Financial Accounting

4TH EDITION

Robert Kemp Jeffrey Waybright

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Fourth Edition

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The authors and Pearson Education, Inc. wish to thank Susan and Brian Miller, owners of the Bold City Brewery, for their contributions to this edition of *Financial Accounting*. They, and their team, have helped us make accounting come alive for students, showing the importance of financial accounting in making any business a success.

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 dedicate this edition to my parents, Bud and Rosalie Waybright, for their unconditional love and support my entire life.

Jeffrey Waybright

About the Authors

Robert 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 36 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 also 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 23 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 entrepreneurship, 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

- Introduced business and the nature and importance of accounting with the Bold City Brewery, a real-life, successful entrepreneurial venture
- Updated all of the A and B series exercises and problems to better reflect small business
- Updated the Continuing Exercise and Continuing Problem
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2014 annual report
- Updated end-of-chapter material related to Under Armour and Columbia Sportswear using the 2014 annual reports

Chapter 2 Analyzing and Recording Business Transactions

- Changed chapter introduction company from Target to the Bold City Brewery
- Updated all of the A and B series exercises and problems to better reflect small business
- Updated the Continuing Exercise and Continuing Problem
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2014 annual report
- Updated end-of-chapter material related to Under Armour and Columbia Sportswear using the 2014 annual reports

Chapter 3 Adjusting and Closing Entries

- Changed chapter introduction company from Disney to the Bold City Brewery
- Introduced the new FASB guidance related to the standardization of the revenue recognition rules
- Updated all of the A and B series exercises and problems to better reflect small business
- Updated the Continuing Exercise and Continuing Problem
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2014 annual report
- Updated end-of-chapter material related to Under Armour and Columbia Sportswear using the 2014 annual reports

Chapter 4 Accounting for a Merchandising Business

- Changed chapter introduction company from Toys R Us to the Bold City Brewery
- Added chapter coverage of the new FASB guidance related to the revenue recognition rules regarding accounting for sales returns and allowances and sales discounts
- Added chapter coverage of accounting for partial payments of invoices within the discount period
- Updated all of the A and B series exercises and problems to better reflect small business

- Updated the Continuing Exercise and Continuing Problem
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2014 annual report
- Updated end-of-chapter material related to Under Armour and Columbia Sportswear using the 2014 annual reports

Chapter 5 Inventory

- Changed chapter introduction company from Toys R Us to the Bold City Brewery
- Updated all of the A and B series exercises and problems to better reflect small business
- Updated the Continuing Exercise and Continuing Problem
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2014 annual report
- Updated end-of-chapter material related to Under Armour and Columbia Sportswear using the 2014 annual reports

Chapter 6 The Challenges of Accounting: Standards, Internal Control, Audits, Fraud, and Ethics

- Introduced the nature and importance of accounting standards with the Bold City Brewery
- Updated the status of the adoption of IFRS in the United States
- Updated all of the A and B series exercises and problems to better reflect small business
- Updated the Continuing Exercise and Continuing Problem
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2014 annual report
- Updated end-of-chapter material related to Under Armour and Columbia Sportswear using the 2014 annual reports

Chapter 7 Cash and Receivables

- Changed chapter introduction company from Hershey to the Bold City Brewery
- Updated all of the A and B series exercises and problems to better reflect small business
- Updated the Continuing Exercise and Continuing Problem
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2014 annual report
- Updated end-of-chapter material related to Under Armour and Columbia Sportswear using the 2014 annual reports

Chapter 8 Long-Term and Other Assets

- Changed chapter introduction company from AT&T to the Bold City Brewery
- Updated all of the A and B series exercises and problems to better reflect small business
- Updated the Continuing Exercise and Continuing Problem
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2014 annual report
- Updated end-of-chapter material related to Under Armour and Columbia Sportswear using the 2014 annual reports

Chapter 9 Current Liabilities and Long-Term Debt

- Changed chapter introduction company from Ford to the Bold City Brewery
- Updated all of the A and B series exercises and problems to better reflect small business
- Updated the Continuing Exercise and Continuing Problem

- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2014 annual report
- Updated end-of-chapter material related to Under Armour and Columbia Sportswear using the 2014 annual reports

Chapter 10 Corporations: Paid-In Capital and Retained Earnings

- Changed chapter introduction company from Apple to the Bold City Brewery
- Updated all of the A and B series exercises and problems to better reflect small business
- Updated the Continuing Exercise and Continuing Problem
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2014 annual report
- Updated end-of-chapter material related to Under Armour and Columbia Sportswear using the 2014 annual reports

Chapter 11 The Statement of Cash Flows

- Changed chapter introduction company from Delta Airlines to the Bold City Brewery
- Updated all of the A and B series exercises and problems to better reflect small business
- Updated the Continuing Exercise and Continuing Problem
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2014 annual report
- Updated end-of-chapter material related to Under Armour and Columbia Sportswear using the 2014 annual reports

Chapter 12 Financial Statement Analysis

- Added the Bold City Brewery to the introduction of financial analysis
- Updated the chapter coverage to reflect the new FASB rules related to accounting for extraordinary items
- Updated all of the A and B series exercises and problems to better reflect small business
- Updated the Continuing Exercise and Continuing Problem
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2014 annual report
- Updated end-of-chapter material related to Under Armour and Columbia Sportswear using the 2014 annual reports

Appendix C (new)

- Added coverage of Accounting Standards Update (ASU) number 2014–09 and the five-step process for revenue recognition

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

As has been our goal in past editions, the fourth 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 students understand not only accounting but its critical role in the business world. We want to help you help your students master the basic concepts of financial accounting and apply them to everyday business decisions.

To help with this goal, we've focused the fourth edition on businesses to which students can better relate. First, we introduce the topic of each chapter with the Bold City Brewery—a successful, entrepreneurial business. We conclude each chapter by showing the importance of the chapter topic to the Bold City Brewery and larger firms. Second, throughout the chapter and at the end of the chapter, we use examples and problems that reflect typical businesses that students encounter in their real lives. This means smaller and more manageable numbers.

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. Included in this edition are more than 18 live examples, 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 solutions manual and contributed to and accuracy checked the algorithmic test bank. In addition to these supplements, there are automatically graded homework assignments in MyAccountingLab.

We believe in 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 fourth 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 Kemp, DBA, CPA
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The University of Virginia

Jeffrey Waybright
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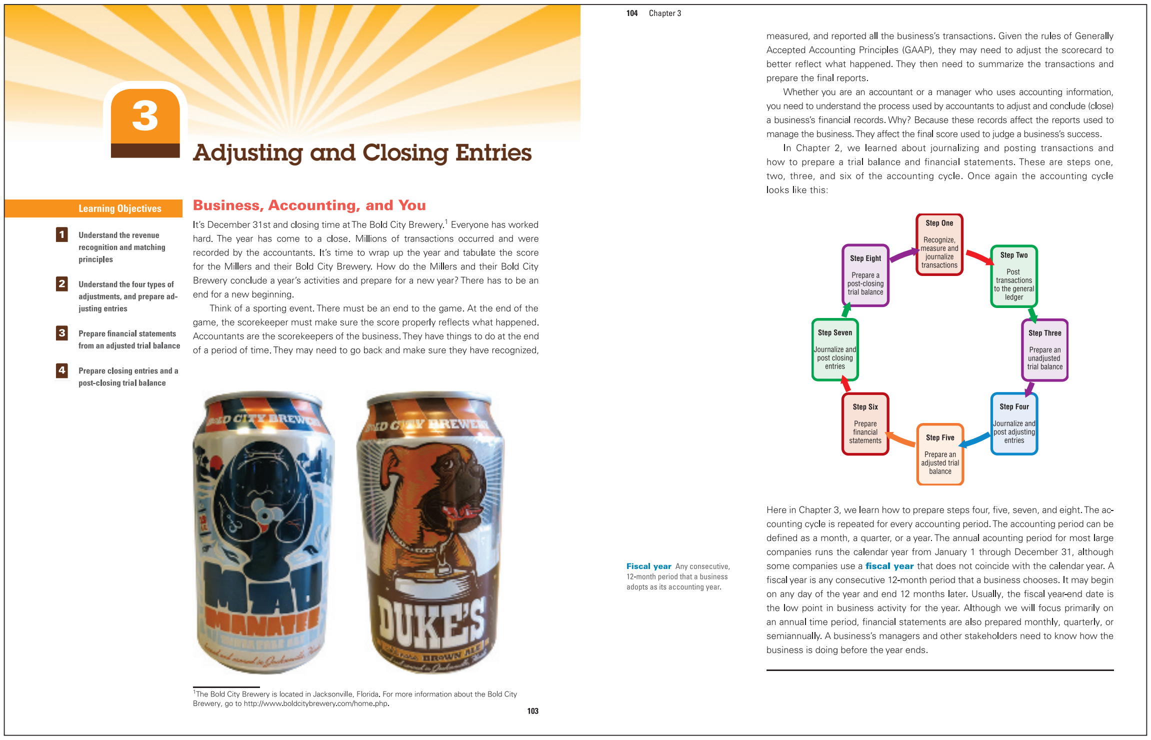
Visual Walk-Through

