

FUNDAMENTALS OF Financial Accounting



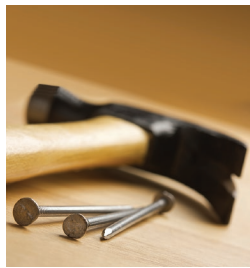
SIXTH EDITION

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Fundamentals of FINANCIAL ACCOUNTING



Sixth Edition

FRED PHILLIPS

University of Saskatchewan

ROBERT LIBBY

Cornell University

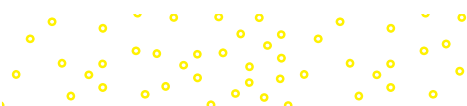
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Ithaca College

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FUNDAMENTALS OF FINANCIAL ACCOUNTING, SIXTH EDITION

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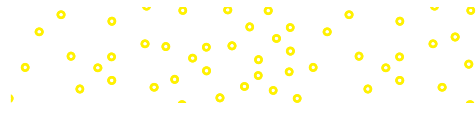
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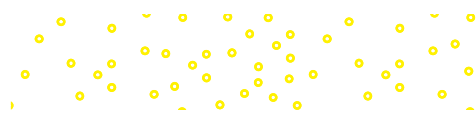
Dedicated to

Barb, Harrison, and Daniel, my Mom, and (memory of) my Dad.

FRED PHILLIPS

Herman and Doris Hargenrater, Laura Libby, Oscar and Selma Libby

PATRICIA AND ROBERT LIBBY



Meet the Authors

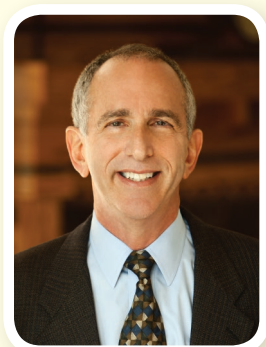


Courtesy of Fred Phillips

Fred Phillips

Fred Phillips is a professor at the University of Saskatchewan, where he teaches introductory financial accounting. He also has taught introductory accounting at the University of Texas at Austin and the University of Manitoba. Fred has an undergraduate accounting degree, a CPA, CA (Canada), and a PhD from the University of Texas at Austin. He previously worked as an audit manager at KPMG.

Fred's main career interest is accounting education. He has been recognized with more than 26 awards, as chosen by his students and peers. In 2006, Fred was awarded the title Master Teacher at the University of Saskatchewan. In 2011, he was admitted to the 3M National Teaching Fellowship, the highest honor for undergraduate teaching in Canada. In 2012, Fred received the L. S. Rosen Outstanding Educator Award, the American Accounting Association's Innovation in Auditing and Assurance Education Award, and the American Accounting Association's Award for Outstanding Research in Accounting Education. Most recently, he received the Edwards MPAcc Teaching Effectiveness Award and, for the third time in his career, the University of Saskatchewan Student Union's Teaching Excellence Award. His peer-reviewed publications include education-focused research and instructional cases in *Issues in Accounting Education*, as well as professional judgment studies in *Journal of Accounting Research* and *Organizational Behavior and Human Decision Processes*, among others. Fred is a current member of the Teaching, Curriculum, & Learning and Two-Year College sections of the American Accounting Association. In his spare time, he likes to play tennis, drink iced cappuccinos, and relax with his family.



Courtesy of Robert Libby

Robert Libby

Robert Libby is the David A. Thomas Professor of Accounting and Accounting Area Coordinator at Cornell University, where he teaches the introductory financial accounting course. He previously taught at the University of Illinois, Pennsylvania State University, the University of Texas at Austin, the University of Chicago, and the University of Michigan. He received his BS from Pennsylvania State University and his MAS and PhD from the University of Illinois; he also successfully completed the CPA exam (Illinois).

Bob was selected as the AAA Outstanding Educator in 2000 and received the AAA Outstanding Service Award in 2006 and the AAA Notable Contributions to the Literature Award in 1985 and 1996. He has received the Core Faculty Teaching Award multiple times at Cornell. Bob is a widely published author and researcher specializing in behavioral accounting. He has

published numerous articles in *The Accounting Review*; *Journal of Accounting Research*; *Accounting, Organizations, and Society*; and other accounting journals. He has held a variety of offices, including vice president, in the American Accounting Association, and he is a member of the American Institute of CPAs and the editorial boards of *The Accounting Review* and *Accounting, Organizations, and Society*.

Patricia A. Libby

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

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



Courtesy of Patricia A. Libby

Engaging Students with Real-World Context and Business

One of the most widely used introductory accounting textbooks, Phillips/Libby/Libby *Fundamentals of Financial Accounting* focuses on four key attributes.

Engaging Writing. *Fundamentals of Financial Accounting* introduces students to financial accounting using a balanced mix of conversational wording, clear and concise presentations, and everyday examples. Students can feel comfortable as they are introduced to the world of financial accounting. This measured approach allows students to grasp concepts fundamental to financial accounting, without sacrificing rigor or coverage.



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Entrepreneurial Focus. Each chapter makes financial accounting engaging by using a real company whose products and services are popular with students. Students learn financial accounting concepts through the use of examples from such companies as **American Eagle** (clothing), **Koss Corporation** (headphones), and **Under Armour** (sportswear). The accounting cycle chapters tap into students' innate curiosity about start-up culture by focusing on an actual startup, **Noodlecake Studios**, providing details and financial accounting lessons through a real-life entrepreneurial story.

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*Practical, applicable to both accounting and non-accounting majors and a **very thorough** financial accounting textbook.*

—Ronald Premuroso, University of Montana

*Students should find the use of **companies from their generation**, as examples, interesting.*

—Diane Marker, University of Toledo

Data-Driven Pedagogy. The authors' approach to introducing the accounting cycle and using visual aids has been tested in peer-reviewed, published research studies. One of these award-winning studies has shown this accounting cycle approach yields learning gains that outpace other approaches by a significant margin. By breaking the accounting cycle down into more cohesive, bite-sized segments, students develop a stronger foundational understanding. This paced introduction to the core concepts of accounting enables improved student success, allowing them to better retain and apply key concepts.

Video Asset Variety. *Fundamentals of Financial Accounting* offers a diverse range of video assets within the Connect platform that can fit nearly any instructor need. From reinforcing key lessons to painting the big picture, videos can be a critical and complementary learning tool for engaging students.

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*Phillips does an **excellent job of writing** at a level the average student will understand. [The authors] . . . know how to **engage the students** by using real companies; discussing relevant current events; using colorful, enticing-to-read graphs that are efficient at making a point; and most importantly, they know the frequent misconceptions and typical issues students have.*

—Nancy Lynch, West Virginia University

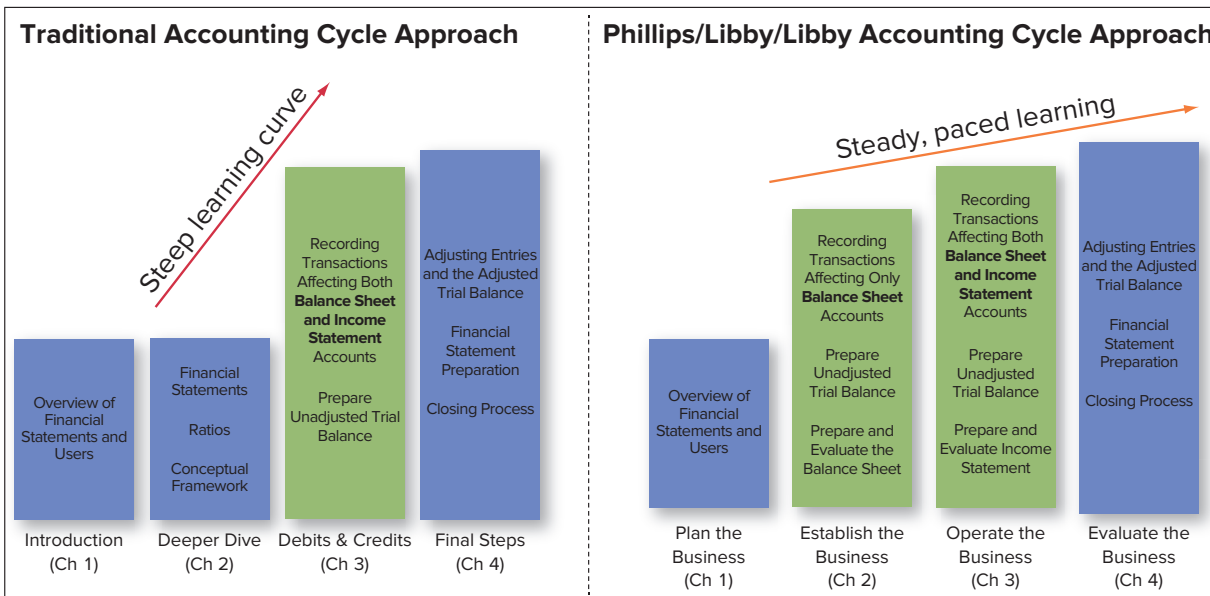
Driving Success with Clear, Effective, and Innovative Ideas

