



# Survey of Accounting

**Carl S. Warren** | **8e**



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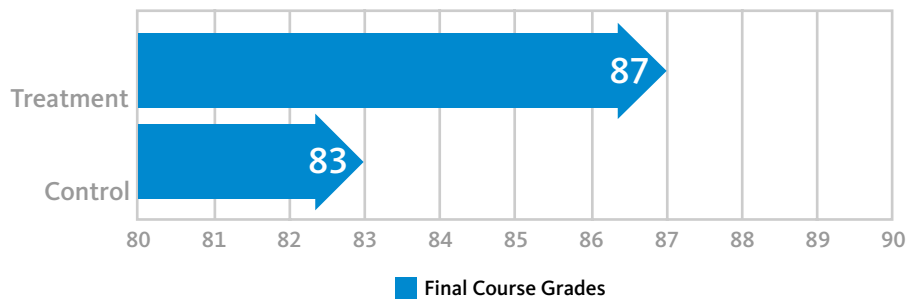
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# Survey of Accounting 8e

**Carl S. Warren\***

Professor Emeritus of Accounting  
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\* A special thanks to Amanda Farmer, Andrea Meyer, and Mark Sears for their contributions to this edition.



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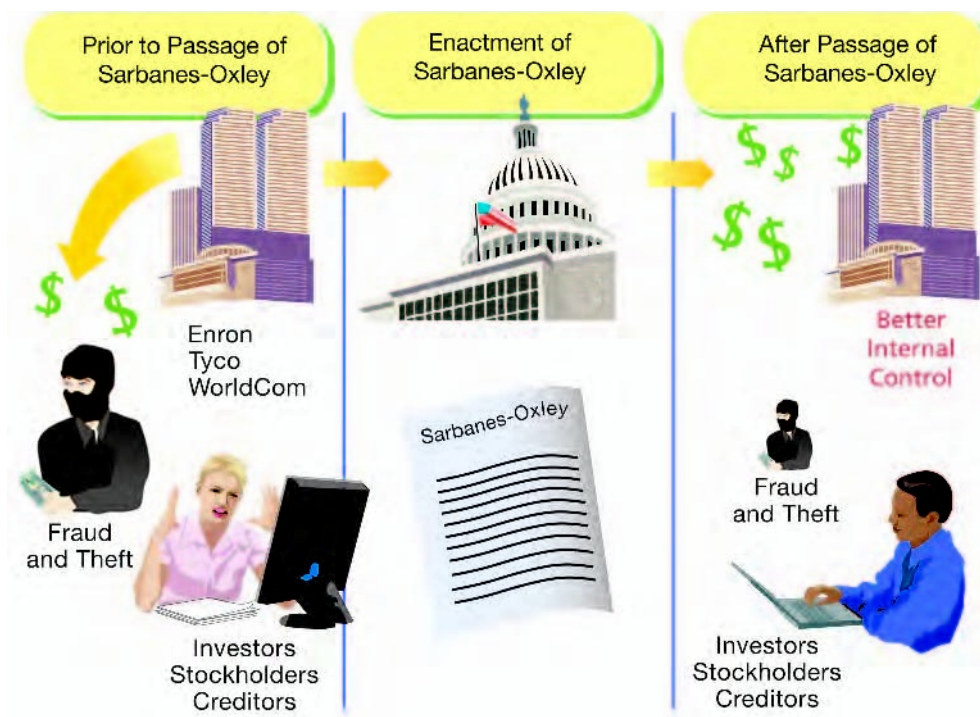
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**S**urvey of Accounting, Eighth Edition, is designed for a one-term introductory accounting course. Written for students who have no prior knowledge of accounting, this text emphasizes how managers, investors, and other business stakeholders use accounting reports. It provides an overview of the basic topics in financial and managerial accounting.

## Hallmark Features

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

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





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

## Illustrative Problem

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

### Instructions

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

### Solution

	Year	Depreciation Expense	Accumulated Depreciation, End of Year	Book Value, End of Year
a.	1	\$27,600*	\$ 27,600	\$122,400
	2	27,600	55,200	94,800
	3	27,600	82,800	67,200
	4	27,600	110,400	39,600
	5	27,600	138,000	12,000
* $\$27,600 = (\$150,000 - \$12,000) \div 5$				
b.	1	\$60,000**	\$ 60,000	\$ 90,000
	2	36,000	96,000	54,000
	3	21,600	117,600	32,400
	4	12,960	130,560	19,440
	5	7,440***	138,000	12,000

\*\* $\$60,000 = \$150,000 \times 40\%$ .

