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USING FINANCIAL ACCOUNTING INFORMATION

THE ALTERNATIVE TO DEBITS AND CREDITS



PORTER / NORTON

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THE ALTERNATIVE TO
DEBITS AND CREDITS

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Australia • Brazil • Mexico • Singapore • United Kingdom • United States

**Using Financial Accounting Information:
The Alternative to Debits and Credits,
10th edition**

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To those who really “count”

Melissa

Kathy, Amy, Andrew

In memory of

Sophie

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- 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, students are also expected to demonstrate that they understand the link between transactions and financial statements—consistent with the text.

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

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

LO3

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.



REAL WORLD

Required

1. Locate the note in each company's annual report included in its Form 10-K for the 2015 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
NORDSTROM
READING THE BALANCE SHEET

4-1 The note from page 43 of Nordstrom's Form 10-K for the fiscal year ended January 30, 2016, explains that gift card liabilities are included in other current liabilities. The gift card liability is \$327 million at the end of 2015 and \$286 million at the end of 2014. 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 2015 and 2014? (See answers on p. 205.)

- **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.

How Will I Use **ACCOUNTING?**

Inventory is the lifeblood of all businesses that sell products and chances are you will work for one of them at some time during your career. As a salesperson, you need to track inventory levels and know when to re-order merchandise. As a store manager, you need to evaluate the profitability of product lines and monitor how quickly inventory is turned over. Inventory matters to everyone in a business, not just the accountants.

- 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

- 1. Formulate the Question**
How many times a year does the company turn over its accounts receivable?
- 2. 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
- 3. 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 26, 2015	September 27, 2014	September 28, 2013
Net sales	\$233,715	\$182,795	\$170,910
Cost of sales	140,089	112,258	106,606
Gross margin	\$ 93,626	\$ 70,537	\$ 64,304

Apple Inc. Partial Consolidated Balance Sheets (in millions)	
	September 26, 2015
Current assets:	
Accounts receivable, less allowances of \$82 and \$86, respectively	\$ 16,849
	\$17,460

Accounts Receivable Turnover = $\frac{\$233,715^*}{\$17,154.5} = 13.6 \text{ times}$

*Assuming all sales are on credit.

Average accounts receivable less allowances = $(\$16,849 + \$17,460)/2 = \$17,154.5$
- 4. Compare the Ratio with Other Ratios**
Ratios are of no use in a vacuum. It is necessary to compare them with prior years and with competitors.

ACCOUNTS RECEIVABLE TURNOVER RATIO			
Apple Inc.		Hewlett-Packard	
Year Ended	Year Ended	Year Ended	Year Ended
September 26, 2015	September 27, 2014	October 31, 2015	October 31, 2014
13.6 times	12.0 times	7.6 times**	7.5 times**

**Based on "Products and Services Revenues."

5. Interpret the Ratios

In fiscal year 2015, Apple Inc. turned over its accounts receivable an average of 13.6 times. This is faster than the turnover in the prior year, and 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 2015, assuming 360 days in a year:

$$\begin{aligned} \text{Number of Days' Sales in Receivables} &= \frac{\text{Number of Days in the Period}}{\text{Accounts Receivable Turnover Ratio}} \\ &= \frac{360}{13.6} \\ &= 26 \text{ days} \end{aligned}$$

This measure tells us that it took Apple Inc. 26 days or less than a 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 *Using Financial Accounting Information*, 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	
Review	<p>LO1 Explain the difference between external and internal events.</p> <ul style="list-style-type: none"> • Both of these different types of events affect an entity and are usually recorded in the accounting system as a transaction. <ul style="list-style-type: none"> • External events are interactions between an entity and its environment. • Internal events are interactions entirely within an entity.
	<p>LO2 Explain the role of source documents in an accounting system.</p> <ul style="list-style-type: none"> • Source documents provide the evidence needed to begin the procedures for recording and processing a transaction. • These documents need not be in hard copy form and can come from parties that are either internal or external to the company.
	<p>LO3 Analyze the effects of transactions on the accounting equation and understand how these transactions affect the balance sheet and the income statement.</p> <ul style="list-style-type: none"> • 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. <ul style="list-style-type: none"> • The accounting equation: Assets = Liabilities + Stockholders' Equity • 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: $\text{Assets} = \text{Liabilities} + \text{Capital Stock} + \text{Retained Earnings}$
	<p>LO4 Describe the use of the account and the general ledger to accumulate amounts of financial statement items.</p> <ul style="list-style-type: none"> • The general ledger is a crucial part of the accounting system that lists all the accounts and their balances. Financial statements may be prepared from current account balances in the general ledger.
Question	1. What are the two types of events that affect an entity? Describe each.
	2. What is the significance of source documents to the recording process? Give two examples of source documents.
	3. What is the difference between a chart of accounts and the general ledger?
Apply	1. Provide three examples of source documents and the event for which each would provide the evidence to record.
	2. 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?
	3. 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?
	4. Assume that Vail Resorts 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?