A Proven Teaching and Learning Methodology

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

The graphic shows how, unlike other texts, the Phillips/Libby/Libby approach spreads transaction analysis coverage over two chapters so that students have the time to master the material. In Chapter 2, students are exposed to the accounting equation and transaction analysis for transactions that affect only balance sheet accounts. This provides students with the opportunity to learn the basic structure and tools used in accounting in a simpler setting. In Chapter 3, students are exposed to more complex transactions that affect both balance sheet and income statement accounts. As a result of this progressive approach to transaction analysis, students learn more, as documented in peer-reviewed research.* This innovative approach also prepares students to better understand adjustments, financial statement preparation, and more advanced topics.

In addition, the accounting cycle approach used here tells a natural business story—one that would be familiar to any modern entrepreneur. From planning and establishing the business to opening and evaluating the business, the first few chapters clearly break out each key stage in starting a company. The accounting cycle coverage steadily unfolds as students move along this company’s journey, allowing them to keep pace and absorb how accounting events unfold in the real world of business.



Phillips/Libby/Libby *introduces all of the financial statements* in the first chapter, then utilizes debits and credits combined with increases and decreases for transactions affecting the balance sheet, and then *reinforces the methodology* when presenting the transactions affecting the income statement in Chapter 3. This area is the toughest for students and requires the most practice. Phillips understands this and *expertly navigates* through the two statements and demonstrates how the two interconnect and depend upon each other, setting the stage for an easier adjustment and closing process ahead.

—Margaret Costello Lambert, Oakland Community College

*F. Phillips and L. Heiser, “A Field Experiment Examining the Effects of Accounting Equation Emphasis and Transaction Scope on Students Learning to Journalize,” *Issues in Accounting Education* 26 (2011), pp. 681–699.

Modern Businesses Bring Accounting Concepts to Life



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Written in *clear, understandable language* . . . The multiple *real-world examples, colorful and “clean” exhibits*, as well as other illustrations *enhance the student’s learning process* by making the information relevant and understandable. The *“building block” approach* allows the student to gain a *solid understanding* of the fundamentals of each chapter before moving on to the next.

—Muriel Anderson, SUNY–Buffalo

Not all students learn financial accounting with ease. With so many distractions these days, it is difficult to keep both majors and nonmajors focused on the big picture. The authors of *Fundamentals of Financial Accounting* understand the challenges instructors face and the need for a financial accounting text that is relevant, easy to read, and current.

Fundamentals of Financial Accounting responds by using **carefully chosen focus companies that students recognize and engage with in their everyday lives**. From tech start-ups to some of the world’s most familiar trademark brands, each chapter opens with an engaging scenario or story using a familiar company. The same focus company, such as **Walmart**, **Cedar Fair**, **American Eagle**, **National Beverage**, **Under Armour**, or **General Mills**, is used throughout the entire chapter so that students can see how the concepts and calculations apply to a real-world company they are already familiar with.

Today’s students have grown up hearing about start-up culture, and many are entrepreneurially minded having seen the rise of Apple, Facebook, and the “gig economy.” The authors showcase accounting’s relevance by using **Noodlecake Studios**, a digital start-up, as the company profiled in Chapters 1–4. With this example, students see how a new small business uses accounting, from planning to evaluation of financial performance.

Through crisp, clear, and engaging writing, the financial decisions these companies make and the financial statements they use come alive for students, who are able to see the big picture of how accounting relates to the real world—their world.

The **[Cedar Fair] focus company** is fantastic; this keeps the classes on this chapter fast-paced. You could not have picked a better company for **demonstration of acquisitions and impairments of PPE**. Students love Chapter 9 because of **great examples**, such as the installation and shipping of a roller coaster and the impairment of a ride due to “vortex shedding.” **This chapter is simply exciting.**

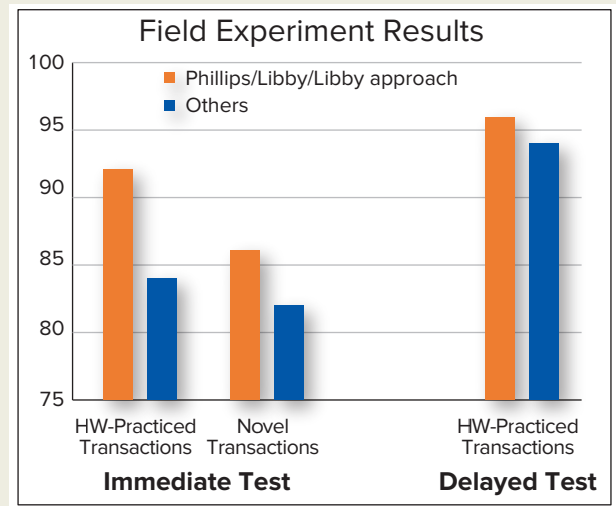
—Lisa McKinney, University of Alabama

Pedagogy Built on Research Data and Analysis

Fundamentals of Financial Accounting uses peer-reviewed research and careful analysis of data to inform decisions on pedagogy and presentation of concepts. For example, the authors' research on various approaches to teaching the accounting cycle informed the step-by-step model used in the text—a model proven to lead to better results in short-term assessment as well as in long-term understanding and application of the material.

In a peer-reviewed study published in *Issues in Accounting Education*, author Fred Phillips and his research partner Lindsay Heiser studied the effects of teaching the accounting cycle by initially restricting the scope of transactions to only those affecting balance sheet accounts, while waiting to introduce transactions involving both balance sheet and income statement accounts until later. The pair hypothesized that further scaffolding concepts would help ensure students didn't get overwhelmed. To test this theory, students were assigned to random groups, with each group learning the accounting cycle via a different approach. All students were evaluated with the same homework assignments and in-class tests.

The results showed that students who learned the accounting cycle via the scaffolded approach were better able to prepare journal entries on similar types of transactions both immediately and one week later. Importantly, these same students later performed just as well on complex transactions affecting balance sheet *and* income statement accounts despite having had less practice with them. The scaffolded accounting cycle approach that proved so effective in this study is the same that is used in *Fundamentals of Financial Accounting*, helping students to “work smarter,” and better preparing them for success in financial accounting and beyond.




“Clear, concise, and the most reader friendly text I’ve come across. Most importantly, it is based on sound learning theory, which greatly enhances the learning experience.”

—Professor Audrey Agnello, Niagara County Community College

From Concepts to Comprehension— Reinforcement Is Key

Whether you're presenting, discussing, or problem solving, you want materials that will motivate students and hold their interest. Motivating today's students requires materials that connect them with the workplace and encourage them to think about course topics before, during, and after class. *Fundamentals of Financial Accounting* offers students many tools to help reinforce the concepts discussed throughout the text.

Picture



Receives

Gives

Name

- Noodlecake has received \$20,000 cash.
- Noodlecake gave a note, payable to the bank for \$20,000.