\*\*\*The asset is not depreciated below the estimated residual value of \$12,000.

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



## Integrity, Objectivity, and Ethics in Business

### Tips on Preventing Employee Fraud in Small Companies

- Do not have the same employee write company checks and keep the books. Look for payments to vendors you don't know or payments to vendors whose names appear to be misspelled.
- If your business has a computer system, restrict access to accounting files as much as possible. Also, keep a backup copy of your accounting files and store it at an off-site location.
- Be wary of anybody working in finance that declines to take vacations. They may be afraid that a replacement will uncover fraud.

- Require and monitor supporting documentation (such as vendor invoices) before signing checks.
- Track the number of credit card bills you sign monthly.
- Limit and monitor access to important documents and supplies, such as blank checks and signature stamps.
- Check W-2 forms against your payroll annually to make sure you're not carrying any fictitious employees.
- Rely on yourself, not on your accountant, to spot fraud.

Source: Steve Kaufman, "Embezzlement Common at Small Companies," Knight-Ridder Newspapers, reported in *Athens Daily News/Athens Banner-Herald*, March 10, 1996, p. 4D.

- “**Business Insight Make Money**” vignettes emphasize practical ways in which businesses apply accounting concepts when generating profit strategies.

### Got the Flu? Why Not Chew Some Gum?

Facing a slumping market for sugared chewing gum—such as Juicy Fruit™ and Doublemint™—**Wm. Wrigley Jr. Company**, a subsidiary of **Mars Incorporated**, is reinventing itself by expanding its product lines and introducing new chewing gum applications. Wrigley's new products include sugarless breath mints and more powerful flavored mint chewing gum, like Extra Polar Ice™. In addition, Wrigley is experimenting with health-care applications

of chewing gum. For example, the company founded the Wrigley Science Institute™ with the objective of promoting scientific research on the benefits of chewing gum. Specifically, the Institute sponsors research in such areas as weight reduction, management and stress relief, and cognitive focus. The Institute provides grants to leading researchers who investigate the role of chewing gum in health and wellness.

Source: Wrigley.com and *USA Today*, “Wrigley Wants Science to Prove Gum-Chewing Benefit,” by Dave Carpenter, The Associated Press, March 28, 2006.

*Business  
Insight*



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

### *International Connection*

#### **Adoption or Convergence?**

The largest public accounting firms, known as the Big Four, have pushed for the “adoption” of IFRS in the United States within a relatively short period of time. Such a strategy of adoption would generate millions of dollars of consulting and accounting work within the U.S. for the Big Four: Deloitte Touche Tohmatsu, PwC (PriceWaterhouseCoopers), Ernst & Young, and KPMG.

In contrast, others have argued for a strategy of gradual “convergence” to IFRS over time. Currently, it appears that regulators within the United States and the FASB are favoring convergence rather than adoption. For example, since November 2010, the FASB and IASB have completed several projects to converge U.S. and IFRS standards.<sup>1</sup>



1. FASB.org, “Progress Report on IASB-FASB Convergence Work,” April 21, 2011.

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

## Integrated Financial Statement (IFS) Approach

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

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

**Exhibit 10** Integrated Financial Statements

The Hershey Company Balance Sheet December 31					
Assets		=	Liabilities	+	Stockholders' Equity
Cash	\$ 728		.		\$5,028 Retained Earnings
.	.		.		360 Common Stock
.	.		.		
	<u>\$4,754</u>	=	<u>\$3,706</u>	+	<u>\$1,048</u>
			\$4,754 Total Liabilities + Stockholders' Equity		

The Hershey Company Statement of Cash Flows for the Year Ended Dec. 31	
Operating act.	\$1,095
Investing act.	(473)
Financing act.	(587)
Increase in cash	\$ 35
Cash, Jan. 1	693
Cash, Dec. 31	<u>\$ 728</u>

The Hershey Company Income Statement for the Year Ended Dec. 31	
Revenues	\$6,644
Expenses	<u>(5,983)</u>
Net income	<u>\$ 661</u>

The Hershey Company Statement of Stockholders' Equity for the Year Ended Dec. 31				
	Common Stock	Retained Earnings	Other Items	Total
Bal. Jan. 1	\$360	\$4,798	\$(4,188)	\$ 880
Net income		661		661
Dividends		(341)		(341)
Other items			(152)	(152)
Bal. Dec. 31	<u>\$360</u>	<u>\$5,028</u>	<u>\$(4,340)</u>	<u>\$1,048</u>