Chapter Openers

The Bold City Brewery is discussed at the beginning of each chapter in the Business, Accounting, and You feature. This feature motivates students by tying the business concept directly to the chapter's accounting topics and demonstrating the importance and usefulness of the chapter's topics.


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 The Bold City Brewery.[1] Everyone has worked hard. The year has come to a close. Millions of transactions occurred and were recorded by the accountants. It's time to wrap up the year and tabulate the score for the Millers and their Bold City Brewery. How do the Millers and their Bold City Brewery 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 properly reflects what happened. Accountants are the scorekeepers of the business. They have things to do at the end of a period of time. They may need to go back and make sure they have recognized,

[1]The Bold City Brewery is located in Jacksonville, Florida. For more information about the Bold City Brewery, go to http://www.boldcitybrewery.com/home.php.

103

104 Chapter 3

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.

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 these records 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 and how to prepare a trial balance and financial statements. These are steps one, two, three, and six of the accounting cycle. Once again the accounting cycle looks like this:

Here in Chapter 3, we 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, financial statements are also prepared monthly, quarterly, or semiannually. A business's managers and other stakeholders need to know how the business is doing before the year ends.

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

How Does a Company Accurately Report Its Income?

Revenue Recognition and Matching Principles

1 Understand the revenue recognition and matching principles

Accrual accounting Accounting method that records revenues when earned and expenses when incurred without regard to when cash is exchanged.

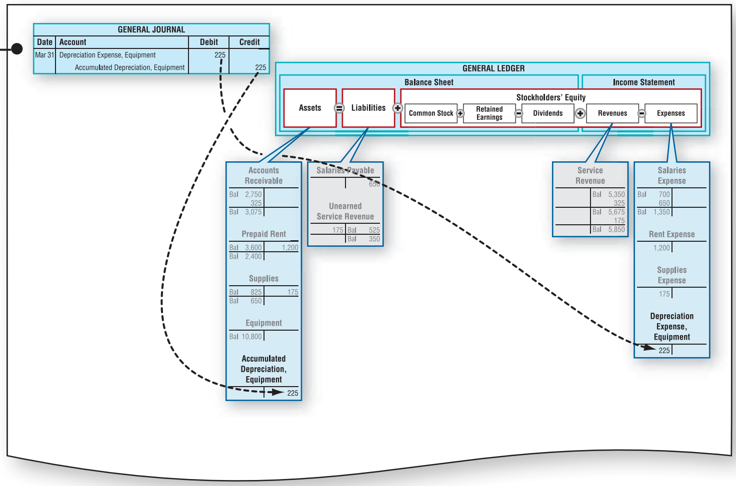
Revenue recognition principle Recording revenues when they are earned by providing goods or services to customers.

