Financial Accounting

Fifth Edition

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Glenn **Pfeiffer**

FIFTH EDITION

Financial Accounting

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To my wife, Ann, and children, Daniel, James, Linda, and David; and to Pete Dukes, a friend who is always there.

—TRD

To my husband, Chris, and to our children, Clark and Josie.

—MLH

To my wife, Peggy, and our family, Paul and Teisha, Michael and Heather, and grandchildren Sage, Caillean, Rhiannon, Corin, Connor, and Harrison.

—RPM

To my wife, Kathie, and my daughter, Jaclyn.

—GMP

Cambridge Business Publishers

FINANCIAL ACCOUNTING, Fifth Edition, by Thomas R. Dyckman, Michelle L. Hanlon, Robert P. Magee, and Glenn M. Pfeiffer.

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About the Authors

The combined skills and expertise of Tom Dyckman, Michelle Hanlon, Bob Magee, and Glenn Pfeiffer create the ideal team to author this exciting financial accounting textbook. Their combined experience in award-winning teaching, consulting, and research in the area of financial accounting and analysis provides a powerful foundation for this pioneering textbook.

Thomas R. Dyckman is Ann Whitney Olin Professor Emeritus of Accounting and Quantitative Analysis at Cornell University's Johnson Graduate School of Management. In addition to teaching accounting and quantitative analysis, he has taught in Cornell's Executive Development Program. He earned his doctorate degree from the University of Michigan. He is a former member of the Financial Accounting Standards Board Advisory Committee and the Financial Accounting Foundation, which oversees the FASB. He was president of the American Accounting Association in 1982 and received the association's *Outstanding Educator* Award for the year 1987. He also received the AICPA's *Notable Contributions to Accounting Literature Award* in 1966 and 1978.

Professor Dyckman has extensive industrial experience that includes work with the U.S. Navy and IBM. He has conducted seminars for Cornell Executive Development Program and Managing the Next Generation of Technology, as well as for Ocean Spray, Goodyear, Morgan Guaranty, GTE, Southern New England Telephone, and Goulds Pumps. Professor Dyckman was elected to The Accounting Hall of Fame in 2009.

Professor Dyckman has coauthored eleven books and written over 50 journal articles on topics from financial markets to the application of quantitative and behavioral theory to administrative decision making. He has been a member of the editorial boards of *The Accounting Review, The Journal of Finance and Quantitative Analysis, The Journal of Accounting and Economics, The Journal of Management Accounting Research,* and *The Journal of Accounting Education*.

Michelle L. Hanlon is the Howard W. Johnson Professor at the MIT Sloan School of Management. She earned her doctorate degree at the University of Washington. Prior to joining MIT, she was a faculty member at the University of Michigan. Professor Hanlon has taught financial accounting to undergraduates, MBA students, Executive MBA students, and Masters of Finance students. Professor Hanlon also teaches Taxes and Business Strategy to MBA students. She is the winner of the 2013 Jamieson Prize for Excellence in Teaching at MIT Sloan.

Professor Hanlon's research focuses primarily on the intersection of taxation and financial accounting. Her recent work examines the capital market effects of the accounting for income tax, the reputational effects of corporate tax avoidance, and the economic consequences of U.S. international tax policies for multinational corporations. She has published research studies in the *Journal of Accounting and Economics*, the *Journal of Accounting Research*, *The Accounting Review*, the *Review of Accounting Studies*, the *Journal of Finance*, the *Journal of Financial Economics*, the *Journal of Public Economics*, and others. She has won several awards for her research and has presented her work at numerous universities and conferences. Professor Hanlon has served on several editorial boards and currently serves as an editor at the *Journal of Accounting and Economics*.

Professor Hanlon is a co-author on another textbook, *Taxes and Business Strategy*. She has testified in front of the U.S. Senate Committee on Finance and the U.S. House of Representatives Committee on Ways and Means about the interaction of financial accounting and tax policy. She served as a U.S. delegate to the American-Swiss Young Leaders Conference in 2010 and worked as an Academic Fellow at the U.S. House Ways and Means Committee in 2015.

Robert P. Magee is Keith I. DeLashmutt Professor of Accounting Information and Management at the Kellogg School of Management at Northwestern University. He received his A.B., M.S. and Ph.D. from Cornell University. Prior to joining the Kellogg faculty in 1976, he was a faculty member at the University of Chicago's Graduate School of Business. For academic year 1980-81, he was a visiting faculty member at IMEDE (now IMD) in Lausanne, Switzerland.

Professor Magee's research focuses on the use of accounting information to facilitate decision-making and control within organizations. He has published articles in *The Accounting Review,* the *Journal of Accounting Research*, the *Journal of Accounting and Economics*, and a variety of other journals. He is the author of *Advanced Managerial Accounting* and co-author (with Thomas R. Dyckman and David H. Downes) of *Efficient Capital Markets and Accounting: A Critical Analysis*. The latter book received the Notable Contribution to the Accounting Literature Award from the AICPA in 1978. Professor Magee has served on the editorial boards of *The Accounting Review,* the *Journal of Accounting Research*, the *Journal of Accounting and Economics* and the *Journal of Accounting, Auditing and*

Finance. From 1994–96, he served as Editor of *The Accounting Review*, the quarterly research journal of the American Accounting Association. He received the American Accounting Association's Outstanding Accounting Educator Award in 1999 and the Illinois CPA Society Outstanding Educator Award in 2000.

Professor Magee teaches financial accounting to MBA and Executive MBA students. He has received several teaching awards at the Kellogg School, including the Alumni Choice Outstanding Professor Award in 2003.

Glenn M. Pfeiffer is the Warren and Doris Uehlinger Professor of Business at the George L. Argyros School of Business and Economics at Chapman University. He received his M.S. and Ph.D. from Cornell University after he earned a bachelors degree from Hope College. Prior to joining the faculty at the Argyros School, he held appointments at the University of Washington, Cornell University, the University of Chicago, the University of Arizona, and San Diego State University.

Professor Pfeiffer's research focuses on accounting and capital markets. He has investigated issues relating to lease accounting, LIFO inventory liquidation, earnings per share, management compensation, corporate reorganization, and technology investments. He has published articles in *The Accounting Review*, *Accounting Horizons*, the *Financial Analysts Journal*, the *International Journal of Accounting Information Systems*, the *Journal of High Technology Management Research*, the *Journal of Economics*, the *Journal of Accounting Education*, and several other academic journals. In addition, he has published numerous case studies in financial accounting and reporting.

Professor Pfeiffer teaches financial accounting and financial analysis to undergraduate, MBA, and Law students. He has also taught managerial accounting for MBAs. He has won several teaching awards at both the undergraduate and graduate levels.