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

**Exhibit 1** Integrated Financial Statement Framework**Integrated Financial Statement Framework**

BALANCE SHEET					
	Assets	=	Liabilities	+	Stockholders' Equity
	Assets	=	Liabilities	+	Capital Stock + Retained Earnings
Transaction	XXX		XXX		XXX
	XXX				
	XXX		XXX		XXX

STATEMENT OF CASH FLOWS	
+/- Operating activities	XXX
+/- Investing activities	XXX
+/- Financing activities	XXX
Increase or decrease in cash	XXX
Beginning cash	XXX
Ending cash	XXX

INCOME STATEMENT	
Revenues	XXX
Expenses	XXX
Net income or loss	XXX



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

### Transaction (d)

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

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

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

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

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

#### Financial Statement Effects

BALANCE SHEET						
Assets			=	Liabilities	+	Stockholders' Equity
Cash	+	Land	=	Notes Payable	+	Common Stock + Retained Earnings
Balances	4,000	12,000	=	10,000	+	6,000
d. Fees earned	5,500					5,500
Balances	9,500	12,000	=	10,000	+	6,000 + 5,500

STATEMENT OF CASH FLOWS	
d. Operating	5,500

INCOME STATEMENT	
d. Fees earned	5,500

#### Transaction Metric Effects

The effects of receiving \$5,500 of patient fees on Family Health Care’s liquidity and profitability metrics are as follows:

LIQUIDITY	
Cash	\$5,500

PROFITABILITY	
Net Income – Cash Basis	\$5,500

## Eighth Edition: Changes and Enhancements

### NEW! Warren’s Metric Analyses

As illustrated above, the Eighth Edition of Survey of Accounting introduces and incorporates Warren’s Metric Analyses throughout. It uses common business metrics to assess

a company's financial condition and performance. Metrics are assessed at three levels: the Transaction Level, Financial Statement level, and Managerial Decision-Making Level.

To accompany the addition of Warren's Metric Analyses, end-of-chapter problems have been added to test the students knowledge and understanding of the concepts.

Metric Analyses are clearly identified with a separate screen of color. This allows for quick identification of the analyses through the chapters and text. This separate screen of color also identifies the end-of-chapter section for assigning homework.

## MBA 2-4 Common-Sized Statements

Obj. 6

Southwest Airlines Co. (LUV) provides passenger services throughout the United States, Mexico, Jamaica, The Bahamas, Aruba, and the Dominican Republic. The following operating data (in millions) were adapted from recent financial statements of Southwest.

	Year 1	Year 2
Revenue.....	\$ 17,699	\$ 18,605
Operating expenses:		
Fuel .....	\$(5,763)	\$(5,293)
Aircraft-related .....	(3,411)	(3,322)
Selling and general .....	(5,035)	(5,434)
Other expenses.....	(2,212)	(2,331)
Total operating expenses .....	<u>\$(16,421)</u>	<u>\$(16,380)</u>
Operating income .....	<u>\$ 1,278</u>	<u>\$ 2,225</u>

1. Prepare common-sized statements for Years 2 and 1. Round to one decimal place.
2. Using (1), analyze and comment on the performance of Southwest in Year 2.

## Other Enhancements

- Retained Earnings Statement is REPLACED with Statement of Stockholders Equity throughout the book. This will reflect what students will see in business and also allows for real-world examples of statements of stockholder's equity for in-class illustrations or homework.
- Each Financial Accounting Chapter now includes one financial statement metric at the end of each chapter. In addition, each financial chapter transaction is analyzed using a liquidity and profitability metric. Depending upon chapter content, a variety of liquidity and profitability metrics are used throughout the financial accounting chapters.
- Each Managerial Accounting Chapter now includes one metric used by managers in operating a business. Many of these metrics are operational in nature and include margin of safety, cost per unit, process yield, and utilization rate.
- This edition includes updated or replaced chapter openers to feature recent, intriguing developments in accounting. The author has woven connections to the opening company highlighted in each chapter throughout each chapter. This now promotes a stronger connection for students, allowing them to gain additional insight into the opening company and its relationship to the chapter content.
- For this edition, when Real Publicly Traded Companies appear through out the book, their (TICKERS) symbol is also represented. This allows students to easily look up company's financial data on the internet.

