	XXX	XXX	

Statement of Cash Flows

+/– Operating activities	XXX
+/– Investing activities	XXX
+/– Financing activities	XXX
Increase or decrease in cash	XXX
Beginning cash	XXX
Ending cash	XXX

INTEGRATED FINANCIAL STATEMENT FRAMEWORK

Income Statement

Revenues	XXX
Expenses	XXX
Net income or loss	XXX

The primary focus in Chapter 2 is on cash transactions, which helps eliminate confusion for students who may have difficulty determining whether an event or transaction should be recorded.

Transaction (d)

During the first month of operations, Family Health Care earned patient fees of $5,500, receiving the fees in cash.

The effects of this transaction on Family Health Care's financial statements are recorded as follows:

1. Under the Statement of Cash Flows column, Cash from Operating activities is increased by $5,500.
2. Under the Balance Sheet column, Cash under Assets is increased by $5,500. To balance the accounting equation, Retained Earnings under Stockholders' Equity is also increased by $5,500.
3. Under the Income Statement column, Fees earned is increased by $5,500.

This transaction illustrates an inflow of cash from operating activities by earning revenues (fees earned) of $5,500. Retained Earnings is increased under Stockholders' Equity by $5,500 because fees earned contribute to net income and net income increases stockholders' equity. Since fees earned are a type of revenue, Fees earned of $5,500 is also entered under the Income Statement column.

The effects of this transaction on Family Health Care's financial statements are shown below.

Statement of Cash Flows	Balance Sheet									Income Statement
	Assets			=	Liabilities +	Stockholders' Equity				
	Cash	+	Land	=	Notes Payable	+	Capital Stock	+	Retained Earnings	
Balances	4,000		12,000		10,000		6,000			
d. Fees earned	5,500								5,500	*d.*
Balances	9,500		12,000		10,000		6,000		5,500	

Statement of Cash Flows	
d. Operating	5,500

Income Statement	
d. Fees earned	5,500

Seventh Edition Changes and Enhancements

Financial Analysis

- A Financial Analysis section has been added to each of the financial accounting chapters (Chapters 1–8). Each financial analysis section describes common financial ratios and analyses and then uses real world companies to illustrate and interpret the results. For example, in Chapter 1, Apple Inc. and Dell Inc. are used to illustrate the computation and analysis of the rate of return on assets.
- The objective of the financial analysis section is to provide students meaningful insights into how financial statements are used in the real world. This, in turn, emphasizes the importance of understanding financial statements, their integrations, and interpretations.

- A separate end-of-chapter financial analysis section has also been added. This section extends the chapter discussion to a variety of real world companies. For example, in Chapter 1, FA 1-4 asks students to (1) think about how the rate of return on assets might differ for ExxonMobil, Coca-Cola, and Walmart; (2) compute the rate of return on assets for each company using recent financial statements; and (3) analyze the differences.
- New key terms have been added to reflect the additional content in the Financial Analysis sections.

Other Enhancements

- The "Activities" section of previous editions is now renamed "Cases," which better reflects the scenario-based issues presented in these items. The Cases have been updated and refreshed.
- Designed for today's students, the seventh edition's new full-color design enhances the presentation of integrated financial statements, clarity of graphs and illustrations, and invites student engagement.
- This edition uses an innovative, high-impact writing style that emphasizes topics concisely and clearly. Direct sentences, concise paragraphs, numbered lists, and step-by-step calculations provide students with an easy-to-follow structure for learning accounting without sacrificing content or rigor.
- Instead of identifying specific years such as 2014, we have converted most year designations to 20Y1, 20Y2, 20Y3...20Y9. Using a date-neutral approach extends the 7th edition's usefulness over a longer period. One exception is made in the discussion and illustration of Hershey Company's financial statements in Chapter 1. This exception was made so that students and instructors could compare the chapter's adapted illustration with Hershey's actual financial statements, if so desired.
- All real-world company data have been updated including **The Hershey Company**, **Home Depot**, **Starbucks**, and **Microsoft**. All real-world company names are identified in blue boldface color font as shown in the preceding sentence. All other names, including individuals and companies, are fictitious, and any resemblance to existing individuals or companies is a coincidence.
- Company names, numerical data, and solutions to end-of-chapter exercises and problems have been extensively revised to create unique course content.

Technology

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CengageNOW is an online **teaching and learning resource** that provides **more control in less time** and delivers **better student outcomes –** NOW. CengageNOW provides a more interactive way for students to read, study, and learn online.

