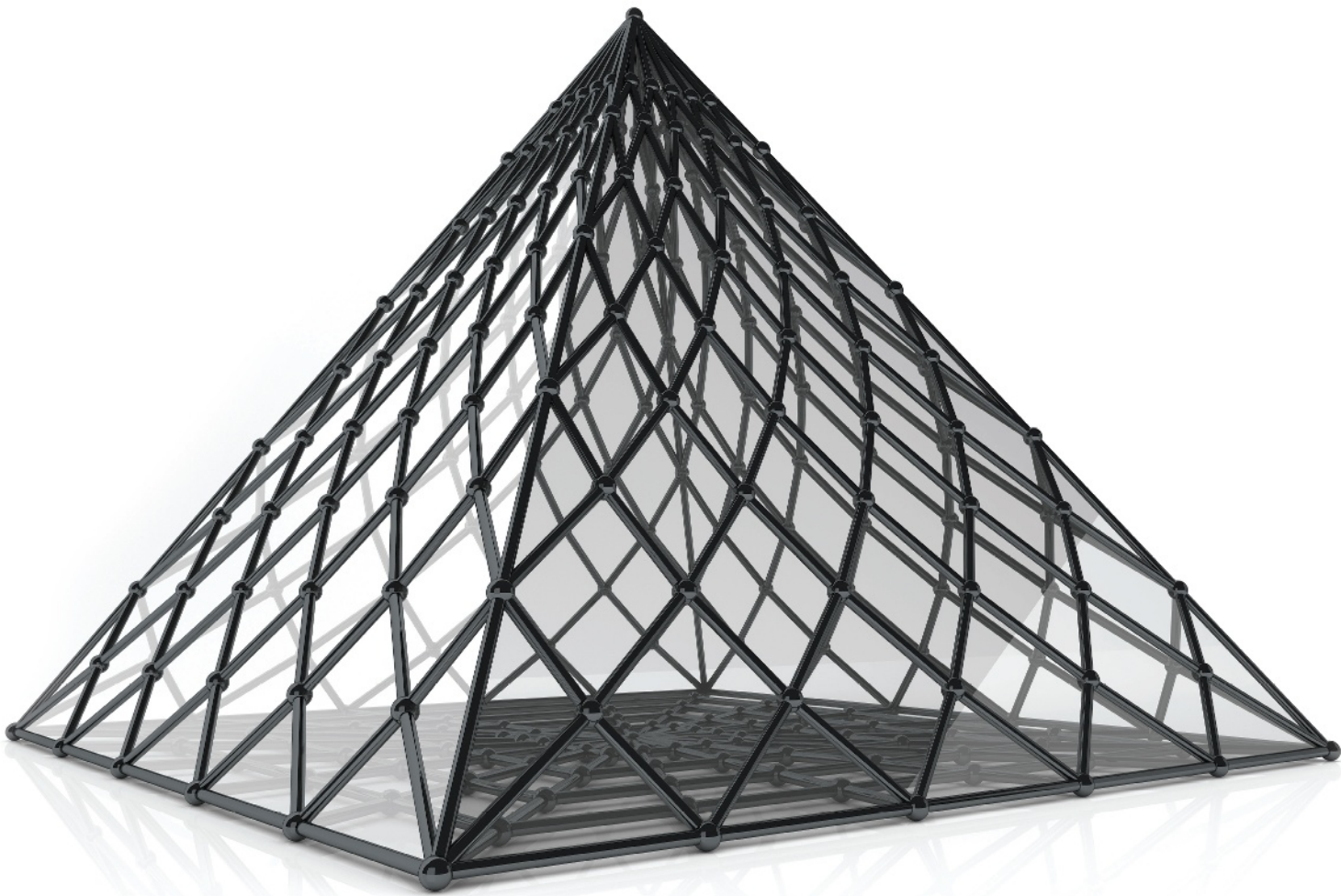


C O R N E R S T O N E S

of Financial Accounting

FOURTH EDITION



Rich • Jones

FOURTH EDITION

CORNERSTONES OF FINANCIAL ACCOUNTING

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Illinois State University

Jefferson P. Jones

Auburn University



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

**Cornerstones of Financial Accounting,
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NEW TO THIS EDITION

- **Show Me How Videos:** Are developed by Jay Rich himself to provide a walk-through of some of the most commonly assigned exercises. These provide an office-hour type experience and give students a detailed example of a similar problem without giving away the answer.



SHOW ME HOW

Adjusting entry for supplies

The balance in the supplies account, before adjustment at the end of the year, is \$2,389. Journalize the adjusting entry required if the amount of supplies on hand at the end of the year is \$850.