## Technology



### What is CengageNOWv2?

CengageNOWv2 is a powerful course management and online homework tool that provides robust instructor control and customization to optimize the student learning experience and meet desired outcomes.

CengageNOWv2 includes

- Integrated eBook
- End-of-Chapter homework with static and algorithmic version
- Adaptive Study Plan with quizzing and multimedia study tools
- Test Bank
- Course management tools and flexible assignment options
- Reporting and grade book options
- Mastery Problems
- Tell Me More eLectures
- Show Me How Demonstration Videos
- Animated Activities

CengageNOWv2 for Warren's *Survey of Accounting, 8e* is designed to help students learn more effectively by providing engaging resources at unique points in the learning process:

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

## Preparing for Class

CengageNOWv2 helps you motivate students and prepare them for class with a host of resources. These resources were developed with visual learners and those that don't like to read textbooks in mind. Available in the Study Tools tab in CengageNOWv2, students may access these resources on demand. Each resource is fully assignable and gradable!

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

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

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

### Financial Analysis and Interpretation: Fixed Asset Turnover Ratio

- A measure of a company's efficiency in using its fixed assets to generate revenue is the fixed asset turnover ratio. The **fixed asset turnover ratio** measures the number of dollars of sales earned per dollar of fixed assets.
- The fixed asset turnover ratio is computed as follows:  

$$\text{Fixed Asset Turnover Ratio} = \frac{\text{Sales}}{\text{Average Book Value of Fixed Assets}}$$
- The higher the fixed asset turnover, the more efficiently a company is using its fixed assets in generating sales. **the better a company is at using its fixed assets**

**Adjusting Entries**

b. Supplies on hand at August 31, \$675.

Supplies available during August (balance of account)	\$3,000
Supplies on hand, August 31	675
Supplies used (amount of adjustment)	<u>2,325</u>

Journal					
Date	Description	Post. Ref.	Debit	Credit	
Aug. 31	Supplies Expense		2,325		
	Supplies			2,325	

<b>Assets</b>		=	<b>Liabilities</b>	=	<b>Owner's Equity (Expense)</b>
Supplies					Supplies Expense
Bal. 5,000					Aug. 31 2,325
Adj. Bal. 675					

By crediting it for the same amount.

**Journal** Shared Help icon feedback

Journalize the December 31 adjusting entry to record the depreciation. Refer to the Chart of Accounts for exact wording of account titles.

How does grading work?

DATE	DESCRIPTION	POST. REF.	DEBIT	CREDIT
Dec. 31	Depreciation Expense		7,500.00	
	Accumulated Depreciation—Equipment			7,500.00

The amount for this account is incorrect.

**Line**

- The amount for this account is incorrect, although you've entered the amount in the correct column. [-2]

**Transaction**

- The debits and credits do not balance. [-2]

This transaction was matched to the first transaction (lines 2-3) of the solution. This line was matched to the second line in the transaction.

## Completing Homework

Students sometimes struggle with accounting homework. By using CengageNOWv2's powerful instructor tools you can fine-tune the amount of help that your students receive as they work on their homework. Help your students succeed by making the right amount of assistance available at the right time!

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

Made without giving away the answer.

CengageNOWv2 provides 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.
- Check My Work Feedback in CengageNOWv2 only reports on what students have attempted, which prevents them from “guessing” their way through assignments.
- Explanations are available after the assignment has been submitted and provide a detailed description of how the student should have arrived at the solution.

## Going Further

Mastering accounting includes making connections between concepts and asking students to apply what they've learned to different scenarios. CengageNOWv2 has the tools that help you assess your students' abilities in these key skill areas!

In CengageNOWv2, all of the special activities in Warren, *Survey of Accounting, 8th Edition* are available for you to assign to your students. These **Mastery Assignments** do more than test your students' ability to recall, understand and apply. These assignments challenge your students to go further by demonstrating their ability to analyze and evaluate accounting information.

**Conceptual Conversions** are open-ended requirements from the end-of-chapter homework that have been converted into automatically gradable formats in CengageNOWv2. Now you can assess your students' understanding of more conceptual, open-ended questions previously not available to assign in an online environment.