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 *Using Financial Accounting Information*, 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, an increase in 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 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:

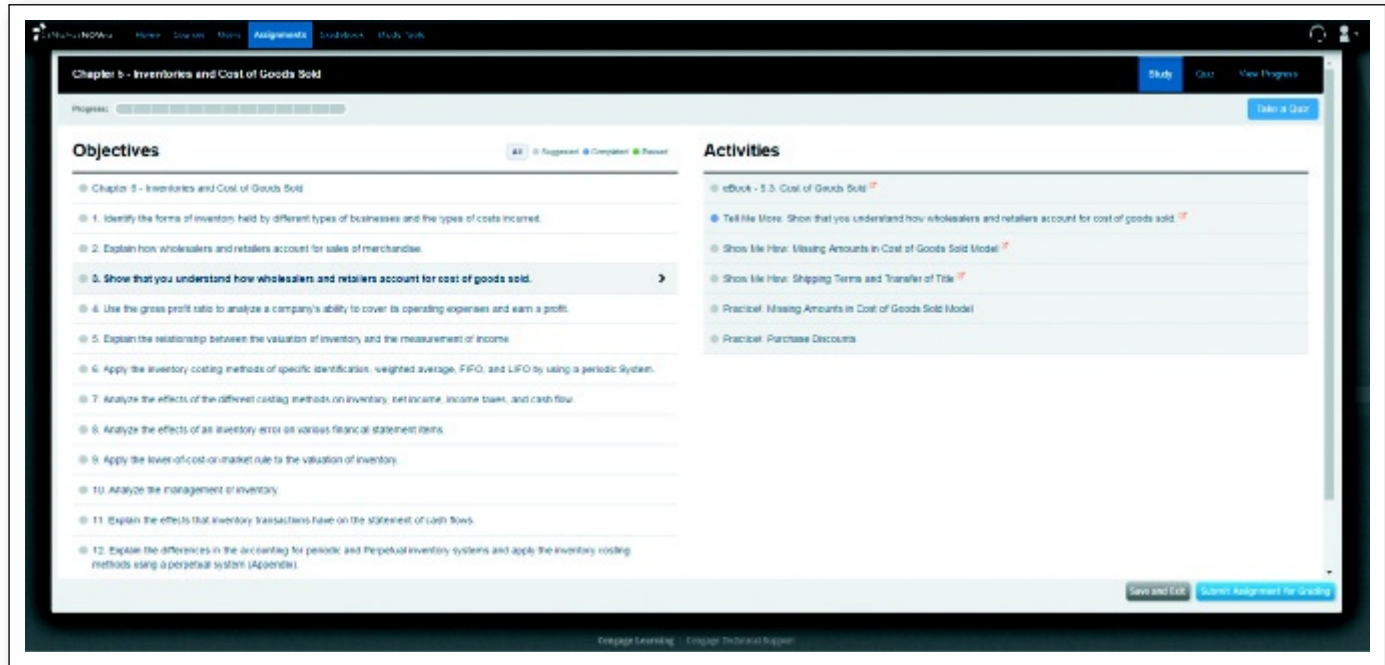
$$\text{Accounts Receivable Turnover} = \frac{\text{Sales}}{\text{Average Accounts Receivable}}$$

~~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.



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**

Activity Take: Practice!: Missing Amounts in Cost of Goods Sold Model

Missing Amounts in Cost of Goods Sold Model
For each of the following independent cases, fill in the missing amounts.
Enter all answers as positive numbers.

	Case 1	Case 2	Case 3
Beginning Inventory	\$	\$2,200	\$2,500
Purchases (net)	5,620		
Transportation-in	150	500	420
Cost of goods available for sale	7,120		8,870
Ending Inventory		1,820	1,200
Cost of goods sold	5,500	5,670	

Buttons: [Submit Answer](#) [Try Another Version](#)

Footer: [Save and Exit](#) [Submit Assignment for Grading](#)

Application: Provide Help Right When Students Need It

Students often complete homework at odd times. And when they use CengageNOWv2, they get help right when they need it.