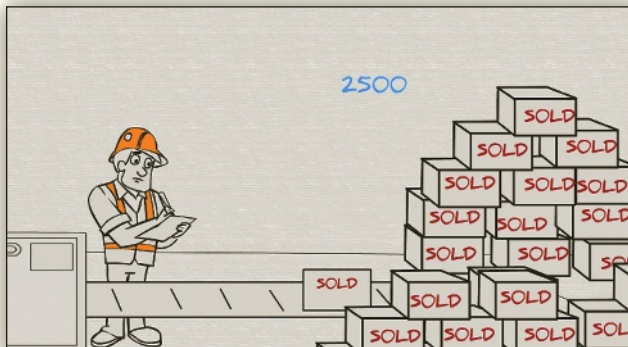
Supplies, before adjustment	\$2,389
Supplies on hand, December 31	(850)
Supplies used (amount of adjustment)	\$1,539

Journal				
Date	Description	Post. Ref.	Debit	Credit
Dec. 31	Supplies Expense		1,539	
	Supplies			1,539

- **Concept Clips:** Animated concept clips are brief, captivating video clips that expose students to why a concept is important and how the concept is used in the real world.



CONCEPT CLIP



- **Tell Me More Videos:** Correlated to each Learning Objective (LO), these videos review the material covered in each LO, giving students a way to review what is covered in each objective in a digestible activity. These allow students to come to class more prepared and ready to participate.



TELL ME MORE

Prepaid Expenses: Prepaid Insurance

The December 31 unadjusted trial balance of Meridianco indicates a balance in the prepaid insurance account of \$2,400. The debit balance of \$2,400 represents the December 1 encumbrance of insurance for 12 months. At the end of December, the insurance expense account is increased (debited), and the prepaid insurance account is decreased (credited) by \$200, the insurance for one month.

Dec. 31	Insurance Expense	15	200	
	Prepaid Insurance		15	200
	Insurance expired (\$2,400 ÷ 12)			

Accounting Equation Impact

Assets		=	Liabilities	+	Stockholders' Equity (Expense)
Prepaid Insurance	15				Insurance Expense
Bal.	2,400				Dec. 31
Adj. Bal.	2,200				15

↓ decrease ↑ increase

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- **New Revenue Recognition Standards:**
 - Consistent with the requirements of the new standard to record sales revenue at the amount companies expect to collect, we now show sales discounts using the net method because most customers will be expected to take advantage of favorable sales discount terms.
 - We now show the gross method for handling sales discounts in an appendix to the chapter
 - Returns & allowances must be estimated at year end so sales revenue reflects the amount companies expect to collect
- **Real World Examples Updated:** Throughout this edition the Real World Examples have been updated to include financial statements from company's including Under Armour, Columbia Sportswear, General Electric Company, Mitsubishi, AMR Corporation and Fed Ex.

WHAT IS CENGAGENOWv2?



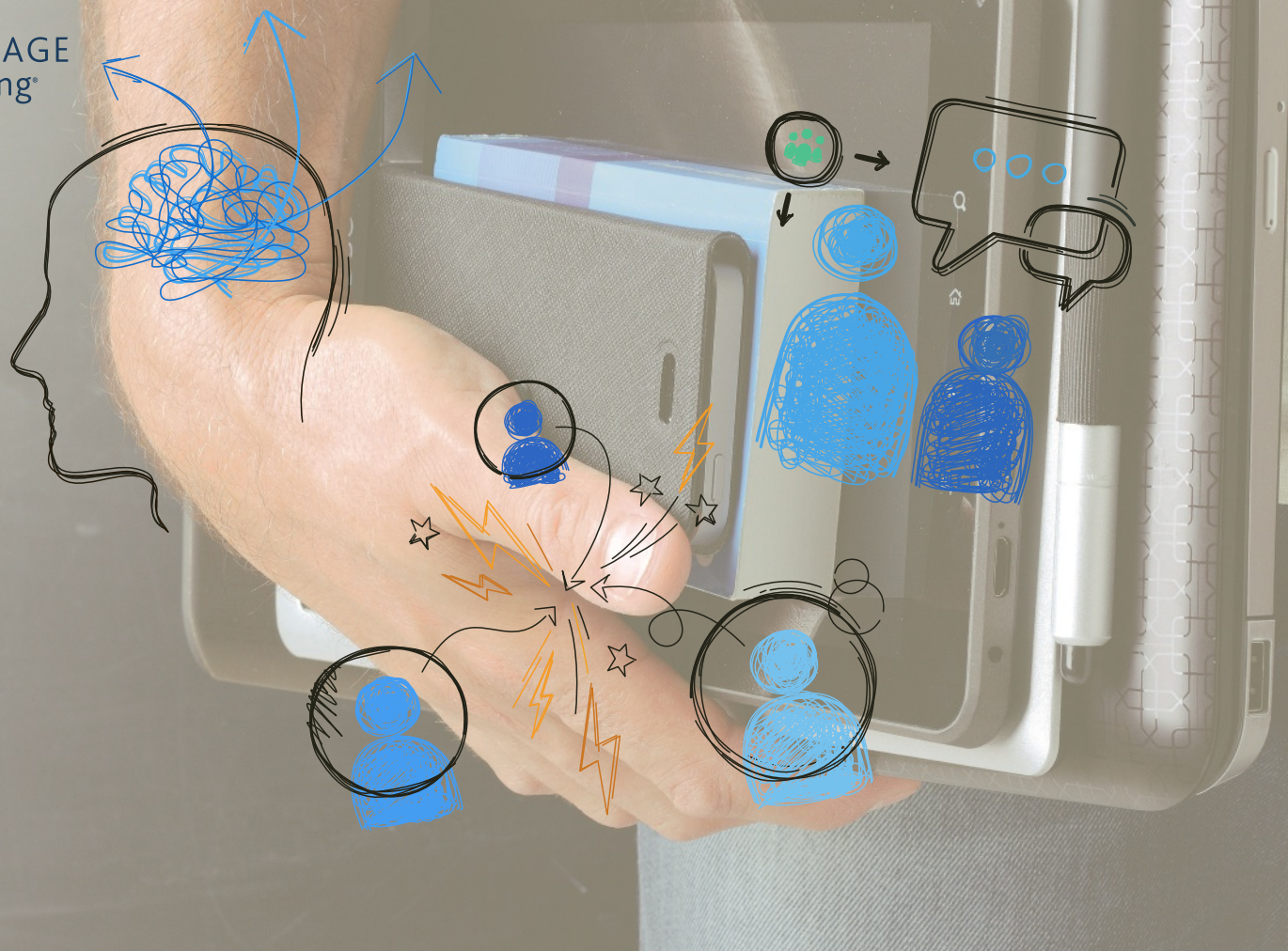
CengageNOWv2 is a powerful course management and online homework tool that provides robust instructor control and customization to optimize the student learning experience and meet desired outcomes.