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Learning accounting is often like learning a new language. Repetition and practice are crucial to the student learning process. CengageNOW allows students to learn concepts when and how they want – *accelerating their success!*

1. **It provides *students* with** a tool that enhances their learning process by supplying them with:
    - Resources that support their understanding of core concepts so they come to class prepared

- The right type and amount of feedback when they need it and resources to help them as they complete their homework
- Assignments to help them go further and make connections between concepts and apply what they've learned to different scenarios

2. **It provides *instructors*** with a tool that allows them to:
   - Easily manage your assignments and students
   - Achieve continuity and time savings term after term
   - Diagnose students' level of comprehension at any given point
   - Help you report on outcomes to accrediting bodies or internally to your institution

CengageNOW for Warren's *Survey of Accounting, 7e* is designed to help students learn more effectively by providing engaging resources at unique points in the learning process:

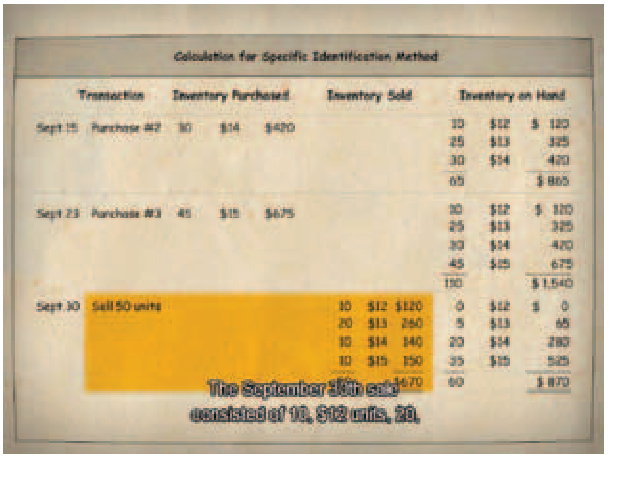
When to use it?	What to use?	How will it help?
Preparing for Class	Lecture Activities Animated Activities Experience Managerial Accounting Videos	Recall Understand
Completing Homework	Solutions Videos Enhanced Feedback	Apply
Going Further	Mastery Assignments Conceptual Conversions	Analyze Evaluate

Preparing for Class

CengageNOW helps you motivate students and prepare them for class with a host of resources. These resources were developed with visual learners and those that don't like to read textbooks in mind. Available in the Study Tools tab in CengageNOW, students may access these resources on demand. Each resource is fully assignable and gradable – great for **Flipping the Classroom**!

***New* Lecture Activities** are available and correlate to each Learning Objective (LO). These Lecture Assignments review the material covered in each LO, giving students a way to review what is covered in each objective in a digestible video activity format so they come to class more prepared and ready to participate.

Animated Activities are available on a chapter-by-chapter basis. Animated Activities are assignable/gradable illustrations that visually explain and guide students through selected core topics. Each activity uses a realistic company example to illustrate how the concepts relate to the everyday activities of a business. After finishing the video, a student is expected to answer questions based on what they've seen. These activities offer excellent resources for students prior to coming to lecture and will especially appeal to visual learners.

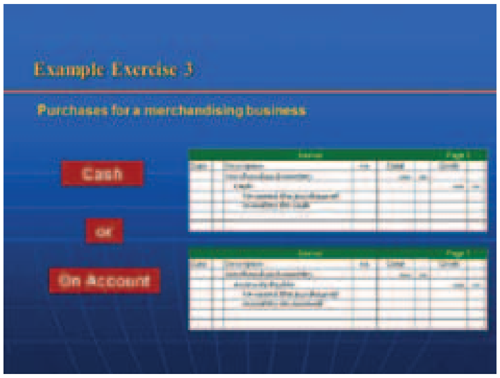


For selected Managerial chapters, **Experience Managerial Accounting Videos** are available to show how real-world companies apply managerial topics in a day-to-day business setting.

By using these resources, you have a powerful suite of content to help you ensure students can familiarize themselves with content prior to coming to class – an excellent way to help you flip the classroom!

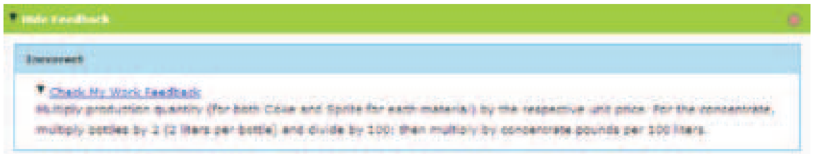
Completing Homework

Students sometimes struggle with accounting homework. By using CengageNOW's powerful instructor tools you can fine-tune the amount of help that your students receive as they work on their homework. Help your students succeed by making the right amount of assistance available at the right time!



