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# FINANCIAL ACCOUNTING

THE IMPACT ON DECISION MAKERS

PORTER / NORTON

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# Financial Accounting

THE IMPACT ON DECISION MAKERS

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To those who really “count”

Melissa

Kathy, Amy, Andrew

In memory of

Sophie

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# Preface

## Seeing the Forest for the Trees

*Accounting is more than just recording business events.* It is a powerful tool for investors, managers, and decision makers. It is a common and powerful tool in every business.

## Connecting to the Big Picture

By demonstrating that accounting is an important decision-making tool, Porter/Norton's *Financial Accounting*, 10e helps students see the big picture and understand how accounting is more than recording a series of events. Students that understand why accounting is important are more motivated to learn and succeed.

This text uses a variety of methods to connect students to the big picture. First, a hallmark of this text has always been emphasizing why accounting is important through the use of financial statements and other data for real-world company examples, chapter openers, and end-of-chapter material, giving students the opportunity to use that data to apply what they're learning.

This emphasis is continued through the text's unique journal entry analysis model:

<b>Journal Entry Analysis</b>	<b>July 25</b>	Accounts Receivable	1,000									
		Service Revenue		1,000								
		To recognize revenue from house painting.										
		The accounting equation must balance after each transaction is recorded. Throughout the remainder of the book, each time a journal entry is recorded, the effect of the entry on the equation is illustrated. The effect of the preceding entry on the equation is as follows:										
		<b>Balance Sheet</b>		<b>Income Statement</b>								
		ASSETS	=	LIABILITIES	+	STOCKHOLDERS' EQUITY	←	REVENUES	-	EXPENSES	=	NET INCOME
		Accounts Receivable	1,000			1,000		Service Revenue	1,000			1,000

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

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

This model is extended into the end-of-chapter material and CengageNOWv2™. In CengageNOWv2, in addition to completing the journal entry in a Blank Sheet of Paper Experience, students are also expected to demonstrate that they understand the link between transactions and financial statements—consistent with the text.

The screenshot shows a software window titled "Instructions" with a sub-window "Journal". The instructions state: "Prepare a Journal entry on June 30 for the transaction described in the Instructions. Refer to the Chart of Accounts for exact wording of account titles." Below the instructions is a "GENERAL JOURNAL" table with columns for DATE, DESCRIPTION, DEBIT, and CREDIT. Three entries are shown: 1. Jun. 30 Cash 550; 2. Notes Receivable 500; 3. Interest Revenue 50. To the right of the journal are templates for "BALANCE SHEET" and "INCOME STATEMENT".

GENERAL JOURNAL				BALANCE SHEET		INCOME STATEMENT							
DATE	DESCRIPTION	DEBIT	CREDIT	A	=	L	+	SE	R	-	E	-	NI
1 Jun. 30	Cash	550			+								
2	Notes Receivable		500	-									
3	Interest Revenue		50					+		+			+

Other features throughout the book help students make the connection and see the big picture:

- Focus on highly recognizable companies such as Chipotle, Panera Bread, Nike, and many others draws students into the chapter.
- Financial statements and notes from Chipotle and Panera Bread allow students to apply the accounting models they're learning to real financial data from two companies in the same industry.

The real-world flavor that demonstrates how accounting can be used to make decisions continues in the end-of-chapter activities. **Decision Cases** ask students to read and interpret financial statements:

## DECISION CASES

### Reading and Interpreting Financial Statements

#### LO3 Decision Case 4-1 Comparing Two Companies in the Same Industry: Chipotle and Panera Bread



REAL WORLD

Refer to the financial information for **Chipotle** and **Panera Bread** reproduced at the back of the book for the information needed to answer the following questions.

#### Required

1. Locate the note in each company's annual report included in its Form 10-K for the 2014 year in which it discusses revenue recognition. How does each company describe the point at which it recognizes revenue from customers? Are there any significant differences in the organizations' revenue recognition policies?
2. What dollar amount does Chipotle report for accounts receivable on its most recent balance sheet? What percent of the company's total current assets are comprised of accounts receivable? What is the dollar amount of Panera Bread's trade accounts receivable on its most recent balance sheet? What percent of total current assets is comprised of accounts receivable? For which company does its accounts receivable constitute a higher percentage of its total current assets?

- Each chapter highlights a focus company and real company information is used throughout the narrative and end-of-chapter activities to help students develop their analytical skills.

- **Connect to the Real World** features ask students to read and interpret the financial statements of the chapter’s focus company, applying what they have learned in the chapter.
- **NEW HOW WILL I USE ACCOUNTING?** feature demonstrates relevance by providing students with examples of how marketing, sales, and management professionals use accounting in their careers.

CONNECT TO THE REAL WORLD

**NORDSTROM**  
 READING THE BALANCE SHEET

**4-1** The note from page 42 of Nordstrom’s Form 10-K for the fiscal year ended February 1, 2014 explains that gift card liabilities are included in other current liabilities. The gift card liability is \$255 million at the end of 2013 and \$231 million at the end of 2012. Refer to Nordstrom’s partial balance sheet shown in the chapter opener. What percentage of total current liabilities is made up of gift card liabilities at the end of 2013 and 2012? (See answers on p. 217.)

## How Will I Use ACCOUNTING?

If you start up your own company it is very likely you will extend credit to your customers. Financial statements are the starting point in evaluating the credit-worthiness of a potential customer. They tell you about the company’s liquidity, its profitability and how it uses its cash. Granting credit always involves some degree of risk, but only after reading the financials are you able to make an informed decision.

- The Ratio Analysis Model guides students through formulating a question about a real company, and then calculating, comparing, and interpreting ratios. Students will identify relevant financial information, analyze that information, and make better business decisions based on what they uncover – powerfully demonstrating the relevance and importance of accounting.

### A. The Ratio Analysis Model

- Formulate the Question**  
How many times a year does the company turn over its accounts receivable?
- Gather the information from the Financial Statements**  
To calculate a company’s accounts receivable turnover ratio, it is essential to know its net credit sales and the average balance in accounts receivable:
  - Net credit sales: From the income statement
  - Average accounts receivable: From the balance sheet at the end of the two most recent years
- Calculate the Ratio**  

$$\text{Accounts Receivable Turnover} = \frac{\text{Net Credit Sales}}{\text{Average Accounts Receivable}}$$

Apple Inc. Partial Consolidated Statements of Operations (in millions)			
	Years Ended		
	September 27, 2014	September 28, 2013	September 29, 2012
Net sales	\$182,795	\$170,910	\$156,508
Cost of sales	112,258	106,606	87,846
Gross margin	\$ 70,537	\$ 64,304	\$ 68,662

Apple Inc. Partial Consolidated Balance Sheets (in millions)		
	September 27, 2014	September 28, 2013
Current assets:		
Accounts receivable, less allowances of \$86 and \$99, respectively	\$ 17,460	\$13,102

Accounts Receivable Turnover =  $\frac{\$182,795}{\$15,281} = 12.0$  times

\*Assuming all sales are on credit.

Average accounts receivable less allowances =  $(\$17,460 + \$13,102) / 2 = \$15,281$
- Compare the Ratio with Other Ratios**  
Ratios are of no use in a vacuum. It is necessary to compare them with prior years and with competitors.

ACCOUNTS RECEIVABLE TURNOVER RATIO				
Apple Inc.		Hewlett-Packard		
Year Ended	Year Ended	Year Ended	Year Ended	Year Ended
September 27, 2014	September 28, 2013	October 31, 2014	October 31, 2013	October 31, 2013
12.0 times	14.2 times	7.5 times**	7.5 times**	6.9 times**

\*\*Based on "Products and Services Revenues."