CengageNOWv2 includes

- Integrated eBook
- End-of-Chapter homework with static and algorithmic versions
- 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 NEW!
- Show Me How Demonstration Videos NEW!
- Concept Clips NEW!

CengageNOWv2 for *Cornerstones of Financial Accounting, 4e* is designed to help students learn more effectively by providing engaging resources at unique points in the learning process.

- Preparing For Class
 - Tell Me More Activities
 - Concept Clips
- Completing Homework
 - Show Me How Videos
 - Enhanced Feedback
- Going Further
 - Mastery Assignments
 - Post Submission Feedback



Close the Gap

Between Homework and Exam Performance
with CengageNOWv2.

We've talked with hundreds of accounting instructors across the country, and we are learning that online homework systems have created a new challenge in the accounting course.

We are hearing that students perform well on the homework but poorly on the exam, which leads instructors to believe that students are not truly learning the content, but rather are memorizing their way through the system.



CengageNOWv2 better prepares students for the exam by providing an online homework experience that is similar to what students will experience on the exam and in the real world.

Read on to see how CengageNOWv2 helps close this gap.

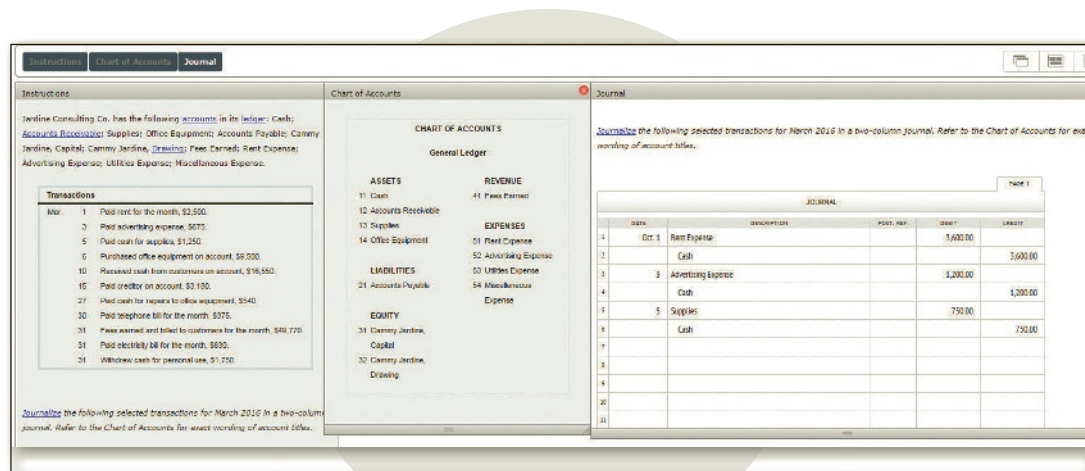
Closing the gap, one step at a time.



Multi-Panel View

One of the biggest complaints students have about online homework is the scrolling, which prevents students from seeing the big picture and understanding the accounting system. This new Multi-Panel View in CengageNOW2 enables students to see all the elements of a problem on one screen.

- Students make connections and see the tasks as connected components in the accounting process.
- Dramatically reduced scrolling eliminates student frustration.