<p>2. a. Under the percent of sales method used by Mandy, select <input type="text" value="25"/> is the focus of the estimation process. The percent of sales method places more emphasis on the <input type="text" value="Debit"/> and thus emphasizes the <input type="text" value="Debit"/>.</p> <p>b. When advising Mandy about whether an account is uncollectible, you would suggest all of the following as indicators of uncollectibility, except:</p> <p>a. When a customer files for bankruptcy.</p> <p>b. When the customer closes his/her business.</p> <p>c. When the customer cannot be located.</p> <p>d. When the customer's credit score increases.</p>
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- **Instructor Excel<sup>®</sup> Templates** This resource provides the solutions for the problems and exercises that have enhanced Excel<sup>®</sup> templates for students.
- **Instructor's Manual** Each chapter contains a number of resources designed to aid instructors as they prepare lectures, assign homework, and teach in the classroom.
- **Solutions Manual** The Solutions Manual contains answers to all exercises, problems, and cases that appear in the text. As always, the solutions are author-written and verified multiple times for numerical accuracy and consistency with the core text.

## Acknowledgments

Many people deserve thanks for their contributions to this text. For the Eighth edition Amanda Farmer and Mark Sears provided a thorough technical review and verification of the end-of-chapter materials. Robin Browning and Tomeika Williams did a thorough review of the CNOWv2 content. Andrea Meyer, the Content Developer from Cengage who helped to manage the timeline and development process for this edition. The comments from the following reviewers also influenced recent edition of the text as well as the current edition:

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

**Carl S. Warren**



# About the Author



## **Carl S. Warren**

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



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# Chapter 1

# The Role of Accounting in Business

## What's Covered:

### Topics: The Role of Accounting in Business

#### Nature of Business

- Types of Business (Obj. 1)
- Forms of Business (Obj. 1)
- Business Strategies (Obj. 1)
- Business Stakeholders (Obj. 1)
- Business Activities (Obj. 2)

#### Role of Accounting

- Financial and Managerial Accounting (Obj. 3)
- Income Statement (Obj. 4)
- Statement of Changes in Stockholders' Equity (Obj. 4)
- Balance Sheet (Obj. 4)
- Statement of Cash Flows (Obj. 4)
- Accounting Concepts (Obj. 5)

#### Metric-Based Analysis

- Types of Analyses (Obj. 6)
- Return on Assets (Obj. 6)

### Learning Objectives

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

### Chapter Metrics

Use the following metrics to analyze transactions and financial statements

#### TRANSACTIONS\*

Liquidity: N/A

Profitability: N/A

#### FINANCIAL STATEMENTS

Return on Assets

\* There are no transactions in this chapter.

# LinkedIn



Evan Lorne/  
Shutterstock.com

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

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

**LinkedIn Corporation (LNKD)** offered its stock for sale to the public in May 2011. At that time, LinkedIn was the world's largest professional network on the Internet with more than 100 million members in over 200 countries. Members join the network free of cost and are able to create and manage their professional identity online. LinkedIn generates its revenues by offering premium services to its members and

by selling services such as hiring and marketing solutions to businesses and professional organizations.

In its prospectus filed with the Securities and Exchange Commission in 2011, LinkedIn indicated that it anticipated a price for its stock of between \$42.00 and \$45.00 per share. On the first day the stock was publicly traded, LinkedIn's stock rose to a high of \$122.70, more than two and a half times its highest anticipated price of \$45.00. LinkedIn recently traded on the New York Exchange for over \$135.

Is LinkedIn's stock really worth over \$100 per share? To answer this question, investors analyze LinkedIn's financial condition and performance using public information, including its financial statements.\*

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

\* In June 2016 Microsoft and LinkedIn entered into an agreement in which Microsoft (MSFT) would acquire LinkedIn for \$196 per share.

## Objective 1

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

# Nature of Business and Accounting

A **business**<sup>1</sup> is an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers. Businesses come in all sizes, from a local coffee house to **Starbucks**, which sells over \$19 billion of coffee and related products each year.

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

## Types of Businesses

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

**Service businesses** provide services rather than products to customers.

**Delta Air Lines** (transportation services)

**The Walt Disney Company** (entertainment services)

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

**Wal-Mart** (general merchandise)

**Amazon.com** (books, music, videos)

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

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

**General Motors Corporation** (cars, trucks, vans)

**Dell Inc.** (personal computers)

LinkedIn is a service business that provides value to its members by connecting them to people, knowledge, and opportunities to advance their careers.