**5. Interpret the Ratios**

In fiscal year 2014, Apple Inc. turned over its accounts receivable an average of 12.0 times. This is slower than the turnover in the prior year, but the turnover for both years is quicker than the ratios for its competitor, Hewlett-Packard. An alternative way to look at a company's efficiency in managing its accounts receivable is to calculate the number of days, on average, that accounts receivables are outstanding. This measure is called **number of days' sales in receivables** and is calculated as follows for Apple Inc. in 2014, assuming 360 days in a year:

$$\begin{aligned} \text{Number of Days' Sales in Receivables} &= \frac{\text{Number of Days in the Period}}{\text{Accounts Receivable Turnover Ratio}} \\ &= \frac{360}{12.0} \\ &= 30 \text{ days} \end{aligned}$$

This measure tells us that it took Apple Inc. 30 days or one month on average to collect its accounts receivable.

The Business Decision Model moves a step beyond ratios by formulating a question as a user of financial information, gathering and analyzing the necessary information, making a decision, and then monitoring that decision. This framework, integrated throughout the text, provides students with models for honing their analysis and decision-making skills using real company information in a relevant, applicable context.

**B. The Business Decision Model****1. Formulate the Question**

If you were a banker, would you loan money to Apple Inc.?

**2. Gather Information from the Financial Statements and Other Sources**

This information will come from a variety of sources, not limited to but including:

- The balance sheet provides information about liquidity, the income statement regarding profitability, and the statement of cash flows on inflows and outflows of cash.
- The outlook for the computer industry, including consumer trends, foreign markets, labor issues, and other factors.
- The outlook for the economy in general.
- Alternative uses for the money.

**3. Analyze the Information Gathered**

- Compare Apple Inc.'s accounts receivable turnover ratio in (A) above with Hewlett-Packard as well as with industry averages.
- Look at trends over time in the accounts receivable turnover ratios.
- Look at trends in net income over time as an indication of the ability to control expenses other than cost of goods sold.
- Review projections for the economy and the industry.

**4. Make the Decision**

Taking into account all of the various sources of information, decide either to

- Loan money to Apple Inc. or
- Find an alternative use for the money

**5. Monitor Your Decision**

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

**Built for Today's Students**

In addition to helping students see the big picture and understand why accounting is important, Porter/Norton's *Financial Accounting*, 10e is built for today's students.

**New to this edition, the unique modular organization** breaks the chapter into logical groupings of concepts, allowing students to absorb the chapter content in smaller sections for better retention.



**Test Yourself reviews**, at the end of each module, provide students with an opportunity to check their understanding, answer questions, and work brief exercises to build confidence. Solutions to Test Yourself, located at the end of the chapter, allow students to check their answers.

MODULE 1 TEST YOURSELF		
<b>Review</b>	<b>LO1</b> Explain the difference between external and internal events.	<ul style="list-style-type: none"> <li>Both of these different types of events affect an entity and are usually recorded in the accounting system as a transaction.</li> <li>External events are interactions between an entity and its environment.</li> <li>Internal events are interactions entirely within an entity.</li> </ul>
	<b>LO2</b> Explain the role of source documents in an accounting system.	<ul style="list-style-type: none"> <li>Source documents provide the evidence needed to begin the procedures for recording and processing a transaction.</li> <li>These documents need not be in hard copy form and can come from parties that are either internal or external to the company.</li> </ul>
	<b>LO3</b> Analyze the effects of transactions on the accounting equation and understand how these transactions affect the balance sheet and the income statement.	<ul style="list-style-type: none"> <li>The accounting equation illustrates the relationship between assets, liabilities, and stockholders' equity accounts. Understanding these relationships helps to see the logic behind the double-entry system in recording transactions.</li> <li>The accounting equation: Assets = Liabilities + Stockholders' Equity</li> <li>This equality must always be maintained. The equation can be expanded to show the linkage between the balance sheet and the income statement through the Retained Earnings account:</li> </ul> <p style="text-align: center;"><b>Assets = Liabilities + Capital Stock + Retained Earnings</b></p>
<b>Question</b>	<ol style="list-style-type: none"> <li>What are the two types of events that affect an entity? Describe each.</li> <li>What is the significance of source documents to the recording process? Give two examples of source documents.</li> </ol>	
<b>Apply</b>	<ol style="list-style-type: none"> <li>Provide three examples of source documents and the event for which each would provide the evidence to record.</li> <li>List the three elements in the accounting equation. How is the third element expanded to show the linkage between the balance sheet and the income statement?</li> <li>Third State Bank loans a customer \$5,000 in exchange for a promissory note. What is the effect of this transaction on the bank's accounting equation?</li> <li>Assume that <b>Vail Resorts</b> borrows \$5 million by signing a promissory note. The next day the company uses the money to buy new ski lifts. What is the effect of each of these transactions on Vail Resorts' accounting equation?</li> </ol>	

Answers are located at the end of the chapter.

- **Study Tips** in the margins alert students to be on the lookout for certain things. This could be the similarities between two different concepts or a warning to watch out for a common pitfall.

**CengageNOWv2.** CengageNOWv2 for Porter/Norton's *Financial Accounting*, 10e helps elevate student thinking with unique content that addresses each stage of the learning process from motivation to mastery. This integrated solution provides tools and resources specifically developed to **motivate** students to learn, **apply accounting** concepts, and **achieve mastery** of course content.

**In a recent survey of nearly 300 CengageNOW student users:**

- **Motivation:** 77% said that using CengageNOW made them more interested/engaged in the course.
- **Application:** 87% said that CengageNOW made completing homework an effective learning process.
- **Mastery:** 72% said CengageNOW helped them go beyond memorization and recall to reach higher levels of learning.
- **76%** said the use of CengageNOW helped them better understand why accounting matters and the importance of accounting in making critical business decisions.

### STUDY TIP

Think of the Accumulated Depreciation account as an extension of the related asset account, in this case, the Store Fixtures account. Therefore, although the Store Fixtures account is not directly reduced for depreciation, a credit to its companion account, Accumulated Depreciation, has the effect of reducing the asset.





## **Motivation: Set Expectations and Prepare Students for the Course**

CengageNOWv2 helps motivate students and get them ready to learn by reshaping their misconceptions about the introductory accounting course, and providing a powerful tools to engage students.

**CengageNOWv2 Start-Up Center.** Students are often surprised by the amount of time they need to spend outside of class working through homework assignments in order to succeed. The **CengageNOWv2 Start-Up Center** will help students identify what they need to do and where they need to focus in order to be successful with a variety of brand new resources.

**NEW What Is Accounting?** Module ensures students understand course expectations and how to be successful in the introductory accounting course. This module consists of two assignable videos: *Introduction to Accounting* and *Success Strategies*. The Student Advice Videos offer advice from real students about what it takes to do well in the course.

**NEW Math Review Module**, designed to help students get up to speed with necessary math skills, includes **math review assignments** and **Show Me How** math review videos to ensure that students have an understanding of basic math skills, including:

- Whole number operations
- Decimal operations and rounding
- Percentage operations and conversion
- Fraction operations
- Converting numbers expressed in one form to a different form
- Positive and negative numbers
- Ratios and averages

**NEW How to Use CengageNOWv2 Module** focuses on learning accounting, not on a particular software system. Quickly familiarize your students with CengageNOWv2 and direct them to all of its built-in student resources.

## **Motivation: Engage Students and Better Prepare Them for Class.**

With all the outside obligations accounting students have, finding time to read the textbook before class can be a struggle. Point students to the key concepts they need to know before they attend class.

**Video: Tell Me More.** Short Tell Me More lecture activities explain the core concepts of the chapter through an engaging auditory and visual presentation. Available both on a stand-alone basis or as an assignment, they are ideal for all class formats—flipped model, online, hybrid, face-to-face.