Solutions Videos are available for the most commonly assigned end-of-chapter assignments. *Linked only to algorithms*, Solutions Videos provide students with both a detailed walk-through of a similar problem and problem-solving strategies.

Enhanced feedback for each homework question! CengageNOW questions provide additional, immediate feedback so your students can learn as they go. In addition to showing students the fields they got correct or incorrect, written guidance is offered when students click on "Check My Work" within an assignment attempt. You have the ability to turn this assistance on or off in the assignment settings options.

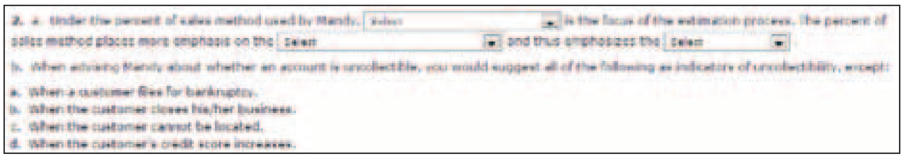


Going Further

Mastering accounting includes making connections between concepts and asking students to apply what they've learned to different scenarios. CengageNOW has the tools that help you assess your students' abilities in these key skill areas!

In CengageNOW, all of the special activities in Warren, *Survey of Accounting, 7th Edition* are available for you to assign to your students. These **Mastery Assignments** do more than test your students' ability to recall, understand and apply. These assignments challenge your students to go further by demonstrating their ability to analyze and evaluate accounting information.

Conceptual Conversions are open-ended requirements from the end-of-chapter homework that have been converted into automatically gradable formats in CengageNOW. Now you can assess your students' understanding of more conceptual, open-ended questions previously not available to assign in an online environment.



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- **Instructor's Manual** Each chapter contains a number of resources designed to aid instructors as they prepare lectures, assign homework, and teach in the classroom.
- **Solutions Manual** The Solutions Manual contains answers to all exercises, problems, and cases that appear in the text. As always, the solutions are author-written and verified multiple times for numerical accuracy and consistency with the core text.

Acknowledgments

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Your comments and suggestions as you use this text are sincerely appreciated.

Carl S. Warren

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Dr. Carl S. Warren is Professor Emeritus of Accounting at the University of Georgia, Athens. For over twenty-five years, Professor Warren has taught all levels of accounting classes. In recent years, Professor Warren has focused his teaching efforts on principles of accounting and auditing courses. Professor Warren has taught classes at the University of Iowa, Michigan State University, and University of Chicago. Professor Warren received his doctorate degree (PhD) from Michigan State University and his undergraduate (BBA) and master's (MA) degrees from the University of Iowa. During his career, Professor Warren published numerous articles in professional journals, including *The Accounting Review, Journal of Accounting Research, Journal of Accountancy, The CPA Journal,* and *Auditing: A Journal of Practice & Theory*. Professor Warren's outside interests include handball, skiing, hiking, fly-fishing, and golf. Professor Warren also spends time backpacking U.S. national parks (Yellowstone and the Grand Canyon), playing with his grandchildren, and riding ATVs and motorcycles.

BRIEF CONTENTS

CONTENTS

CHAPTER 1

The Role of Accounting in Business

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- **Obj 1** Describe the types and forms of businesses, how businesses make money, and business stakeholders.
- **Obj 2** Describe the three business activities of financing, investing, and operating.
- **Obj 3** Define accounting and describe its role in business.
- **Obj 4** Describe and illustrate the basic financial statements and how they interrelate.
- **Obj 5** Describe eight accounting concepts underlying financial reporting.
- **Obj 6** Financial Analysis: Describe and illustrate how the rate of return on assets can be used to analyze and assess a company's financial performance.

LinkedIn

How much are you willing to pay for stock of a company that has never been traded on a public market? Investors must come up with an answer to this question for companies that offer stock to the public for the first time, which is called an *initial public offering*.

In the United States, before such companies can offer stock for sale, they must file a prospectus (Form S-1) with the Securities and Exchange Commission. The prospectus includes background information on the company, including its business strategy and the range of prices that the stock is expected to sell for in the market. Also included in the prospectus are the company's financial statements for the past three years.

Recently, **LinkedIn Corporation** offered its stock for sale to the public. LinkedIn is the world's largest professional network on the Internet with more than 100 million members in over 200 countries. Members join the network free of cost and are able to create and manage their professional identity online. LinkedIn generates its revenues by offering premium services to its members and by selling services such as hiring and marketing solutions to businesses and professional organizations.

In its prospectus filed with the Securities and Exchange Commission, LinkedIn indicated that it anticipated a price for its stock of between $42.00 and $45.00 per share. On the first day the stock was publicly traded, LinkedIn's stock rose to a high of $122.70, more than two and a half times its highest anticipated price of $45.00.