Analyze

	=		+	
Assets		Liabilities		Stockholders' Equity
(c) Cash +20,000		= Notes Payable +20,000		


Logo: Noodlecake Studios Inc.; Money photo: ©Comstock/PunchStock RF

Coach's Tips

Every student needs encouragement and Coach's Tips are just one way *Fundamentals of Financial Accounting* fulfills that need. Coach's Tips appear throughout the text and in selected end-of-chapter problems to offer tips, advice, and suggestions.

How's it going? Self-Study Practice

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

 **How's it going?**

Self-Study Practice

For each item listed below, indicate whether the company should report it on the income statement this period (yes/no). If yes, indicate an appropriate account title for the item described.

Description	Yes/No	Account Title
1. Bank of America charges customers a monthly service fee.	_____	_____
2. Target buys a new building to use as a retail store.	_____	_____
3. Dell pays to deliver computers to customers.	_____	_____
4. Pizza Hut buys supplies to be used next month.	_____	_____
5. Snap pays this week's wages to employees.	_____	_____

After you have finished, check your answers with the solution.

Phillips does an *outstanding job of incorporating real world data into the text*, which increases a student's engagement with the material and enhances their learning. I think that the writing style is very conversational, which makes reading the chapter a manageable task for the students.

—Anne Clem, Iowa State University

SPOTLIGHT ON **The World**

IFRS Does Not Allow LIFO

SPOTLIGHT ON **Financial Reporting**

Revenue Recognition Policy

SPOTLIGHT ON **Controls**

Is That a Control, Too?

SPOTLIGHT ON **Ethics**

35 Days Hath September?

SPOTLIGHT ON **Business Decisions**

The New Bookkeeper Is a Robot

That's the headline of a *Wall Street Journal* article describing how mundane accounting tasks, such as entering data and paying suppliers, are increasingly being performed by com-



SPOTLIGHT ON **Big Data and Analytics**

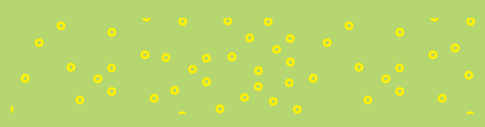
Applying Inventory Turnover and Gross Profit to LCM/NRV Judgments

Accountants and managers often use **data visualization** techniques to identify key relationships between financial measures. For example, to identify particular inventory items at risk of requiring an LCM/NRV write-down, accounting analysts plot the *days to sell* and *gross profit percentage* by product line on a graph such as the following:

Spotlight Features


Each chapter includes Spotlight features focusing on business decisions, ethics, internal controls, financial reporting, big data and analytics, and the world (IFRS). These features are designed to further engage students and provide instructors with material for in-class discussion.

- **NEW Spotlight on Big Data and Analytics**—highlights topics relating to big data, data visualization, and data and business analytics.
- **Spotlight on the World**—highlights significant differences between U.S. GAAP and IFRS.
- **Spotlight on Financial Reporting**—connects chapter topics with real-world disclosures provided in the financial statements of our focus companies and other contrast companies.
- **Spotlight on Controls**—highlights applications of internal control principles in the workplace.
- **Spotlight on Ethics**—emphasizes ethical issues and the importance of acting responsibly.
- **Spotlight on Business Decisions**—helps students develop strong decision-making skills by illustrating the relevance of accounting in real-world decision making and the lessons learned from the global economic crisis.



Videos: Present, Expand, and Reinforce Key Concepts

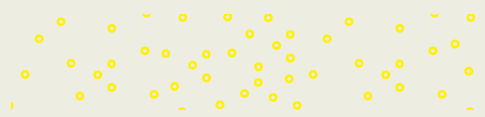
Modern businesses expect their employees to be lifelong learners. As a result, businesses and educators increasingly rely on videos as “just-in-time” resources to present, reinforce, and augment critical concepts. Whether the viewer is a student in a classroom or a newly hired CPA at a Big 4 accounting firm, learning on the go via a variety of multimedia-based assets is key in both the corporate world and academic settings. *Fundamentals of Financial Accounting* provides a range of video offerings and formats to facilitate understanding and help students learn wherever and whenever they need to.

Instructional Video	Where to Find it?	Video Description
Concept Overview Videos	Assignable in Connect	Assignable videos cover each chapter’s learning objectives followed by auto-graded knowledge checks that confirm students’ comprehension. A great tool for introducing students to new topics.
Guided Examples	Hints for students in select exercises in Connect	A narrated, animated, step-by-step walkthrough of an exercise similar to the assigned exercise, these videos provide just-in-time help for students when they are working on assignments.
Spotlight Videos	Assignable in Connect or directly in the eBook	Selected Spotlight on Ethics, Financial Reporting, and Business Decisions features are brought to life in 2- to 5-minute news magazine-style videos, which are available and assignable in McGraw-Hill Education’s Connect. These engaging investigative videos, written by author Fred Phillips, tie to specific topics in <i>Fundamentals of Financial Accounting</i> . Instructors can assign students to watch the videos and answer questions regarding the content in Connect. 
In Action Videos	Select How’s it going? Self-Study Practices in the eBook.	These tutorial videos illustrate the thought processes applicable to a sample of topics, including how to analyze transactions, adjust accounts, account for inventory and receivables, and prepare a statement of cash flows.
Flash Topic Videos	Assignable in Connect	Introduce students to hot topics in accounting including revenue recognition, big data, sales returns, stock buybacks, and sustainability. These videos extend the ideas presented in the text and are assignable in Connect.

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*I thought the coverage on fraud and SOX was very good. **The information presented was easy to read and understand.***


—Victoria White, Ivy Tech Community College of Indiana—Evansville





Practice and Review Materials Build Confidence and Success

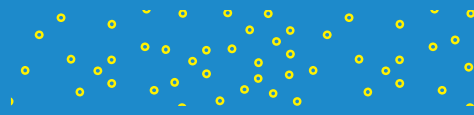
To effectively evaluate and guide student success with the appropriate feedback, instructors need homework and test materials that are **easy to use** and tied to the chapter discussions. Each chapter of *Fundamentals of Financial Accounting* is followed by an extensive variety of end-of-chapter material that applies and integrates topics presented in the chapter.

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- **Demonstration Case:** End-of-chapter review material begins with a demonstration case that provides another self-study opportunity for students. The demonstration case is practice material that previews what students will see in the homework problems. The accompanying solution allows students to check their understanding of the material before completing and submitting homework for a grade. It also can serve as a study tool for exams.
 - **Chapter Summary:** Each chapter concludes with an end-of-chapter summary organized by learning objectives. This allows students to revisit the learning objectives from the beginning and middle of the chapter.
 - **Key Terms:** Key terms include the most important words and phrases, definitions, and page references. Full definitions for all key terms can be found in the glossary.
 - **Homework Helper** immediately precedes each chapter's homework materials, highlighting subtleties discussed in the chapter and providing practical advice so students avoid common pitfalls when completing homework assignments.
 - **Multiperspective Discussion Questions:** Each chapter includes 10–20 questions that ask students to explain and discuss terms and concepts presented in the chapter. Selected questions, denoted with an icon , are designed to help students begin developing critical thinking skills. These questions are ideal for sparking debate at the beginning of class or when transitioning between or reviewing topics.
 - **Multiple-Choice Questions:** Each chapter includes 10 multiple-choice questions that let students practice basic concepts. Solutions for these questions are provided in the back of the text.



The end-of-chapter **problems and exercises** are **ample, diverse** (in terms of rigor), and **congruent** with the material covered in the chapter.

—Brian Nagle, Duquesne University




- **Mini-Exercises, Exercises, Problems (Coached, Group A, and Group B):** Each chapter includes a wide variety of assignment material from questions that illustrate and apply a single learning objective to problem sets that help students develop decision-making skills.

- **Level-up Questions:**



In each chapter, particularly challenging questions, designated by the level-up icon, require students to combine multiple concepts to advance to the next level of accounting knowledge.

