THIRD EDITION

FINANCIAL ACCOUNTING

KEMP ▪ WAYBRIGHT

Financial Accounting

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Financial Accounting

Third Edition

Robert Kemp
University of Virginia

Jeffrey Waybright
Spokane Community College

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PEARSON

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Dedication

I dedicate this book to my beloved children: Adam, Meg, and Sarah. I also dedicate this book to their spouses and children. They give meaning to my life and are my dream come true.

Robert Kemp

I would like to dedicate this book to my colleagues in the Business Department at Spokane Community College.

Jeffrey Waybright

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About the Authors

Robert S. Kemp, DBA, CPA Professor Kemp is the Ramon W. Breeden, Sr. Research Professor at the McIntire School of Commerce, University of Virginia. He is a certified public accountant and possesses a baccalaureate, master's, and doctorate in business administration.

Professor Kemp is an accomplished scholar, conducting research and writing in the theory and practice of contemporary business. He currently is conducting research in the funding of pensions, the management of financial institutions, and corporate finance. His scholarly works include 70 completed projects, including monographs, articles, cases, research presentations, and working papers. His work is published in, among other places, *The Financial Review; The Journal of Financial Research; Advances in Accounting, A Research Journal; Benefits Quarterly; The Journal of Mathematics Applied in Business and Industry; The Journal of Accountancy; The Journal of Commercial Bank Lending; The Journal of Bank Accounting and Auditing;* and *The Journal of Business Economics.*

Professor Kemp is likewise an accomplished teacher, to both University students and executives throughout the world. During his 34 years at the University of Virginia, he has taught numerous undergraduate and graduate courses. He has taught classes using lectures, case studies, discussion groups, and distance learning. His consistently high evaluations by students reflect his devotion to the classroom. This high quality is likewise seen in his teaching of business executives. He has worked with and taught for organizations such as Bank of America, the FDIC, Navigant—Tucker Alan, the Siberian Banking Institute, the Barents Group, KPMG, Gerson Lehrman, Wellington Management, the Russian Bankers Association, the Central Asian American Enterprise Fund, the American Institute of Certified Public Accountants, and the Consumer Bankers Association.

Jeffrey Waybright teaches accounting at Spokane Community College, which is part of a multi-college district in eastern Washington. He has been a full-time, tenured community college instructor for more than 21 years. In addition to teaching at the community college level, he has also taught upper division courses for Linfield College. Jeffrey is a co-recipient of the Washington Society of CPA's Outstanding Educator Award.

Jeffrey received his BA in business administration (emphasis in accounting) and MBA from Eastern Washington University. Before becoming a professor, Jeffrey spent eight years as a practicing CPA in Washington State and still holds his license. During his teaching career, he has taught in many disciplines of accounting including financial, managerial, computerized, and payroll accounting as well as in the disciplines of economics, business math, and general business. Jeffrey developed online courses in accounting, teaches online and traditional courses for financial and managerial accounting, and advises students. Jeffrey is passionate about teaching students the subject of accounting.

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Brief Contents

Contents

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Preface

Changes to this Edition

Chapter 1 Business, Accounting, and You

- Added Real World Accounting Video summary of David Hitchner, owner and manager of ABC Wine, to set the chapter content in a real world business context for students.
- Added two questions to the Self Checks that assess student understanding of the Real World Accounting Videos.
- Changed 50% of the exercises and problems to provide diverse practice and teaching opportunities for students and teachers.
- EXCEL is now in MyAccountingLab**.** For every chapter, instructors have the option to assign students 2 end-of-chapter problems that can be completed in an Excel-simulated environment, auto graded and visible in the grade book. Excel remediation will be available to students.

Chapter 2 Analyzing and Recording Business Transactions

- Changed chapter introduction company from Best Buy to Target.
- Added Real World Accounting Video of Julie Gaines, owner and manager of Fishs Eddy, to set the chapter content in a real world business context for students.
- Animated each hybrid equation example so that students can drill themselves as many times as needed on the interrelationship of the journal entries, t-accounts, and general ledger when posting transactions. Available in the eText only, located in MyAccountingLab®.
- Changed 50% of the exercises and problems to provide diverse practice and teaching opportunities for students and teachers.
- Added two questions to the Self Checks that assess student understanding of the Real World Accounting Videos.
- Updated Continuing Financial Statement Analysis featuring Target using the 2012 annual report.
- Designated two Excel problems and exercises that can be automatically graded in MyAccountingLab. These materials are designated by a "Try It In Excel" icon.
- Updated the end of chapter material related to Under Armour and Columbia Sportswear using the 2012 annual reports.

Chapter 3 Adjusting and Closing Entries

- Changed chapter introduction company from Best Buy to Disney.
- Added Real World Accounting Video of Jeanette Cebollero, the chief financial officer (CFO) of Rosa Mexicano Restaurants, to set the chapter content in a real world business context for students.

- Animated each hybrid equation example so that students can drill themselves as many times as needed on the interrelationship of the journal entries, t-accounts, and general ledger when posting transactions. Available in the etext only, located in MyAccountingLab.
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- Updated the end of chapter material related to Under Armour and Columbia Sportswear using the 2012 annual reports.

Chapter 4 Accounting for a Merchandising Business

- Changed chapter introduction company from Best Buy to Toys R Us.
- Added Real World Accounting Video of Noah Lenovitz, a partner and chief operating officer of Fishs Eddy, to set the chapter content in a real world business context for students.
- Changed 50% of the exercises and problems to provide diverse practice and teaching opportunities for students and teachers.
- Added two questions to the Self Checks that assess student understanding of the Real World Accounting Videos.
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Chapter 5 Inventory

- Changed chapter introduction company from Best Buy to Toys R Us.
- Added Real World Accounting Video of Keith Beavers, owner and operator of ABC Wines, to set the chapter content in a real world business context for students.
- Changed 50% of the exercises and problems to provide diverse practice and teaching opportunities for students and teachers.
- Added two questions to the Self Checks that assess student understanding of the Real World Accounting Videos.
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Chapter 6 The Challenges of Accounting: Standards, Internal Control, Audits, Fraud, and Ethics

- Added Real World Accounting Video of Vince Molinari, CEO and founder of Gate Technologies, to set the chapter content in a real world business context for students.
- Changed 50% of the exercises and problems to provide diverse practice and teaching opportunities for students and teachers.

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- Updated the end of chapter material related to Under Armour and Columbia Sportswear using the 2012 annual reports.

Chapter 7 Cash and Receivables

- Changed chapter introduction company from Best Buy to Hershey.
- Added Real World Accounting Video of Zachary Mack, owner and founder of Alphabet City Beer Company, to set the chapter content in a real world business context for students.
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- Updated the end of chapter material related to Under Armour and Columbia Sportswear using the 2012 annual reports.

Chapter 8 Long-Term and Other Assets

- Changed chapter introduction company from Best Buy to AT&T.
- Added Real World Accounting Video of Jason Berry of Rosa Mexicano Restaurants to set the chapter content in a real world business context for students.
- Changed 50% of the exercises and problems to provide diverse practice and teaching opportunities for students and teachers.
- Added two questions to the Self Checks that assess student understanding of the Real World Accounting Videos.
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- Updated the end of chapter material related to Under Armour and Columbia Sportswear using the 2012 annual reports.