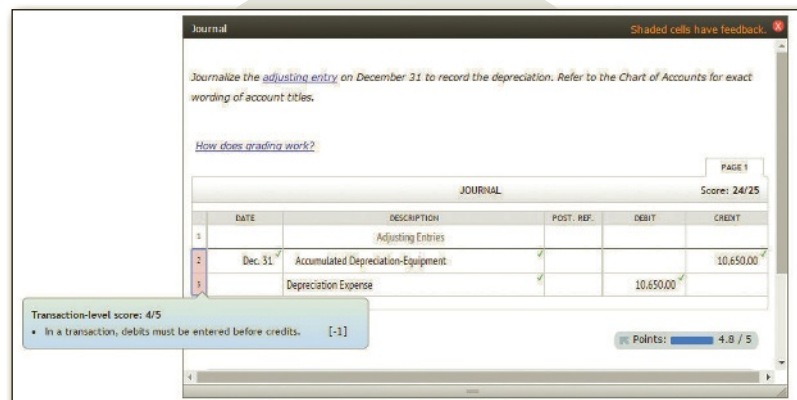
Blank Sheet of Paper Experience

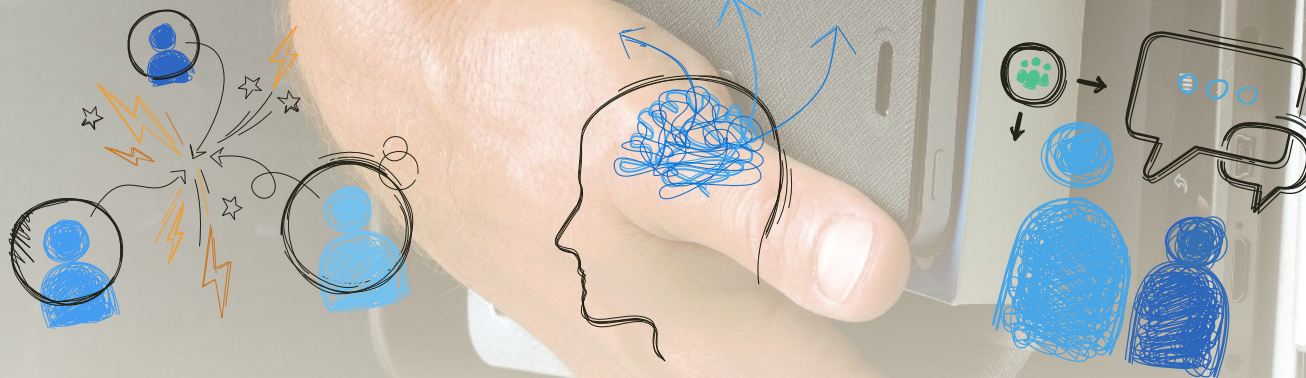
Many students perform well on homework but struggle when it comes to exams. Now, with the new Blank Sheet of Paper Experience, students must problem-solve on their own, just as they would if taking a test on a blank sheet of paper. This discourages overreliance on the system.

- Students must refer to the Chart of Accounts and decide for themselves which account is impacted.
- The number of accounts in each transaction is not given away.
- Whether the account should be debited or credited is not given away.
- Transactions may be entered in any order (as long as the entries are correct).

Adaptive Feedback

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





And that's not all...

You might also want to learn about the MindTap eReader, our LMS integration options, and more.

MindTap eReader

The MindTap eReader is the most robust digital reading experience available.

- Fully optimized for the iPad.
- Note-taking, highlighting, and more.
- Offline access to smartphones.
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The MindTap eReader also features ReadSpeaker®, an online text-to-speech application that vocalizes, or “speechnables,” online educational content.

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CengageNOWv2 can be seamlessly integrated with most Learning Management Systems. Adopters will enjoy:

- **A Seamless User Experience**—Access your Cengage resources seamlessly using only your LMS login credentials.
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- **Automatic Grade Synchronization***—Need to have your course grades recorded in your LMS gradebook? No problem. Simply select the activities you want synched and grades will automatically be recorded in your LMS gradebook.

* Grade synchronization is currently available with Blackboard, Brightspace (powered by D2L), Angel 8, and Canvas.

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- With the latest release of CengageNOWv2:
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- All videos are created with closed captioning and transcripts available for download.
- The MindTap eReader is HTML-based and compatible with most screen reading assistive software. The eReader supports browser settings for high-contrast narrative text, variable font sizes, and multiple foreground and background color options.

For more information on accessibility, please visit www.cengage.com/accessibility.

iPad Tablet Compatibility

CengageNOWv2 is fully compatible with the iPad and other tablet devices, with the exception of General Ledger (CLGL) and Excel Tutorials, which are flash based.



SUPERIOR SUPPLEMENTS

Solutions Manual

Author-written and carefully verified multiple times to ensure accuracy and consistency with the text, the Solutions Manual contains answers to all Discussion Questions, Multiple-Choice Exercises, Cornerstone Exercises, Brief Exercises, Exercises, Problem Set A, Problem Set B, and Cases that appear in the text. These solutions help you easily plan, assign, and efficiently grade assignments. All solutions are given in simplified Excel spreadsheets and also available in PDF format. The Solutions Manual is available electronically for instructors only on the password-protected portion of the text's website at <http://login.cengage.com>.

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This book is dedicated to our students—past, present, and future—who are at the heart of our passion for teaching.