Preface

Welcome to the fifth edition of *Financial Accounting* and, to adopters of the first four editions, thank you for the great success those editions have enjoyed. We wrote this book to equip students with the accounting techniques and insights necessary to succeed in today's business environment. It reflects our combined experience in teaching financial accounting to college students at all levels. For anyone who pursues a career in business, the ability to read, analyze, and interpret published financial reports is an essential skill. *Financial Accounting* is written for future business leaders who want to understand how financial statements are prepared and how the information in published financial reports is used by investors, creditors, financial analysts, and managers. Our goal is to provide the most engaging, relevant, and accessible textbook available.

TARGET AUDIENCE

Financial Accounting is intended for use in the first financial accounting course at either the undergraduate or graduate level; one that balances the preparation of financial statements with their analysis and interpretation. This book accommodates mini-courses lasting only a few days as well as extended courses lasting a full semester.

Financial Accounting is real-world oriented and focuses on the most salient aspects of accounting. It teaches students how to read, analyze, and interpret financial accounting data to make informed business decisions. To that end, it consistently incorporates **real company data**, both in the body of each chapter and throughout the assignment material.

REAL DATA INCORPORATED THROUGHOUT

Today's business students must be skilled in using real financial statements to make business decisions. We feel strongly that the more exposure students get to real financial statements, the more comfortable they become with the variety in financial statements that exists across companies and industries. Through their exposure to various financial statements, students will learn that, while financial statements do not all look the same, they can readily understand and interpret them to make business decisions. Furthermore, today's students must have the skills to go beyond basic financial statements to interpret and apply nonfinancial disclosures, such as footnotes and supplementary reports. We expose students to the analysis and interpretation of real company data and nonfinancial disclosures through the use of focus companies in each chapter, the generous incorporation of footnotes, financial analysis discussions in nearly every chapter, and an abundance of assignments that draw on real company data and disclosures.

Focus Companies for Each Chapter

Each chapter's content is explained through the accounting and reporting activities of real companies. Each chapter incorporates a "focus company" for special emphasis and demonstration. The enhanced instructional value of focus companies comes from the way they engage students in real analysis and interpretation. Focus companies were selected based on student appeal and the diversity of industries.

Chapter 1	**Nike**	**Chapter 7**	**Home Depot**
Chapter 2	**Walgreens**	**Chapter 8**	**Procter & Gamble**
Chapter 3	**Walgreens**	**Chapter 9**	**Verizon**
Chapter 4	**Golden Enterprises**	**Chapter 10**	**Delta Air Lines**
Chapter 5	**PepsiCo**	**Chapter 11**	**Pfizer**
Chapter 6	**Cisco**	**Chapter 12**	**Google**

Footnotes and Management Disclosures

We incorporate footnote and other management disclosures, where appropriate, throughout the book. We explain the significance of the footnote and then demonstrate how to use the disclosed information to make managerial inferences and decisions. A representative sample follows.

Footnote Disclosures and Interpretations

In its balance sheets, Cisco reports Accounts receivables, net of allowance for doubtful accounts of $5,157 million at July 26, 2014, and $5,470 at July 27, 2013. In its MD&A (Management Discussion and Analysis), the company provides the following information.

Allowances for Receivables and Sales Returns

The allowances for receivables were as follows (in millions, except percentages):

	July 26, 2014	July 27, 2013
Allowance for doubtful accounts	$265	$228
Percentage of gross accounts receivable	4.9%	4.0%

The allowance for doubtful accounts is based on our assessment of the collectability of customer accounts. We regularly review the allowances to ensure their adequacy by considering internal factors such as historical experience, credit quality, age of the receivable balances as well as external factors such as economic conditions that may affect a customer's ability to pay. . . . We also consider the concentration of receivables outstanding with a particular customer in assessing the adequacy of our allowances . . .

In Cisco's 10-K report filed with the Securities and Exchange Commission, it discloses that its

Financial Analysis Discussions

Each chapter includes a financial analysis discussion that introduces key ratios and applies them to the financial statements of the chapter's focus company. By weaving some analysis into each chapter, we try to instill in students a deeper appreciation for the significance of the accounting methods being discussed. One such analysis discussion follows.

ANALYZING FINANCIAL STATEMENTS

LO5 Define and interpret gross profit margin and inventory turnover ratios. Use inventory footnote information to make appropriate adjustments to ratios.

Analysis Objective

We are trying to determine whether Home Depot's sales provide sufficient revenues to cover its operation costs, primarily selling and administrative expenses, after allowing for the costs of manufacturing.

Analysis Tool Gross Profit Margin (GPM) Ratio

$$\textbf{Gross profit margin} = \frac{\textbf{Sales revenue} - \textbf{Cost of goods sold}}{\textbf{Sales revenue}}$$

Applying the Gross Profit Margin Ratio to Home Depot

$$\textbf{2012:}\ \frac{(\$74{,}754 - \$48{,}912)}{\$74{,}754} = 0.346 \text{ or } 34.6\%$$

$$\textbf{2013:}\ \frac{(\$78{,}812 - \$51{,}422)}{\$78{,}812} = 0.348 \text{ or } 34.8\%$$

$$\textbf{2014:}\ \frac{(\$83{,}176 - \$54{,}222)}{\$83{,}176} = 0.348 \text{ or } 34.8\%$$

Guidance The gross profit margin is commonly used instead of the dollar amount of gross

Assignments that Draw on Real Data

It is essential for students to be able to apply what they have learned to real financial statements. Therefore, we have included an abundance of assignments in each chapter that draw on recent, real data and disclosures. These assignments are readily identified by an icon in the margin that usually includes the company's ticker symbol and the exchange on which the company's stock trades. A representative example follows.

P5-45. Comparing Profitability Ratios for Competitors

LO3

Abbott Laboratories NYSE :: ABT
Bristol-Myers Squibb Company NYSE :: BMY
Johnson & Johnson NYSE :: JNJ
GlaxoSmithKline plc (ADR) NYSE :: GSK
Pfizer Inc. NYSE :: PFE

Selected income statement data for **Abbott Laboratories**, **Bristol-Myers Squibb Company**, **Johnson & Johnson**, **GlaxoSmithKline plc**, and **Pfizer, Inc.** is presented in the following table:

($ millions)	Abbott Laboratories	Bristol-Myers Squibb	Johnson & Johnson	Glaxo Smith Kline plc	Pfizer
Sales revenue	$20,247	$11,660	$74,331	$35,872	$49,605
Cost of sales	9,218	3,932	22,746	11,418	9,577
SG&A expense	6,530	4,822	21,954	13,466	14,097
R&D expense	1,345	4,534	8,494	5,379	8,393
Interest expense	150	203	533	1,134	1,360
Net income	2,284	2,029	16,323	4,297	9,168

REQUIRED

a. Compute the profit margin (PM) and gross profit margin (GPM) ratios for each company. (As a British company, GlaxoSmithKline plc has a statutory tax rate of 26.5% in 2014.)

b. Compute the research and development (R&D) expense to sales ratio and the selling, general and administrative (SG&A) expense to sales ratio for each company.

c. Compare the relative profitability of these pharmaceutical companies.