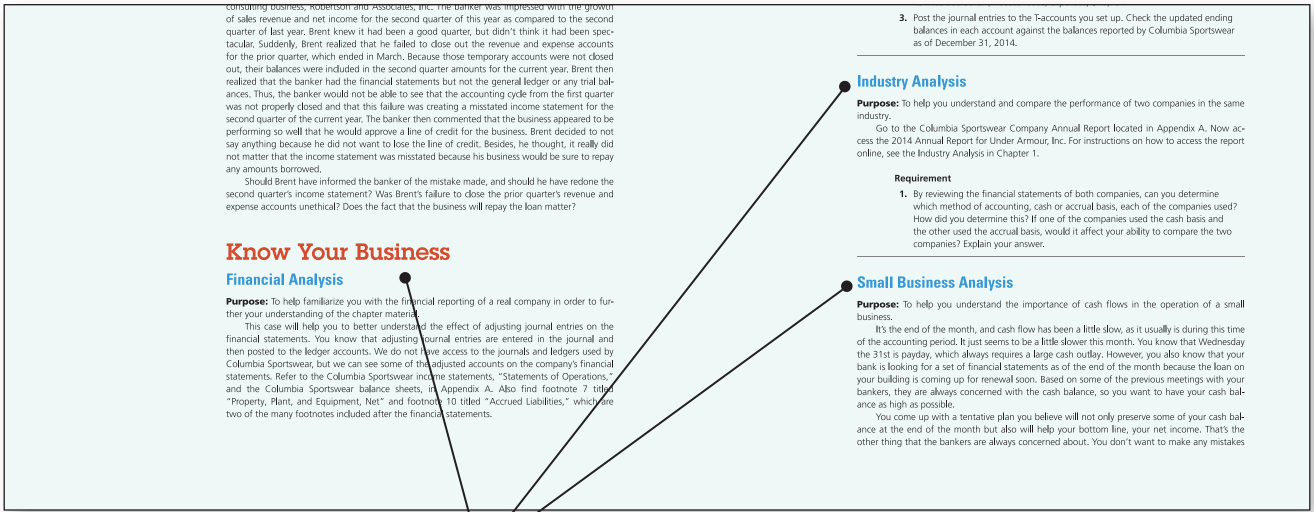
In Chapter 1, we learned that financial statements are prepared in order to provide useful information to various users. However, for financial statements to be useful, they must be accurate and up to date. To ensure that financial statements are up to date, GAAP requires the use of **accrual accounting**. To practice accrual accounting, a business must follow the next two accounting principles:

- The **revenue recognition principle** states that revenues should be recognized, or recorded, when they are earned regardless of when cash is received.
- The **matching principle** states that expenses should be matched with the revenues they helped generate. In other words, expenses should be recorded when they are incurred regardless of when they are paid for

Question-and-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.

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





consulting business, Robertson and Associates, Inc. The banker was impressed with the growth 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 7 titled "Property, Plant, and Equipment, Net" and footnote 10 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, 2014.

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 2014 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 shows students how to make financially sound business decisions and to evaluate risk and the impact of those decisions on a company.

Focus on Decision Making

"Who Owns Net Income and Where Does Net Income Go?"

What is net income? You can't touch it. You can't see it. You can't spend it. There's not even an account in the general ledger called Net Income. You can touch, see, and spend cash. But using accrual accounting, net income is not cash. So what is net income? Net income is the net of revenues less expenses. But who gets the net income? Who owns net income?

The answer is owners own net income. Think of revenues as something that benefits owners. Think of expenses as something that takes away some of that benefit that revenues provide. The net, whether net income or loss, belongs to the owners.

At the end of each accounting period, we want to close out the old measures and start new measures of revenues, expenses, and net income. We have closing entries that zero out all the revenue and expense accounts so they start with a zero balance. However, we do not zero out the impact that revenues and expenses had on balance sheet accounts such as cash, accounts receivable, and accounts payable. To get this to work, we take the net income and recognize that it belongs to the business's owners. It's a part of the owners' equity. If the business does not distribute it to the owners, the net income is retained in the business. Earnings over time can be retained in the business or distributed to owners.