- **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.

EX.05.01

Classification of Inventory Costs
Select the appropriate classification of each inventory item to indicate its most likely classification on the books of a company that manufactures furniture and then sells it in retail company stores.

Inventory Item	Classification
Fabric	Raw Material ✓
Lumber	Merchandise Inventory X
Unfinished tables	Work in Process ✓
Chairs on the showroom floor	
Cushions	
Decorative knobs	
Drawers	
Sofa frames	
Chairs in the plant warehouse	
Chairs in the retail storeroom	

Feedback
* Check My Work
Merchandise Inventory consists of goods purchased by retailers and wholesalers for purposes of resale. The goods are received in completed form and require no (or very little) further transformation before resale. Manufacturers have three distinct stages of inventory whereas a merchandiser has only one.

Buttons: [Check My Work](#)

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



Missing Amounts in Cost of Goods Sold Model			
	Case 1	Case 2	Case 3
Beginning inventory	\$ 700	\$2,500	\$2,650
Purchases (net)	6,500	(c)	(e)
Transportation-in	300	550	450
Cost of goods available for sale	7,500	(d)	9,000
Ending inventory	(b)	2,000	1,500
Cost of goods sold	5,500	5,600	(f)

Case 1:

(a) Beginning Inventory = Cost of Goods Available for Sale - Cost of Goods Purchased
 $= \$7,500 - \$6,800$
 $= \$700$

(b) Ending Inventory = Cost of Goods Available for Sale - Cost of Goods Sold
 $=$ **Thus, by subtracting the cost of goods sold of \$5,500**

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.

Enhanced Reporting Capabilities. CengageNOWv2's new Gradebook Analytics allow instructors unprecedented insight into classroom performance. This includes:

- classroom performance versus a variety of objectives, including Learning Objectives, AACSB, Bloom's, and more;
- classroom performance on specific items; and,
- classroom performance versus national scores.

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 E3-8 and E3-17 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: DC4-2 and DC4-3.
- Revised DC4-1 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 5-9, 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 analysis for purchase discounts, returns, and allowances.
- Updated end-of-chapter material: E5-15, 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, 6-3, and 6-4 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 of 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 Walgreens Boots Alliance.
- 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, E13-8, and E13-11.
- 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 transaction effects equation 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:

- author, edit, and manage test bank content from multiple Cengage Learning solutions
- create multiple test versions in an instant
- deliver tests from your LMS, your classroom, or wherever you want



Excel[®] Templates

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

PowerPoint® Slides

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

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Cindy Bleasdale <i>Hilbert College</i>	Andy Garcia <i>Bowling Green State University</i>	Cindy Powell <i>Southern Nazarene University</i>
Bradley Boercker <i>Fletcher College, Lone Star College</i>	Amy Giesler <i>Butler University</i>	Robert Rusnacko <i>North Hennepin Community College</i>
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Gary A. Porter
Curtis L. Norton
September 2016

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10e

Using Financial Accounting Information

THE ALTERNATIVE TO
DEBITS AND CREDITS

1

Accounting as a Form of Communication

MODULES	LEARNING OBJECTIVES	WHY IS THIS CHAPTER IMPORTANT?
<p>1 The Nature of Business</p>	<p>LO1 Explain what business is about.</p> <p>LO2 Distinguish among the forms of organization.</p> <p>LO3 Describe the various types of business activities.</p>	<ul style="list-style-type: none"> You need to know what a business is. (See p. 4.) You need to know what forms of organization carry on business activities. (See pp. 4–6.) You need to know in what types of business activities those organizations engage. (See pp. 6–8.)
<p>2 Accounting and Financial Statements</p>	<p>LO4 Define accounting and identify the primary users of accounting information and their needs.</p> <p>LO5 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"> You need to know what net income is and how it is measured. (See p. 13.) You need to know how revenue and net income relate to a company's assets. (See pp. 12–13.) You need to know where the various items appear on a company's financial statements. (See pp. 12–15.)
<p>3 Conceptual Framework of Accounting</p>	<p>LO6 Identify and explain the primary assumptions made in preparing financial statements.</p> <p>LO7 Identify the various groups involved in setting accounting standards and the role of auditors in determining whether the standards are followed.</p> <p>LO8 Explain the critical role that ethics plays in providing useful financial information.</p>	<ul style="list-style-type: none"> You need to know who determines the rules for the preparation of financial statements. (See pp. 21–22.)