Is LinkedIn's stock really worth $122.70 per share? To answer this question, investors examined LinkedIn's stock prospectus and will monitor its financial condition and performance over time. LinkedIn's current and future financial statements will be an important input into investors' valuation of LinkedIn.

In this chapter, the nature, types, and activities of businesses, such as LinkedIn, are described and illustrated. In addition, the role of accounting in business, including financial statements, basic accounting concepts, and how to use financial statements to evaluate a business's performance, is also described and illustrated.

Obj 1

Describe the types and forms of businesses, how businesses make money, and business stakeholders.

Nature of Business and Accounting

A **business**[1] is an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers. Businesses come in all sizes, from a local coffee house to **Starbucks**, which sells almost $11 billion of coffee and related products each year.

The objective of most businesses is to earn a profit. **Profit** is the difference between the amounts received from customers for goods or services and the amounts paid for the inputs used to provide the goods or services. In this text, we focus on businesses operating to earn a profit. However, many of the same concepts and principles also apply to not-for-profit organizations such as hospitals, churches, and government agencies.

Types of Businesses

Roughly eight out of every ten workers in the United States are service providers.

Three types of businesses operated for profit include service, merchandising, and manufacturing businesses. Each type of business and some examples are described below.

Service businesses provide services rather than products to customers.

Delta Air Lines (transportation services)
The Walt Disney Company (entertainment services)

Merchandising businesses sell products they purchase from other businesses to customers.

Walmart (general merchandise)
Amazon.com (books, music, videos)

Manufacturing businesses change basic inputs into products that are sold to customers.

General Motors Corporation (cars, trucks, vans)
Dell Inc. (personal computers)

Forms of Business

A business is normally organized in one of the following four forms:

- proprietorship
- partnership
- corporation
- limited liability company

A **proprietorship** is owned by one individual. More than 70% of the businesses in the United States are organized as proprietorships. The frequency of this form is due to the ease and low cost of organizing. The primary disadvantage of proprietorships is that the financial resources are limited to the individual owner's resources. In addition, the owner has unlimited liability to creditors for the debts of the company.

A **partnership** is owned by two or more individuals. About 10% of the businesses in the United States are organized as partnerships. Like a proprietorship, a partnership may outgrow the financial resources of its owners. Also, the partners have unlimited liability to creditors for the debts of the company.

1. A complete glossary of terms appears at the end of the text.

A **corporation** is organized under state or federal statutes as a separate legal entity. The ownership of a corporation is divided into shares of stock. A corporation issues the stock to individuals or other companies, who then become owners or stockholders of the corporation. A primary advantage of the corporate form is the ability to obtain large amounts of resources by issuing shares of stock. In addition, the stockholders' liability to creditors for the debts of the company is limited to their investment in the corporation.

A **limited liability company (LLC)** combines attributes of a partnership and a corporation. The primary advantage of the limited liability company form is that it operates similar to a partnership, but its owners' (or members') liability for the debts of the company is limited to their investment.

Many professional practices such as lawyers, doctors, and accountants are organized as limited liability companies.

In addition to the ease of formation, ability to raise capital, and liability for the debts of the business, other factors such as taxes and legal life of the business should be considered when forming a business. For example, corporations are taxed as separate legal entities, while the income of sole proprietorships, partnerships, and limited liability companies is passed through to the owners and taxed on the owners' tax returns. As separate legal entities, corporations also continue on, regardless of the lives of the individual owners. In contrast, sole proprietorships, partnerships, and limited liability companies may terminate their existence with the death of an individual owner.

The characteristics of sole proprietorships, partnerships, corporations, and limited liability companies are summarized below.

Organizational Form	Ease of Formation	Legal Liability	Taxation	Limitation on Life of Entity	Access to Capital
Proprietorship	Simple	No limitation	Nontaxable (pass-through) entity	Yes	Limited
Partnership	Simple	No limitation	Nontaxable (pass-through) entity	Yes	Average
Corporation	Complex	Limited liability	Taxable entity	No	Extensive
Limited Liability Company	Moderate	Limited liability	Nontaxable (pass-through) entity by election	Yes	Average

The three types of businesses we discussed earlier—manufacturing, merchandising, and service—may be proprietorships, partnerships, corporations, or limited liability companies. However, businesses that require a large amount of resources, such as many manufacturing businesses, are corporations. Likewise, most large retailers such as **Walmart**, **Sears**, and **JCPenney** are corporations.

Because most large businesses are corporations, they tend to dominate the economic activity in the United States. For this reason, this text focuses on the corporate form of organization. However, many of the concepts and principles discussed also apply to proprietorships, partnerships, and limited liability companies.