- **Comprehensive Problems:** Selected chapters include problems that cover topics from earlier chapters to refresh, reinforce, and build an integrative understanding of the course material. These are a great resource for helping students stay up-to-date throughout the course.
- **Questions** designated with the **general ledger** icon have been written to take advantage of Connect's general ledger simulation. A much-improved student experience when working with accounting cycle questions, students' work in the general journal is automatically posted to the ledger, navigation is much simpler, and students can easily link back to their original entries simply by clicking in the ledger if edits are needed. These questions include critical thinking components to maximize students' foundational knowledge of accounting concepts and principles. 
- **Skills Development Cases:** Each chapter offers cases designed to help students develop analytical, critical thinking, and technology skills. These cases are ideal for individual assignments, class discussions, and group projects.
 - Encourage your students to find financial information in an actual annual report. The first case of every chapter presents, in multiple-choice format, an opportunity to connect your students with real-world financial reporting. These are assignable in Connect.
- **Continuing Case:** In Chapter 1, students are introduced to Nicole's Getaway Spa (NGS). In the following chapters, this continuing case is extended to encompass each new topic.





What's New in the Sixth Edition?

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

- Introduced the **new 5-step revenue model** as it applies to service companies (Chapter 3) and merchandisers (Chapter 6). As part of these changes, all references to Unearned Revenue have been replaced with Deferred Revenue. Additional changes to Chapter 6 are summarized below.
- Integrated **new companies**, including a new focus company (**Noodlecake Studios**) that won an Apple Design Award and many other companies familiar to students (**Alphabet, Apple, Facebook, Fitbit, Samsung**, and so on).
- **New Spotlight on Big Data and Analytics** highlights topics relating to big data, data visualization, and data and business analytics.
- Reviewed, updated, and introduced new end-of-chapter material in each chapter to support new topics and learning objectives, including **Connect problems that auto-post** from journal entries to T-accounts to trial balances.
- Fine **line-editing guided by student data from LearnSmart**.

CHAPTER 1: BUSINESS DECISIONS AND FINANCIAL ACCOUNTING

Focus Company: **Noodlecake Studios**

- **New** contemporary focus company: a private company that develops award-winning game apps for smartphones and tablets
- **Updated** Spotlight on Ethics to refer to fraud allegations at **Valeant Pharmaceuticals**
- **New** chapter supplement explaining financial reporting by public companies
- Updated demonstration case featuring **Under Armour**
- Reviewed and updated all end-of-chapter material, including financial data for **Activision Blizzard, DSW, Cinemark, Fitbit**, and others

CHAPTER 2: THE BALANCE SHEET

Focus Company: **Noodlecake Studios**

- **New** contemporary focus company: continuation of business case from Chapter 1
- **New** Spotlight on Business Decisions to highlight the value of accounting automation
- Updated analysis of current ratios in Exhibit 2.14 and Spotlight on Financial Reporting to focus on technology companies, including **Apple, Expedia, Electronic Arts, Facebook**, and **TripAdvisor**
- Reviewed and updated all end-of-chapter material, including financial data for **Columbia Sportswear, Ethan Allen Interiors, Starbucks**, and others

CHAPTER 3: THE INCOME STATEMENT

Focus Company: **Noodlecake Studios**

- **New** contemporary focus company: continuation of business case from Chapter 2
- **New** discussion and illustration to introduce the five-step revenue model (Exhibit 3.5)
- **New** Spotlight on Financial Reporting to illustrate revenue recognition policy of **Noodlecake Studios**
- **Updated** net profit margin ratios at **Electronic Arts, Activision Blizzard, TripAdvisor**, and **Facebook** in Spotlight on Financial Reporting
- Updated demonstration case featuring **Carnival Corporation**
- Reviewed and updated all end-of-chapter material, including financial data for **Expedia, Priceline**, and others

CHAPTER 4: ADJUSTMENTS, FINANCIAL STATEMENTS, AND FINANCIAL RESULTS

Focus Company: **Noodlecake Studios**

- **New** contemporary focus company: continuation of business case from Chapter 3
- Reviewed and updated all end-of-chapter material, including financial data for **FedEx Corporation, Regis Corporation**, and others

CHAPTER 5: FRAUD, INTERNAL CONTROL, AND CASH

Focus Company: **Koss Corporation**

- **Updated** data relating to frequency and losses from employee fraud in Exhibit 5.1

CHAPTER 5: (continued)

- Updated discussion of p-cards in Spotlight on Controls
- Updated illustration of restricted cash reporting at **Whole Foods Market** (Exhibit 5.10)
- Reviewed, updated, and introduced new end-of-chapter material, including financial data for **Expedia**, **Home Depot**, and others

CHAPTER 6: MERCHANDISING OPERATIONS AND THE MULTISTEP INCOME STATEMENT

Focus Company: **Walmart**

- Substantially changed from the fifth edition to incorporate the five-step revenue model's requirement to report revenue at the amount an entity expects *to be entitled* to receive from customers
 - Simplified chapter by discussing purchase and sale discounts in the chapter and relocating journal entries to chapter supplement 6A
 - Simplified chapter by recording sales allowances directly against sales rather than in a contra-revenue account
 - Clarified accounting for sales returns by distinguishing actual and estimated returns
 - **New** learning objective and Exhibit 6.7 to demonstrate application of the five-step revenue model to the sale of bundled goods/services
- Updated focus company illustrations (**Walmart**) and introduced **Planet Fitness** to contrast financial statements of service company with merchandiser (Exhibit 6.2)
- Updated data regarding inventory shrinkage costs in Spotlight on Controls
- **New** Spotlight on Business Decisions to discuss the shift in credit terms away from 2/10, n/30
- **New** Spotlight on Financial Reporting on misreporting of sales rebates at **Monsanto Company**
- **New** Spotlight on Business Decisions to demonstrate the prevalence of bundled goods/services and multiple performance obligations including **Apple's** iPhone upgrades
- Updated illustration of gross profit percentage analysis at **Walmart** and **Neiman Marcus**
- **New** chapter supplement 6A to illustrate journal entries for purchase and sale discounts using the gross and net methods
- **New** demonstration case B to illustrate the application of the new five-step revenue model to sales of bundled goods/services

- Added new end-of-chapter material for bundled sales, and reviewed and updated all other end-of-chapter material, including financial data for **Luxottica**, **Fortune Brands**, **The Gap**, **Macy's**, and others

CHAPTER 7: INVENTORY AND COST OF GOODS SOLD

Focus Company: **American Eagle Outfitters**

- Updated focus company illustrations
- **New** discussion of FASB's simplification in reporting inventory at the lower of cost or market/net realizable value (LCM/NRV)
- **New** Spotlight on Financial Reporting discussing the \$2.5 billion LCM/NRV write-down at **Samsung** for its exploding Galaxy Note 7 smartphones
- Updated inventory turnover analysis in Exhibit 7.7, involving **Harley-Davidson**, **McDonald's**, and **American Eagle**
- **New** Spotlight on Big Data and Analytics to demonstrate data visualization that combines inventory turnover and gross profit analysis when evaluating LCM/NRV
- Restructured selected exercises to focus on individual inventory costing methods, and reviewed and updated all end-of-chapter material, including financial data for **BlackBerry**, **Amazon**, **Polaris Industries**, **GameStop**, and others

CHAPTER 8: RECEIVABLES, BAD DEBT EXPENSE, AND INTEREST REVENUE

Focus Company: **VF Corporation (VFC)**

- Updated focus company illustrations for **VF Corp.**—the maker of **North Face** jackets, **JanSport** backpacks, **Wrangler** jeans, and **Vans** shoes
- Updated Spotlight on Business Decisions showing credit card costs at **Nordstrom**
- Revised description of bad debt estimates to reflect the current expected credit loss model in ASC 326-20
- Updated receivables turnover analysis in Exhibit 8.7, involving **VF Corp.**, **Post**, and **Apple**
- **New** Spotlight on Big Data and Analytics to demonstrate data visualization that combines customer location information with measures of liquidity and profitability
- Reviewed and updated all end-of-chapter material, including financial data for **Adobe**, **Callaway Golf**, **Microsoft**, **Sears**, and others