**Financial Analysis and Interpretation:  
Accounts Receivable Turnover**

- The **accounts receivable turnover** measures how frequently during the year the accounts receivable are being converted to cash.
- The accounts receivable turnover is computed as follows:

$$\text{Accounts Receivable Turnover} = \frac{\text{Sales}}{\frac{\text{Beginning accounts receivable} + \text{Ending accounts receivable}}{2}}$$

**Beginning accounts receivable  
plus ending accounts receivable**

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Students don't want to waste time going over concepts that they have already mastered. With the NEW Adaptive Study Plan, they can focus on learning new topics and fully understanding difficult concepts.

**NEW Adaptive Study Plan** in CengageNOWv2 is an assignable/gradable study center that adapts to each student's unique needs and provides a remediation pathway to keep students progressing. With the NEW Adaptive Study Plan, they can focus on learning new topics and fully understanding difficult concepts.

The screenshot displays the user interface for Chapter 8 - Receivables. At the top, there are tabs for 'Study', 'Quiz', and 'View Progress'. Below the tabs is a progress bar and a 'Take a Quiz' button. The main content is divided into two sections: 'Objectives' and 'Activities'. The 'Objectives' section has a filter for 'All' and a list of seven objectives. The eighth objective is highlighted in blue and underlined: '8. Describe and illustrate the use of accounts receivable turnover and number of days sales in receivables to evaluate a company's efficiency in collecting its receivables'. The 'Activities' section has a list of four activities, with the first one highlighted in blue: 'eBook - 8.8: Financial Analysis and Interpretation: Accounts Receivable Turnover and Number of Days' Sales in Receivables'.

## How Does It Work?

**Step 1:** Students take a chapter-level quiz consisting of random questions that cover both conceptual and procedural aspects of the chapter.

**Step 2:** Feedback is provided for each answer option explaining why the answer is right or wrong.

**Step 3:** Based on the quiz results, students are provided a remediation path that includes media assets and algorithmic practice problems to help them improve their understanding of the course material.

Instructors may use prerequisites that require students to achieve mastery in the Adaptive Study Plan before moving on to new material.

Using the Adaptive Study Plan, students may also review and check their knowledge with the new Practice! Activities. These items (generally one per learning objective) build application skills by allowing students to complete practice problems and “Try Another Version.”

*“The new Adaptive Study Plan offers the benefit of customization coupled with remediation.”*

**– Jennifer Schneider,  
professor at University of North Georgia**



## Application: Close the Gap between Homework and Exam Performance

Many students perform well on homework but struggle when it comes to exams. Now, with the new Blank Sheet of Paper Experience in CengageNOWv2, students must problem solve on their own, just as they would if taking a test on a blank sheet of paper.

- **Blank Sheet of Paper Experience.** A less-leading Blank Sheet of Paper Experience discourages overreliance on the system.
- The use of drop-down menus and Smart Entry (type-ahead) has been eliminated.
- Students must decide for themselves what account is impacted.
- The number of accounts in each transaction is not given away.
- Whether the account should be debited or credited is not given away.
- Transactions may be entered in any order (as long as the entries are correct).
- Check My Work feedback only reports on what students have actually attempted, which prevents students from “guessing” their way through the assignment.

Bamboo Consulting			
Balance Sheet			
July 31, 2016			
1	Assets		
2	(Label)		
3			
4			
5			
6			
7			
8	(Label)		
9			
10			
11			
12			
13	Liabilities		
14	(Label)		
15			
16			
17			
18			
19	Owner's equity		
20			
21			

*"This will minimize students' complaints about how the exam looks different from the homework format."*  
 – Rama Ramamurthy, professor  
 at Georgetown University

*"I like it because it appears to bridge the gap between the homework and my exam."*

– Lawrence Chui, professor  
 at University of St. Thomas

*"Good tool to make students understand concepts without overly relying on technology's help."*

– Ramesh Narasimhan, professor  
 at Montclair State University

### Application: Connect the Transactions to the Financial Statements

- **NEW** Journal entries in CengageNOWv2™ require students to demonstrate understanding of not only debits and credits but the impact of transactions on the balance sheet and income statement.

*"Really like that it now links a journal entry with both the accounting equation and these two basic financial statements ... Think this helps students see big picture and understand how each journal entry can affect the business's financials."*

– Timothy Griffin, professor at Hillsborough CC



*“The benefit would be in regularly reinforcing balance sheet impact of transactions along with traditional journalizing. It is never a bad thing to remind students that, ultimately, EVERY transaction has an impact on the balance sheet.”*

*– Michael Gurevitz, professor at Montgomery College*

*“This is a method I would use to teach my students. It is much clearer than the other methods presented.”*

*– Marie Kelly, professor at Stephen F. Austin State University*

**Application: Help Students See the Big Picture.** Homework software should not get in the way of learning. One of the biggest complaints students have about online homework is the scrolling, which prevents students from seeing the big picture and understanding the accounting system. The new Multi-Panel View addresses this issue and enhances student learning.

- **Multi-Panel View.** The new Multi-Panel View in CengageNOWv2 enables students to see all the elements of a problem on one screen.
  - Students make connections and see the tasks as connected components in the accounting process.
  - Dramatically reduced scrolling eliminates student frustration.

With the ability to move and resize journals, ledgers, forms, and financial statements, it is easier to navigate the problem and understand the accounting system.

The screenshot displays three panels from the CengageNOWv2 software interface, illustrating the Multi-Panel View. The panels are:

- Instructions:** Contains the problem description and the adjusted trial balance for Bamboo Consulting as of July 31, 2016.
- Income Statement:** A blank form for preparing an income statement for the year ended July 31, 2016.
- Statement of Owner's Equity:** A blank form for preparing a statement of owner's equity for the year ended July 31, 2016.

The adjusted trial balance table from the Instructions panel is as follows:

Bamboo Consulting ADJUSTED TRIAL BALANCE July 31, 2016			
ACCOUNT TITLE	DEBIT	CREDIT	
1 Cash	57,100.00		1
4 Accounts Receivable	108,400.00		2
2 Supplies	6,625.00		3
7 Prepaid Insurance	5,400.00		4
2 Office Equipment	245,000.00		5
4 Accumulated Depreciation		33,600.00	6
7 Accounts Payable		8,225.00	7
8 Note Payable		10,500.00	8
9 Salaries Payable		2,500.00	9
20 Lisa Gosh's Capital		518,700.00	10
18 Lisa Gosh's Drawing	25,000.00		11
12 Fees Earned		318,300.00	12
14 Rent Revenue		16,750.00	13
24 Supplies Expense	7,500.00		14
26 Salary Expense	134,470.00		15

*“This is just a lot better and less confusing than scrolling up and down. ... Having it like that would make it much easier—not so much scrolling and it wouldn’t be so confusing.”*

**– Tyler Mason,  
Northern Essex Community College**

*“Multi-Panel View makes it much easier for students to see how each piece of the accounting cycle impacts the other pieces. Having it all in one view reduces student frustration and gives them a clearer picture of the complete accounting cycle.”*