Chapter 9 Current Liabilities and Long-Term Debt

- Changed chapter introduction company from Best Buy to Ford.
- Added Real World Accounting Video of Bill Mercer, Controller of Sheffield Pharmaceuticals, to set the chapter content in a real world business context for students.
- Changed 50% of the exercises and problems to provide diverse practice and teaching opportunities for students and teachers.
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- Updated the end of chapter material related to Under Armour and Columbia Sportswear using the 2012 annual reports.

Chapter 10 Corporations: Paid-In Capital and Retained Earnings

- Changed chapter introduction company from Best Buy to Apple.
- Added Real World Accounting Video of Howard Greenstone, President and CEO of Rosa Mexicano Restaurants, to set the chapter content in a real world business context for students.
- Changed 50% of the exercises and problems to provide diverse practice and teaching opportunities for students and teachers.
- Added two questions to the Self Checks that assess student understanding of the Real World Accounting Videos.
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- Updated the end of chapter material related to Under Armour and Columbia Sportswear using the 2012 annual reports.

Chapter 11 The Statement of Cash Flows

- Changed chapter introduction company from Best Buy to Delta Airlines.
- Added Real World Accounting Video of Peter Kranes, managing director of Fishs Eddy, to set the chapter content in a real world business context for students.
- Changed 50% of the exercises and problems to provide diverse practice and teaching opportunities for students and teachers.
- Added two questions to the Self Checks that assess student understanding of the Real World Accounting Videos.
- Updated Continuing Financial Statement Analysis featuring Target using the 2012 annual report.
- Designated two Excel problems and exercises that can be automatically graded in MyAccountingLab. These materials are designated by a “Try It In Excel” icon.
- Updated the end of chapter material related to Under Armour and Columbia Sportswear using the 2012 annual reports.
- Added an all new comprehensive problem that would make an excellent capstone problem for the course.

Chapter 12 Financial Statement Analysis

- Added Real World Accounting Video of David Drake of LDJ Capital to set the chapter content in a real world business context for students.
- Changed 50% of the exercises and problems to provide diverse practice and teaching opportunities for students and teachers.
- Added two questions to the Self Checks that assess student understanding of the Real World Accounting Videos.
- Updated Continuing Financial Statement Analysis featuring Target using the 2012 annual report.
- Designated two Excel problems and exercises that can be automatically graded in MyAccountingLab. These materials are designated by a “Try It In Excel” icon.
- Updated the end of chapter material related to Under Armour and Columbia Sportswear using the 2012 annual reports.

Dear Colleagues,

We are very excited about the newest edition of Kemp and Waybright's *Financial Accounting*. After you have had a chance to look at this edition's changes, we think you will be as excited about our latest edition as we are.

Practical Approach: Accounting from a Business Perspective
The goal and focus of the third edition of *Financial Accounting* is all about helping students learn. We believe the text and supporting materials tackle challenging topics in a pragmatic, easily understood manner so that they understand not only accounting but its critical role in the business world. After this course ends, it is our hope that your students will have mastered the basic concepts of financial accounting and can apply them to everyday business decisions.

Execution: Ensuring Student Success
Every feature in *Financial Accounting* is about helping you, the faculty, help your students achieve this goal. Based on our years of teaching, we believe we have created a complete package of instructional materials, using traditional and digital methods. For example, examine how each topic is introduced, explained, and demonstrated. Notice how students not only learn the topic, but also see how it is applied in the real world. Moreover, the end of chapter exercises, problems, and cases, prepared by us, create a progressive and appropriately challenging learning experience. For this edition, we developed more than 15 hybrid equation simulations, so that students can test their understanding of the relationship between the general journal, journal entries, and the impact on the accounting equation. These materials were all crafted carefully to help you ensure that your students have more of those "I get it" moments.

Assessment: Ensuring Your Success
We are first and foremost teachers. It's our passion. We understand the challenges you face as teachers. For example, in order to assure continuity between the text and the assessments, we prepared the test bank and solutions manual. In addition to all the updated, automatically graded homework assignments in MyAccountingLab, we added gradable Excel simulation problems so that you can easily evaluate student performance using Excel.

We love this text. Every day, we see how this text and supporting materials help students learn in and out of the classroom. We believe you too will love this text. We believe you will quickly see how *Financial Accounting*, with all of its supporting materials, creates success in your students.

Thank you for looking at *Financial Accounting.* We believe the third edition of *Financial Accounting* is unique. It's special. We hope you'll look at it, compare it to other books, and think about what is best for your students and you. If you do, we think there is one obvious choice. It's Kemp and Waybright's *Financial Accounting*. It's all about success for you and your students.

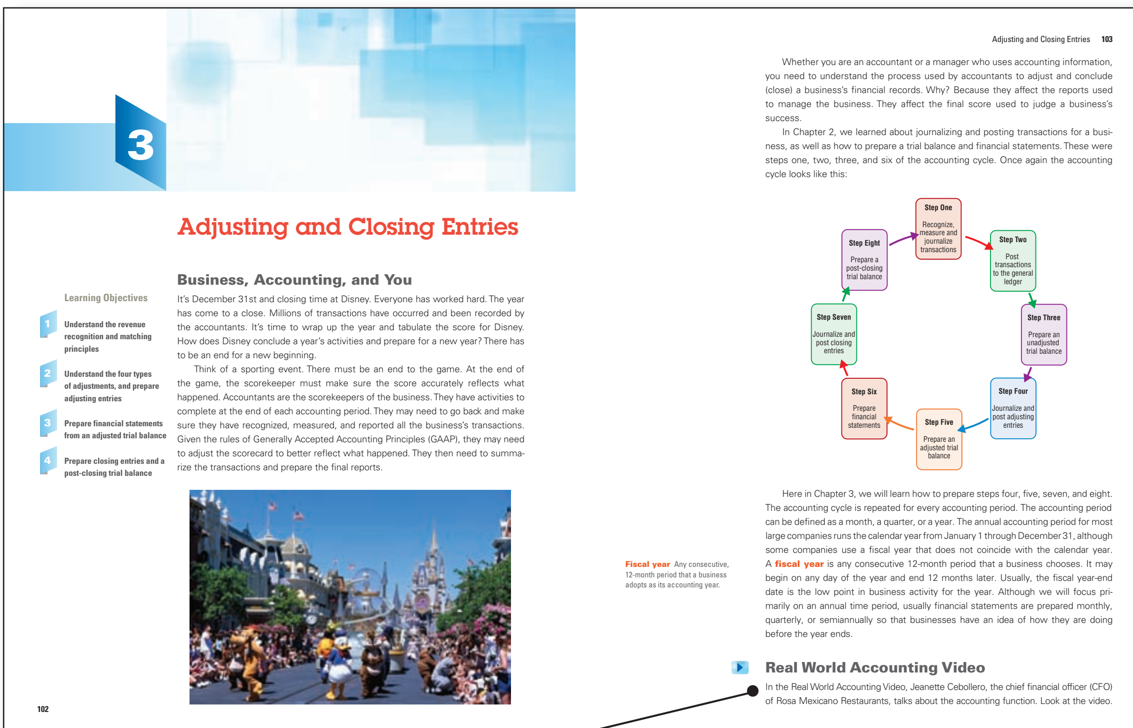
Best wishes,

Bob Kemp
Robert S. Kemp, DBA, CPA
Ramon W. Breeden Senior Research Professor
McIntire School of Commerce
The University of Virginia

Jeffrey Waybright
Jeffrey Waybright, CPA, MBA
Accounting Instructor
Spokane Community College

Visual Walk-Through

Chapter Openers
Business, Accounting, and You ties the business concept directly to the accounting topics covered in the chapters using a variety of well-known US and international companies as examples.