CHAPTER 9: LONG-LIVED TANGIBLE AND INTANGIBLE ASSETS

Focus Company: **Cedar Fair**

- Updated focus company illustrations
- Updated Spotlight on the World to include component allocation of golf course bunkers at **TWC Enterprises**
- Clarified that asset impairment involves two steps: (1) eliminate accumulated depreciation against the asset (cost) account and (2) write down the asset account for its impairment in fair value
- **New** Spotlight on Financial Reporting about interpreting gains on disposal (involving tragic events)
- Updated fixed asset turnover analysis in Exhibit 9.5, involving **Cedar Fair**, **Six Flags**, and **Facebook**
- **New** Spotlight on Financial Reporting to explain how **Intel's** longer estimated life was bad news
- Reviewed and updated all end-of-chapter material, including financial data for **Amazon**, **Hasbro**, **Alphabet**, **TripAdvisor**, and others

CHAPTER 10: LIABILITIES

Focus Company: **General Mills**

- Updated focus company illustrations
- Updated analysis of debt-to-assets and times interest earned ratios for **Kellogg**, **Post**, and **Campbell Soup** comparison companies
- Chapter supplement 10D on installment notes now included in chapter (previously available online only)
- Reviewed and updated all end-of-chapter material, including financial data for **FedEx Corporation**, **Lowe's**, and others

CHAPTER 11: STOCKHOLDERS' EQUITY

Focus Company: **National Beverage Corp.**

- Updated focus company illustrations, as well as stock prices of rivals **Coca-Cola** and **PepsiCo**
- Updated Spotlight on Business Decisions to discuss the SEC's oversight of crowdfunding equity portals, such as **Wefunder.com**
- **New** Spotlight on Business Decisions involving **Boeing's** treasury stock purchase to boost EPS
- Revised Spotlight on Business Decisions to describe **National Beverage's** dividend program to reward stockholder loyalty
- **New** discussion of preferred stock redemptions

- Updated ratio analyses in Exhibit 11.6, involving **National Beverage** and **PepsiCo**
- Reviewed and updated all end-of-chapter material, including financial data for **General Mills**, **Stanley Black & Decker**, **Delta**, **Southwest Airlines**, and others

CHAPTER 12: STATEMENT OF CASH FLOWS

Focus Company: **Under Armour Inc.**

- Updated focus company illustrations
- Reviewed and updated all end-of-chapter material, including financial data for **Colgate-Palmolive**, **Walt Disney Company**, **Gibraltar Industries**, and others

CHAPTER 13: MEASURING AND EVALUATING FINANCIAL PERFORMANCE

Focus Company: **Lowe's**

- Updated focus company analyses
- Revised Exhibit 13.5 and related discussion to reflect changes made to all other chapters
- Updated discussion to reflect FASB's going concern standards update
- Reviewed and updated all end-of-chapter material, including financial data for **Chevron**, **Cintas Corporation**, **Procter & Gamble**, **Dollar General**, **Kohl's**, and others

APPENDIXES A & B: EXCERPTS FROM ANNUAL REPORTS OF THE HOME DEPOT AND LOWE'S

- Updated excerpts from the Fiscal 2016 Annual Reports of **The Home Depot** and **Lowe's**

APPENDIX C: PRESENT AND FUTURE VALUE CONCEPTS

- Reviewed and updated all end-of-chapter material

APPENDIX D: INVESTMENTS IN OTHER CORPORATIONS

Focus Company: **Alphabet Inc.**

- **New** focus company (**Alphabet Inc.**) to provide contemporary context for topics
- **New** discussion of fair value method, as applied to all investments in equity securities with readily determinable fair values (ASC 321)
- Eliminated discussion of available-for-sale equity securities and reporting fair value through OCI



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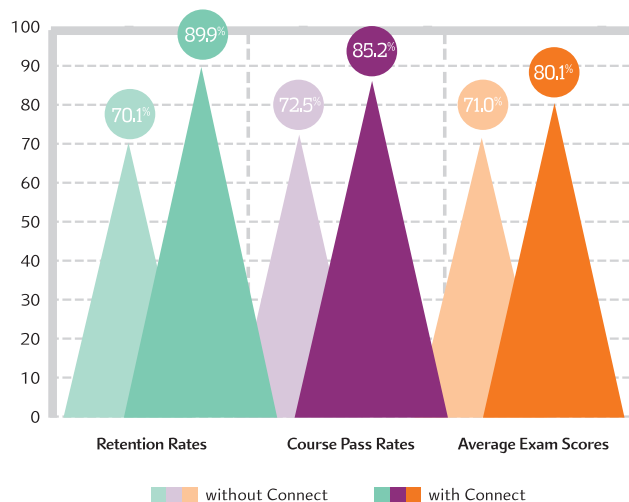
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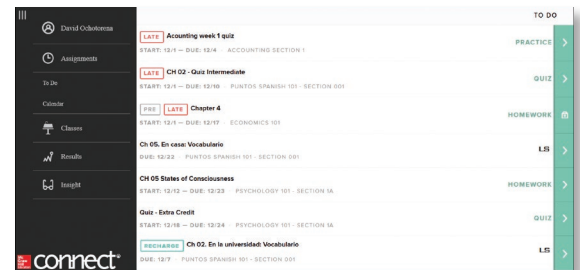


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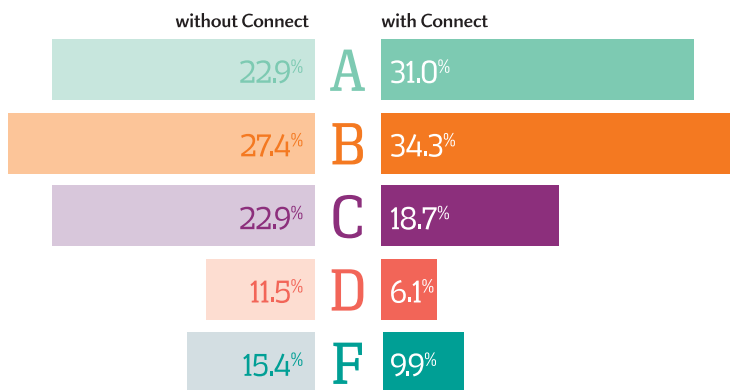
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Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. Connect grades homework automatically and gives immediate feedback on any questions students may have missed. The extensive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

End-of-chapter questions in Connect include

- Mini-Exercises
- Exercises
- Problems (Coached, Group A, and Group B)
- Comprehensive Problems
- Skills Development Cases
- Continuing Cases

"The textbook's General Ledger, Concept Overview Videos, and Excel Simulations are outstanding."

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General Ledger Problems

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

M2-10 Preparing Journal Entries [LO 3]

The following are the transactions of Spotlighter, Inc., for the month of January 2013:

- Borrowed \$3,940 from a local bank on a note due in six months.
- Received \$4,630 cash from investors and issued stock to them.
- Purchased \$1000 in equipment, paying \$200 cash and promising the rest on a note due in one year.
- Paid \$300 cash for supplies.
- Bought and received \$700 of supplies on account.

Prepare journal entries for each transaction. (If no entry is required for a transaction/event, select "No Journal Entry Required" in the first account field.)

view transaction list view general journal

Journal Entry Worksheet

Record the borrowing of \$3,940 from a local bank on a note due in six months.

Transaction	General Journal	Debit	Credit
a	Cash	3,940	
	Notes Payable (long-term)		
	Notes Payable (short-term)		
	Notes Receivable		
	Other Noncurrent Assets		

*Enter debits before credits

done clear transaction record transaction

Requirement General Journal General Ledger Trial Balance Income Statement Statement of Retained Balance Sheet Analysis

Each journal entry is posted automatically to the general ledger. Use the drop-down button to view the unadjusted, adjusted, or post-closing balances.