BALANCED APPROACH

As instructors of introductory financial accounting, we recognize that the first financial accounting course serves the general business students as well as potential accounting majors. *Financial Accounting* embraces this reality. This book **balances financial reporting, analysis**, **interpretation**, and **decision making** with the more standard aspects of accounting such as **journal entries**, **T-accounts**, and the **preparation of financial statements**.

3-Step Process: Analyze, Journalize, Post

One technique we use throughout the book to maintain a balanced approach is the incorporation of a 3-step process to analyze and record transactions. **Step 1** analyzes the impact of various transactions on the financial statements using the financial statement effects template. **Step 2** records the transaction using journal entries, and **Step 3** requires students to post the journal entries to T-accounts.

		Balance Sheet						*Income Statement*				
	Transaction	Cash Asset	Noncash Assets	=	Liabil-ities	Contrib. Capital	Earned Capital	*Revenues*	-	*Expenses*	=	*Net Income*
ANALYZE	**(b)** Adjusting entry to record expiration of 1 month of prepaid insurance.		140 Prepaid Insurance	=			140 Retained Earnings		-	140 Insurance Expense	=	140

JOURNALIZE

		Debit	Credit
(b)	**Insurance expense (E, SE)**	**140**	
	Prepaid insurance (A)		**140**

POST

	Insurance Expense (E)		
(b)	140		

Prepaid Insurance (A)		
	140	**(b)**

The posting of this adjusting entry creates the proper Insurance Expense of $140 for December

The template captures each transaction's effects on the four financial statements: the balance sheet, income statement, statement of stockholders' equity, and statement of cash flows. For the balance sheet, we differentiate between cash and noncash assets to identify the cash effects of transactions. Likewise, equity is separated into the contributed and earned capital components (the latter includes retained earnings as its major element). Finally, income statement effects are separated into revenues, expenses, and net income (the updating of retained earnings is denoted with an arrow line running from net income to earned capital). This template provides a convenient means to represent financial accounting transactions and events in a simple, concise manner for assessing their effects on financial statements.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

The convergence of U.S. GAAP and International Financial Reporting Standards (IFRS) is in process. Our introductory students should be prepared for this eventuality with a basic understanding of the similarities and differences in the current reporting requirements and methods under U.S. GAAP and IFRS. Consequently, we incorporate discussions that examine these similarities and differences where appropriate throughout the book in Global Perspective boxes, as illustrated here:

A GLOBAL PERSPECTIVE

Under U.S. GAAP, inventory that has been written down cannot be revalued later at higher levels even if the market value of that inventory increases. IFRS, on the other hand, does allow companies to reverse the write-down of the inventory up to the acquisition cost if market values warrant. The revaluation results in a debit to Inventory and a credit to Cost of Goods Sold. The option to revalue inventory after a write-down differs across countries.

We also include exercises and problems throughout the text, where appropriate, to stimulate a discussion of international reporting differences. Our approach is conceptual—we purposefully avoid the detailed mechanics that are more appropriate for an intermediate level accounting course at either the undergraduate or graduate level. We feel strongly that our IFRS coverage exposes students to the similarities and differences without overwhelming them.

INNOVATIVE PEDAGOGY

Business Insights

Students appreciate and become more engaged when they can see the real world relevance of what they are learning in the classroom. We have included a generous number of current, real world examples throughout each chapter in Business Insight boxes. The following is a representative example:

BUSINESS INSIGHT

Alibaba's IPO In September of 2014, **Alibaba Group** offered its shares to the general public for the first time. The first public sale of common stock by a corporation is called an initial public offering, or IPO for short. After the IPO, any offering of stock to the public is called a seasoned equity offering.

At the time, Alibaba's IPO was the largest in history, raising approximately $25 billion. The common stock had a par value of $0.000025, but was offered to the public for $68 per share. Within a couple of months after the stock opened for trade on the New York Stock Exchange, the price increased to almost $120 per share, but then began to fall. By the company's fiscal year end in March 2015, Alibaba's shares were trading for just over $83 per share, about 20% greater than their original offer price and almost 50 times their earnings per share.

Decision Making Orientation

One primary goal of a financial accounting course is to teach students the skills needed to apply their accounting knowledge to solving real business problems. With that goal in mind, **You Make the Call** boxes in each chapter encourage students to apply the material presented to solving actual business scenarios.

YOU MAKE THE CALL

You are the Division Manager You are the division manager for a main operating division of your company. You are concerned that a declining PPE turnover is adversely affecting your division's profitability. What specific actions can you take to increase PPE turnover? [Answers on page 395]

Mid-Chapter and Chapter-End Reviews

Financial accounting can be challenging—especially for students lacking business experience or previous exposure to business courses. To reinforce concepts presented in each chapter and to ensure student comprehension, we include mid-chapter and chapter-end reviews that require students to recall and apply the financial accounting techniques and concepts described in each chapter.

CHAPTER-END REVIEW

GuidedExample MBC

Publix Super Markets Inc. reports inventory and cost of goods sold using the last-in, first-out (LIFO) costing method for a "significant portion" of U.S. inventory. The table below presents financial information from its 2012, 2013, and 2014 10-K reports.

($ millions)	2014	2013	2012
Revenue	$30,560	$28,917	$27,485
Cost of goods sold	22,233	20,937	19,911
Gross profit	$ 8,327	$ 7,980	$ 7,574
Balance Sheet:			
Inventory	$ 1,598	$ 1,507	$ 1,409
Notes to financial statements			
LIFO reserve	$ 421	$ 390	$ 375

REQUIRED

1. Compute the gross profit margin for each year, 2012 through 2014, and the inventory turnover ratio for 2013 and 2014.
2. What amount for cost of goods sold and gross profit would Publix report in 2013 and 2014 if FIFO were used to assign costs to inventory and cost of goods sold? (Assume that FIFO cost is equal to the current value of Publix's inventory.)
3. Recalculate Publix's inventory turnover ratio for 2013 and 2014 assuming that FIFO had been used to value inventory.