3

Adjusting and Closing Entries

Learning Objectives

1. Understand the revenue recognition and matching principles
2. Understand the four types of adjustments, and prepare adjusting entries
3. Prepare financial statements from an adjusted trial balance
4. Prepare closing entries and a post-closing trial balance

Business, Accounting, and You

It's December 31st and closing time at Disney. Everyone has worked hard. The year has come to a close. Millions of transactions have occurred and been recorded by the accountants. It's time to wrap up the year and tabulate the score for Disney. How does Disney conclude a year's activities and prepare for a new year? There has to be an end for a new beginning.

Think of a sporting event. There must be an end to the game. At the end of the game, the scorekeeper must make sure the score accurately reflects what happened. Accountants are the scorekeepers of the business. They have activities to complete at the end of each accounting period. They may need to go back and make sure they have recognized, measured, and reported all the business's transactions. Given the rules of Generally Accepted Accounting Principles (GAAP), they may need to adjust the scorecard to better reflect what happened. They then need to summarize the transactions and prepare the final reports.

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Adjusting and Closing Entries 103

Whether you are an accountant or a manager who uses accounting information, you need to understand the process used by accountants to adjust and conclude (close) a business's financial records. Why? Because they affect the reports used to manage the business. They affect the final score used to judge a business's success.

In Chapter 2, we learned about journalizing and posting transactions for a business, as well as how to prepare a trial balance and financial statements. These were steps one, two, three, and six of the accounting cycle. Once again the accounting cycle looks like this:

Here in Chapter 3, we will learn how to prepare steps four, five, seven, and eight. The accounting cycle is repeated for every accounting period. The accounting period can be defined as a month, a quarter, or a year. The annual accounting period for most large companies runs the calendar year from January 1 through December 31, although some companies use a fiscal year that does not coincide with the calendar year. A **fiscal year** is any consecutive 12-month period that a business chooses. It may begin on any day of the year and end 12 months later. Usually, the fiscal year-end date is the low point in business activity for the year. Although we will focus primarily on an annual time period, usually financial statements are prepared monthly, quarterly, or semiannually so that businesses have an idea of how they are doing before the year ends.

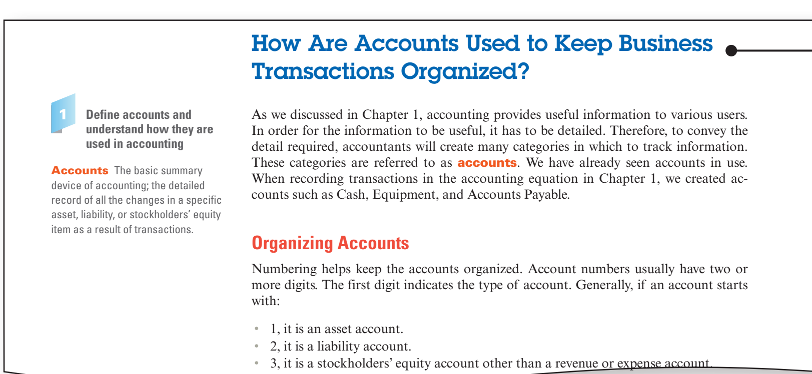
Fiscal year Any consecutive, 12-month period that a business adopts as its accounting year.

Real World Accounting Video

In the Real World Accounting Video, Jeanette Cebollero, the chief financial officer (CFO) of Rosa Mexicano Restaurants, talks about the accounting function. Look at the video.

NEW!

Real Business Videos
Real Business Videos bring accounting to life in the business world. Denoted by an icon in the chapter openers and developed by the author, interviews with CFOs, financial analysts, investment bankers, and small business owners highlight chapter concepts and help students understand that accounting is the language of business. Self-check questions, two in each chapter, assess student understanding of the real business videos and the concepts illustrated.


How Are Accounts Used to Keep Business Transactions Organized?

1 Define accounts and understand how they are used in accounting

Accounts The basic summary device of accounting; the detailed record of all the changes in a specific asset, liability, or stockholders' equity item as a result of transactions.

As we discussed in Chapter 1, accounting provides useful information to various users. In order for the information to be useful, it has to be detailed. Therefore, to convey the detail required, accountants will create many categories in which to track information. These categories are referred to as **accounts**. We have already seen accounts in use. When recording transactions in the accounting equation in Chapter 1, we created accounts such as Cash, Equipment, and Accounts Payable.

Organizing Accounts

Numbering helps keep the accounts organized. Account numbers usually have two or more digits. The first digit indicates the type of account. Generally, if an account starts with:

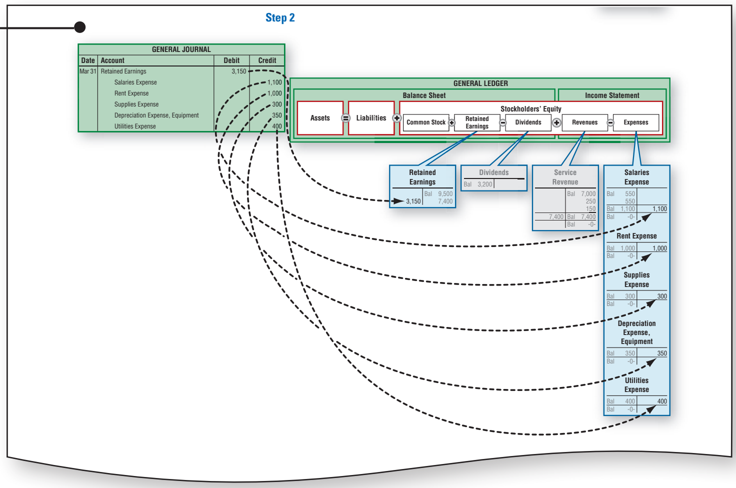
- 1, it is an asset account.
- 2, it is a liability account.
- 3, it is a stockholders' equity account other than a revenue or expense account.
- 4, it is a revenue account.