How Do Businesses Make Money?

The objective of a business is to earn a profit by providing goods or services to customers. How does a company decide which products or services to offer its customers? Many factors influence this decision. Ultimately, however, the decision is based on how the company plans to gain an advantage over its competitors and, in doing so, maximize its profits.

Companies try to maximize their profits by generating high revenues while maintaining low costs, which results in high profits. However, a company's competitors are also trying to do the same, and thus, a company can only maximize its profits by gaining an advantage over its competitors.

Generally, companies gain an advantage over their competitors by using one of the following two strategies:

- A **low-cost strategy**, where a company designs and produces products or services at a lower cost than its competitors. Such companies often sell no-frills, standardized products and services.
- A **premium-price strategy**, where a company tries to design and produce products or services that serve unique market needs, allowing it to charge premium prices. Such companies often design and market their products so that customers perceive their products or services as having a unique quality, reliability, or image.

Walmart and Southwest Airlines are examples of companies using a low-cost strategy. John Deere, Tommy Hilfiger, and BMW are examples of companies using a premium-price strategy.

Since business is highly competitive, it is difficult for a company to sustain a competitive advantage over time. For example, a competitor of a company using a low-cost strategy may copy the company's low-cost methods or develop new methods that achieve even lower costs. Likewise, a competitor of a company using a premium-price strategy may develop products that are perceived as more desirable by customers.

Examples of companies utilizing low-cost and premium-price strategies include:

- Local pharmacies who develop personalized relationships with their customers. By doing so, they are able to charge premium (higher) prices. In contrast, Walmart's pharmacies use the low-cost emphasis and compete on cost.
- Grocery stores such as Kroger and Safeway develop relationships with their customers by issuing preferred customer cards. These cards allow the stores to track consumer preferences and buying habits for use in purchasing and advertising campaigns.
- Honda promotes the reliability and quality ratings of its automobiles and thus charges premium prices. Similarly, Volvo promotes the safety characteristics of its automobiles. In contrast, Kia uses a low-cost strategy.
- Harley-Davidson emphasizes that its motorcycles are "Made in America" and promotes its "rebel" image as a means of charging higher prices than its competitors Honda, Yamaha, or Suzuki.

Companies sometimes struggle to find a competitive advantage. For example, JCPenney and Sears have difficulty competing on low costs against Walmart, Kohl's, T.J. Maxx, and Target. At the same time, JCPenney and Sears have difficulty charging premium prices against competitors such as The Gap, Eddie Bauer, and Talbot's. Likewise, Delta Air Lines and United Airlines have difficulty competing against low-cost airlines such as Southwest. At the same time, Delta and United don't offer any unique services for which their passengers are willing to pay a premium price.

Exhibit 1 summarizes low-cost and premium-price strategies with common examples of companies that employ each strategy.

EXHIBIT 1

Business Strategies and Industries

	Industry					
Business Strategy	**Airline**	**Freight**	**Automotive**	**Retail**	**Financial Services**	**Hotel**
Low cost	Southwest	Union Pacific	Hyundai	Sam's Club	Ameritrade	Super 8
Premium price	Virgin Atlantic	FedEx	BMW	Talbot's	Morgan Stanley	Ritz-Carlton

Business Stakeholders

A **business stakeholder** is a person or entity with an interest in the economic performance and well-being of a company. For example, owners, suppliers, customers, and employees are all stakeholders in a company.

Business stakeholders can be classified into one of the four categories illustrated in Exhibit 2.

EXHIBIT 2

Business Stakeholders

Business Stakeholder	Interest in the Business	Examples
Capital market stakeholders	Providers of major financing for the business	Banks, owners, stockholders
Product or service market stakeholders	Buyers of products or services and vendors to the business	Customers and suppliers
Government stakeholders	Collect taxes and fees from the business and its employees	Federal, state, and city governments
Internal stakeholders	Individuals employed by the business	Employees and managers

Capital market stakeholders provide the financing for a company to begin and continue its operations. Banks and other long-term creditors have an economic interest in receiving the amount loaned plus interest. Owners want to maximize the economic value of their investments.