Post-closing

Cash				Accounts Receivable			
Date	Debit	Credit	Balance	Date	Debit	Credit	Balance
Jan 01, 2015			3	Jan 01, 2015			5
Mar 01, 2015	12		15				
Mar 02, 2015		9	6				
Apr 03, 2015	23		29				
Jul 04, 2015		10	19				
Nov 06, 2015		13	6				

Supplies				Land			
Date	Debit	Credit	Balance	Date	Debit	Credit	Balance
Jan 01, 2015			12	Jan 01, 2015			0
Oct 05, 2015	18		30	Mar 02, 2015	9		9

Equipment				Accumulated Depreciation—Equipment			
Date	Debit	Credit	Balance	Date	Debit	Credit	Balance
Jan 01, 2015			60	Jan 01, 2015			6

Software				Accumulated Amortization			
Date	Debit	Credit	Balance	Date	Debit	Credit	Balance
Jan 01, 2015			15	Jan 01, 2015			5
Jul 04, 2015	10		25				

Accounts Payable				Notes Payable (short-term)			
Date	Debit	Credit	Balance	Date	Debit	Credit	Balance
Jan 01, 2015			5	Jan 01, 2015			0
Oct 05, 2015		18	23	Mar 01, 2015		12	12
Nov 06, 2015		13	10				

Common Stock				Retained Earnings			
Date	Debit	Credit	Balance	Date	Debit	Credit	Balance
Jan 01, 2015			71	Jan 01, 2015			8
Apr 03, 2015		23	94				

Requirement General Journal General Ledger Trial Balance Income Statement Statement of Retained Balance Sheet Analysis

Notice the dropdown below that gives the options to select the unadjusted, adjusted or post-closing trial balance. The option you choose will be the values used to populate the income statement and balance sheet tabs. Do not complete and review the financial statements until you have verified that total debits equal total credits.

Post-closing

H & H TOOL, INC.		
Trial Balance		
December 31, 2015		
Account Title	Debit	Credit
Cash	\$ 6	
Accounts Receivable	5	
Supplies	30	
Land	9	
Equipment	60	
Accumulated Depreciation—Equipment		6
Software		25
Accumulated Amortization		5
Accounts Payable		10
Notes Payable (short-term)		12
Common Stock		94
Retained Earnings		8
Total	\$ 135	\$ 135

previous next

NEW! Concept Overview Videos

The **Concept Overview Videos** provide engaging narratives of key topics in an assignable and interactive online format. They follow the structure of the text and are organized to match the chapter's learning objectives. The Concept Overview Videos provide additional explanation and enhancement of material from the text chapter, allowing students to learn, study, and practice with instant feedback, at their own pace.

NEW! Excel Simulations

Simulated Excel Questions, assignable within Connect, allow students to practice their Excel skills—such as basic formulas and formatting—within the content of financial accounting. These questions feature animated, narrated Help and Show Me tutorials (when enabled), as well as automatic feedback and grading for both students and professors.

Guided Examples

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

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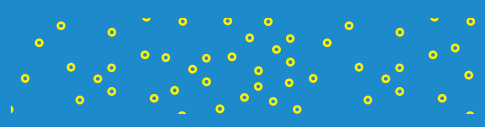
Unadjusted Trial Balance		
SONICGATEWAY, INC. Unadjusted Trial Balance At September 30		
Account Name	Debits	Credits
Cash	\$16,900	
Accounts Receivable	500	
Supplies	600	
Prepaid Rent	7,200	
Equipment	9,600	
Software	9,000	
Logo and trademarks	300	
Accounts Payable		\$10,700
Unearned Revenue		300
Note Payable		20,000
Common Stock		10,000
Retained Earnings		0
Sales Revenue		12,000
Salaries and Wages Expense	7,800	
Utilities Expense	600	
Advertising Expense	500	
Totals	\$53,000	\$53,000

Knowledge Check 01

A trial balance can best be explained as a list of:

Prepare a schedule of net cash provided by operating activities.

	End of year	Beginning of year
Current assets:		
Cash	\$ 75,000	\$ 90,000
Accounts receivable	158,000	140,000
Inventory	285,000	246,000
Prepaid expenses	11,000	16,000
Current liabilities:		
Accounts payable	284,000	302,000
Accrued liabilities	9,500	11,200
Income taxes payable	27,000	24,000
Net income		\$ 94,500
Accumulated depreciation		
total credits		\$ 45,000



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Many educational institutions today are focused on the notion of *assurance of learning*, an important element of some accreditation standards. *Fundamentals of Financial Accounting* is designed specifically to support your assurance of learning initiatives with a simple, yet powerful solution.

Each test bank question for *Fundamentals of Financial Accounting* maps to a specific chapter learning objective listed in the text. You can use Connect to easily query for learning outcomes/objectives that directly relate to the learning objectives for your course. You can then use the reporting features of Connect to aggregate student results in a similar fashion, making the collection and presentation of assurance of learning data simple and easy.

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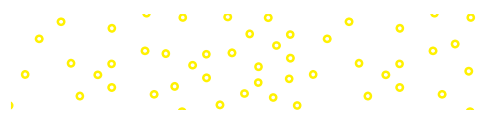
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 Barbara Merino, *University of North Texas*
 Tony Mifsud, *Catawba Valley Community College*
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 Tim Mills, *Eastern Illinois University*
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Fundamentals of
FINANCIAL ACCOUNTING

1

Business Decisions and Financial Accounting

CHAPTER ONE

YOUR LEARNING OBJECTIVES

- LO 1-1** Describe various organizational forms and business decision makers.
- LO 1-2** Describe the purpose, structure, and content of the four basic financial statements.
- LO 1-3** Explain how financial statements are used by decision makers.
- LO 1-4** Describe factors that contribute to useful financial information.
- LO 1-S1** Describe examples where accounting helps in pursuing other business careers.
- LO 1-S2** Describe the decision to become a public company and explain the implications for accounting.

THAT WAS THEN

If you think accounting is far removed from your personal life, you might be in for a surprise. Your ordinary life experiences, especially as a student, actually prepare you well to learn accounting.



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FOCUS COMPANY: NOODLECAKE STUDIOS, INC.



Welcome to the world of business and financial accounting. One of our goals for this book is to help you see the role accounting plays in helping people turn their good ideas into successful businesses. The founder of **FedEx** first introduced his ideas about a nationwide transportation business in a college essay. With the help of accounting, FedEx has become a multibillion-dollar business. Perhaps the only thing stopping you from doing this is you need to know more about starting and running a business. We're here to help with that.

Another important goal for us is to explain topics in ways that connect with your personal life experiences. Often, we will explain topics in the context of a real business. For example, in the first four chapters, you will learn the steps to starting a successful business. By reading about these experiences, you'll gain a realistic understanding of how accounting is a key part of all businesses. So, let's get started.