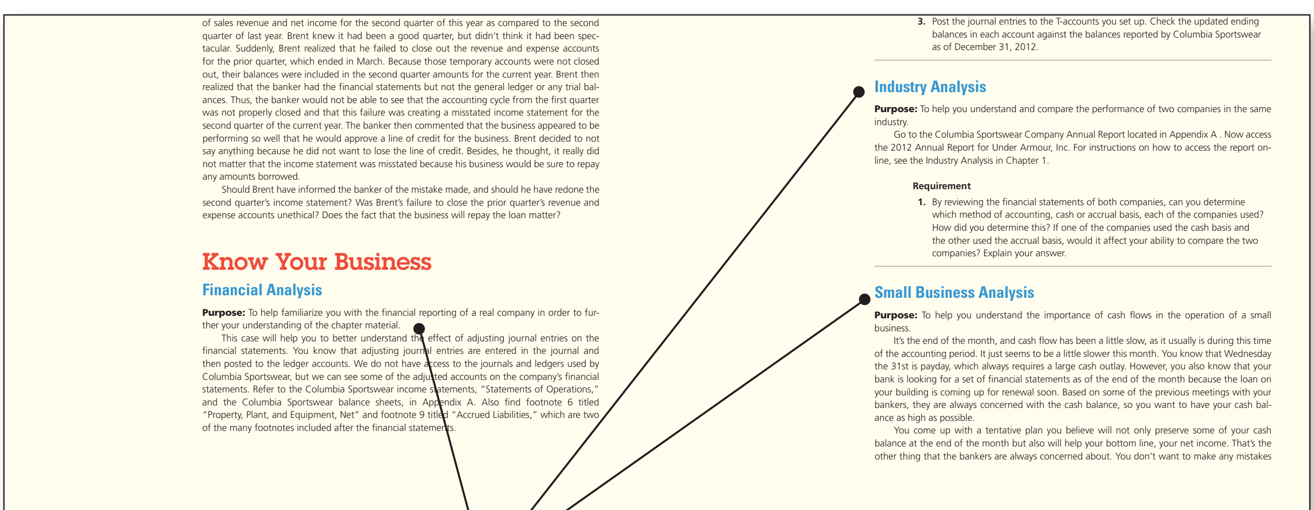
Question & Answer Format mirrors those valuable teachable moments in the classroom when a student asks a question that gets straight to the heart of the topic.

Hybrid Approach Animations

NEW!

The authors introduce unique hybrid visuals to illustrate the connection between the accounting equation and journalizing transactions. In Chapters 2 and 3 of the eText, students can journalize transactions, create T-Accounts, and test their understanding of the relationship between journal entries and the accounting equation. Eighteen animations will allow students to practice over and over again until they comprehend these critical accounting concepts.





of sales revenue and net income for the second quarter of this year as compared to the second quarter of last year. Brent knew it had been a good quarter, but didn't think it had been spectacular. Suddenly, Brent realized that he failed to close out the revenue and expense accounts for the prior quarter, which ended in March. Because those temporary accounts were not closed out, their balances were included in the second quarter amounts for the current year. Brent then realized that the banker had the financial statements but not the general ledger or any trial balances. Thus, the banker would not be able to see that the accounting cycle from the first quarter was not properly closed and that this failure was creating a misstated income statement for the second quarter of the current year. The banker then commented that the business appeared to be performing so well that he would approve a line of credit for the business. Brent decided to not say anything because he did not want to lose the line of credit. Besides, he thought, it really did not matter that the income statement was misstated because his business would be sure to repay any amounts borrowed.

Should Brent have informed the banker of the mistake made, and should he have redone the second quarter's income statement? Was Brent's failure to close the prior quarter's revenue and expense accounts unethical? Does the fact that the business will repay the loan matter?

Know Your Business

Financial Analysis

Purpose: To help familiarize you with the financial reporting of a real company in order to further your understanding of the chapter material.

This case will help you to better understand the effect of adjusting journal entries on the financial statements. You know that adjusting journal entries are entered in the journal and then posted to the ledger accounts. We do not have access to the journals and ledgers used by Columbia Sportswear, but we can see some of the adjusted accounts on the company's financial statements. Refer to the Columbia Sportswear income statements, "Statements of Operations," and the Columbia Sportswear balance sheets, in Appendix A. Also find footnote 6 titled "Property, Plant, and Equipment, Net" and footnote 9 titled "Accrued Liabilities," which are two of the many footnotes included after the financial statements.

3. Post the journal entries to the T-accounts you set up. Check the updated ending balances in each account against the balances reported by Columbia Sportswear as of December 31, 2012.

Industry Analysis

Purpose: To help you understand and compare the performance of two companies in the same industry.

Go to the Columbia Sportswear Company Annual Report located in Appendix A . Now access the 2012 Annual Report for Under Armour, Inc. For instructions on how to access the report online, see the Industry Analysis in Chapter 1.

Requirement

1. By reviewing the financial statements of both companies, can you determine which method of accounting, cash or accrual basis, each of the companies used? How did you determine this? If one of the companies used the cash basis and the other used the accrual basis, would it affect your ability to compare the two companies? Explain your answer.

Small Business Analysis

Purpose: To help you understand the importance of cash flows in the operation of a small business.

It's the end of the month, and cash flow has been a little slow, as it usually is during this time of the accounting period. It just seems to be a little slower this month. You know that Wednesday the 31st is payday, which always requires a large cash outlay. However, you also know that your bank is looking for a set of financial statements as of the end of the month because the loan on your building is coming up for renewal soon. Based on some of the previous meetings with your bankers, they are always concerned with the cash balance, so you want to have your cash balance as high as possible.

You come up with a tentative plan you believe will not only preserve some of your cash balance at the end of the month but also will help your bottom line, your net income. That's the other thing that the bankers are always concerned about. You don't want to make any mistakes

The Perfect Balance of Small Business Perspective and Corporate Coverage Not every student will graduate and become part of a large corporation, which is why it's important for students to understand how financial accounting applies in small business scenarios as well as corporate ones.

Focus On Decision Making

How Does Accounting Report Business Transactions?

Think of the school you are attending. What are some of the transactions that are conducted every day at your school? How would the following transactions be recorded? Make sure you think through each of these transactions and understand that you need to acknowledge the total transaction.

1. You enroll in class and pay the school your tuition.
2. Your school hires your teacher, who teaches your class.
3. Your school pays the utilities that make your classroom comfortable.
4. You buy a ticket to an athletic event, concert, or other special activity.
5. Your school pays for advertising to promote the athletic event, concert, or other special activity.

Managers need good information about all the aspects of a business transaction. They need accounting systems to recognize, measure, record, and report the entire transaction. Financial statements must report the total transaction and how everything in a business works together.

How They Do It: A Look at Business

Businesses produce income by using assets financed with money. Think about Target, the large discount retailer. Target buys and sells goods such as clothing, groceries, electronics, and toys. Target sells these goods in large buildings. To earn more net income, Target tries to sell more goods. However, as sales increase, Target needs more assets. The more assets Target has, the more financing it needs. It needs money to finance the growing amount of clothing, groceries, electronics, and toys it sells. It also needs money to finance new and bigger buildings. Target gets this money from either borrowing the money (which increases Target's liabilities) or from its owners (stockholders' equity). For the year ended February 2, 2013, Target had revenues of $73.3 billion, expenses of $70.3 billion, and net income of $3 billion. As of February 2, 2013, Target had assets of $48.2 billion. These assets were financed with liabilities of $31.6 billion and stockholders' equity of $16.6 billion. As can be seen by comparing its 2012 and 2013 financial statements, Target grew its assets. For the year ended January 28, 2012, Target had revenues of $69.9 billion, expenses of $66.9 billion, and net income of $3 billion. As of January 28, 2012, Target had assets of $46.6 billion, liabilities of $30.8 billion, and stockholders equity of $15.8 billion. Target increased its assets, and thus its financing, in hopes of seeing net income increase in the future.

Focus on Decision Making shows students how to make financially sound business decisions and to evaluate risk and the impact of those decisions on a company.

Decision Guidelines focus students on the key business decisions that require a firm understanding of the accounting concepts in each chapter. UPDATED!

Decision Guidelines

Decision	Guideline	Analyze
How can I tell how well a business is performing?	A company's financial statements will provide information regarding the performance of the company.	The income statement reflects how profitable a business has been for a specified period of time. The statement of retained earnings shows how much of a company's earnings have been distributed to the stockholders during the period. And the balance sheet reflects the business's financial position on a given date. In other words, it shows what assets the business has and who has rights to those assets.