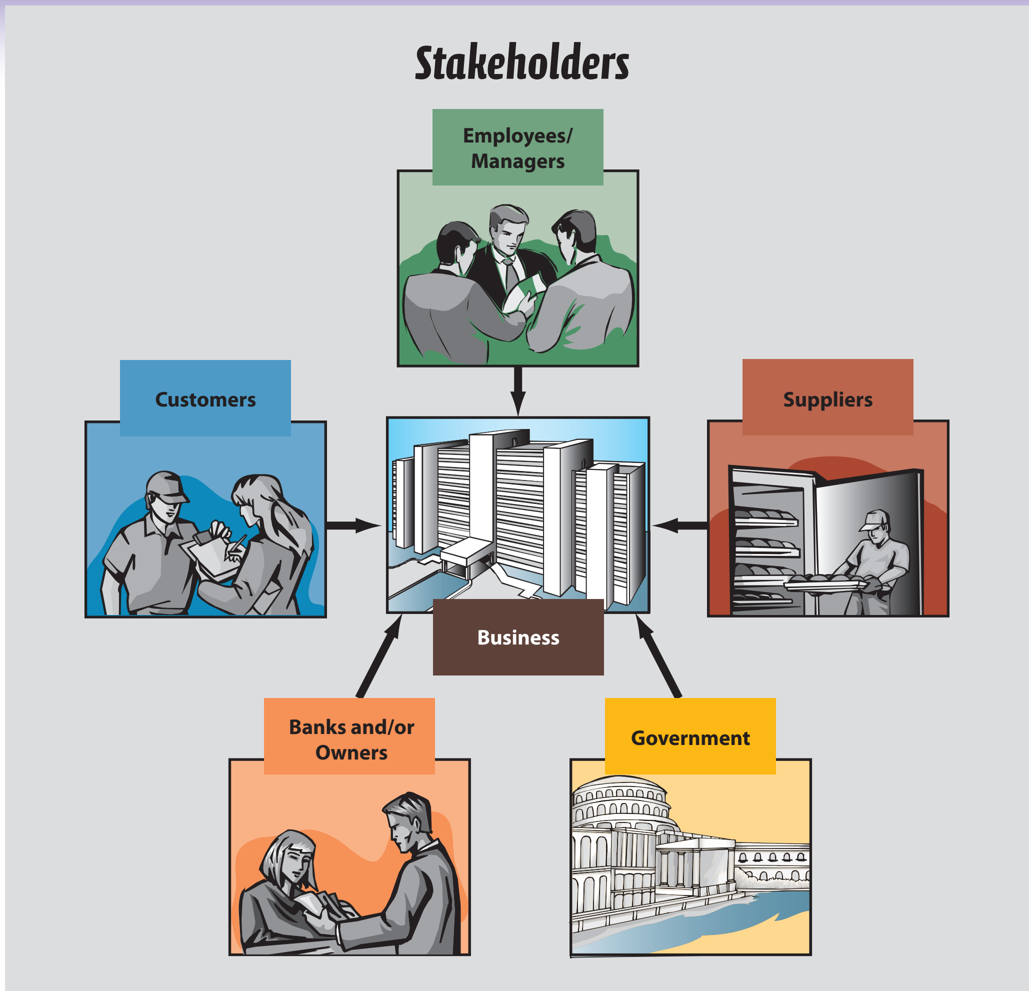
Product or service market stakeholders purchase the company's products or services or sell their products or services to the company. Customers have an economic interest in the continued success of the company. For example, customers who purchase advance tickets on Delta Air Lines are depending on Delta continuing in business. Likewise, suppliers depend on continued success of their customers. For example, if a customer fails or cuts back on purchases, the supplier's business will also decline.

Government stakeholders such as federal, state, county, and city governments collect taxes from companies. The better a company does, the more taxes the government collects. In addition, workers who are laid off by a company can file claims for unemployment compensation, which results in a financial burden for the state and federal governments.

Internal stakeholders such as managers and employees depend upon the continued success of the company for keeping their jobs. Managers of companies that perform poorly are often fired by the owners. Likewise, during economic downturns companies often lay off workers. Stakeholders are illustrated in Exhibit 3.

EXHIBIT 3

Business Stakeholders



Integrity, Objectivity, and Ethics in Business

THE HERSHEY TRUST COMPANY

Milton Snavely Hershey founded The Hershey Company after serving as a candy apprentice in Philadelphia, running a failing candy shop, and finally succeeding at caramel making. Milton started The Hershey Company in the early 1900s after selling his caramel company.

© Finnbarr Webster/Alamy

Milton and his wife, Catherine, couldn't have children, and in 1909, they created the Milton Hershey School. After Catherine's death, Milton willed virtually his entire fortune, including his interest in The Hershey Company, to the School. Today, the School provides free education, meals, clothing, health care, and a home to almost 2,000 children in financial and social need. The School is run by The Hershey Trust Company, which is the largest shareholder of The Hershey Company.

A public uproar was created in 2002 when the trustees of The Hershey Trust Company tried to sell their controlling stock interest in The Hershey Company. As a result of the public outcry, the majority of the trustees were forced to resign.

Source: Adapted from www.thehersheycompany.com.