How They Do It: A Look at Business

During a period of time, a business sells products and earns revenue. In doing so, a business incurs expenses. Revenue less expenses is net income or net loss. Think about a microbrewery such as the Bold City Brewery.[2] Remember in Chapter 1 that our dream brewery started with $1,500,000 in assets. It financed $1,500,000 in assets with $750,000 in liabilities and $750,000 in stockholders' equity. So what did it do with its assets? During the year, it used the assets to make and sell beer. Sales were $3,000,000. It incurred expenses in making and selling the beer of $2,700,000. During the year, the brewery made its owners $300,000 in net income. The owners started with $750,000 in stockholders' equity. It increased its stockholders' equity by adding $300,000 in net income to retained earnings. Thus, at the end of the year, the $300,000 in additional retained earnings increased stockholders' equity from $750,000 to $1,050,000. If the brewery does not pay a dividend to its owners, the brewery will have ending stockholders' equity of $1,050,000. The brewery will start the next year with $1,050,000 in stockholders' equity.

Now let's look at the Walt Disney Company. Disney operates amusement parks, makes movies, sells clothing, and a lot of oth
tertainment business. Some years are

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

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.

Try It! gives students the opportunity to apply the concept they just learned to an accounting problem.

Try It!

Jane Richards is the accountant for Crazy Curls, Inc., a local salon. After Jane finished preparing the financial statements for the year, she realized that she failed to make an adjusting entry to record $975 of depreciation expense on equipment. What effect did this error have on Crazy Curls' financial statements?

Answer

In order to determine the effect of omitting an adjusting entry, we must examine what the adjusting entry should have been. The adjusting entry Jane should have made is:

DATE	ACCOUNTS	POST REF.	DR.	CR.
	Depreciation Expense, Equipment		975	
	Accumulated Depreciation, Equipment			975

As we can see from the journal entry, Depreciation Expense, Equipment should have been debited (increased), which would have increased total expenses for the year. An increase in total expenses causes a decrease in Net Income. So, the omission of the adjusting entry for depreciation expense causes Net Income, and therefore Retained Earnings, to be overstated. We also see that the Accumulated Depreciation, Equipment account should have been credited (increased), which would cause total assets to decrease because Accumulated Depreciation, Equipment is a contra-asset account. So, the omission of the adjusting entry for depreciation expense also causes the total assets to be overstated.

Stop and Think includes a question-and-answer snapshot asking students to apply what they just learned.

Stop and Think...

If cash is so important to the well-being of a business, why does US GAAP require the use of accrual accounting instead of cash-basis accounting?

Answer

The goal of US GAAP is for financial statements to reflect accurate information regarding the performance of a business. The fact that a business has received cash from customers does not necessarily mean that the business is performing well. For example, let's assume that during the year a business received $95,000 from customers for services it had provided during the same year. The business also received another $15,000 from customers for services that will not be provided until the following year. Under cash-basis accounting, the business would report $110,000 of revenues in the first year. Now, suppose during the second year the customers asked for (and received) a refund of the $15,000 before the services were provided. The $110,000 in revenues originally reported under cash-basis accounting during the first year now seems inaccurate because the business only ended up with revenues of $95,000. Under accrual accounting, the business would have reported only $95,000 of revenues in the first year, which would have reflected a more accurate picture of the business's performance. This is because, under accrual accounting, revenues are recorded when they are earned instead of when cash is received.

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 $120 in advance to mow his or her lawn while he or she was on vacation. You also performed landscaping services for a local business, but the business hasn't paid you the $390 fee yet. In addition, a customer paid you $130 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.

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 entry. Consider each situation separately.

End of Chapter 100 percent of problems and exercises (A and B sets), continuing exercises, and continuing problems have been updated.

MyAccountingLab

Problems (Group A)

P3-42A. Common adjusting journal entries (*Learning Objective 2*) 15–20 min.

Journalize the adjusting entry needed at December 31, the end of the current accounting year, for each of the following independent cases affecting Premier Powersports, 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 $4,800. Premier Powersports, Inc., pays liability insurance each year on June 1.
b. Premier Powersports, Inc., pays employees each Friday. The amount of the weekly payroll is $6,500 for a five-day workweek. December 31, the fiscal year-end, is a Tuesday.

a. Record the expired rent.
b. Supplies on hand, $450.
c. Depreciation; $450 equipment, $115 furniture, $1,200 vehicles.
d. Services performed but unbilled, $2,800.
e. Accrued salaries, $675.
f. Unearned service revenue earned as of May 31, $700.