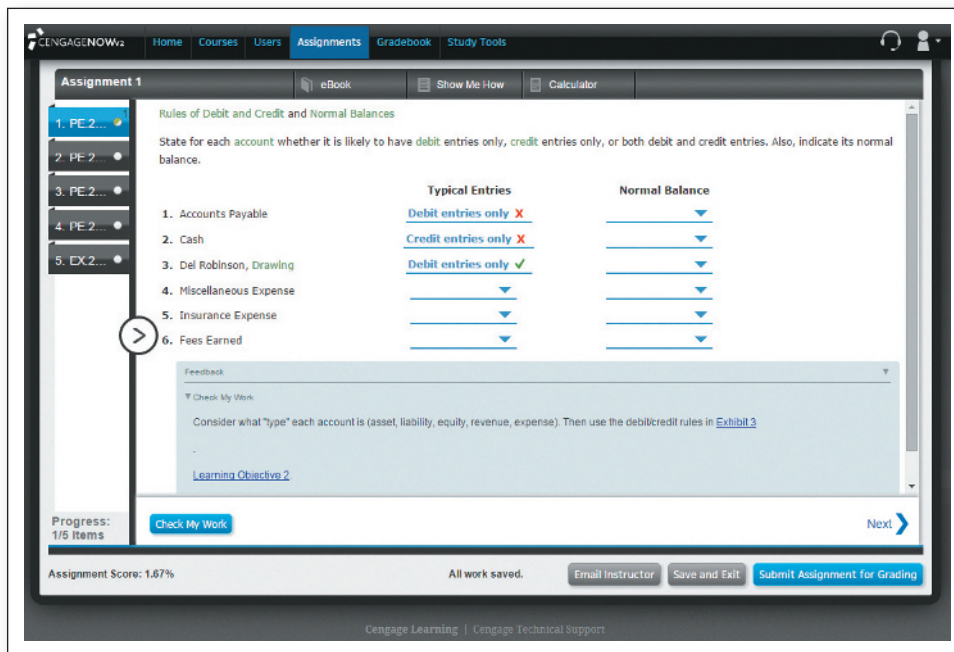
**– Kristen Quinn, professor  
at Northern Essex Community College**

**Application: Keep Students on Track and Progressing.** Students often complete homework at odd times. And when they use CengageNOWv2, they get help right when they need it.

**NEW Adaptive Feedback.** Adaptive Feedback in CengageNOWv2 responds to students based upon their unique answers and alerts them to the type of error they have made without giving away the answer.

In addition to groundbreaking, adaptive feedback, CengageNOWv2 continues to provide multiple layers of guidance to keep students on track and progressing.

- **Check My Work Feedback** provides general guidance and hints as students work through homework assignments.
- **NEW Check My Work Feedback** in CengageNOWv2 now only reports on what students have actually attempted, which prevents them from “guessing” their way through assignments.



- **Post-Submission Feedback** is available after the assignment has been submitted and provides a detailed description of how to arrive at the solution.

*"I like the adaptive feedback. It will reduce a number of errors that cause students to give up."*

*– Kevin Jones, professor at Drexel University*

*"Excellent! Often learning from feedback is more powerful than learning from the instructor, text, etc."*

*– Lisa Brown, professor at Indiana Institute of Technology*

**Application: Provide Help Right When Students Need It.** The best way to learn accounting is through practice, but students often get stuck when attempting homework assignments on their own.



**Video: Show Me How.** Created for the most frequently assigned end-of-chapter items, NEW Show Me How problem demonstration videos provide a step-by-step model of a similar problem. Embedded tips and warnings help students avoid common mistakes and pitfalls.

Trial Balance			
The following list of accounts was taken from the general ledger of Spencer Corporation on December 31. The bookkeeper thought it would be helpful if the accounts were arranged in alphabetical order. Each account contains the balance that is normal for that type of account; for example, Cash normally has a debit balance. Prepare a trial balance as of this date with the accounts arranged in the following order: (1) assets, (2) liabilities, (3) stockholders' equity, (4) revenues, (5) expenses, and (6) dividends.			
Account	Balance	Account	Balance
Accounts Payable	\$ 7,650	Heat, Light, and Water Expense	\$ 1,400
Accounts Receivable	5,325	Income Tax Expense	1,700
Automobiles	9,200	Income Taxes Payable	2,500
Buildings	150,000	Interest Revenue	1,300
Capital Stock	100,000	Land	50,000
Cash	10,500	Notes Payable	90,000
Commissions Expense	2,600	Office Salaries Expense	6,000
Commissions Revenue	2,000	Office Supplies Expense	500
Dividends	8,000	Retained Earnings	110,025
Equipment	81,000		

**from the general ledger  
have been provided.**

**Mastery: Help Students Go Beyond Memorization to True Understanding.** Students often struggle to understand how concepts relate to one another. For most students, an introductory accounting course is their first exposure to both *business transactions* and the *accounting system*. While these concepts are already difficult to master individually, their combination and interdependency in the introductory accounting course often pose a challenge for students.

- **Mastery Problems.** New Mastery Problems enable you to assign problems and activities designed to test students' comprehension and mastery of difficult concepts. Can they apply what they have learned to a new problem set that offers a twist?
- **Decision Cases.** Decision Cases require students to read and interpret financial statements from real-world companies—applying learned concepts to real firms and real situations.



# Chapter-by-Chapter Changes

## Chapter 1

- Introduced modular approach to chapter topics, including Test Yourself with Review, Question, and Apply at the end of each module.
- Introduced one of two new flagship companies, Chipotle Mexican Grill, Inc., as the focus company for Chapter 1.
- Revised Exhibits 1-1, 1-3, 1-7, and 1-8 to reflect new flagship company, Chipotle Mexican Grill, Inc.
- Introduced new feature: How Will I Use Accounting?
- Revised “Connect to the Real World” feature (Real World Practice in prior edition) to reflect new flagship company.
- Updated end-of-chapter material: E1-9, E1-16, P1-8, P1-9, P1-8A, and P1-9A.
- Revised DC1-1 and DC1-2 to reflect new flagship company, Chipotle Mexican Grill, Inc.
- Revised DC1-3 to reflect new flagship companies, Chipotle Mexican Grill, Inc., and Panera Bread Company.
- Added Answers to “Questions” and “Apply” at the end of the chapter for all modules.
- Added Answers to “Connect to the Real World” at the end of the chapter.

## Chapter 2

- Introduced modular approach to chapter topics, including Test Yourself with Review, Question, and Apply at the end of each module.
- Introduced one of two new flagship companies, Panera Bread Company, as the focus company for Chapter 2.
- Introduced new feature: How Will I Use Accounting?
- Revised Exhibits 2-1, 2-2, and 2-3 to reflect new flagship company, Panera Bread Company.
- Revised “Connect to the Real World” feature (Real World Practice in prior edition) to reflect new flagship company.
- Revised Ratio Decision and Business Decision Models for the Current Ratio to reflect new flagship company.
- Revised Ratio Decision Model for the Profit Margin Ratio to reflect new flagship company.
- Revised Exercise 2-3 to reflect Regal Entertainment Group.
- Updated end-of-chapter material: P2-10 and P2-10A.
- Revised DC2-1 to reflect new flagship companies, Chipotle Mexican Grill, Inc., and Panera Bread Company.
- Revised DC2-2 to reflect new flagship company, Panera Bread Company.
- Added Answers to “Questions” and “Apply” at the end of the chapter for all modules.
- Added Answers to “Connect to the Real World” at the end of the chapter.

## Chapter 3

- Introduced modular approach to chapter topics, including Test Yourself with Review, Question, and Apply at the end of each module.
- Introduced Vail Resorts, Inc., as the new focus company for Chapter 3.
- Revised “Connect to the Real World” feature (Real World Practice in prior edition) to reflect new focus company, Vail Resorts, Inc.
- Revised E3-7 and E3-16 to reflect new focus company, Vail Resorts, Inc.
- Revised DC3-1 to reflect new flagship companies, Chipotle Mexican Grill and Panera Bread Company.
- Revised DC3-2 to reflect new flagship company, Panera Bread Company.
- Updated end-of-chapter material: DC3-3.

- Added Answers to “Questions” and “Apply” at the end of the chapter for all modules.
- Added Answers to “Connect to the Real World” at the end of the chapter.