Business Activities

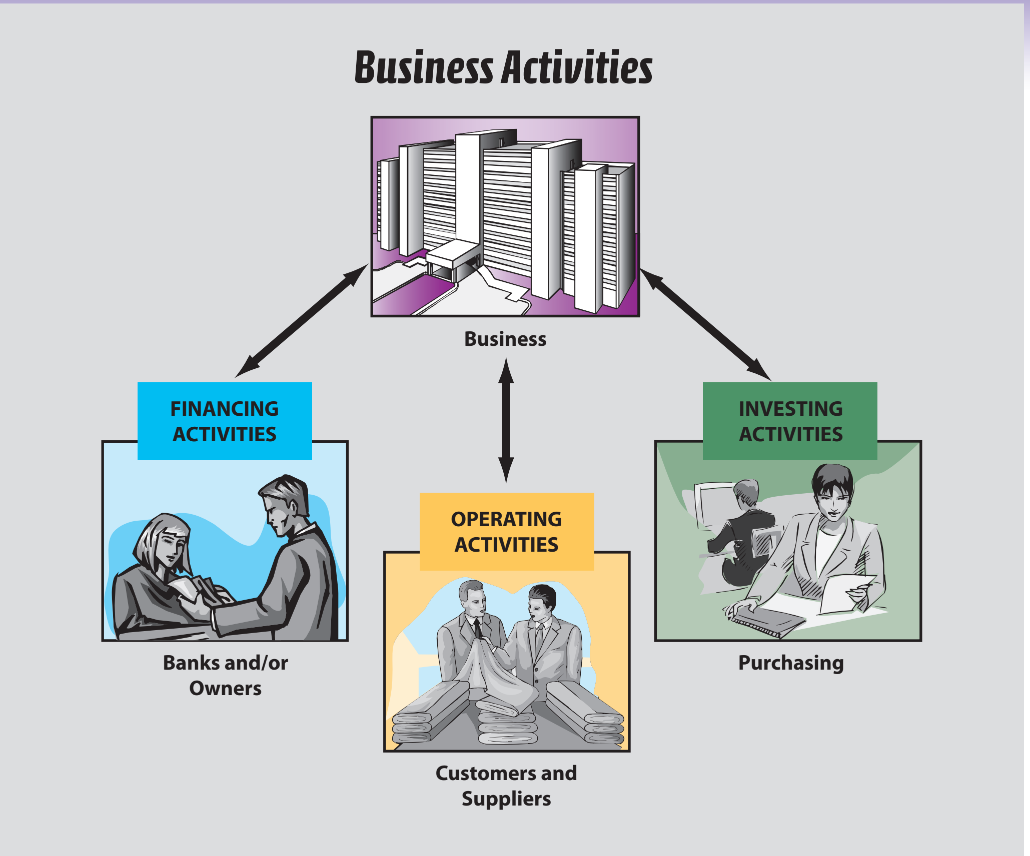
Obj 2
Describe the three business activities of financing, investing, and operating.

All companies engage in the following three business activities:

- **Financing activities** to obtain the necessary funds (monies) to organize and operate the company
- **Investing activities** to obtain assets such as buildings and equipment to begin and operate the company
- **Operating activities** to earn revenues and profits

The preceding business activities are illustrated in Exhibit 4.

EXHIBIT 4
Business Activities



Financing Activities

Financing activities involve obtaining funds to begin and operate a business. Companies obtain financing through the use of capital markets by:

- borrowing
- issuing shares of ownership

When a company borrows money, it incurs a liability. A **liability** is a legal obligation to repay the amount borrowed according to the terms of the borrowing agreement. When a company borrows from a vendor or supplier, the liability is called an **account payable**. In such cases, the company promises to pay according to the terms set by the vendor or supplier. Most vendors and suppliers require payment within a relatively short time, such as 30 days.

On a recent balance sheet **Google** reported total liabilities of $14,429 million, of which $7,148 million were accounts payable.

A company may also borrow money by issuing bonds. *Bonds* are sold to investors and require repayment normally with interest. The amount of the bonds, called the *face value*, usually requires repayment several years in the future. Thus, bonds are a form of long-term financing. The interest on the bonds, however, is normally paid semiannually. Bond obligations are reported as **bonds payable**, and any interest that is due is reported as **interest payable**.

Many companies borrow by issuing notes payable. A **note payable** requires payment of the amount borrowed plus interest. Notes payable are similar to bonds except that they may be issued on a short-term or long-term basis.