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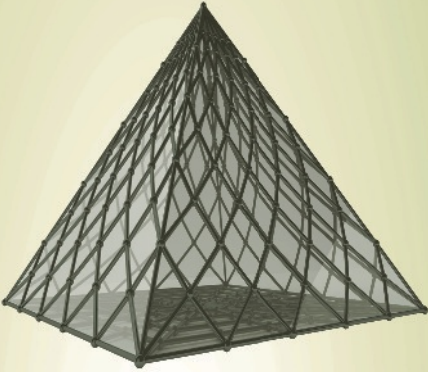
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1

Accounting and the Financial Statements



After studying Chapter 1, you should be able to:

- 1 Explain the nature of accounting.
- 2 Identify the forms of business organizations and the types of business activities.
- 3 Describe the relationships shown by the fundamental accounting equation.
- 4 Prepare a classified balance sheet and understand the information it communicates.
- 5 Prepare an income statement and understand the information it communicates.
- 6 Prepare the retained earnings statement and understand the information it communicates.
- 7 Understand the information communicated by the statement of cash flows.
- 8 Describe the relationships among the financial statements.
- 9 Describe other information contained in the annual report and the importance of ethics in accounting.

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EXPERIENCE FINANCIAL ACCOUNTING

with Apple

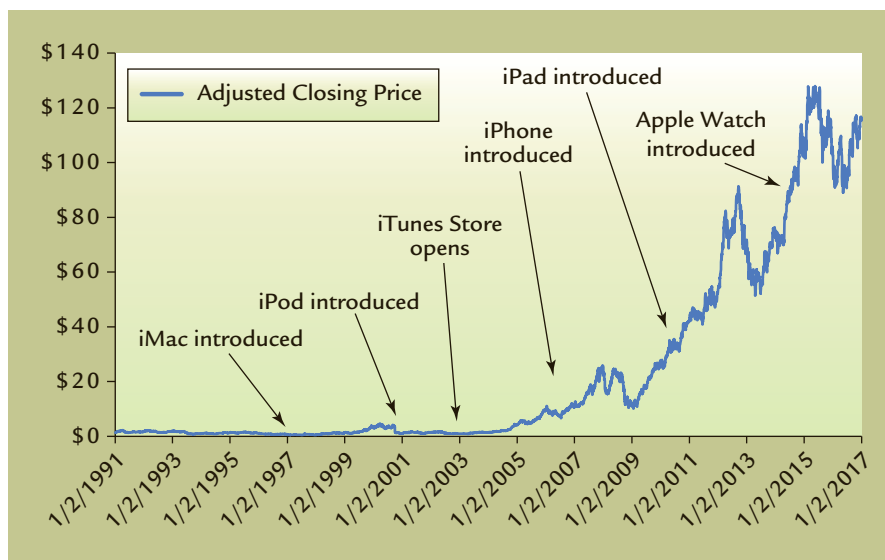
In 1976, Steve Jobs and Steve Wozniak, the founders of **Apple Inc.**, began building personal computers in Jobs' parents' garage. By 1984, Apple had become a leader in the personal computing industry, and its Macintosh computer is regarded by many as a key contributor to the development of the desktop publishing market.

Apple appeared invincible. However, the development of Microsoft's Windows operating system and several Apple product failures led many to predict the end of one

of the computer industry's most prominent companies. How could a company with such a bright future experience failure? And, perhaps more remarkable, how could a company on the verge of extinction experience the kind of success that Apple has recently experienced? With the introduction of the iMac, the iPod, the iTunes Store, the iPhone, the iPad, and the

Apple Watch, Apple's stock price increased from approximately \$7 per share in June 1998 to \$116 at the beginning of 2017.

What type of information can help someone predict the successes of a company like Apple? A good place to start is with the financial information contained in a



Source: Apple Inc. 2016 10K.

company's annual report. This financial information is provided in the form of financial statements—a summary of the results of a company's operations. A study of a company's

financial statements will help you determine how successful a company has been in the past as well as its prospects for the future. While this information is easily accessible and free of charge, your final judgment on a company's future prospects will be influenced by how well you understand the information contained in its financial statements.

OBJECTIVE 1

Explain the nature of accounting.

**CONCEPT CLIP****WHAT IS ACCOUNTING?**

Our economy is comprised of many different businesses. Some companies, such as **Apple Inc.**, focus on providing goods, which for Apple take many forms including desktop and laptop computers, iPads, iPhones, Apple Watches, and downloadable music. Other companies are primarily concerned with providing services. For example, **The Walt Disney Company** offers a variety of entertainment services from theme parks to motion pictures. While most entities, like Apple and Disney, exist in order to earn a profit, some are organized to achieve some other benefit to society (for example, school districts exist to meet the educational needs of a community). Regardless of their objective, all entities use accounting to plan future operations, make decisions, and evaluate performance.

Accounting is the process of identifying, measuring, recording, and communicating financial information about a company's business activities so decision-makers can make informed decisions. Accounting information is useful because it helps people answer questions and make better decisions.

The demand for accounting information comes from both inside and outside the business. Inside the business, managers use accounting information to help them plan and make decisions about the company. For example, managers can use accounting information to predict the consequences of their actions and to help decide which actions to take. They also use accounting information to control the operations of the company and evaluate the effectiveness of their past decisions. Employees use accounting information to help them judge the future prospects of their company, which should translate into future promotion opportunities. Outside the business, investors (owners) use accounting information to evaluate the future prospects of a company and decide where to invest their money. Creditors (lenders) use accounting information to evaluate whether to loan money to a company. Even governments use accounting information to determine taxes owed by companies, to implement regulatory objectives, and to make policy decisions. This demand for accounting information is summarized by Exhibit 1.1.