## **Chapter 4**

- Introduced modular approach to chapter topics, including Test Yourself with Review, Question, and Apply at the end of each module.
- Updated the chapter opener with the most current information available and replaced the financial statements from Nordstrom as the focus company for Chapter 4.
- Introduced new feature: How Will I Use Accounting?
- Revised section on the revenue recognition principle to conform to new accounting standard.
- Updated “Connect to the Real World” (Real World Practice in prior edition) for new information for Nordstrom, Inc.
- Updated end-of-chapter material: E4-31, DC4-2, and DC4-3.
- Revised DC3-1 to reflect new flagship companies, Chipotle Mexican Grill and Panera Bread Company.
- Added Answers to “Questions” and “Apply” at the end of the chapter for all modules.
- Added Answers to “Connect to the Real World” at the end of the chapter.

## **Chapter 5**

- Introduced modular approach to chapter topics, including Test Yourself with Review, Question, and Apply at the end of each module.
- Updated the chapter opener with the most current information available and replaced the financial statements from Gap Inc. as the focus company for Chapter 5.
- Introduced new feature: How Will I Use Accounting?
- Revised Net Sales of Merchandise section to conform to new FASB standard on revenue recognition, “Revenue from Contracts with Customers.”
- Revised coverage of purchase returns and allowances to conform to coverage of sales returns and allowances.
- Revised coverage of purchase discounts to illustrate the net method of recording.
- Updated Example 5-14 for Winnebago Industries’ LIFO reserve.
- Revised Exhibit 5-11, substituting a partial statement of cash flows for Chipotle Mexican Grill, Inc.
- Updated “Connect to the Real World” (Real World Practice in prior edition) for new information for Gap Inc.
- Updated Ratio Model for the Gross Profit Ratio for new information available.
- Updated Ratio Model for the Inventory Turnover Ratio for new information available.
- Deleted Exercise requiring detailed entries for purchase discounts, returns, and allowances.
- Updated end-of-chapter material: E5-16, P5-2, P5-5, P5-8, P5-14, P5-2A, P5-5A, P5-8A, P5-14A, DC5-2, and DC5-3.
- Revised DC5-1 to reflect new flagship companies, Chipotle Mexican Grill, Inc. and Panera Bread Company.
- Deleted Decision Case on sales returns and allowances.
- Revised DC5-9 to integrate the concept of ethics in accounting with the practice of modeling ethical decision making.
- Added Answers to “Questions” and “Apply” at the end of the chapter for all modules.
- Added Answers to “Connect to the Real World” at the end of the chapter.

## **Chapter 6**

- Introduced modular approach to chapter topics, including Test Yourself with Review, Question, and Apply at the end of each module.
- Introduced Regal Entertainment Group as the new focus company for Chapter 6.
- Updated “Connect to the Real World” (Real World Practice in prior edition) for new flagship company, Panera Bread Company.

- Revised Exhibits 6-1, 6-4, and 6-5 to illustrate statements and reports for new focus company, Regal Entertainment Group.
- Revised DC6-1 to reflect new flagship companies, Chipotle Mexican Grill, Inc., and Panera Bread Company.
- Updated end-of-chapter material: DC6-2.
- Added Answers to “Questions” and “Apply” at the end of the chapter for all modules.
- Added Answers to “Connect to the Real World” at the end of the chapter.

## **Chapter 7**

- Introduced modular approach to chapter topics, including Test Yourself with Review, Question, and Apply at the end of each module.
- Updated the chapter opener with the most current information available and replaced the financial statements from Apple Inc. as the focus company for Chapter 7.
- Introduced new feature: How Will I Use Accounting?
- Updated “Connect to the Real World” (Real World Practice in prior edition) for new information for Apple Inc.
- Updated Ratio Decision Model for the Accounts Receivable Turnover Ratio with new information available.
- Revised E7-5 to reflect Nike.
- Updated end-of-chapter material: P7-3, P7-3A, DC7-1, DC7-2, and DC7-3.
- Added Answers to “Questions” and “Apply” at the end of the chapter for all modules.
- Added Answers to “Connect to the Real World” at the end of the chapter.

## **Chapter 8**

- Introduced modular approach to chapter topics, including Test Yourself with Review, Question, and Apply at the end of each module.
- Updated the chapter opener with the most current information available and replaced the financial statements from Nike as the focus company for Chapter 8.
- Introduced new feature: How Will I Use Accounting?
- Updated Ratio Decision Model with new information for Nike and Foot Locker.
- Updated end-of-chapter material: DC8-1 features Panera Bread Company, and DC8-2 reflects Panera Bread Company and Chipotle.
- Added Answers to “Questions” and “Apply” at the end of the chapter for all modules.
- Added Answers to “Connect to the Real World” at the end of the chapter.

## **Chapter 9**

- Introduced modular approach to chapter topics, including Test Yourself with Review, Question, and Apply at the end of each module.
- Updated the chapter opener with the most current information available and replaced the financial statements from Starbucks as the focus company for Chapter 9.
- Introduced new feature: How Will I Use Accounting?
- Changed Exhibit 9-4 concerning contingent liabilities.
- Updated P9-2 for Burger King, P9-3 for Brinker, P9-2A for McDonald’s, and P9-3A for Darden Restaurants.
- Changed DC9-1 to Panera Bread Company and Chipotle.
- Updated DC9-2 for Caribou Coffee, DC9-3 for Walmart, and DC9-4 for Hewlett-Packard.
- Added Answers to “Questions” and “Apply” at the end of the chapter for all modules.
- Added Answers to “Connect to the Real World” at the end of the chapter.

## **Chapter 10**

- Introduced modular approach to chapter topics, including Test Yourself with Review, Question, and Apply at the end of each module.
- Updated the chapter opener with the most current information available and replaced the financial statements from Coca-Cola and Pepsi as the focus companies for Chapter 10.

- Updated Ratio Decision Model with new information for Coca-Cola and Pepsi.
- Eliminated references to extraordinary items because of FASB pronouncement.
- Updated P10-9 on Walgreens and P10-9A on Boeing.
- Retained the section on leasing but noted pending FASB pronouncement. This module can be skipped by instructors and it will not affect other portions of the chapter.
- DC10-1 features Panera Bread Company, and DC10-2 reflects Panera Bread Company and Chipotle. DC10-3 has been updated for Pepsi.
- Added Answers to “Questions” and “Apply” at the end of the chapter for all modules.
- Added Answers to “Connect to the Real World” at the end of the chapter.

## **Chapter 11**

- Introduced modular approach to chapter topics, including Test Yourself with Review, Question, and Apply at the end of each module.
- Updated the chapter opener with the most current information available and replaced the financial statements from Southwest Airlines as the focus company for Chapter 11.
- Introduced new feature: How Will I Use Accounting?
- Updated end-of-chapter material: P11-7 for Southwest Airlines and P11-7A for Costco.
- DC11-1 features Panera Bread Company and Chipotle, and DC11-2 highlights Panera Bread Company.
- Made substantial changes to Interactive Problem to eliminate leasing as one of the alternatives. Problem is now more straightforward.
- Added Answers to “Questions” and “Apply” at the end of the chapter for all modules.
- Added Answers to “Connect to the Real World” at the end of the chapter.

## **Chapter 12**

- Introduced modular approach to chapter topics, including Test Yourself with Review, Question, and Apply at the end of each module.
- Updated the chapter opener with the most current information available and replaced the financial statements from Walgreen Co. as the focus company for Chapter 12.
- Deleted exhibit detailing cash flow and net income differences for four companies.
- Updated “Connect to the Real World” (Real World Practice in prior edition) for new flagship company Chipotle Mexican Grill, Inc., and for new information for Apple Inc.
- Updated Ratio Decision Model for the Cash Flow Adequacy Ratio with new information available.
- Updated end-of-chapter material: E12-4, DC12-2, and DC12-3.
- Revised DC12-1 to reflect new flagship companies, Chipotle Mexican Grill, Inc., and Panera Bread Company.
- Added Answers to “Questions” and “Apply” at the end of the chapter for all modules.
- Added Answers to “Connect to the Real World” at the end of the chapter.