*LinkedIn  
Connection*

## Forms of Business

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

- proprietorship
- partnership
- corporation
- limited liability company

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

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

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

LinkedIn is organized as a corporation in Delaware even though its offices are in Mountain View, California. Many companies incorporate in Delaware because of its favorable legal and business environment.

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A **limited liability company (LLC)** combines attributes of a partnership and a corporation. The primary advantage of the limited liability company form is that it operates similar to a partnership, but its owners' (or members') liability for the debts of the company is limited to their investment. Many professional practices such as, lawyers, doctors, and accountants are organized as limited liability companies.

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

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

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

The three types of businesses we discussed earlier—manufacturing, merchandising, and service—may be proprietorships, partnerships, corporations, or limited liability companies. However, businesses that require a large amount of resources, such as many manufacturing businesses, are corporations. Likewise, most large retailers such as **Wal-Mart**, **Target**, and **Macy's** are corporations.

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

## How Do Businesses Make Money?

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

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

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

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

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

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

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

- Local pharmacies who develop personalized relationships with their customers. By doing so, they are able to charge premium (higher) prices. In contrast, Wal-Mart's pharmacies use the low-cost emphasis and compete on cost.
- Grocery stores such as **Kroger** and **Safeway** develop relationships with their customers by issuing preferred customer cards. These cards allow the stores to track consumer preferences and buying habits for use in purchasing and advertising campaigns.

- **Honda** promotes the reliability and quality ratings of its automobiles and thus charges premium prices. Similarly, **Volvo** promotes the safety characteristics of its automobiles. In contrast, **Kia** uses a low-cost strategy.
- **Harley-Davidson** emphasizes that its motorcycles are “Made in America” and promotes its “rebel” image as a means of charging higher prices than its competitors **Honda**, **Yamaha**, or **Suzuki**.

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

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

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

**Exhibit 1**  
Business Strategies and Industries

LinkedIn’s strategy is to be the premier online professional network that allows its members to be more productive and successful. It provides a free platform for members to manage their professional identify and engage in professional networks. To make money (monetize itself), it provides recruiting and marketing services to organizations and enterprises for a fee.

*LinkedIn Connection*

## Business Stakeholders

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

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

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

**Exhibit 2**  
Business Stakeholders

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

*Product or service market stakeholders* purchase the company’s products or services or sell their products or services to the company. Customers have an economic interest

in the continued success of the company. For example, customers who purchase advance tickets on **Delta Air Lines** are depending on Delta continuing in business. Likewise, suppliers depend on continued success of their customers. For example, if a customer fails or cuts back on purchases, the supplier's business will also decline.

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

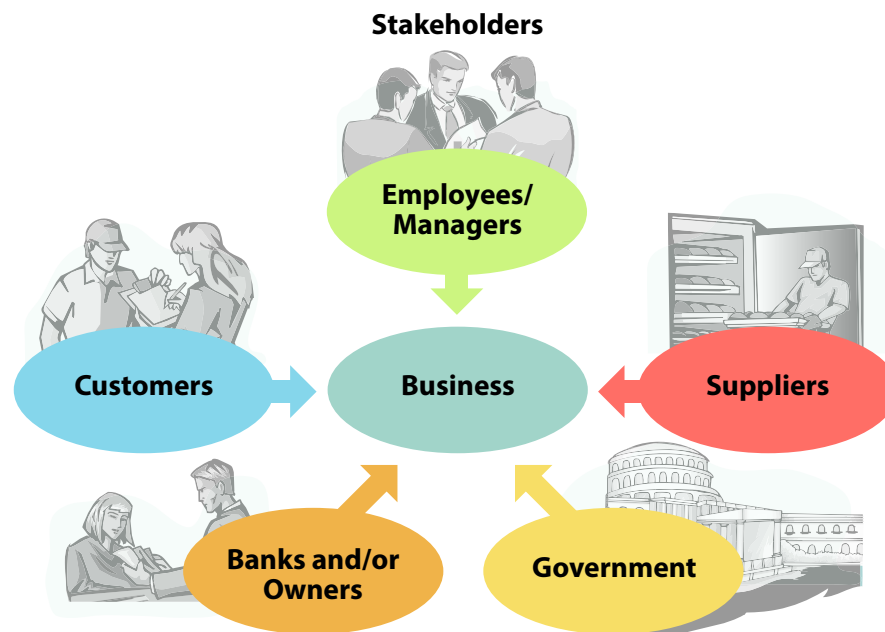
*Internal stakeholders*, such as managers and employees, depend upon the continued success of the company for keeping their jobs. Managers of companies that perform poorly are often fired by the owners. Likewise, during economic downturns companies often lay off workers. Stakeholders are illustrated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

### LinkedIn Connection

LinkedIn's stakeholders include common stockholders, bondholders, network members, employees, and U.S. and state governments who receives taxes.