Accounting is more than the process of recording information and maintaining accounting records—activities that are frequently called bookkeeping. Accounting is the “language of business.” That is, accounting can be viewed as an information system that communicates the business activities of a company to interested parties. The focus of this book is to provide information that satisfies the needs of external decision-makers (outside demand) and is termed **financial accounting**. The objectives of financial

EXHIBIT 1.1**The Demand for Accounting Information and Typical Questions**

accounting involve providing decision-makers with information that assists them in assessing the amounts, timing, and uncertainties of a company's future cash flows. This information is provided through four basic financial statements: the balance sheet, the income statement, the retained earnings statement, and the statement of cash flows.

In this chapter, we will discuss the basic functioning of the accounting system within a business. We will address the following questions:

- What forms do businesses take?
- What are the basic business activities?
- How does the accounting system report these activities?
- How can decision-makers use the information provided by the accounting system?

Regardless of your major or future plans, knowledge of accounting and the ability to use accounting information will be critical to your success in business.

BUSINESSES: FORMS AND ACTIVITIES

Accounting identifies, measures, records, and communicates financial information about an accounting entity. An accounting entity is a company that has an identity separate from that of its owners and managers and for which accounting records are kept.

Forms of Business Organization

This text emphasizes accounting for entities which take one of three forms: sole proprietorship, partnership, or corporation.

Sole Proprietorship A **sole proprietorship** is a business owned by one person. Sole proprietorships, which account for more than 70% of all businesses, are usually small, local businesses such as restaurants, photography studios, retail stores, or website developers. This organizational form is popular because it is simple to set up and gives the owner control over the business. While a sole proprietorship is an accounting entity separate from its owner, the owner is personally responsible for the debt of the business. Sole proprietorships can be formed or dissolved at the wishes of the owner.

Partnership A **partnership** is a business owned jointly by two or more individuals. Small businesses and many professional practices of physicians, lawyers, and accountants are often organized as partnerships. Relative to sole proprietorships, partnerships provide increased access to financial resources as well as access to the individual skills of each of the partners. Similar to sole proprietorships, partnerships are accounting entities separate from the partners; however, the partners are jointly responsible for all the debt of the partnership.¹ Finally, the partnership is automatically dissolved when any partner leaves the partnership; of course, the remaining partners may form a new partnership and continue to operate.

Corporation A **corporation** is a business organized under the laws of a particular state. A corporation, such as **Apple**, is owned by one or more persons called *stockholders*, whose ownership interests are represented by shares of stock. A primary advantage of the corporate form is the ability to raise large amounts of money (capital) by issuing shares of stock. Unlike a sole proprietorship or a partnership, a corporation is an “artificial person” and the stockholders’ legal responsibility for the debt of the business is limited to the amount they invested in the business. In addition, shares of stock can be

¹ Many professional partnerships—including the largest public accounting firms—have been reorganized as *limited liability partnerships* (LLPs), which protect the personal assets of the partners from being used to pay partnership debts.

concept Q&A

How will accounting affect my life?

Answer:

Accounting will impact many aspects of your daily life. The business that sells you goods or services uses accounting to keep track of how much money it received as well as the cost of operating the business. Calculating the amount of tax that is owed to the government requires accounting. When you invest your money, you should use accounting to understand a company's business and its prospects for the future. Plans that you make for the future often involve accounting to determine how much money you will need.

OBJECTIVE 2

Identify the forms of business organizations and the types of business activities.



TELL ME MORE

easily transferred from one owner to another through capital markets without affecting the corporation that originally issued the stock. The ability to raise capital by selling new shares, the limited legal liability of owners, and the transferability of the shares give the corporation an advantage over other forms of business organization. However, the requirements to form a corporation are more complex compared to the other forms of business organization. In addition, owners of corporations generally pay more taxes than owners of sole proprietorships or partnerships for two reasons:

- First, the corporate income tax rate is greater than the individual income tax rate.
- Second, a corporation's income is taxed twice—at the corporate level as income is earned, and at the individual level as earnings are distributed to stockholders. This is known as double taxation.

Exhibit 1.2 illustrates the advantages and disadvantages of each form of organization. While the combined number of sole proprietorships and partnerships greatly exceeds that of corporations, the majority of business in the United States is conducted by corporations. Therefore, this book emphasizes the corporate form of organization.

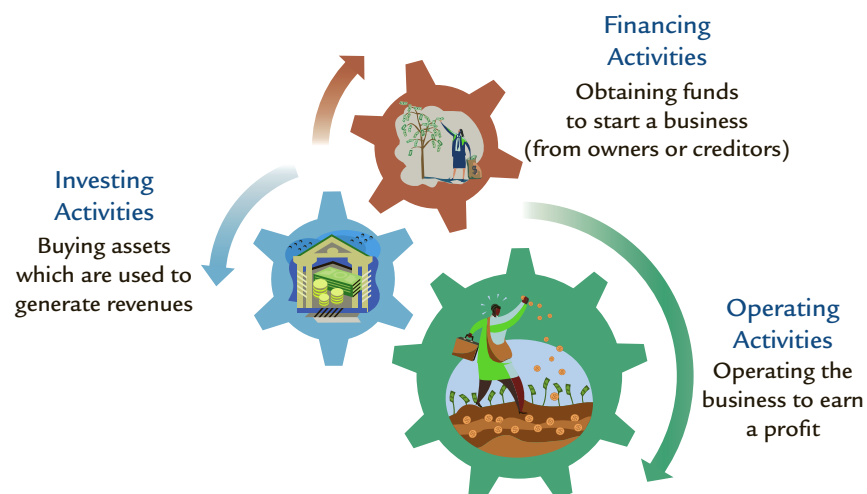
EXHIBIT 1.2 Forms of Business Organization