The solution to this review problem can be found on page 369.

eLectures

Research Insights for Business Students

Academic research plays an important role in the way business is conducted, accounting is performed, and students are taught. It is important for students to recognize how modern research and modern business practice interact. Therefore, we periodically incorporate relevant research to help students understand the important relation between research and modern business.

RESEARCH INSIGHT

Accounting Conservatism and Cost of Debt Research indicates that companies applying more conservative accounting methods incur a lower cost of debt. Research also suggests that while accounting conservatism can lead to lower-quality accounting income (because such income does not fully reflect economic reality), creditors are more confident in the numbers and view them as more credible. Evidence also implies that companies can lower the required return demanded by creditors (the risk premium) by issuing high-quality financial reports that include enhanced footnote disclosures and detailed supplemental reports.

FLEXIBILITY FOR COURSES OF VARYING LENGTHS

Many instructors have approached us to ask about suggested chapter coverage based on courses of varying length. To that end, we provide the following table of possible course designs:

	15 Week Semester-Course	10 Week Quarter-Course	6 Week Mini-Course	1 Week Intensive-Course
Chapter 1	Week 1	Week 1	Week 1	Day 1
Chapter 2	Week 2 & 3	Week 2	Week 1 & 2	
Chapter 3	Week 3 & 4	Week 3 & 4	Week 2 & 3	Day 2
Chapter 4	Week 5 & 6	Week 4 & 5	Optional	Optional
Chapter 5	Week 6 & 7	Optional	Optional	Optional
Chapter 6	Week 7 & 8	Week 6	Week 3	Day 3
Chapter 7	Week 9	Week 7	Week 4	Day 4
Chapter 8	Week 10	Week 8	Week 5	
Chapter 9	Week 11 & 12	Week 9	Week 6	Day 5
Chapter 10	Week 12 & 13	Week 10	Week 6 (optional)	Skim
Chapter 11	Week 14	Optional	Optional	Optional
Chapter 12	Week 15	Optional	Optional	Optional

NEW IN THE 5TH EDITION

- **New Co-author:** Michelle Hanlon, the Howard W. Johnson Professor and Professor of Accounting at the MIT Sloan School of Management, joined the 5th edition. Michelle has won several awards for her research and is the winner of the 2013 Jamieson Prize for Excellence in Teaching at Sloan where she regularly teaches introductory financial accounting to MBAs. Hanlon recently testified in front of the U.S. Senate Committee on Finance and the U.S. House of Representatives Committee on Ways and Means regarding U.S. tax policy. She brings a wealth of knowledge and expertise to this best-selling author team.

- **myBusinessCourse:** myBusinessCourse (MBC) is a complete learning and assessment program that accompanies the textbook and contributes to student success in this course. MBC has been expanded to include nearly all the multiple choice questions, mini-exercises, and exercises from the 5th edition. In addition, the Guided Examples and eLectures have been revised and improved. The 5th edition will also feature Flashcards and other tools that help students master concepts.

- **Updated Standards:** As appropriate, the text and assignments have been updated to reflect the latest standards. A brief discussion of the pending Revenue Recognition standard is included in Chapter 6 and the chapter-end appendix contains more detailed coverage of the new standard. The text and assignments have also been revised to reflect the change in accounting standards related to Extraordinary Items. Chapter 10 now includes a discussion of the new lease standard.

In addition to the chapter specific changes, there have been several changes that span the entire book. Some of these global changes include: updated numbers for examples, illustrations, and assignments that use real data; updated footnotes and other nonfinancial disclosures; updated excerpts from the business and popular press; numerous assignments in each chapter have been revised or replaced with new assignments; and a new, accessible design was created for the 5th edition.

SUPPLEMENT PACKAGE

Fundamentals of Financial Accounting Tutorial

This interactive tutorial is intended for use in programs that either require or would like to offer a pre-term tutorial that creates a baseline of accounting knowledge for students with little to no prior exposure to financial accounting. Initially developed as a pre-term tutorial for first year MBA students, this product can be used as a warm-up for any introductory level financial accounting course. It is designed as an asynchronous, interactive, self-paced experience for students.

Available Learning Modules (You Select)

1. Introducing Financial Accounting (approximate completion time 2 hours)
2. Constructing Financial Statements (approximate completion time 4 hours)
3. Adjusting Entries and Completing the Accounting Cycle (approximate completion time 4 hours)
4. Reporting and Analyzing Cash Flows (approximate completion time 3.5 hours)
5. Analyzing and Interpreting Financial Statements (approximate completion time 3.5 hours)

This is a separate, saleable item. Contact your sales representative to receive more information or email customerservice@cambridgepub.com.

Companion Casebook

Cases in Financial Reporting, 8th edition by Michael Drake (Brigham Young University), Ellen Engel (University of Chicago), D. Eric Hirst (University of Texas – Austin), and Mary Lea McAnally (Texas A&M University). This book comprises 27 cases and is a perfect companion book for faculty interested in exposing students to a wide range of real financial statements. The cases are current and cover companies from Canada, France, Austria, the Netherlands, the UK, India, as well as from the U.S. Many of the U.S. companies are major multinationals. Each case deals with a specific financial accounting topic within the context of one (or more) company's financial statements. Each case contains financial statement information and a set of directed questions pertaining to one or two specific financial accounting issues. This is a separate, saleable casebook (**ISBN 978-1-61853-122-3**). Contact your sales representative to receive a desk copy or email **customerservice@cambridgepub.com.**

For Instructors

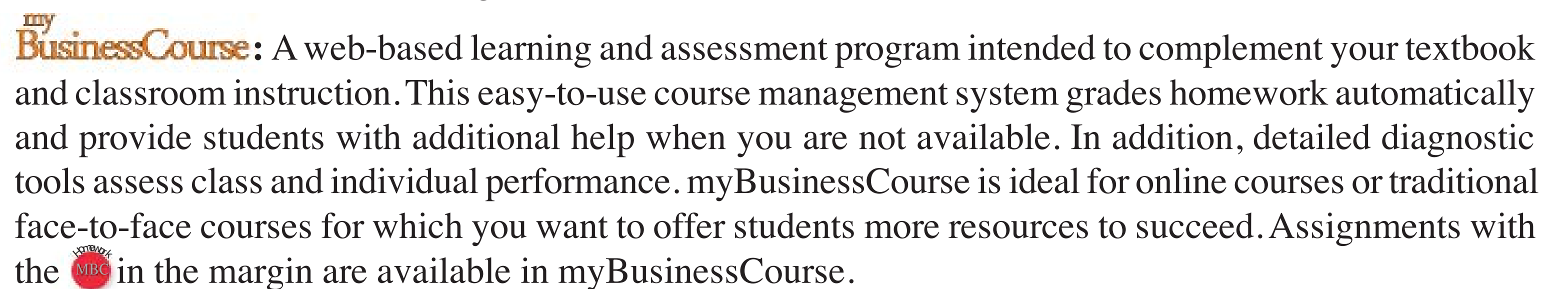
Instructor CD-ROM: This convenient supplement provides the text's ancillary materials on a portable CD-ROM. All the faculty supplements that accompany the textbook are available, including PowerPoint, Solutions Manual, Test Bank, and Computerized Test Bank.