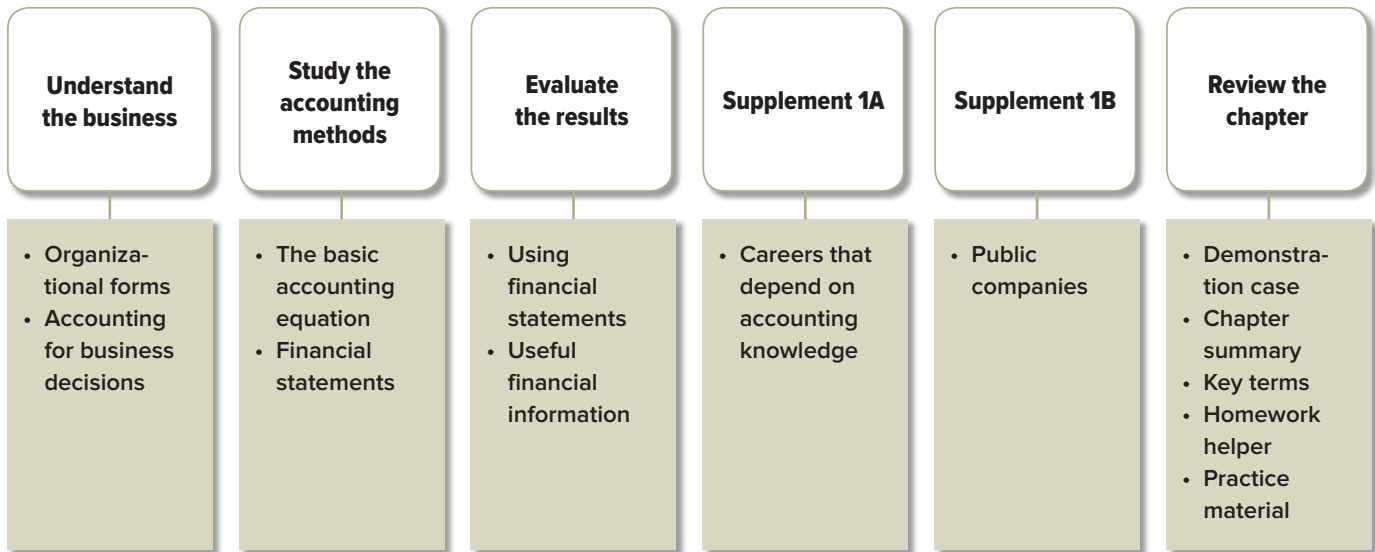
For Jordan Schidlowsky and Ty Bader, the last few years have been incredible. Their *Super Stickman Golf* series and other game apps they've developed for mobile devices have won awards and recognitions on iTunes and Google Play. The crowning achievement (so far) was being awarded an Apple Design Award for their game *Chameleon Run*. Their marketing director, Ryan Holowaty, says it's like winning an Academy Award. They continue to grow their business, now developing and publishing games for not only the iPhone and Android, but also game consoles and PCs. They have benefited greatly from the advice of Laurie Norris—a CPA (certified public accountant)—who has helped them establish their business and understand how to monitor its success. As you will read in this chapter, Laurie met with Jordan in June to answer his many questions about getting started. By following Laurie's business and accounting advice, Jordan and Ty successfully launched their company, named **Noodlecake Studios, Inc.** (noodlecake.com).

THIS IS NOW

This chapter focuses on the key financial reports that business people rely on when evaluating a company's performance.

Logo: Noodlecake Studios, Inc.

ORGANIZATION OF THE CHAPTER



Understand the Business

“Jordan, we should start by talking about how you want to organize your business.”



“Well, I’m starting a technology company to sell apps in Apple’s App Store and on Google Play. What else do I need to know?”

Learning Objective 1-1

Describe various organizational forms and business decision makers.

ORGANIZATIONAL FORMS

Laurie outlined three primary ways businesses can be organized: sole proprietorship, partnership, and corporation.

Sole Proprietorship

This is a form of business owned (and usually operated) by one individual. It is the easiest form of business to start because it doesn’t require any special legal maneuvers. Just get a business license and you’re good to go. A sole proprietorship is considered a part of the owner’s life, with all profits (or losses) becoming part of the taxable income of the owner, and the owner being personally liable for all debts of the business.

Partnership

A partnership is similar to a sole proprietorship, except that profits, taxes, and legal liability are the responsibility of two or more owners instead of just one. It is slightly more expensive to form than a sole proprietorship because a lawyer typically is needed to draw up a partnership agreement, which describes how profits are shared between partners and how that would

change if new partners are added or existing partners leave. The key advantage of a partnership over a sole proprietorship is that, by having more owners, a partnership typically has more resources available to it, which can fuel the business's growth.

Corporation

Unlike sole proprietorships and partnerships, a corporation is a separate entity from both legal and accounting perspectives. This means the corporation, not its owners, is legally responsible for its own taxes and debts. Thus, owners cannot lose more than their investment in the corporation, which is a major advantage to the owners. Two disadvantages of incorporation are the legal fees for creating a corporation can be expensive and income taxes must be paid by both the corporation and its owners.

Corporations can raise large amounts of money for growth because they divide ownership of the corporation into shares that can be sold to new owners. A share of the corporation's ownership is indicated on a legal document called a stock certificate. The owners of a company's stock (stockholders) can buy and sell stock privately or publicly on a stock exchange if the company has legally registered to do so. Most corporations start out as **private companies** and, as explained in Chapter Supplement 1B, will apply to become **public companies** ("go public") if they need a lot of financing, which they obtain from issuing new stock certificates to investors. Some big-name corporations, like **Cargill** and **Chick-fil-A**, haven't gone public because they get enough financing from private sources, but many that you are familiar with (and most examples in this book) are public companies.

Other

Other organizational forms exist, such as a limited liability company (LLC), which combines characteristics of a partnership and a corporation. We focus on corporations in this book.

"I'm interested in limiting my legal liability and getting some financing by selling ownership shares to investors, so I will create a private corporation called Noodlecake Studios, Inc. What's next?"



ACCOUNTING FOR BUSINESS DECISIONS

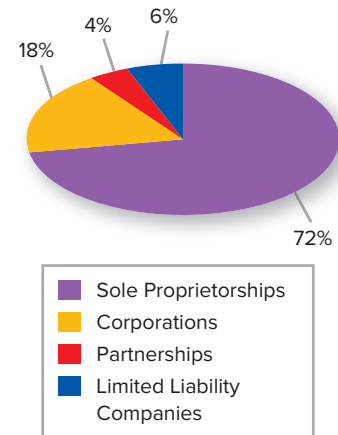
Most companies exist to earn profits for their stockholders. They earn profits by selling goods or services to customers for more than they cost to produce. **Noodlecake** will be successful if it is able to sell enough apps to cover the costs of making them and running the company. To know just how successful the company is, Jordan and Ty will need to establish and maintain a good system of financial record-keeping—an accounting system. **Accounting** is an information system designed by an organization to capture (analyze, record, and summarize) the activities affecting its financial condition and performance and then report the results to decision makers, both inside and outside the organization. It's such a key part of business that business people typically talk about their companies using accounting terms, which is why they often call it the "language of business."

Every organization needs accountants to assist in reporting financial information for decision making and to help its owners understand the financial effects of those business decisions. Jordan can get this help in one of two ways. He can hire an accountant to work as an employee of his business (a **private accountant**) or he can contract with someone like Laurie who provides advice to several businesses (a **public accountant**). Because Jordan's business is small, he doesn't yet need a full-time accountant. Instead, he agrees for Noodlecake to pay fees to Laurie for basic services. She'll help him to set up an accounting system and advise him on key business decisions.

"How will an accounting system help me run my business?"



Percentage of Organizational Forms in the U.S.



Source: IRS.gov.

YOU SHOULD KNOW

Accounting: A system of analyzing, recording, and summarizing the results of a business's operating, investing, and financing activities and then reporting them to decision makers.

EXHIBIT 1.1

The Accounting System Reports Information for Decision Makers



The main goal of an accounting system is to capture information about the operating, investing, and financing activities of a company so that it can be reported to decision makers, both inside and outside the business. Exhibit 1.1 illustrates this role and shows that this information can be presented in two kinds of reports. **Managerial accounting reports** include detailed financial plans and continually updated reports about the operating performance of the company. These reports are made available only to the company's employees (internal users) for making business decisions related to production, marketing, human resources, and finance. For example, managerial accounting reports are needed when determining whether to build, buy, or rent a building; whether to continue or discontinue making particular products; how much to pay employees; and how much to borrow. As manager of Noodlecake, Jordan will regularly need managerial accounting reports to monitor the number of app downloads and evaluate the various costs associated with making and selling apps.



“Financial information about your business will be needed by others outside your company. For example, where will the money come from to start your business?”

“Ty and I will contribute \$5,000 each from personal savings. But I’ll still need to ask the bank for a \$20,000 loan to buy computer equipment and software. What will the bank want to know?”



YOU SHOULD KNOW

Financial Statements: Reports that summarize the financial results of business activities.