## **Chapter 13**

- Introduced modular approach to chapter topics, including Test Yourself with Review, Question, and Apply at the end of each module.
- Updated the chapter opener with the most current information available and replaced the financial statements from lululemon athletica inc. as the focus company for Chapter 13.
- Updated Exhibit 13-1, with the most current information available for lululemon athletica inc.
- Updated “Connect to the Real World” (Real World Practice in prior edition) for new information for lululemon athletica inc. and for new flagship company Chipotle Mexican Grill, Inc.
- Deleted Appendix on Reporting and Analyzing Other Income Statement Items and end-of-chapter material to conform to new accounting standard to no longer allow recognition of extraordinary items on the income statement.

- Updated Review Problem for the most current information available for lululemon athletica inc.
- Updated end-of-chapter material: E13-5, E13-6, E13-7, and E13-8.
- Revised DC13-1 and DC13-2 to reflect new flagship company, Chipotle Mexican Grill, Inc.
- Revised DC13-3 to reflect new flagship companies, Chipotle Mexican Grill, Inc., and Panera Bread Company.
- Revised DC13-4 to reflect new flagship company, Panera Bread Company.
- Added Answers to “Questions” and “Apply” at the end of the chapter for all modules.
- Added Answers to “Connect to the Real World” at the end of the chapter.

## Additional Instructor and Student Supplements

### Instructor’s Manual

The Instructor’s Manual contains detailed lecture outlines, lecture topics, and suggestions for classroom activities. The chapter activities in the Instructor’s Manual have been analyzed and assigned the same set of objectives that are used in the Solutions Manual and the Test Bank (available on the Instructor Companion website).

### Solutions Manual

The Solutions Manual, by the text authors, consists of solutions to all the end-of-chapter material keyed to learning objectives and using the Journal Entry Analysis form of transaction notation for journal entries found in the text. (Available on the Instructor Companion website.)

### Test Bank

The Test Bank contains a comprehensive set of test items to meet every assessment need from brief exercises to problems and decision cases. The Test Bank is offered in Cognero.

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

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### Excel<sup>®</sup> Templates

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



### PowerPoint<sup>®</sup> Slides

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

### Student Web Resources

Chapter-by-chapter quizzes, topical discussions, updates on IFRS integration, and more are available. These items help reinforce and shed light on text topics. Discover more by logging into the text website. Visit [www.cengagebrain.com](http://www.cengagebrain.com).

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Dr. Porter's professional activities include experience as a staff accountant with Deloitte & Touche, a participant in KPMG Peat Marwick Foundation's Faculty Development program, and a leader in numerous bank training programs. He has won an Excellence in Teaching Award from the University of Colorado and Outstanding Professor Awards from both San Diego State University and the University of Montana. He served on the Illinois CPA Society's Innovations in Accounting Education Grants Committee, the steering committee of the Midwest region of the American Accounting Association, and the board of directors of the Chicago chapter of Financial Executives International.

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**Curtis L. Norton** is currently a Clinical Professor at Arizona State University. He is also a Professor Emeritus at Northern Illinois University in DeKalb, Illinois, where he has taught since 1976. Dr. Norton received his Ph.D. from Arizona State University and an M.B.A. from the University of South Dakota. Dr. Norton earned the University Excellence in Teaching Award at NIU and has published in *The Accounting Review*, *The Journal of Accounting Education*, *CPA Journal*, and other journals. A member of the American Accounting Association and Financial Executives International, he also consults and conducts training for private and governmental authorities, banks, utilities, and others.



# 1

# Accounting as a Form of Communication

MODULES	LEARNING OBJECTIVES	WHY IS THIS CHAPTER IMPORTANT?
<p><b>1</b> The Nature of Business</p>	<p><b>LO1</b> Explain what business is about.</p> <p><b>LO2</b> Distinguish among the forms of organization.</p> <p><b>LO3</b> Describe the various types of business activities.</p>	<ul style="list-style-type: none"> <li>You need to know what a business is. (See p. 4.)</li> <li>You need to know what forms of organization carry on business activities. (See pp. 5–6.)</li> <li>You need to know in what types of business activities those organizations engage. (See pp. 6–7.)</li> </ul>
<p><b>2</b> Accounting and Financial Statements</p>	<p><b>LO4</b> Define accounting and identify the primary users of accounting information and their needs.</p> <p><b>LO5</b> Explain the purpose of each of the financial statements and the relationships among them and prepare a set of simple statements.</p>	<ul style="list-style-type: none"> <li>You need to know what net income is and how it is measured. (See p. 13.)</li> <li>You need to know how revenue and net income relate to a company's assets. (See pp. 12–13.)</li> <li>You need to know where the various items appear on a company's financial statements. (See pp. 12–15.)</li> </ul>
<p><b>3</b> Conceptual Framework of Accounting</p>	<p><b>LO6</b> Identify and explain the primary assumptions made in preparing financial statements.</p> <p><b>LO7</b> Identify the various groups involved in setting accounting standards and the role of auditors in determining whether the standards are followed.</p> <p><b>LO8</b> Explain the critical role that ethics plays in providing useful financial information.</p>	<ul style="list-style-type: none"> <li>You need to know who determines the rules for the preparation of financial statements. (See pp. 21–22.)</li> </ul>

## MAKING BUSINESS DECISIONS

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# CHIPOTLE MEXICAN GRILL, INC.

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

Simply put, the more you know about how successful companies work, the better are your chances of doing well in your chosen field. And to know why these companies are successful you need to be able to read their financial statements. Whatever you plan to do, your knowledge of business and accounting helps you compete whether you invest, work for a company, or go into business for yourself.

Consider one very successful company, **Chipotle Mexican Grill, Inc.** Maybe you are a frequent customer at one of its restaurants. The company got its start in 1993, when Steve Eells left his job as a chef and with a modest loan from his parents opened his first restaurant in a former ice cream shop in Denver. Over the next few years, additional restaurants were opened in the Denver area. In 1998 the entrepreneur brought in outside investors to help finance his grow-

ing chain. And, in 2006, Chipotle went public on the New York Stock Exchange.

With each of these decisions Steve Eells made was a calculated risk: quitting his job to go it alone, opening new restaurants, bringing in new investors, and going public. How can we know whether they were good decisions? The financial statements produced by an accounting system go a long way in assessing a company's performance. Look at the Revenue data shown below as they appeared in Chipotle's 2014 Form 10-K, the annual report filed with the Securities and Exchange Commission. You can see that Chipotle has grown to a chain of 1,783 restaurants generating revenue of over \$4 billion!

As you study accounting, you will learn how to read financial statements and what they can tell you about a company's performance and the decisions they make—such as those made by a one-time chef who built one of the most successful restaurant chains in the country.

### Revenue

	Years ended December 31			% increase 2014 over 2013	% increase 2013 over 2012
	2014	2013	2012		
	(dollars in millions)				
Revenue	\$4,108.3	\$3,214.6	\$2,731.2	27.8%	17.7%
Average restaurant sales	\$ 2.472	\$ 2.169	\$ 2.113	14.0%	2.7%
Comparable restaurant sales increases	16.8%	5.6%	7.1%		
Number of restaurants as of the end of the period	1,783	1,595	1,410	11.8%	13.1%
Number of restaurants opened in the period, net of relocations	188	185	180		

Source: Chipotle Mexican Grill, Inc.: website and Form 10-K for the Fiscal Year Ended December 31, 2014.