5. Prepare an adjusted trial balance for Fitness Equipment Doctor, Inc., at the end of May.
6. Prepare the income statement and statement of retained earnings for the three-month period March 1 through May 31, 2016. Also prepare a balance sheet at May 31, 2016.
7. Prepare and post closing entries.
8. Prepare a post-closing trial balance at May 31, 2016.

Continuing Financial Statement Analysis Problem

Let's look at Dick's Sporting Goods (Dick's) some more. Think about Dick's. Think about accountants reporting what Dick's has, where it got its money, and what it has been doing to create value. Is Dick's earning net income or loss? What resources did Dick's need to operate? Think about the business of Dick's. Return to Dick's financial statements contained in its Annual Report (see the Continuing Financial Statement Analysis Problem in Chapter 2 for instructions on how to access the Annual Report). Go to page 44 where you will find Dick's income statement for the year ending January 31, 2015 (called the Consolidated Statement of Income). On page 46, you'll find Dick's balance sheet as of January 31, 2015. On page 47, you'll find Dick's statement of retained earnings for the year ending January 31, 2015. It's a part of Dick's statement titled Consolidated Statements of Changes in Stockholders' Equity.

Now answer the following questions:

1. Look at Dick's income statement. Is Dick's profitable? Does it have a positive net income or a negative net income (loss) for the year ending January 31, 2015? How does that compare with the previous year?
2. Look at Dick's statement of retained earnings, found in its Consolidated Statements of Changes in Stockholders' Equity. How does Dick's net income flow into its balance sheet?
3. Look at Dick's balance sheet. What assets does Dick's own? How much has Dick's invested in each type of assets and in total
4. Look at Dick's

UPDATED!
Continuing Financial Statement Analysis Problem uses Dick's Sporting Goods 2014 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.

Digital Walk-Through

Pearson eText NEW!

The Pearson eText, available through MyAccountingLab, gives students access to their textbook anytime, anywhere. In addition to note taking, highlighting, and bookmarking, the Pearson eText offers interactive and sharing features. Rich media options let students watch lecture and example videos as they read or do their homework. Instructors can share their comments or highlights, and students can add their own, creating a tight community of learners in your class.

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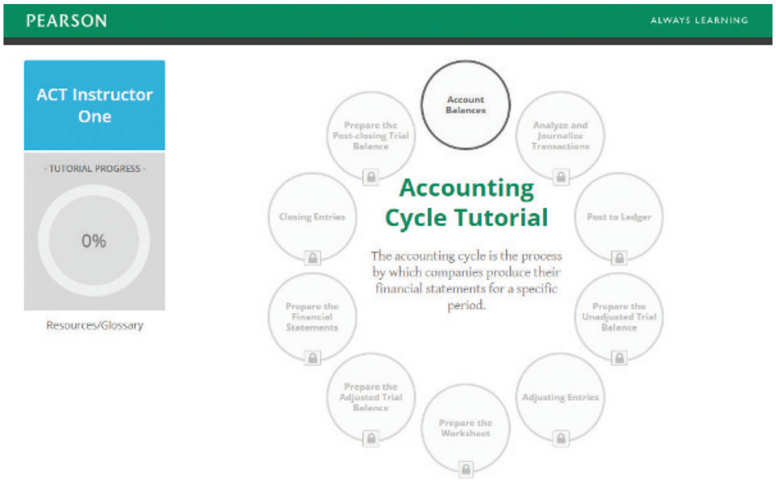
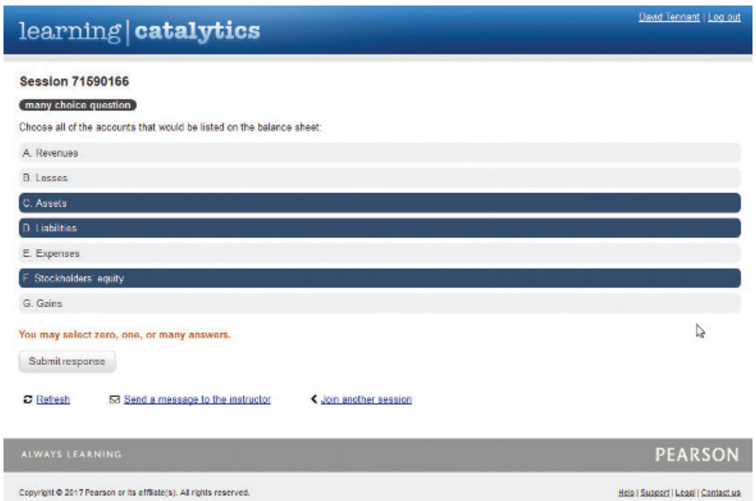
Accounting Cycle Tutorial (ACT) NEW!