Business Activities

Regardless of the form of a business, all businesses engage in activities that can be categorized as financing, investing, or operating activities. These activities are illustrated in Exhibit 1.3.

EXHIBIT 1.3 Business Activities



Financing Activities A company's financing activities include obtaining the funds necessary to begin and operate a business. These funds come from either issuing stock or borrowing money. Most companies use both types of financing to obtain funds.

When a corporation borrows money from another entity such as a bank, it must repay the amount borrowed. The person to whom the corporation owes money is called a **creditor**. This obligation to repay a creditor is termed a **liability** and can take many forms. A common way for a corporation to obtain cash is to borrow money with the promise to repay the amount borrowed plus interest at a future date. Such borrowings are commonly referred to as *notes payable*. A special form of note payable that is used by corporations to obtain large amounts of money is called a *bond payable*.

In addition to borrowing money from creditors, a corporation may issue shares of stock to investors in exchange for cash. The dollar amount paid to a corporation for these shares is termed *common stock* and represents the basic ownership interest in a corporation. As of September 24, 2016, **Apple** had issued 5,336,166 shares of common stock. The corporation is not obligated to repay the stockholder the amount invested; however, many corporations distribute a portion of their earnings to stockholders on a regular basis. These distributions are called *dividends*.

Creditors and stockholders have a claim on the **assets**, or economic resources, of a corporation. However, the claims on these resources differ. In the case of financial difficulty or distress, the claims of the creditors (liabilities) must be paid prior to the claims of the stockholders (called **stockholders' equity**). Stockholders' equity is considered a residual interest in the assets of a corporation that remain after deducting its liabilities.

Investing Activities Once a corporation has obtained funds through its financing activities, it buys assets that enable it to operate. For example, **Apple** reported \$27,010 million in land, buildings, machinery, and equipment that it uses in its operations. The corporation may also obtain intangible assets that lack physical substance, such as copyrights and patents. Apple reported \$3,206 million of intangible assets that it uses in its operations. The purchase and sale of the assets that are used in operations (commonly referred to as property, plant, and equipment) are a corporation's investing activities.

Regardless of its form, assets are future economic benefits that a corporation controls. The assets purchased by a corporation vary depending on the type of business that the corporation engages in, and the composition of these assets is likely to vary across different companies and different industries. For example, in 2016, property, plant, and equipment made up approximately 8.4% of **Apple's** total assets. This is typical of many technology companies. In contrast, property, plant, and equipment made up 73.2% of the total assets of **Southwest Airlines**, a company that relies heavily on airplanes to produce revenue.

Operating Activities Once a corporation has acquired the assets that it needs, it can begin to operate. While different businesses have different purposes, they all want to generate revenue. **Revenue** is the increase in assets that results from the sale of products or services. For example, **Apple** reported revenue of \$215,639 million in 2016. In addition to revenue, assets such as *cash*, *accounts receivable* (the right to collect an amount due from customers), *supplies*, and *inventory* (products held for resale) often result from operating activities.

To earn revenue, a corporation will incur various costs or expenses. **Expenses** are the cost of assets used, or the liabilities created, in the operation of the business. **Apple** reported expenses of \$131,376 million related to the cost of iPhones, iPads, Apple Watches, and other products sold in 2016.

The liabilities that arise from operating activities can be of different types. For example, if a corporation purchases goods on credit from a supplier, the obligation to repay the supplier is called an *account payable*. As of September 24, 2016, **Apple** reported \$37,294 million of accounts payable. Other examples of liabilities created by operating activities include *wages payable* (amounts owed to employees for work performed) and *income taxes payable* (taxes owed to the government).

The results of a company's operating activities can be determined by comparing revenues to expenses. If revenues are greater than expenses, a corporation has earned **net income**. If expenses are greater than revenues, a corporation has incurred a **net loss**.

YOU DECIDE Choice of Organizational Form

You are an entrepreneur who has decided to start a campus-area bookstore. In order to start your business, you have to choose among three organizational forms—sole proprietorship, partnership, or corporation. You have enough personal wealth to finance 40% of the business, but you must get the remaining 60% from other sources.

How does the choice of organizational form impact your control of the business and ability to obtain the needed funds?

The choice of organizational form can greatly impact many aspects of a business's operations. Each form has certain advantages and disadvantages that you should carefully consider.

- *Sole Proprietorship*: A sole proprietorship would give you the most control of your business. However, you would be forced to obtain the additional 60% of funds needed from a bank or

other creditor. It often is difficult to get banks to support a new business.