Laurie described **financial accounting reports**, called **financial statements**, which are prepared periodically to provide information to people not employed by the business. These external financial statement users aren't given access to detailed internal records of

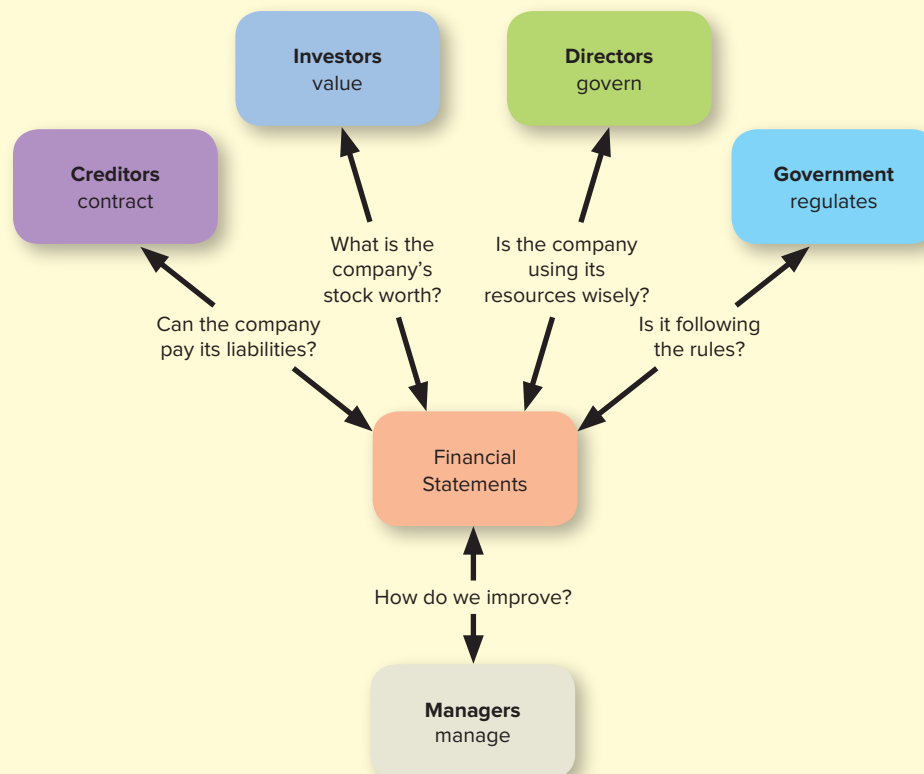
the company, so they rely extensively on the financial statements. The four main groups of external users are (1) creditors, (2) investors, (3) directors, and (4) government.

- 1. Creditors** include suppliers, banks, and anyone to whom money is owed. *Suppliers* want to be sure they will be paid for the goods and services they deliver, so they will evaluate a company's financial statements and check its credit history before allowing it to buy on credit. *Banks* use financial statements to evaluate the risk they will not be repaid the money they've loaned to a company. Because banks take a risk when they loan money to a company, they want periodic financial reports to evaluate how well the company is doing so they can intervene if it looks like the company will have trouble repaying its loan.
- 2. Investors** include existing and potential stockholders. *Stockholders* look to accounting information to assess the financial strength of a business and, ultimately, to estimate its value.
- 3. Directors** is the short title for the members of a company's *board of directors*. The stockholders of public companies or large private companies elect directors to oversee the company's managers. Directors use financial statements to ensure the company's managers make decisions that are in the best financial interests of its stockholders.
- 4. Government** agencies look closely at companies' financial statements. The *Securities and Exchange Commission (SEC)*, for example, is responsible for the functioning of stock markets, so it keeps a close watch on the information public companies report in financial statements. Also, the *Internal Revenue Service (IRS)* and state and local governments use financial statement information to ensure taxes are computed using correct amounts.

Exhibit 1.2 shows that, along with managers inside the company, these external user groups are key users of financial statement information. In Noodlecake's case, the bank will be the

EXHIBIT 1.2

External and Internal Users and Uses of Financial Statements



main external user. Jordan will be expected to prepare financial statements to obtain a bank loan and then regularly provide updated financial reports until the loan is repaid.

While Jordan understood everything Laurie had told him up to this point, he had another major concern.

“I want to sound intelligent when I talk to my banker, but I don’t know much about accounting.”



“This is a common concern for new business owners, so let’s start with the most basic thing you need to know about accounting.”

Study the Accounting Methods

Learning Objective 1-2

Describe the purpose, structure, and content of the four basic financial statements.

THE BASIC ACCOUNTING EQUATION

One of the central concepts to understanding financial reports is that **what a company owns must equal what a company owes to its creditors and stockholders**. In accounting, there are special names for the items a company owns (assets) and the claims on these items by creditors (liabilities) and stockholders (equity), as shown below.

Resources Owned . . .	=	Resources Owed . . .
by the company		to creditors to stockholders
Assets	=	Liabilities + Stockholders' Equity

The relationship between assets (A), liabilities (L), and stockholders' equity (SE) is known as the **basic accounting equation**. The business itself, not the stockholders who own the business, is viewed as owning the assets and owing the liabilities. This separation between stockholders and business is called the **separate entity assumption**, which requires that a business's financial reports include only the activities of the business and not the personal dealings of its stockholders.

The elements of the basic accounting equation are fundamental to reading and understanding financial statements, so let's look at each in detail.

Assets

An **asset** is an economic resource presently controlled by the company; it has measurable value and is expected to benefit the company by producing cash inflows or reducing cash outflows in the future. For **Noodlecake**, assets include things like cash, supplies, equipment, and software. Other companies, such as **Nike** and **Target**, have an asset called inventory, which consists of merchandise held for sale.

Liabilities

Liabilities are measurable amounts the company owes to creditors. If **Noodlecake** borrows from a bank, it would owe a liability called a Note Payable. This particular name is used because banks require borrowers to sign a legal document called a *note* that describes details

YOU SHOULD KNOW

Basic Accounting Equation:

Assets = Liabilities + Stockholders' Equity.

Separate Entity Assumption:

States that business transactions are separate from and should exclude the personal transactions of the owners.

about the company's promise to repay the bank. Noodlecake is likely to also owe suppliers for paper, pens, business cards, and other supplies delivered to its office. When a company buys goods from another company, it usually does so on credit by promising to pay for them at a later date. The amount owed is called an Account Payable because purchases made using credit are said to be "on account." Noodlecake could also owe salaries and wages to employees (Salaries and Wages Payable) and taxes to governments (Taxes Payable). From a legal perspective, creditors have priority over stockholders. Thus, if a company goes out of business, liabilities must be paid before any amounts are paid to stockholders.

Stockholders' Equity

Stockholders' equity represents the owners' claims on the business. These claims arise from two sources.

- 1. Paid-in capital.** The owners have a claim on amounts they contributed directly to the company in exchange for its stock (Common Stock).
- 2. Earned capital.** The owners have a claim on profits the company has earned for them through its business operations (Retained Earnings).

The second item listed above is particularly important because a business can survive only if it is profitable. It will be profitable if the total amount earned from selling goods and services is greater than the costs incurred to generate those sales. Theoretically, these profits belong to the company's owners, so they increase stockholders' equity. Through these profits, owners can get more money back from the company than they paid in (a return on their investment).

Given the importance of a company's profits, accounting systems separately track the two components of profit: revenues and expenses.

Revenues Revenues are earned by selling goods or services to customers. For **Noodlecake**, revenues are measured at the amount the company charges customers for its apps.

Expenses Expenses are all costs of doing business that are necessary to earn revenues. Noodlecake incurs expenses for advertising, utilities, rent, salaries and wages, insurance, and supplies used up in the office. Notice that expenses are said to be "incurred" to generate revenues. The word *incurred* means the activities giving rise to a cost (e.g., running an ad, using electricity) have occurred in the period in which the related revenues have been generated.

Net Income Although *profit* is used in casual conversation, the preferred term in accounting is *net income*. Net income is calculated as revenues minus expenses. For Noodlecake to be profitable, its revenues must be greater than its expenses. (If revenues are less than expenses, the company would have a net loss, but for now we'll assume Noodlecake is going to earn a profit.) **By generating net income, a company increases its stockholders' equity**, as illustrated below. This net income can be left in the company to accumulate (with earnings that have been retained from prior years) or it can be paid out to the company's stockholders for their own personal use (called *dividends*).