MyAccountingLab's new interactive tutorial helps students master the accounting cycle for early and continued success in the Introduction to Accounting course. The tutorial, accessed by computer, Smartphone, or tablet, provides students with brief explanations of each concept of the accounting cycle through engaging videos and animations. Students are immediately assessed on their understanding, and their performance is recorded in the MyAccountingLab grade book. Whether the Accounting Cycle Tutorial is used as a remediation self-study tool or course assignment, students have yet another resource within MyAccountingLab to help them be successful with the accounting cycle.





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Learning Catalytics, available through MyAccountingLab, is a "bring your own device" assessment and classroom activity system that expands the possibilities for student engagement. Using Learning Catalytics, you can deliver a wide range of automatically graded or open-ended questions that test content knowledge and build critical thinking skills. Eighteen different answer types provide great flexibility, including graphical, numerical, textual input, and more.

Student and Instructor Resources

For Students

http://www.myaccountinglab.com online Homework and Assessment Manager

- Pearson eText
- Accounting Cycle Tutorial
- Dynamic Study Modules
- Videos
- Demo Docs
- Student PowerPoint® Presentations
- Working Papers
- QuickBook Data Files
- Excel-in-Practice Data Files
- Flash Cards

Student resource Web site: http://www.pearsonhighered.com/kemp

The book's Web site contains the following:

- QuickBooks Data Files and Excel-in-Practice Data Files related to select end-of-chapter problems
- Working Papers for completing end-of-chapter questions in preformatted templates
- Student PowerPoint® Presentations

For Instructors

For the instructor's convenience, resources can be downloaded from the textbook's catalog page (http://www.pearsonhighered.com/kemp) and MyAccountingLab. Available resources include the following:

- **Instructor's Resource Manual** includes chapter summaries and the following resources:

Course Content

- Introduction to the Instructor's Resource Manual with a list of resources and a roadmap to help navigate MyAccountingLab
- Instructor tips for teaching courses in multiple formats: traditional, hybrid, or online
- "First Day of Class" student handout that includes tips for success in the course as well as an additional document that shows students how to register and log on to MyAccountingLab
- Sample syllabi for 10- and 16-week courses

Chapter Content

- Chapter overview and teaching outline that includes a brief synopsis and overview of each chapter
- List of learning objectives from the text
- Key topics that walk instructors through what material to cover and what examples to use when addressing certain items within the chapter
- Student chapter summary handout to assist students in taking notes on the chapter
- Assignment grid that outlines all end-of-chapter exercises, problems, and cases; the topic of a particular exercise, problem, or case; estimated completion time; level of difficulty; and availability in General Ledger or Excel templates
- Ten-minute quizzes that quickly assess students' understanding of the chapter material

- **Instructor's Solutions Manual** contains solutions to all end-of-chapter questions, including short exercises, exercises, and problems
- **Test Bank** includes more than 1,500 questions; both objective-based questions and computational problems are available. Algorithmic test bank is available in MyAccountingLab
- **PowerPoint Presentations** help facilitate classroom
  – Instructor PowerPoint Presentations—complete with lecture notes
  – Student PowerPoint Presentations
- **Working Paper Templates and Solutions in** Excel and PDF Format
- **Image Library**
- **Data and Solution Files** QuickBooks Data Files and Excel-in- Practice Data Files, related to select end-of-chapter problems; corresponding solution files are also provided

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1

Business, Accounting, and You

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

Business, Accounting, and You

Close your eyes and dream. Think about creating or managing a business. Think about creating a product that customers want and value. Think about creating a profitable business that creates value for owners and other stakeholders. Now think what it takes to make this dream come true. It takes a lot. You need good employees. You need assets such as cash, equipment, and inventory. You need financing to fund the acquisition of these assets.