Solutions Manual: Created by the authors, the *Solutions Manual* contains complete solutions to all the assignment material in the text.

PowerPoint: The PowerPoint slides outline key elements of each chapter.

Test Bank: The Test Bank includes multiple-choice items, matching questions, short essay questions, and problems.

Website: All instructor materials are accessible via the book's Website (password protected) along with other useful links and marketing information. **www.cambridgepub.com**



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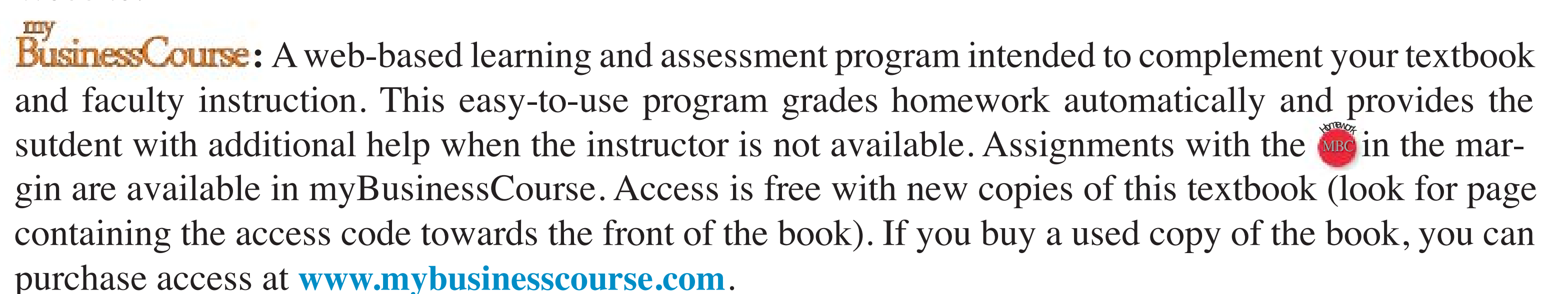
For Students

Student Solutions Manual: Created by the authors, the student Solutions Manual contains solutions to the even numbered assignments in the textbook. This is a **restricted** item that is only available to students after their instructor has authorized its purchase.

Website: Practice quizzes and other useful links are available to students free of charge on the book's Website.



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1

Introducing Financial Accounting

Learning Objectives *identify the key learning goals of the chapter.*

A **Focus Company** *introduces each chapter and illustrates the relevance of accounting in everyday business.*

LEARNING OBJECTIVES

1. Identify the users of accounting information and discuss the costs and benefits of disclosure. (p. 4)
2. Describe a company's business activities and explain how these activities are represented by the accounting equation. (p. 7)
3. Introduce the four key financial statements including the balance sheet, income statement, statement of stockholders' equity, and statement of cash flows. (p. 11)
4. Describe the institutions that regulate financial accounting and their role in establishing generally accepted accounting principles. (p. 17)
5. Compute two key ratios that are commonly used to assess profitability and risk—return on equity and the debt-to-equity ratio. (p. 21)
6. Appendix 1A: Explain the conceptual framework for financial reporting. (p. 25)

NIKE

www.Nike.com

Phil Knight majored in accounting and was a member of the track team at the University of Oregon. Today he is the chairman of the board of **Nike, Inc.**, the largest sports and fitness company in the world.

A few years after graduation, Knight teamed up with his former track coach, Bill Bowerman, to form a business called Blue Ribbon Sports to import, sell, and distribute running shoes from Japan. Blue Ribbon Sports, or BRS as it came to be known, was started on a shoestring—Knight and Bowerman each contributed $500 to start the business. A few years later, BRS introduced its own line of running shoes called Nike. It also unveiled a new logo, the now familiar Nike swoosh. Following the overwhelming success of the Nike shoe line, BRS officially changed its company name to Nike, Inc. Today, the company is worth more than $60 billion.

By 2014, Nike, Inc. products were marketed on six continents with total company sales of $28 billion and income of almost $2.7 billion. Nike owes much of its success to marketing prowess and innovative design and development of new products. The swoosh, along with advertising campaigns featuring taglines such as "just do it," have made the company and its products instantly recognizable to consumers all over the world. Endorsements by the most recognizable icons in sports, including Michael Jordan, Tiger Woods, Maria Sharapova, Tom Brady, LeBron James, and Mike Trout, add to Nike's brand recognition.

In recent years, Nike has expanded its product lines beyond the traditional offerings of athletic shoes, athletic apparel and sports equipment to include eyewear, watches such as the *Nike+ Sportwatch GPS*, and *Fuelband*, a wearable wristband which tracks energy output. In recent years, Nike further expanded its product offering by acquiring other companies such as Converse, an established athletic shoe company; Hurley International, a leading designer and distributor of surf, skate, and snowboarding apparel and footwear; and Umbro, specializing in soccer equipment, footwear, and apparel.

But as CEO Mark Parker recognizes, Nike needs to stay on its toes as newcomers **Under Armour** and **Quiksilver** challenge for customers. Nike also cannot ignore **Adidas**. As Nike's main competitor, it is more than two-thirds of Nike's size in terms of sales. Perhaps this situation, along with new product developments, explains Nike's major new marketing commitment that reached $2.3 billion in 2014 and continues to grow.

How does someone take a $1,000 investment and turn it into a company whose stock is worth more than $60 billion? Well, Nike's success is not an accident. Along the way, Nike management made countless decisions that ultimately led the company to where it is today. Each of these decisions involved identifying alternative courses of action and weighing their costs, benefits, and risks in light of the available information.