- *Partnership*: If you choose to form a partnership, you would still have access to bank loans. In addition, you would also have the ability to obtain the additional funds from your partner or partners. In this situation, the partners would then have a 60% interest in the business, which may be an unacceptable loss of control.
- *Corporation*: If you choose to form a corporation, you could obtain the needed funds by issuing stock to investors. While a 60% interest may still be transferred to the stockholders, if the stock were widely dispersed among many investors, you might still retain effective control of the business with a 40% interest.

The choice of organizational form involves the consideration of many different factors.

OBJECTIVE 3

Describe the relationships shown by the fundamental accounting equation.



TELL ME MORE

EXHIBIT 1.4

COMMUNICATION OF ACCOUNTING INFORMATION

The financing, investing, and operating activities of a company are recorded by accounting systems as detailed transactions. To effectively communicate a company's activities to decision-makers, these detailed transactions are summarized and reported in a set of standardized reports called **financial statements**. The role of financial statements is to provide information that helps investors, creditors, and others make judgments and predictions that serve as the basis for the various decisions they make. Financial statements help answer questions such as those shown in Exhibit 1.4.

Questions Answered by Financial Statements

How much better off is the company at the end of the year than it was at the beginning of the year?



What are the economic resources of the company and the claims against those resources?

From what sources did a company's cash come and for what did the company use cash during the year?

The Four Basic Financial Statements

Companies prepare four basic financial statements:

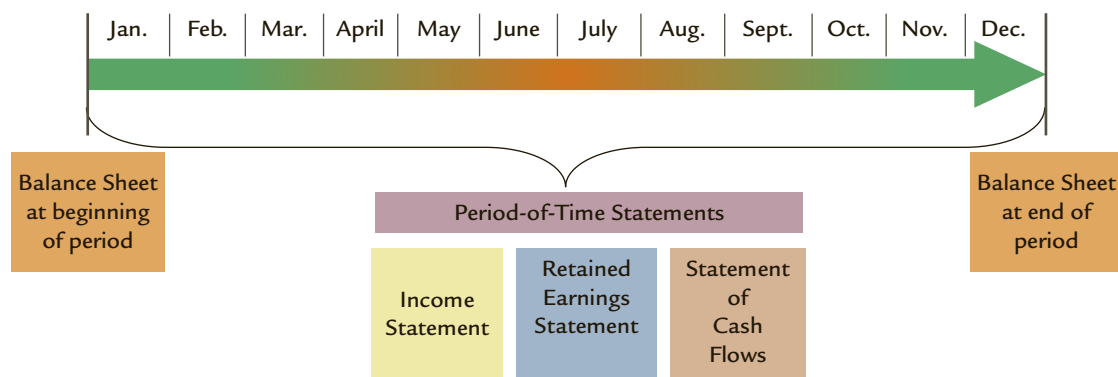
- The **balance sheet** reports the resources (assets) owned by a company and the claims against those resources (liabilities and stockholders' equity) at a specific point in time.

- The **income statement** reports how well a company has performed (revenues, expenses, and income) over a period of time.
- The **retained earnings statement** reports how much of the company's income was retained in the business and how much was distributed to owners over a period of time.²
- The **statement of cash flows** reports the sources and uses of a company's cash over a period of time.

While financial statements can be prepared for any point or period of time (e.g., monthly, quarterly, or annually), most companies prepare financial statements at the end of each month, quarter, and year. Note that the balance sheet is a point-in-time description, whereas the other financial statements are period-of-time descriptions that explain the business activities between balance sheet dates as shown in Exhibit 1.5.

EXHIBIT 1.5

Financial Statement Time Periods



These four statements are prepared and issued at the end of an accounting period. While the accounting period can be a year, companies also issue statements monthly or quarterly to satisfy the users' needs for timely information. The financial statements are accompanied by supporting information and explanatory material called the notes to the financial statements.

In order to make it easier to use financial statements over time and across companies, a common set of rules and conventions have been developed to guide the preparation of financial statements. These rules and conventions, called **generally accepted accounting principles (GAAP)**, were developed by several different organizations over a number of years. In the United States, the **Securities and Exchange Commission (SEC)** has the power to set accounting rules for publicly traded companies. However, the SEC has delegated this authority to the **Financial Accounting Standards Board (FASB)**. While the FASB is the primary accounting standard setter in the United States, the FASB has been working closely with the **International Accounting Standards Board (IASB)** in its development of **international financial reporting standards (IFRS)**. While this text focuses on U.S. GAAP, the importance of IFRS cannot be ignored. Therefore, major differences between U.S. GAAP and IFRS are highlighted in margin notes throughout the text.

IFRS

IFRS describe an international set of generally accepted accounting standards used by over 120 countries in order to facilitate the conduct of business around the world.

While financial statements prepared under GAAP provide the kind of information users want and need, the financial statements do not interpret this information. The financial statement user must use his or her general knowledge of business and accounting to interpret the financial statements as a basis for decision-making.

² Information contained in the retained earnings statement is often included in a more comprehensive statement of changes in stockholders' equity, which describes changes in all components of stockholders' equity. This statement is presented in Chapter 10.