UPDATED!

a. Record the expired rent.
b. Supplies on hand, $250.
c. Depreciation; $180 equipment, $50 furniture, $420 vehicles.
d. Services performed but unbilled, $2,200.
e. Accrued salaries, $625.
f. Unearned service revenue earned as of July 31, $1,100.

5. Prepare an adjusted trial balance for Aqua Magic, Inc., at the end of July.
6. Prepare the income statement and statement of retained earnings for the three-month period May 1 through July 31, 2014. Also prepare a balance sheet at July 31, 2014.
7. Prepare and post closing entries.
8. Prepare a post-closing trial balance at July 31, 2014.

Continuing Financial Statement Analysis Problem

Let's look at Target again. Think about the business of Target. Now return to that place on Target's website called "investor relations." Look at Target's 2012 financial statements contained in its 2012 annual report. Go to: *http://investors.target.com/phoenix.zhtml?c=65828&p=irol-reportsAnnual*. On page 33 of the financial statements, you'll find Target's income statement for the year ending February 2, 2013 (called the Consolidate Statement of Operations). On page 35, you'll find Target's balance sheet as of February 2, 2013 (called the Consolidated Statement of Financial Position). On page 37, you'll find Target's statement of retained earnings for the year ending February 2, 2013. It's a part of Target's statement titled Consolidated Statements of Shareholders' Investment. Now answer the following questions:

1. Look at Target's income statement. Is Target profitable? Does it have a positive net income or a negative net income (loss) for the year ending February 2, 2013? How does that compare with the year ending February 2, 2013?
2. Look at Target's statement of shareholders' investment. How does Target's net income flow into its balance sheet?
3. Look at Target's balance sheet. What assets does Target own? How much has Target invested in each type of assets and in total assets?
4. Look at Target's balance sheet. How does Target finance its assets? How much liabilities and shareholders' equity does Target have?

Continuing Financial Statement Analysis Problem uses Target's 2012 annual report to familiarize students with reading and interpreting financial statements in each chapter. By the end of the text, they have completely analyzed the financial statements.

MyAccountingLab

Exercises (Group A)

E3-14A. Adjusting journal entries—unearned revenue and accrued revenue (*Learning Objective 2*) 10–15 min.

Suppose you started up your own landscaping business. A customer paid you $170 in advance to mow his or her lawn while he or she was on vacation. You performed landscaping services for a local business, but the business hasn't paid you the $440 fee yet. A customer pays you $215 cash for landscaping services. Answer the following questions about the correct way to account for your revenue under accrual-basis accounting:

1. Name the accounts used to record these events.
2. Prepare the journal entries to record the three transactions.

Try it in Excel

E3-15A. Adjusting journal entry—prepaid insurance (*Learning Objective 2*) 5–10 min.

Calculate the missing amounts for each of the following Prepaid Insurance situations. For situation A, journalize the adjusting ent...

End of Chapter 50% of problems and exercises (A and B sets) have been revised.

Problems (Group B)

P3-48B. Common adjusting journal entries (*Learning Objective 2*) 15–20 min.

Journalize the adjusting entries needed at December 31, the end of the current accounting year, for each of the following independent cases affecting Mountain Mania, Inc. No other adjusting entries have been made for the year.

a. Prior to making the adjusting entry on December 31, the balance in Prepaid Insurance is $1,200. Mountain Mania, Inc., pays liability insurance each year on April 30.

b. Mountain Mania, Inc., pays employees each Friday. The amount of the weekly payroll is $12,500 for a five-day workweek. December 31, the fiscal year-end, is a Monday.

c. Mountain Mania, Inc., received notes receivable from some customers for services provided. For the current year, accrued interest amounts to $640 and will be collected next year.

Test Bank and Solutions Manual prepared by author, Jeffrey Waybright.

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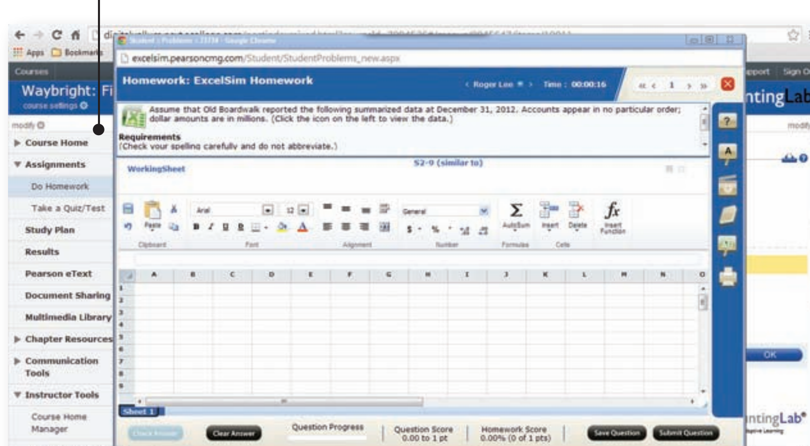

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- Data Files: Select end-of-chapter problems have been set up in different software applications, including Excel, QuickBooks 2012, and General Ledger software.
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Financial Accounting

1

Business, Accounting, and You

Business, Accounting, and You

You are about to study accounting. What is accounting, and why is it so important? Why does the study of business typically start with accounting?

Accounting is the language of business. Can you think of living in a foreign country and not being able to read and speak the native language? It would be very hard. Accounting is the process business people use to communicate what they've been doing. To be successful in business, you need to be able to understand, speak, and use the language of business.

In addition to being the language of business, accounting is the scorekeeping aspect of business. Think of the last sporting event you watched or played in. Can you imagine the end of the game without someone saying who scored, when they scored, and even how they scored? Accounting lets business managers know if they are winning or losing.

Learning Objectives

1. Understand the nature of business and the role of accounting in business
2. Know how a business operates
3. Know the different types and forms of businesses
4. Know the key accounting principles and concepts
5. Know how accounting functions in a business
6. Understand and be able to prepare basic financial statements

Accounting is at the heart of business. Whether you become an accountant or a business manager, understanding the foundation and process of accounting is critical to your success. If you are to be successful in business, your success starts with accounting. At the beginning of each chapter in the section *Business, Accounting, and You*, we will focus on how accounting keeps track of a business's transactions and helps you, as a manager, make good business decisions.

Real World Accounting Video

In the Real World Accounting Video, David Hitchner, owner and manager of ABC Wine, talks about what it means to own and operate a business. Look at the video. Think about what David is saying. And then realize how important accounting is to the success of a business.

What Is a Business, and Why Study Accounting?

1 Understand the nature of business and the role of accounting in business

Accounting Accounting is the process of recognizing, measuring, recording, and reporting information about a business's transactions.

You want to be successful in business. But why study accounting? The answer is what accounting reveals. **Accounting** is the process of recognizing, measuring, recording, and reporting information about a business's transactions. Understanding accounting enables you to recognize and understand business transactions. Understanding business transactions enables you to manage them successfully.

Think about going to a sporting event where you know nothing about the sport. You would probably have many questions. Your questions might include:

- What is the objective of this sport?
- Who are the players, and what are they doing to compete?
- How do players win or lose the competition?
- Who keeps score, and how is the score kept?