Comparison of 5-Year Cumulative Total Return for Nike, Inc., The S&P 500 Index, and The Dow Jones U.S. Footwear Index (Assumes an investment of $100 on May 31, 2009)

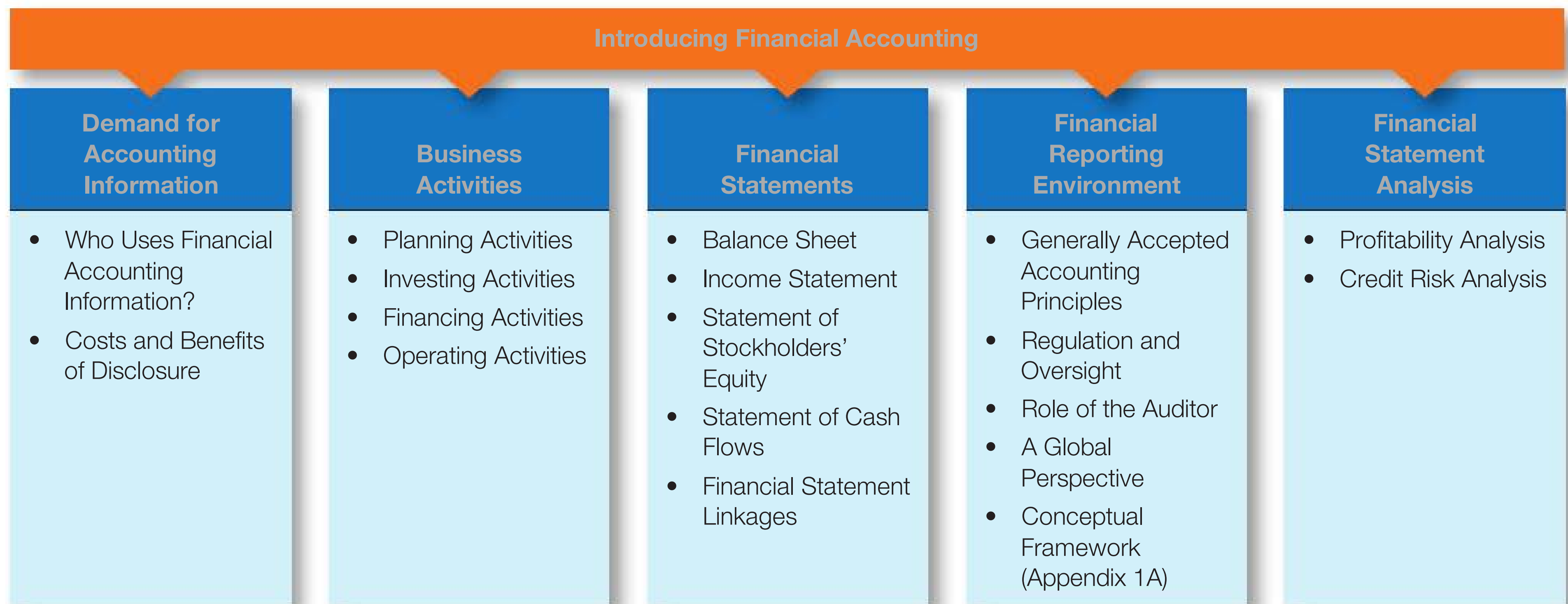
Accounting is the process of identifying, measuring, and communicating financial information to help people make *economic* decisions. People use accounting information to facilitate a wide variety of transactions, including assessing whether, and on what terms, they should invest in a firm, seek employment in a business, or continue purchasing its products. Accounting information is crucial to any successful business, and without it, most businesses would not even exist.

This book explains how to create and analyze financial statements, an important source of accounting information prepared by companies to communicate with a variety of users. We begin by introducing transactions between the firm and its investors, creditors, suppliers, employees, and customers. We continue by demonstrating how accounting principles are applied to these transactions to create the financial statements. Then, we "invert" the process and learn how to analyze the firm's financial statements to assess the firm's underlying economic performance. Our philosophy is simple—we believe it is crucial to have a deep understanding of financial accounting to become critical readers and users of financial statements. Financial statements tell a story—a business story. Our goal is to understand that story, and apply the knowledge gleaned from financial statements to make good business decisions.

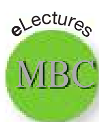
Sources: Nike.com; Nike, Inc. 2014 10-K Report; *Business Week* (October 2007, August 2009); *Portland Business Journal* (October 2007); *Fortune* (February 2012).

CHAPTER ORGANIZATION

***Chapter Organization** Charts visually depict the key topics and their sequence within the chapter.*



***eLecture** icons identify topics for which there are instructional videos in **myBusinessCourse** (MBC). See the Preface for more information on MBC.*



LO1 Identify the users of accounting information and discuss the costs and benefits of disclosure.

DEMAND FOR ACCOUNTING INFORMATION

Accounting can be defined as the process of recording, summarizing, and analyzing financial transactions. While accounting information attempts to satisfy the needs of a diverse set of users, the accounting information a company produces can be classified into two categories (see **Exhibit 1.1**):

- **Financial accounting**—designed primarily for decision makers outside of the company
- **Managerial accounting**—designed primarily for decision makers within the company

Financial accounting reports include information about company profitability and financial health. This information is useful to various economic actors who wish to engage in contracts with the firm, including investors, creditors, employees, customers, and governments. Managerial accounting information is not reported outside of the company because it includes proprietary information about the profitability of specific products, divisions, or customers. Company managers use managerial accounting reports to make decisions such as whether to drop or add products or divisions, or whether to continue serving different types of customers. This text focuses on understanding and analyzing financial accounting information.

EXHIBIT 1.1 Information Needs of Decision Makers Who Use Financial and Managerial Accounting

	Decision Makers	Decisions	Information
Financial Accounting	• Investors and analysts • Creditors • Suppliers and customers	• Buy or sell stock? • Lend or not? • Purchase/sell goods or not?	• Sales and costs • Cash in and out • Assets and liabilities
Managerial Accounting	• Top management • Marketing teams • Production and operations	• Develop new strategy? • Launch a new product or not? • Manage operations	• Product sales and costs • Department performance reports • Budgets and quality reports

Who Uses Financial Accounting Information?

Demand for financial accounting information derives from numerous users including:

- Shareholders and potential shareholders
- Creditors and suppliers
- Managers and directors
- Financial analysts
- Other users

FYI features provide additional information that complements the text.

Shareholders and Potential Shareholders Corporations are the dominant form of business organization for large companies around the world, and corporate shareholders are one important group of decision makers that have an interest in financial accounting information. A **corporation** is a form of business organization that is characterized by a large number of owners who are not involved in managing the day-to-day operations of the company.[1] A corporation exists as a legal entity that issues **shares of stock** to its owners in exchange for cash and, therefore, the owners of a corporation are referred to as *shareholders* or **stockholders**.

FYI Shareholders of a corporation are its owners; although managers can own stock in the corporation, most shareholders are not managers.

Because the shareholders are not involved in the day-to-day operations of the business, they rely on the information in financial statements to evaluate management performance and assess the company's financial condition.