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 2015 Form 10-K, the annual report filed with the Securities and Exchange Commission. You can see that Chipotle has grown to a chain of 2,010 restaurants generating revenue of over \$4.5 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

	Year ended December 31,			% increase (decrease) 2015 over 2014	% increase 2014 over 2013
	2015	2014	2013		
	(dollars in millions)				
Revenue	\$4,501.2	\$4,108.3	\$3,214.6	9.6%	27.8%
Average restaurant sales	\$ 2.424	\$ 2.472	\$ 2.169	(1.9%)	14.0%
Comparable restaurant sales increases	0.2%	16.8%	5.6%		
Number of restaurants as of the end of the period	2,010	1,783	1,595	12.7%	11.8%
Number of restaurants opened in the period, net of relocations	227	188	185		

Source: Chipotle Mexican Grill, Inc.: website and Form 10-K for the Fiscal Year Ended December 31, 2015.

MODULE 1 THE NATURE OF BUSINESS

LO1 Explain what business is about.

Business

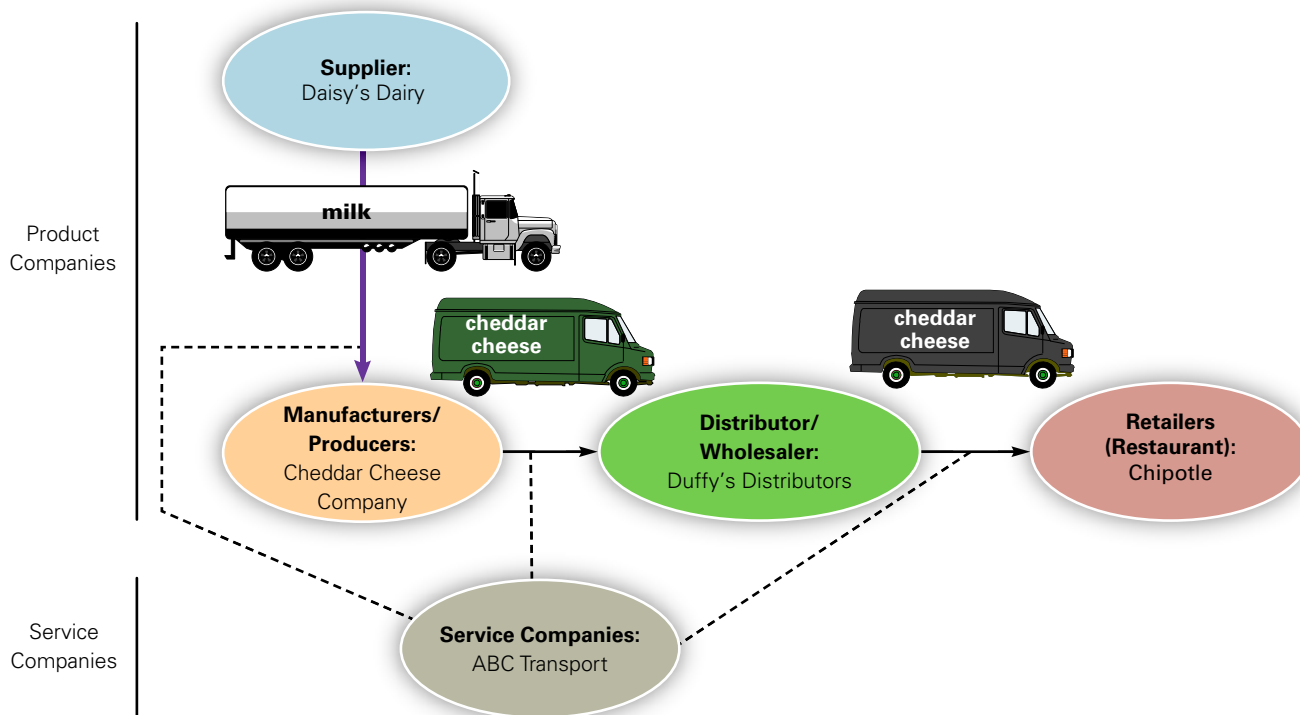
All of the activities necessary to provide the members of an economic system with goods and services.