Business is a competition. Businesses compete for customers, employees, profits, and much more. To successfully compete in business you need to understand the objective of business, the players and their roles in business, the rules of business, and who keeps score and how it is kept.

If accounting is the scorekeeper of business, let's first talk about the game of business. When you look at business, you see people and organizations creating, producing, and selling products. Businesses, both for-profit and not-for-profit businesses, are everywhere. But have you ever stopped and thought about business? Think about it. What is a business? Why does a business exist? How does a business operate?

Business A business is a legal organization that attempts to create value by exchanging products with customers for money.

Product A good or service purchased or produced by a business to be sold.

Goods A good is a physical item that can be touched and felt. Goods are tangible.

The Definition of a Business

A **business** is a legal organization that attempts to create value by exchanging products with customers for money. An organization must have three elements to be called a business:

1. *Businesses are legal entities.* Businesses are empowered to operate by the law.
2. *A business must exchange a* ***product***, often referred to as either a good or a service, for money or money substitutes.
    a. **Goods** are physical items that we can touch and feel. Goods are tangible. Examples include food, cars, and clothing.

Services A service is an activity that exists but cannot be touched and felt. Services are intangible.

b. **Services** are activities that we know exist but we cannot touch and feel. Services are intangible. Examples include medical services, car repairs, and education.

However, providing products is not sufficient criteria for a business to be called a business. Someone must buy these products for money or money substitutes (for example, a receivable or promise to pay later). So who buys the products for money or money substitutes? The answer is **customers**. To succeed, a business must create an exchange with a customer. The exchange is called a **sale**.

Customer A person or organization that purchases a product from a business.

Sale The exchange between a business and customer where the business provides a customer a product and the business receives money or money substitutes.

3. *Businesses create value.* Customers get value from the benefits of a product. However, the other stakeholders in a business should also receive value. Owners get value from the profits a business earns. Employees get value from their wages. Lenders get value from the interest they charge.

The purpose of any business is to create and increase value. In a for-profit business, this value is often measured as the market price of the business, or what you'd pay if you wanted to buy and own the business.[1] All too often people assume that a business exists to create products, sales, profits, and jobs. All these things are important; however, the purpose of a business is to create value. So what is value? What determines value? How does value differ from profit?

The General Concept of Value

Value The price someone is willing to pay for an item.

The **value** of an item is what someone is willing to pay for it. As such, value depends on:

1. What the owner of an item expects to receive.
2. When the owner expects to receive it.
3. How certain the owner is about what he or she will receive and when it will be received.

For example, imagine you plan to cook a very special dinner tonight with a very special person. You need groceries. Where do you go? You think of a grocery store such as Kroger. It's late in the day, and you need food now. You are certain that Kroger will have the food you want and need. So what are you doing? You are entering into an exchange with Kroger. Kroger will provide you food and you will pay Kroger money.

When we go to make an exchange, we seek an exchange *where the value we receive exceeds the value that we give up*. In other words, we want a "good deal." In the Kroger example, you go to the store and ask the grocer how much you would pay for its food. If you believe the value of Kroger's food is greater than the value of the money you must pay, you agree to the exchange. If you believe the value of Kroger's food is less than the value of the money you must pay, you keep your money and do not agree to the exchange. You're basically comparing the value of the food and the value of the money, seeking the greatest value for yourself.

Cost The amount of money or money substitutes that a business pays to receive an item used in operating a business.

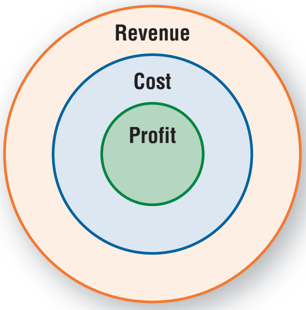
Revenue The amount of money or money substitutes that a business receives from the sale of a product.

Profit The revenue from a sale less the cost of the sale.

Businesses behave in the same way. A business attempts to create value by exchanging a product with a customer. Businesses buy or make products at one value (**cost**) and try to sell these products to their customers at a higher value (**revenue**). This exchange creates a **profit** (net benefit) to the business. An example of this is Kroger's grocery business. If done well, Kroger makes a profit by paying less for the food (cost) than it charges you for the food (revenue). Making a profit is very important in a for-profit business and

[1]For-profit businesses attempt to earn a profit. The concept of profit is discussed later. Examples of for-profit businesses are Target, Southwest Airlines, and many smaller businesses in your community. Not-for-profit businesses attempt to break even, neither experiencing a profit or loss. Examples of not-for-profit businesses are charities, government, and religious organizations. This text will focus on for-profit businesses. However, many of the concepts discussed are applicable to not-for-profit businesses.

drives the value of the business. Accountants are responsible for measuring revenue, costs, and profits.



In addition to the amount of profit, businesspeople also worry about *when* they make a profit and the *risk* they take to generate a profit. As we'll see in later chapters, the old adage that "time is money" is true. Time does affect the value of an item. The quicker a business like Kroger earns a profit, the more valuable it is. The longer a business takes to earn a profit, the less valuable it is. Think about it. Would you pay extra to have Kroger prepare your special meal? The answer is probably yes, given that it is late in the day. As we'll see throughout the book, accountants worry about *when* to recognize business transactions such as revenue, cost, and profit.

Risk Risk is the uncertainty that could result in an outcome not desired.

Loss A loss is a negative profit, which occurs when the cost of a sale is greater than the revenue from the sale.

Risk is also important. **Risk** is the uncertainty that an outcome we do not expect or desire could result. An example is Kroger's success. Do the owners of Kroger know that their business will succeed? The answer is they hope and believe Kroger will succeed but are not certain of its success. Think about Kroger's grocery business. What happens if you and others do not buy Kroger's food? Kroger incurs a **loss**, where revenue is less than cost. If Kroger continues to lose money, it will fail. Risk hurts value. Businesspeople must recognize, understand, measure, and manage risk. To compensate for taking a risk, businesses expect higher profits. Accountants help managers and other decision makers understand risk with accounting information. An example of such accounting information is whether a business can pay its debts on time or at all. In every chapter, specifically in Chapter 12, Financial Statement Analysis, we'll see how accounting information helps managers and other stakeholders understand risk.

Business Owners and Other Stakeholders

Stakeholder A stakeholder is a person or organization that is affected by a business.

A business has many **stakeholders**, or people and organizations that are affected by a business. These stakeholders include customers, employees, suppliers, regulators, society, lenders, and owners. All stakeholders are important. All stakeholders should believe that they are receiving value from the business. In other words, each of the stakeholders in a business gives and receives value through an exchange. Ideally, each stakeholder believes that the value he or she receives exceeds the value he or she gives up. An employee gives a business his or her labor for a paycheck. A supplier sells products to a business, ideally at a profit. A customer buys a product from a business at a price. Society, and regulators appointed by society, benefit from a business through jobs, taxes, and hopefully a better quality of life. In a free-market economy, all stakeholders are free to enter into an exchange, are important, and should not be taken for granted.

However, the providers of money are free to provide their money as they deem appropriate. Nobody forces a bank to make a loan to a business. Nobody forces an owner to put money in a business. There is an old saying that goes "It takes money to make money." What that means is it takes money to form and operate a business. To attract that money, lenders and owners must believe they will receive value greater than they give.