In addition to corporations, sole proprietorships and partnerships are also common forms of business ownership. A **sole proprietorship** has a single owner who typically manages the daily operations. Small family-run businesses, such as corner grocery stores, are commonly organized as sole proprietorships. A **partnership** has two or more owners who are also usually involved in managing the business. Many professionals, such as lawyers and CPAs, organize their businesses as partnerships.

Most corporations begin as small, privately held businesses (sole proprietorships or partnerships). As their operations expand, however, they require additional capital to finance their growth. One of the principle advantages of a corporation over sole proprietorships and partnerships is the ability to raise large amounts of cash by issuing (selling) stock. For example, as Nike grew from a small business with only two owners into a larger company, it raised the funds needed for expansion by selling shares of Nike stock to new shareholders. In the United States, large corporations can raise funds by issuing stock on organized exchanges, such as the **New York Stock Exchange (NYSE)** or **NASDAQ** (which is an acronym for the National Association of Securities Dealers Automated Quotations system). Corporations with stock that is traded on public exchanges are known as *publicly traded corporations* or simply *public corporations*.

Financial statements and the accompanying footnotes provide information on the risk and return associated with owning shares of stock in the corporation, and they reveal how well management has performed. Financial statements also provide valuable insights into future performance by revealing management's plans for new products, new operating procedures, and new strategic directions for the company as well as for their implementation. Corporate management provides this information because the information reduces uncertainty about the company's future prospects which, in turn, increases the market price of its shares and helps the company raise the funds it needs to grow.

Creditors and Suppliers Few businesses rely solely on shareholders for the cash needed to operate the company. Instead, most companies borrow from banks or other lenders known as **creditors**. Creditors are interested in the potential borrower's ability to repay. They use financial accounting information to help determine loan terms, loan amounts, interest rates, and collateral. In addition, creditors' loans often include contractual requirements based on information found in the financial statements.

FYI Financial statements are typically required when a business requests a bank loan.

[1] Most countries have business forms that are similar in structure to those of a U.S. corporation, though they are referred to by different names. For example, while firms that are incorporated in the United States have the extension, "Inc." appended to their names, similar firms in the United Kingdom are referred to as a Public Limited Company, which has the extension "PLC."

Suppliers use financial information to establish credit sales terms and to determine their long-term commitment to supply-chain relationships. Supplier companies often justify an expansion of *their* businesses based on the growth and financial health of their customers. Both creditors and suppliers rely on information in the financial statements to monitor and adjust their contracts and commitments with a company.

Managers and Directors Financial statements can be thought of as a financial report card for management. A well-managed company earns a good return for its shareholders, and this is reflected in the financial statements. In most companies, management is compensated, at least in part, based on the financial performance of the company. That is, managers often receive cash bonuses, shares of stock, or other *incentive compensation* that is linked directly to the information in the financial statements.

Publicly traded corporations are required by law to have a **board of directors**. Directors are elected by the shareholders to represent shareholder interests and oversee management. The board hires executive management and regularly reviews company operations. Directors use financial accounting information to review the results of operations, evaluate future strategy, and assess management performance.

Both managers and directors use the published financial statements of *other companies* to perform comparative analyses and establish performance benchmarks. For example, managers in some companies are paid a bonus for financial performance that exceeds the industry average.

FYI The Sarbanes-Oxley Act requires issuers of securities to disclose whether they have a code of ethics for the senior officers.

BUSINESS INSIGHT

Recent court cases involving corporations such as **Enron**, **Tyco**, and **WorldCom** (now **MCI**) have found executives, including several CEOs, guilty of issuing fraudulent financial statements. These executives have received substantial fines and, in some cases, long jail sentences. These trials have resulted in widespread loss of reputation and credibility among corporate boards.

Financial Analysts Many decision makers lack the time, resources, or expertise to efficiently and effectively analyze financial statements. Instead, they rely on professional financial analysts, such as credit rating agencies like **Moody's** investment services, portfolio managers, and security analysts. Financial analysts play an important role in the dissemination of financial information and often specialize in specific industries. Their analysis helps to identify and assess risk, forecast performance, establish prices for new issues of stock, and make buy-or-sell recommendations to investors.

Other Users of Financial Accounting Information External decision makers include many users of accounting information in addition to those listed above. For example, ***prospective employees*** often examine the financial statements of an employer to learn about the company before interviewing for or accepting a new job.

Labor unions examine financial statements in order to assess the financial health of firms prior to negotiating labor contracts on behalf of the firms' employees. ***Customers*** use accounting information to assess the ability of a company to deliver products or services and to assess the company's long-term reliability.

Government agencies rely on accounting information to develop and enforce regulations, including public protection, price setting, import-export, taxation, and various other policies.[2] Timely and reliable information is crucial to effective regulatory policy. Moreover, accounting information is often used to assess penalties for companies that violate various regulations.

Costs and Benefits of Disclosure

The act of providing financial information to external users is called **disclosure**. As with every decision, the benefits of disclosure must be weighed against the costs of providing the information.

[2] A company's tax returns are distinctly different from its financial statements. Tax returns are prepared for tax authorities in order to comply with income tax rules. The financial statements are prepared to provide information to investors, creditors and other decision makers outside of the business.

One reason companies are motivated to disclose financial information to external decision makers is that it often lowers financing and operating costs. For example, when a company applies for a loan, the bank uses the company's financial statements to help determine the appropriate interest rate. Without adequate financial disclosures in its financial statements, the bank is likely to demand a higher interest rate or perhaps not make the loan at all. Thus, in this setting, a benefit of financial disclosure is that it reduces the company's cost of borrowing.

While there are benefits from disclosing financial information, there are also costs. Besides the obvious cost of hiring accountants and preparing the financial statements, financial disclosures can also result in costs being imposed by competitors. It is common practice for managers to scrutinize the financial statements of competitors to learn about successful products, new strategies, innovative technologies, and changing market conditions. Thus, disclosing too much information can place a company at a competitive disadvantage. Disclosure can also raise investors' expectations about a company's future profitability. If those expectations are not met, they may bring litigation against the managers.

There are also political costs that are potentially associated with accounting disclosure. Highly visible companies, such as defense contractors and oil companies, are often the target of scrutiny by the public and by government officials. When these companies report unusually large accounting profits, they are often the target of additional regulation or increased taxes.

Stock market regulators impose disclosure standards for publicly traded corporations, but the nature and extent of the required disclosures vary substantially across countries. Further, because the requirements only set the minimum level of disclosure, the quantity and quality of information provided by firms will vary. This variation in disclosure ultimately reflects differences among companies in the benefits and costs of disclosing information to the public.