## MODULE 1 THE NATURE OF BUSINESS

**LO1** Explain what business is about.

### Business

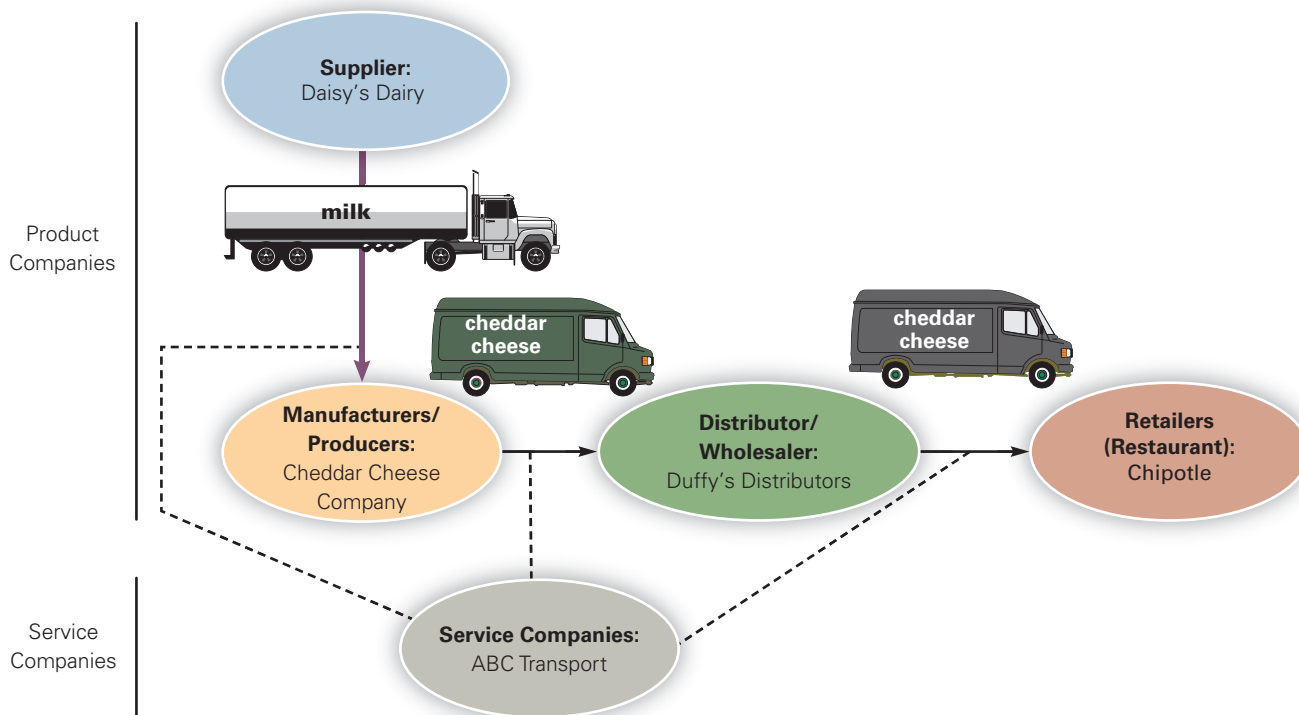
All of the activities necessary to provide the members of an economic system with goods and services.

Broadly defined, **business** consists of all activities necessary to provide the members of an economic system with goods and services. Certain business activities focus on providing goods or products such as ice cream, automobiles, and computers. Some of these companies produce or manufacture the products. Other companies are involved in the distribution of the products while others sell directly to the consumer, as does Chipotle in its restaurants. Other business activities, by their nature, are service-oriented. A broad range of service providers, such as **Walt Disney** and **United Airlines**, provide evidence of the growing importance of the service sector in the U.S. economy.

### EXAMPLE 1-1 Identifying Types of Businesses

To appreciate the kinds of enterprises in our economy, consider the various types of companies that have a stake in the delivery of a shipment of cheese to Chipotle. First, a *supplier* of raw material, in this case, a dairy, must deliver the milk to make cheese to a *manufacturer* or producer. The producer uses the milk to make the cheese. At this stage, the producer sells the cheese to a *distributor* or *wholesaler*, who in turn sells the cheese to a restaurant such as Chipotle. Additionally, *service companies* are involved, such as the transportation companies that deliver the goods to the various companies in the process. Exhibit 1-1 summarizes the various types of businesses.

**EXHIBIT 1-1** Types of Businesses



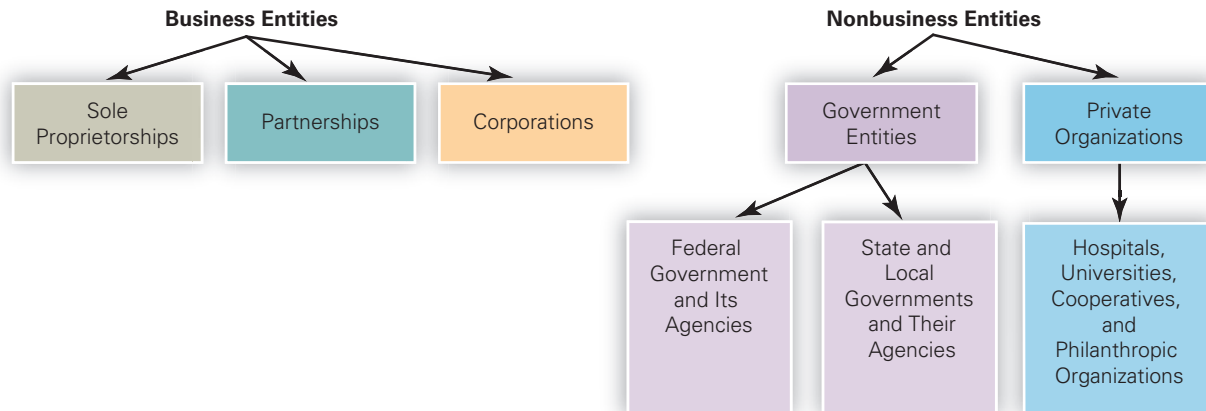
## Forms of Organization

**LO2** Distinguish among the forms of organization.

One convenient way to categorize the many different types of organizations in our society is to distinguish between those that are organized to earn money and those that exist for some other purpose. Although the lines can become blurred, *business entities* such as

Chipotle generally are organized to earn a profit, whereas *nonbusiness entities* generally exist to serve various segments of society. Both types are summarized in Exhibit 1-2.

### EXHIBIT 1-2 Forms of Organization



## Business Entities

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

**Sole Proprietorships** This form of organization is characterized by a single owner. Many small businesses are organized as **sole proprietorships**, often owned and operated by the same person. Because of the close relationship between the owner and the business, the affairs of the two must be kept separate. This is one example in accounting of the **economic entity concept**, which requires that a single, identifiable unit of organization be accounted for in all situations. For example, assume that Bernie Berg owns a neighborhood grocery store. In paying monthly bills such as utilities and supplies, Bernie must separate his personal costs from the costs associated with the grocery business. In turn, financial statements prepared for the business must not intermingle Bernie's personal affairs with the company affairs.

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

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

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

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

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

## Business entity

An organization operated to earn a profit.

## Sole proprietorship

A form of organization with a single owner.

## Economic entity concept

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

## Partnership

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

## Corporation

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

## Share of stock

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

**Bond**

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

**Nonbusiness entity**

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

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

- **A corporation has the ability to raise large amounts of money in a relatively brief period of time.** This is what prompted Chipotle to eventually “go public.” To raise money, the company sold a specific type of security: stock. Corporations may also issue bonds. A **bond** is different from a share of stock because it represents a promise by the company to repay a certain amount of money at a future date. In other words, if you were to buy a bond from a company, you would be lending it money. Interest on the bond is usually paid semiannually.
- **Ownership in a corporation is transferred easily.** If you hold shares of stock in a corporation whose stock is actively traded and you decide that you want out, you simply call your broker and put in an order to sell.
- **Stockholders have limited liability.** Generally, a stockholder is liable only for the amount contributed to the business. That is, if a company goes out of business, the most the stockholder stands to lose is the amount invested. On the other hand, both proprietors and general partners usually can be held personally liable for the debts of the business.