The Goal of a Business

The goal of a business is to create value for its owners. Owners expect a profit that compensates them for the use of their money over time and for the risk they assume. If the business does not create value, owners will not provide the money needed to operate the business. Without the business, customers, suppliers, employees, and society will not receive the value they seek. A business must create value for its owners. However, to do so, owners must appreciate that the other stakeholders must also receive value.

So if the objective of the firm is to create value, and we need to focus on creating value for owners, how does a business create value for its owners? How does a business generate profits, over time, at risk?

How Does a Business Operate?

2 **Know how a business operates**

Operating a business is not simple or easy. It takes a lot of resources. It also takes the ability to use those resources wisely. So what are the resources a business needs, and how does a business use those resources to generate profits, over time and at risk?

Resources Needed to Start and Operate a Business

To operate, businesses need to acquire money and use that money to make a profit. A firm acquires money by:

Liabilities A liability is an amount owed to a lender or other creditor.

Stockholders' equity Money provided to the business by owners either through an initial investment or the retention of profits, also known as **owners' equity**.

1. Borrowing money from lenders (called **liabilities**).
2. Getting owners to put in their money (called **owners'** or **stockholders' equity**) in exchange for a percentage of ownership.

A liability is a financial claim, or debt, that the business owes to a party that is not an owner of the business. Owners' equity represents money provided to the business by owners, either through an initial investment or the retention of profits. Often people will say the owners *invested* their money in the business.

Operating the Business

Asset An economic resource that a business owns and can use to operate the business.

Employees People, hired by a business, for a period of time to operate the business.

Expense Money or other value surrendered due to the sale of goods or services or the operating of the business.

Interest The expense of using borrowed money for a period of time.

Net income Operating profit less interest expense, computed as revenue, less operating expenses, less interest expense.

A business then uses the money to acquire assets and hire people. An **asset** is an economic resource that a business owns and can use to operate the business. Assets include cash, inventory, and buildings. The business also hires people, called **employees**, to operate the business for a period of time.

With the assets and employees, the business operates in hope of generating a profit, where revenue is greater than expenses. Remember, revenue is money or other value received that a business earns from the sale of goods or services. **Expenses**, often referred to as costs, are money or other value surrendered from the operating of the business. Part of operating the business is making sure lenders are paid interest. **Interest** is the expense of using borrowed money for a period of time.

After paying interest and other expenses, the owners of the business get what remains, referred to as profit or **net income**. Net income is revenue, less expenses (including interest expense).[2]

$$\text{Net Income} = \text{Revenue} - \text{Expenses}$$

[2]A business must also pay taxes. Taxes are an expense that will be explored later in this book. Net income is what is left after a business recognizes its tax expense and other expenses.

The question that owners must ask is whether the net income is worth the time and risk involved. Owners have many alternative uses for their money. They, like everyone else, seek the greatest value or return on their money.

Let's look at a simple example. You start a computer repair business. You invest $1,000 in your business, which will be used to start the business and is called owner's equity. You expect net income of $100, or a 10% return on your money ($100/$1000). However, you need $2,000 to start your business. You need equipment and other assets that cost you $2,000. So you go to a bank and ask to borrow $1,000 for one year. The bank looks at your loan application and agrees to lend you $1,000. However, for the time and risk associated with your loan, the bank requires you to pay simple interest of 6%. Thus, in one year you are required to repay the $1,000 loan plus $60 (6%) interest, or a total of $1,060. You borrow the $1,000 from the bank, combine it with your $1,000 equity, and start your business.

After one year, you close and liquidate the business. You are proud of your business because you have worked hard. You had revenue of $500, expenses such as supplies and rent of $400, and interest expense of $60 (6% × $1,000). You made net income of $40 ($500 − $400 − $60 = $40). The revenue from these sales exceeded the expenses by $40. How do you feel? Net income of $40 is good, but is it good enough? Would you have invested your $1,000 in the business if you thought you would only earn net income of $40?

The Cost of Money

Creating value is more than just generating net income by selling a product. Money has a cost. Businesses get money by borrowing it or having owners provide it. If a business borrows money, it must pay the lender rent on the money, called interest. It must also return the borrowed money at an agreed-upon time in the future. However, owners' money also has a cost. Owners are not going to provide their money without expecting to receive a benefit, or return, over time. Why should they? Why would an owner put money in a business for no return when they could deposit their money in a bank and earn interest? Never forget that money, whether borrowed or provided by owners, has a cost. The cost of the money is dependent on many things, but above all else is a function of the risk the lender or owner is taking. Remember, great risk must be compensated by great return.

We just learned that a business first acquires money from lenders (liabilities) and owners (equity). Lenders require the business to pay interest plus return the money they borrow. Owners expect to receive a benefit or return. This benefit or return is based on net income. Then a business uses the money to hire employees and acquire assets. Next, the employees use the assets to generate net income. If successful, the net income is equal to or exceeds the net income expected by owners. When it does, value for the owners is created. When it does not, value for the owners is destroyed.

How Are Businesses Organized?

3 Know the different types and forms of businesses

There are many types and forms of business organizations. The type of business relates to what it does to create value or, in other words, make a profit. The form of business organization relates to how it is legally organized.

The Types of Businesses

Businesses are typically divided into two broad categories, for-profit businesses and not-for-profit businesses. In this book, we'll focus on for-profit businesses that operate as corporations.

For-profit business A business that attempts to create an exchange, or sale, where revenue exceeds expenses, creating a profit.

- **For-profit businesses** attempt to create an exchange or sale where revenue exceeds expenses, creating a profit. Examples of for-profit businesses are Kroger, Facebook, Ford, Walmart, and Apple.

Not-for-profit business A business that attempts to create an exchange or sale where revenue equals costs.

Service business A business that sells a service to its customers.

Merchandise business A business that sells physical goods or products to its customers.

Manufacturing business A business that produces the physical goods that it sells to its customers.

Wholesale business A business that sells products to other businesses for resale.

Retail business A business that sells products to the final consumer of the product.

- **Not-for-profit businesses** attempt to create an exchange or sale where revenue equals costs. Examples of not-for-profit businesses are charities like The Red Cross or Habitat for Humanity, religious organizations, and governments. Although not-for-profit businesses are not the focus of this book, many of the principles and techniques discussed in this book also apply to not-for-profit businesses.

Within these two broad categories of business, there are three types of businesses: **service businesses**, **merchandising businesses**, and **manufacturing businesses**.

- A service business sells services to its customers. In other words, what it sells is time. Common types of service businesses include law firms, accounting firms, physical therapy offices, painting companies, and automotive repair shops.
- A merchandise business sells physical goods or products to its customers. Common types of merchandise businesses include grocery stores, automobile dealerships, and sporting goods stores. A merchandise business may be either a wholesale business or a retail business. A **wholesale business** is a business that sells products to other businesses for resale. The business that sells food products to a grocery store is an example of a wholesale business. A **retail business** is a business that sells products to the final consumer of the product. Target, Macy's, and Kroger are examples of retail businesses.
- A manufacturing business produces the physical goods that it sells to its customers. Common types of manufacturing businesses include automobile manufacturers, the makers of clothing, and soft drink manufacturers.

The Legal Forms of Businesses

A business can be legally organized as a sole proprietorship, partnership, corporation, or limited liability company. Most businesses in the United States are sole proprietorships. However, most business transactions are conducted in and among corporations. Why? The answer is most large businesses like Kroger, Facebook, Ford, Apple, and Target are corporations. But how do you know what type of business organization is best for your business?