Susan and Brian Miller were just like you. They had a dream. They wanted to create something special: a microbrewery that created value for customers, themselves, employees, and others. To be successful, they realized they needed employees, assets, and financing. But they also needed information. Information would enable them to hire and manage their employees, acquire and manage their assets, and finance

their business. When the Millers created the very successful Bold City Brewery,[1] they knew a good accounting system would be critical.

So what is accounting? Why is accounting 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 speak the native language? It would be very hard. Accounting is the process businesses use to communicate what they've got in the way of resources, where they got the money to acquire the resources, and what they've been doing with the resources. To be successful in business, you need to be able to understand, speak, and use the language of business.

Accounting is also the scorekeeping function of a business. Think of the last sporting event you watched or played. Think about a game or contest where nobody kept score. Can you imagine the end of the game without knowing who scored, when they scored, and even how they scored? Accounting lets business managers know if they are winning or losing.

The bottom line is accounting is at the heart of business. Understanding the foundation and process of accounting is critical to success in the business world. To be successful like the Millers, your success starts with accounting. At the beginning of each chapter is a section titled Business, Accounting, and You. Here, we focus on how accounting keeps track of a business's transactions and helps people like you make good business decisions. We'll use the Bold City Brewery to show the importance of the chapter topic. At the end of the chapter is a section titled How They Do It: A Look at Business. Here, we look at how businesses like the Bold City Brewery use the chapter topic to manage the business.

What Is a Business, and Why Study Accounting?

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

Accounting 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.

[1] The Bold City Brewery is located in Jacksonville, Florida. For more information about the Bold City Brewery, go to http://www.boldcitybrewery.com/home.php.

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?

The Definition of a Business

Business 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 Physical items that can be touched and felt.

Services Activities that exist but cannot be touched and felt.

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

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

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

    However, providing products is not a 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**.
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.[2] 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 for 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 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

[2]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, experiencing neither profit nor 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.

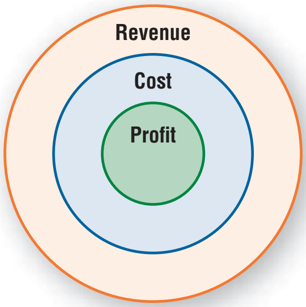
believe the value of Kroger's food is greater than the value of the money you must pay, you agree to the exchange. If you believe the value of Kroger's food is less than the value of the money you must pay, you keep your money and do not agree to the exchange. You're basically comparing the value of the food and the value of the money, seeking the greatest value for yourself.

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

Revenue The amount of money or money substitutes 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 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 "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 The uncertainty that could result in an outcome not desired.

Loss A negative profit that 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 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 person or organization affected by a business.

A business has many **stakeholders**, or people and organizations affected by a business. These stakeholders include customers, employees, suppliers, regulators, society, lenders, and owners. All stakeholders are important. All stakeholders should believe 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 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:

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.

Liabilities 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**.

Operating the Business

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.

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.

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).[3]

Net Income = Revenue − 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 percent 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 percent. Thus, in one year you are required to repay the $1,000 loan plus $60 (6 percent) 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.

[3]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 Types of Businesses

Businesses are typically divided into two broad categories: for-profit businesses and not-for-profit businesses. In this book, we 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.

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

- **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 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.

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.

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

- A service business sells services to its customers. In other words, it sells 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, empowered to conduct business; the corporation and owners are considered as separate for legal and tax purposes.

- 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

Stockholder An owner of part of a corporation.

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

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 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.

Exhibit 1-1

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

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 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 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 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 hardworking 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 (GAAP)

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, established rules and principles 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 set of 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 United States, 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