#### Exhibit 3

Business Stakeholders



## Integrity, Objectivity, and Ethics in Business

### The Hershey Trust Company

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

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

shareholder of The Hershey Company.

A public uproar was created in 2002 when the trustees of The Hershey Trust Company tried to sell their controlling stock interest in The Hershey Company.

As a result of the public outcry, the majority of the trustees were forced to resign.

Source: Adapted from [www.thehersheycompany.com](http://www.thehersheycompany.com).



Finnbarr Webster/Alamy Stock Photo



## Business Activities

All companies engage in the following three business activities:

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

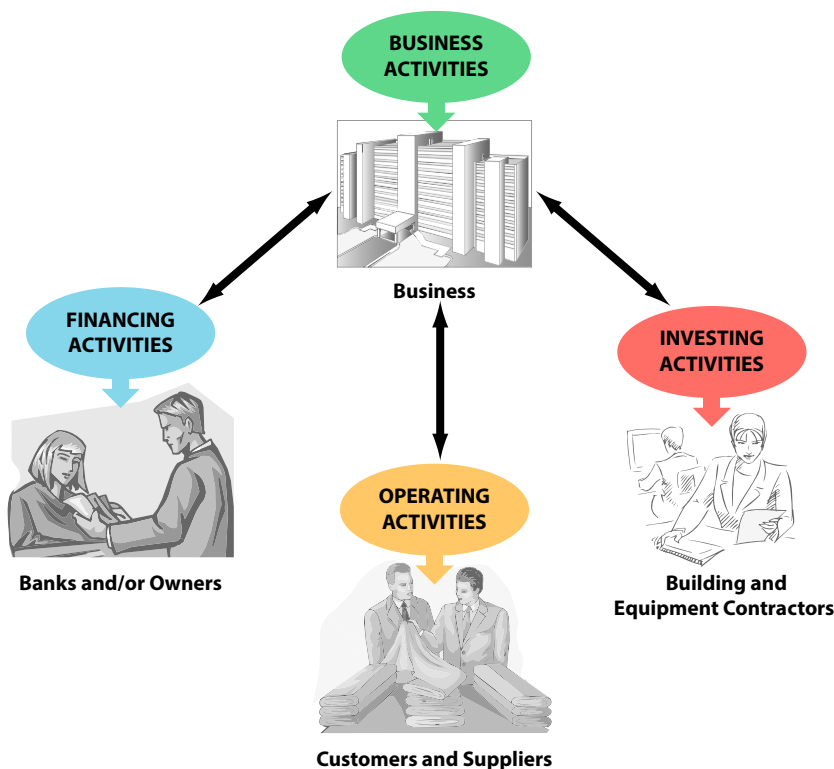
The preceding business activities are illustrated in Exhibit 4.

### Objective 2

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

### Exhibit 4

Business Activities



## Financing Activities

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

- borrowing
- issuing shares of ownership

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

On a recent balance sheet, LinkedIn reported \$100.3 million of accounts payable.

*LinkedIn  
Connection*

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

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

A company may finance its operations by issuing shares of ownership. For a corporation, shares of ownership are issued in the form of shares of stock. Although corporations may issue a variety of different types of stock, the basic type of stock issued to owners is called **common stock**.<sup>2</sup> Investors who purchase the stock are referred to as **stockholders**.

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

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

### LinkedIn Connection

In a recent year, LinkedIn engaged in the financing activities of issuing bonds and stock.

## Investing Activities

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

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

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

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

### LinkedIn Connection

For a recent year, LinkedIn engaged in the investing activities of purchasing property and equipment as well as acquiring other companies, including Bizo, Inc. and Bright Media Corporation.

## Operating Activities

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

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

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

In a recent year, LinkedIn reported \$2.2 billion of revenue.

LinkedIn  
Connection

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

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

In a recent year, LinkedIn reported income from operations of \$36.1 million and a net loss of \$15.3 million after taxes.

LinkedIn  
Connection

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

## What Is Accounting and Its Role in Business?

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

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

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

### Objective 3

Define accounting and describe its role in business.