Sole proprietorship A business entity that has one owner, where, for legal and tax purposes, the business and the owner are considered the same.

Partnership A business that has more than one owner, where, for legal and tax purposes, the business and the owners are considered the same.

Corporation A legal entity, chartered under state law, that is empowered to conduct business. The corporation and owners are considered as separate for legal and tax purposes.

Stockholder An owner of part of a corporation.

Dividend The payment of past and current profits, less losses, previously retained in the business.

- A **sole proprietorship** is a business entity that has one owner. For legal purposes and for tax purposes, the business and the owner are considered the same. The business owner is personally responsible or liable for all of the debts and obligations of the business. If somebody wants to sue the business, he or she would have to sue the owner. In addition, all of the income or loss generated by the business is reported on the owner's personal tax return and taxed at individual rates.
- A **partnership** is very similar to a sole proprietorship except that it has two or more owners. For legal purposes, the owners (partners) and the business are considered the same. If somebody sues the business, he or she would need to sue the business owners. For tax purposes, the partners divide all of the income or loss of the partnership and report it on their personal tax returns. Therefore, it is taxed at individual tax rates just like a sole proprietorship.
- A **corporation** differs from a sole proprietorship or a partnership because it is a separate legal entity from the owners. The business is incorporated under the laws of a state. When you see the abbreviation "Corp." for "Corporation" or "Inc." for "Incorporated," the business is a corporation. The owners of a corporation and the corporation itself are considered as separate under the law. This legal separation is very attractive to the business owners because it limits their personal liability to what they have invested in the corporation. The corporation's debts and obligations are not the debts and obligations of the owners. For tax purposes, the corporation is taxed as a separate entity from the owners. Therefore, income tax is imposed on the income of the corporation at corporate tax rates. If the business chooses to pay owners, called **stockholders**, any of the current or past net income, the business will pay a **dividend**. Stockholders must pay a tax on the dividends they receive. In effect, the income is taxed twice, double taxing the business owners. Many business

S-corporation A small corporation that has met the legal requirements to act as a corporation but elected to be taxed at individual rates.

Limited liability company A hybrid business entity having characteristics of both a *corporation* and a *partnership*.

owners desire to have the legal protection that the corporate form of organization offers. Owners can only lose what they have invested. They thus have limited liability. But they do not want to be subject to the "double taxation" that also occurs. Owners of small corporations are able to make an **S-corporation** election, which allows them to have limited liability and be taxed at individual rates, eliminating the double taxation.

- A **limited liability company** is a relatively new form of business organization. When you see the letters "LLC," the business is a limited liability company. The owners of a limited liability company enjoy the same legal separation that a corporation provides. For tax purposes, a limited liability company's income is treated similar to a sole proprietorship or a partnership. All of the income of the limited liability company is divided among the owners and is taxed at their personal rates. In many ways, a limited liability company is similar to an S-corporation. However, unlike an S-corporation, a limited liability company can be very flexible in how it distributes earnings among the owners.

Exhibit 1-1 summarizes the different types of business organizations.

Type of Business	Legal Status	Tax Status	Benefits	Drawbacks
Sole Proprietorship	Business and owner are considered to be the same entity	Business income is allocated to the owner and taxed at owner's personal tax rate	• Ease of formation • No double taxation	• Unlimited liability of owner • Difficult to raise capital • Limited life
Partnership	Business and owners are considered to be the same entity	Business income is allocated to the owners and taxed at owners' personal tax rates	• Ease of formation • No double taxation • Shared investment/knowledge	• Unlimited liability of owners • Disagreements between partners • Limited life
Corporation	Business and owners are considered to be **separate** entities	Business income is taxed at corporate tax rates. Any income distributed to the owners is also taxed at owners' personal tax rates. Also referred to as a C-corporation.	• Limited liability of owners • Easier to raise capital • Unlimited life	• More difficult and costly to form • Double taxation • More paperwork • More regulations
S-corporation	Business and owners are considered to be **separate** entities	Business income is allocated to the owners and taxed at owners' personal tax rates	• Limited liability of owners • No double taxation • Easier to raise capital • Unlimited life	• More difficult and costly to form • More paperwork • More regulations
Limited Liability Company	Business and owners are considered to be **separate** entities	Business income is allocated to the owners and taxed at owners' personal tax rates	• Limited liability of owners • No double taxation • More flexibility than with S-corporation	• More difficult and costly to form • Limited life

Exhibit 1-1

Although the process of accounting for the different types of business organizations is similar, there are slight variations depending on the type of organization. In this book, we will focus our attention on accounting for corporations.

Decision Guidelines

Decision	Guideline	Analyze
What form of business organization should be chosen?	There are many ways to organize a business including the following: a sole proprietorship, partnership, corporation or S-corporation, or limited liability company. Each type of business organization has different advantages and disadvantages.	Know the tax and legal treatments of each type of organization. Weigh the best treatment of taxes and legal liability of each type, and pick the format that is most advantageous for the business owners.

What Is Accounting, and What Are the Key Accounting Principles and Concepts?

4 **Know the key accounting principles and concepts**

Have you noticed how many kids play little league sports these days and wondered why so many kids compete in these sports? Some kids play to get into better shape and some kids play just for the fun, but most kids play because they want to win. If you think about it, we live in a very competitive world. This competitiveness makes the job of the scorekeeper very important because, without the scorekeeper, nobody would know which team won the contest. In addition to keeping track of who wins, the scorekeeper in an athletic contest tracks many other statistics that help the coach and the players judge individual performances.

The world of business is very much like little league sports. Businesses exist to win, which is usually defined as generating profits and creating value. **Financial accounting** is the process of recognizing, measuring, recording, and reporting information about a business's transactions to stakeholders outside the business. Outside stakeholders include stockholders (owners) and lenders.

Financial accounting The process of recognizing, measuring, recording, and reporting information about a business's transactions to stakeholders outside the business, including stockholders (owners) and lenders.

So what does it take to make a business "win" and create value? It takes many hard-working people performing the functions of the business. It takes people developing great products (for example, the research and development group or department); making great products (for example, the production or operations group or department); promoting, selling, and distributing products (for example, the sales and marketing group or department); and acquiring money (for example, the finance department). But it also takes people providing information about the business's financial condition and operations. Businesses run on information, and accounting is at the heart of providing useful information. In essence, accountants are the scorekeepers in the business world.

Generally Accepted Accounting Principles

Generally Accepted Accounting Principles (GAAP) The rules, principles, and concepts established by the accounting profession that govern financial accounting.

Financial Accounting Standards Board (FASB) A seven-person group primarily responsible for the establishment of standards of financial accounting and reporting called GAAP.

In sports there are established rules and principles that dictate how each game is to be played and how the score is to be kept. In the same way, the accounting profession has created a set of rules and principles that must be followed. This set of rules is codified and called **Generally Accepted Accounting Principles (GAAP)**.

In the United States, financial accounting must follow GAAP, which is the rules, principles, and concepts established by the accounting profession that govern financial accounting. GAAP helps existing and potential owners and creditors compare different companies. In the US, most GAAP is developed by the **Financial Accounting Standards Board (FASB)**. The FASB is a seven-person group primarily responsible for the establishment of GAAP. The main objective of financial accounting is to provide