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



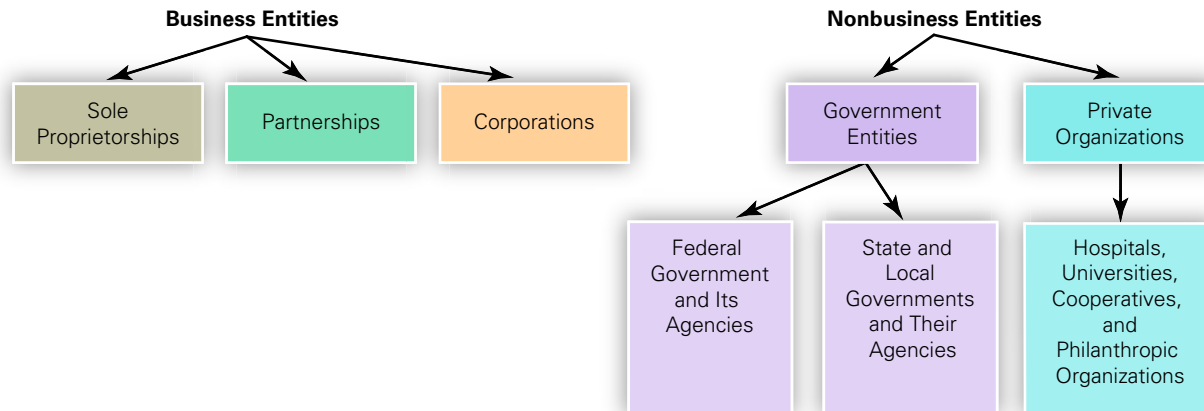
Forms of Organization

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

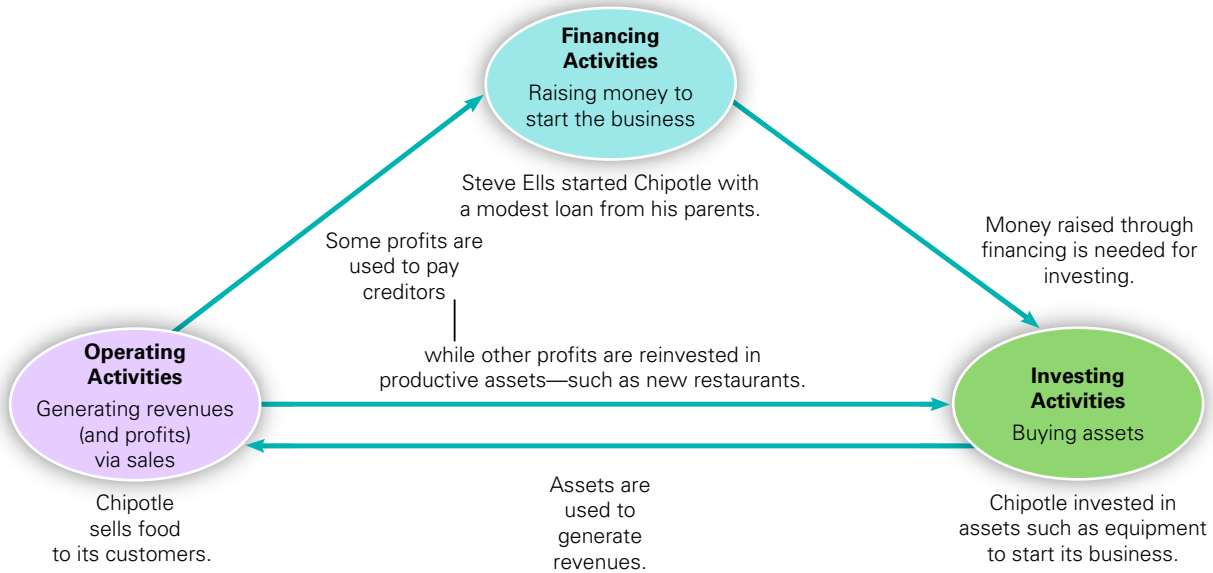
An inflow of assets resulting from the sale of goods and services.

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**

Review	LO1 Explain what business is about.	<ul style="list-style-type: none"> 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.
	LO2 Distinguish among the forms of organization.	<ul style="list-style-type: none"> Some entities are organized to earn a profit, while others are organized to serve various segments of society. The three forms of business entities are sole proprietorships, partnerships, and corporations.
	LO3 Describe the various types of business activities.	<ul style="list-style-type: none"> All business activities can be categorized as operating, investing, or financing activities. Financing activities involve raising money from contributions made by the owners of a business as well as obtaining loans from outsiders. Companies invest the amounts raised from financing activities in various types of assets, such as inventories, buildings, and equipment. 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.

Question	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?

Apply	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.”¹ Each of the three activities in this definition—*identifying*, *measuring*, and *communicating*—requires the judgment of a trained professional. Note that the definition refers to the users of economic information and the decisions they make.

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.² **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.

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

² 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.