A company may finance its operations by issuing shares of ownership. For a corporation, shares of ownership are issued in the form of shares of stock. Although corporations may issue a variety of different types of stock, the basic type of stock issued to owners is called **common stock**. The term **capital stock** refers to all the types of stock a corporation may issue.[2] Investors who purchase the stock are referred to as **stockholders**.

The claims of creditors and stockholders on the assets of a corporation are different. **Assets** are the resources owned by a corporation (company). Creditors have first claim on the company's assets. Only after the creditors' claims are satisfied do the stockholders have a right to the corporate assets.

Microsoft is currently paying $0.92 per share for dividends on its common stock, which with a market price of $35.00 yields a return of 2.6% ($0.92 ÷ $35.00).

Creditors normally receive timely payments, which may include interest. In contrast, stockholders are not entitled to regular payments. However, many corporations distribute earnings to stockholders on a regular basis. These distributions of earnings to stockholders are called **dividends**.

Investing Activities

Investing activities involve using the company's assets to obtain additional assets to start and operate the business. Depending upon the nature of the business, a variety of different assets must be acquired.

Most businesses need assets such as machinery, buildings, computers, office furnishings, trucks, and automobiles. These assets have physical characteristics and as such are **tangible assets**. Long-term tangible assets such as machinery, buildings, and land are normally reported separately as "Property, plant, and equipment." Short-term tangible assets such as cash and inventories are reported separately.

On a recent balance sheet, **Apple** reported goodwill and other intangible assets of over $5 billion.

A business may also need **intangible assets**. For example, a business may obtain patent rights to use in manufacturing a product. Long-term assets such as patents, goodwill, and copyrights are reported separately as intangible assets.

A company may also prepay for items such as insurance or rent. Such items, which are assets until they are consumed, are reported as **prepaid expenses**. In addition, rights to payments from customers who purchase merchandise or services on credit are reported as **accounts receivable**.

Operating Activities

Operating activities involve using assets to earn revenues and profits. The management of a company does this by implementing one of the business strategies discussed earlier.

2. Types of stock are discussed in Chapter 8, "Liabilities and Stockholders' Equity."

Revenue is the increase in assets from selling products or services. Revenues are normally identified according to their source. For example, revenues received from selling products are called **sales**. Revenues received from providing services are called **fees earned**.

On a recent income statement, **Best Buy Co. Inc.** reported revenues of $50,705 million, cost of goods sold of $38,132 million, and selling and administrative expenses of $10,242 million.

To earn revenue, a business incurs costs, such as wages of employees, salaries of managers, rent, insurance, advertising, freight, and utilities. Costs used to earn revenue are called **expenses**, which may be identified and reported in a variety of ways. For example, the cost of products sold is referred to as the **cost of merchandise sold**, **cost of sales**, or **cost of goods sold**. Other expenses are normally classified as either selling expenses or administrative expenses. **Selling expenses** include those costs directly related to the selling of a product or service. For example, selling expenses include such costs as sales salaries, sales commissions, freight, and advertising costs. **Administrative expenses** include other costs not directly related to the selling, such as officer salaries and other costs of the corporate office.

By comparing the revenues for a period to the related expenses, it can be determined whether the company has earned net income or incurred a net loss. **Net income** results when revenues exceed expenses. A **net loss** results when expenses exceed revenues.

As discussed next, the major role of accounting is to provide stakeholders with information on the financing, investing, and operating activities of businesses. Financial statements are one source of such information.

What Is Accounting and Its Role in Business?

Obj | **3**

Define accounting and describe its role in business.

The *role of accounting* is to provide information about the financing, investing, and operating activities of a company to its stakeholders. For example, accounting provides information for managers to use in operating the business. In addition, accounting provides information to other stakeholders, such as creditors, for assessing the economic performance and condition of the company.

In a general sense, **accounting** is defined as an information system that provides reports to stakeholders about the economic activities and condition of a business. This text focuses on accounting and its role in business. However, many of the concepts discussed also apply to individuals, governments, and not-for-profit organizations. For example, individuals must account for their hours worked, checks written, and bills paid. Stakeholders for individuals include creditors, dependents, and the government. A main interest of the government is making sure that individuals pay the proper taxes.

Accounting is often called the "language of business." This is because accounting is a primary means by which business information is communicated to the stakeholders.

A primary purpose of accounting is to summarize the financial performance of the business for external stakeholders, such as banks and governmental agencies. The branch of accounting that is associated with preparing reports for users external to the business is called **financial accounting**. Accounting also can be used to guide management in making financing, investing, and operations decisions for the company. This branch of accounting is called **managerial accounting**. Financial and managerial accounting may overlap. For example, financial reports for external stakeholders are often used by managers in assessing the potential impact of their decisions on the company.

The chief accountant of a company is called the comptroller or chief financial officer.