**Nonbusiness Entities**

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

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

**Organizations and Social Responsibility**

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

**The Nature of Business Activity**

**LO3** Describe the various types of business activities.

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

**Financing Activities**

**All businesses must start with financing.** Steve Ells needed money in the 1990s to open his first Chipotle restaurant, so he went to his parents for a modest loan. The company needed additional financing later and thus made the decision in 2006 to sell stock to the public. Most companies not only sell stock to raise money but also borrow from various sources to finance their operations. These financing activities bring up two important accounting terms: *liabilities* and *capital stock*.

**EXAMPLE 1-2 Distinguishing Between Liabilities and Capital Stock****Liability**

An obligation of a business.

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

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

### Capital stock

Indicates the owners' contributions to a corporation.

### Stockholder

One of the owners of a corporation.

*Alternate term: Shareholder.*

### Creditor

Someone to whom a company or person has a debt.

*Alternate term: Lender.*

## Investing Activities

Once funds are generated from creditors and stockholders, money is available to invest in assets. **An asset is a future economic benefit to a business.** For example, cash is an asset to a company. To Chipotle, its restaurants are assets, as is its inventory of ingredients on hand for use in making menu items. However, not all assets are tangible in nature, as are buildings, equipment, and inventory.

### Asset

A future economic benefit.

### EXAMPLE 1-3 Identifying Assets

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

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

## Operating Activities

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

**Revenue is the inflow of assets resulting from the sale of products and services.**

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

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

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

### Revenue

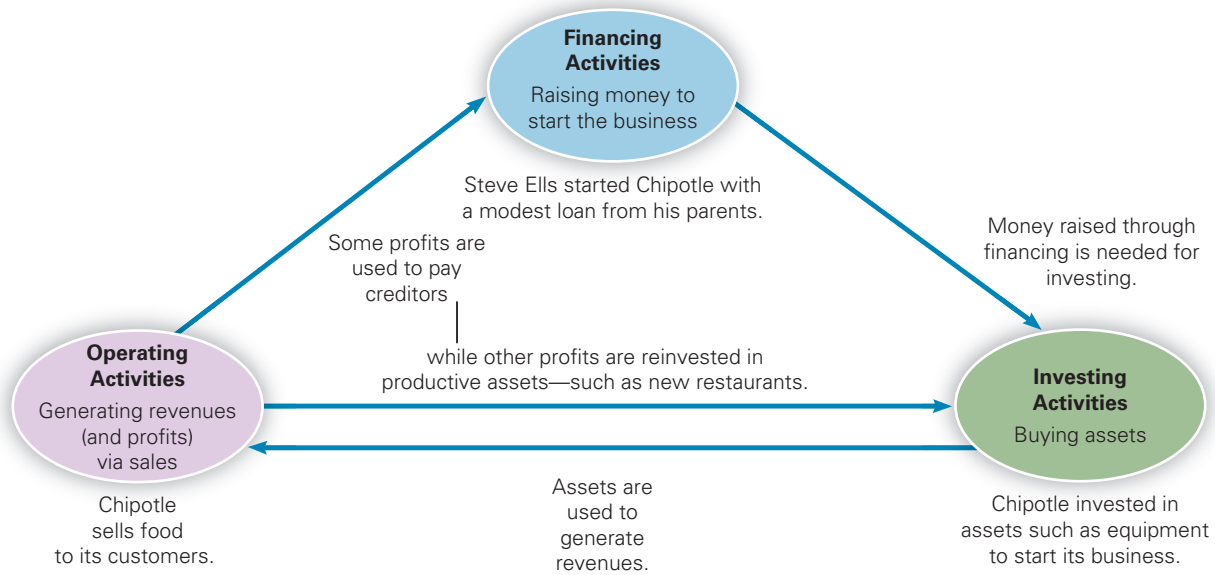
An inflow of assets resulting from the sale of goods and services.

### Expense

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

## Summary of Business Activities

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

**EXHIBIT 1-3** A Model of Business Activities**MODULE 1 TEST YOURSELF**

<b>Review</b>	<b>LO1</b> Explain what business is about.	<ul style="list-style-type: none"> <li>Business consists of all activities necessary to provide members of an economic system with goods and services. Suppliers, manufacturers, wholesalers, and retailers are examples of product companies.</li> </ul>
	<b>LO2</b> Distinguish among the forms of organization.	<ul style="list-style-type: none"> <li>Some entities are organized to earn a profit, while others are organized to serve various segments of society.</li> <li>The three forms of business entities are sole proprietorships, partnerships, and corporations.</li> </ul>
	<b>LO3</b> Describe the various types of business activities.	<ul style="list-style-type: none"> <li>All business activities can be categorized as operating, investing, or financing activities.</li> <li>Financing activities involve raising money from contributions made by the owners of a business as well as obtaining loans from outsiders.</li> <li>Companies invest the amounts raised from financing activities in various types of assets, such as inventories, buildings, and equipment.</li> <li>Once funds are obtained and investments are made in productive assets, a business can begin operations. Operating activities involve providing goods and services to customers.</li> </ul>
<b>Question</b>	1. What is business about? What do all businesses have in common?	
	2. What is an asset? Give three examples.	
	3. What is a liability? How does the definition of <i>liability</i> relate to the definition of <i>asset</i> ?	
	4. Business entities are organized as one of three distinct forms. What are these three forms?	
<b>Apply</b>	1. What does it mean when you own a share of stock in a company rather than one of its bonds?	
	2. Consider your own situation in terms of assets and liabilities. Name three of your financial assets. Name three of your financial liabilities.	
	3. What are the three distinct types of business activity in which companies engage? Assume that you start your own company to rent bicycles in the summer and skis in the winter. Give an example of at least one of each of the three types of business activities in which you would engage.	

Answers are located at the end of the chapter.



## MODULE 2 ACCOUNTING AND FINANCIAL STATEMENTS

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

### Users of Accounting Information and Their Needs

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

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

**External Users** External users, those not directly involved in the operations of a business, need information that differs from that needed by internal users. In addition, the ability of external users to obtain the information is more limited. Without day-to-day contact with the business’s affairs, outsiders must rely on the information presented by the company’s management.

Certain external users such as the IRS require that information be presented in a very specific manner, and they have the authority of the law to ensure that they get the required information. Stockholders and creditors must rely on *financial statements* for their information.<sup>2</sup> **Financial accounting** is the branch of accounting concerned with communication with outsiders through financial statements.

**Stockholders and Potential Stockholders** Both existing and potential stockholders need financial information about a business. If you currently own stock in Chipotle, you need information that will aid in your decision either to continue to hold the stock or to sell it. If you are considering buying stock, you need financial information that will help in choosing among competing alternative investments. What has been the recent performance of the company in the stock market? What were its profits for the most recent year? How do these profits compare with those of the prior year? Did the company pay any dividends? One source for much of this information is the company’s financial statements.

**Bondholders, Bankers, and Other Creditors** Before buying a bond in a company, you need assurance that the company will be able to pay you the amount owed at maturity and the periodic interest payments. Financial statements can help you to decide whether to purchase a bond. Similarly, before lending money, a bank needs financial information that will help it determine the company’s ability to repay both the amount of the loan and interest.

**Government Agencies** Numerous government agencies have information needs specified by law. For example, the IRS is empowered to collect a tax on income from both

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

#### Accounting

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

#### Management accounting

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

#### Financial accounting

The branch of accounting concerned with the preparation of financial statements for outsider use.

<sup>1</sup> American Accounting Association, *A Statement of Basic Accounting Theory* (Evanston, Ill.: American Accounting Association, 1966), p. 1.

<sup>2</sup> Technically, stockholders are insiders because they own stock in the business. In most large corporations, however, it is not practical for stockholders to be involved in the daily affairs of the business. Thus, they are better categorized here as external users because they normally rely on general-purpose financial statements, as do creditors.