You Make The Call *requires you to assume various roles within a business and use your accounting knowledge to address an issue. Solutions are at the end of the chapter.*

YOU MAKE THE CALL

You are a Product Manager There is often friction between investors' needs for information and a company's desire to safeguard competitive advantages. Assume that you are the product manager for a key department at your company and you are asked for advice on the extent of information to disclose in the annual report on a potentially lucrative new product that your department has test marketed. What considerations affect the advice you provide and why? [Answer on page 29]

BUSINESS ACTIVITIES

LO2 Describe a company's business activities and explain how these activities are represented by the accounting equation.

2

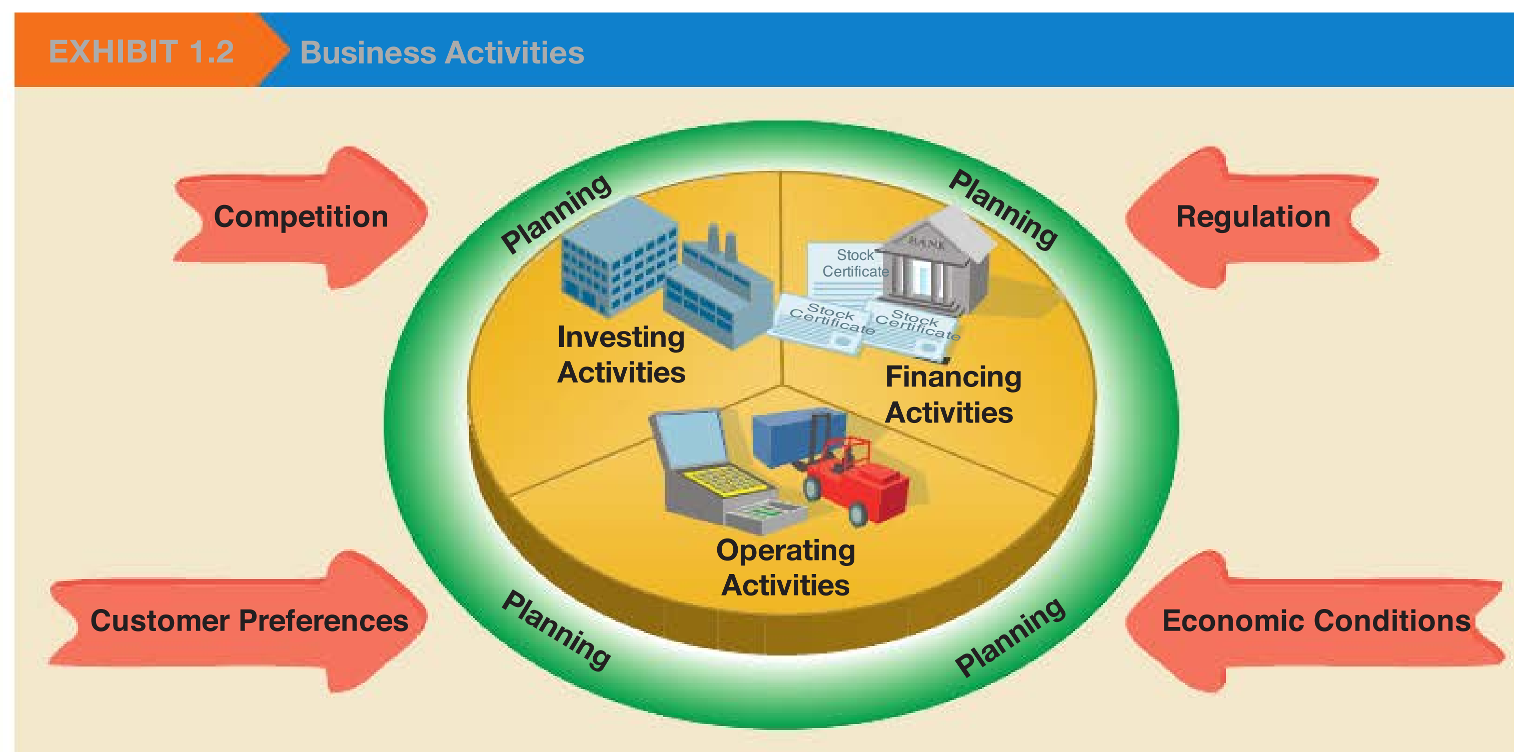
Businesses produce accounting information to help develop strategies, attract financing, evaluate investment opportunities, manage operations, and measure performance. Before we can attempt to understand the information provided in financial statements, we must understand these business activities. That is, what does a business actually do? For example:

- Where does a company such as Nike find the resources to develop new products and open new retail stores?
- What new products should Nike bring to market?
- How much should Nike spend on product development? On advertising? On executive compensation?
- How does Nike's management determine if a product is a success?

Questions such as these define the activities of Nike and other companies.

Exhibit 1.2 illustrates the activities of a typical business. All businesses *plan* business activities, *finance* those activities, *invest* resources in those activities, and then engage in *operating* activities. Companies conduct all these activities while confronting a variety of *external forces,* including competition from other businesses, government regulation, economic conditions and market forces, and changing preferences of customers. The financial statements provide information that helps us understand and evaluate each of these activities.

EXHIBIT 1.2 Business Activities



Planning Activities

Excerpts *from recent financial statements are used to illustrate and reinforce concepts.*

A company's goals, and the strategies adopted to reach those goals, are the product of its **planning activities**. Nike, for example, states that its mission is "To bring inspiration and innovation to every athlete in the world" adding "If you have a body, you are an athlete." However, in its 2014 annual report to shareholders, Nike management suggests another goal that focuses on financial success and earning a return for the shareholders.

> Our goal is to deliver value to our shareholders by building a profitable global portfolio of branded footwear, apparel, equipment, and accessories businesses.

As is the case with most businesses, Nike's primary goal is to create value for its owners, the shareholders. How the company plans to do so is the company's **strategy**.

A company's *strategic* (or *business*) *plan* describes how it plans to achieve its goals. The plan's success depends on an effective review of market conditions. Specifically, the company must assess both the demand for its products and services, and the supply of its inputs (both labor and capital). The plan must also include competitive analyses, opportunity assessments, and consideration of business threats. The strategic plan specifies both broad management designs that generate company value and tactics to achieve those designs.

Most information in a strategic plan is proprietary and guarded closely by management. However, outsiders can gain insight into planning activities through various channels, including newspapers, magazines, and company publications. Understanding a company's planning activities helps focus accounting analysis and place it in context.

Investing Activities

Key Terms *are highlighted in bold, red font.*

Investing activities consist of acquiring and disposing of the resources needed to produce and sell a company's products and services. These resources, called **assets**, provide future benefits to the company. Companies differ on the amount and mix of these resources. Some companies require buildings and equipment while others have abandoned "bricks and mortar" to conduct business through the Internet.

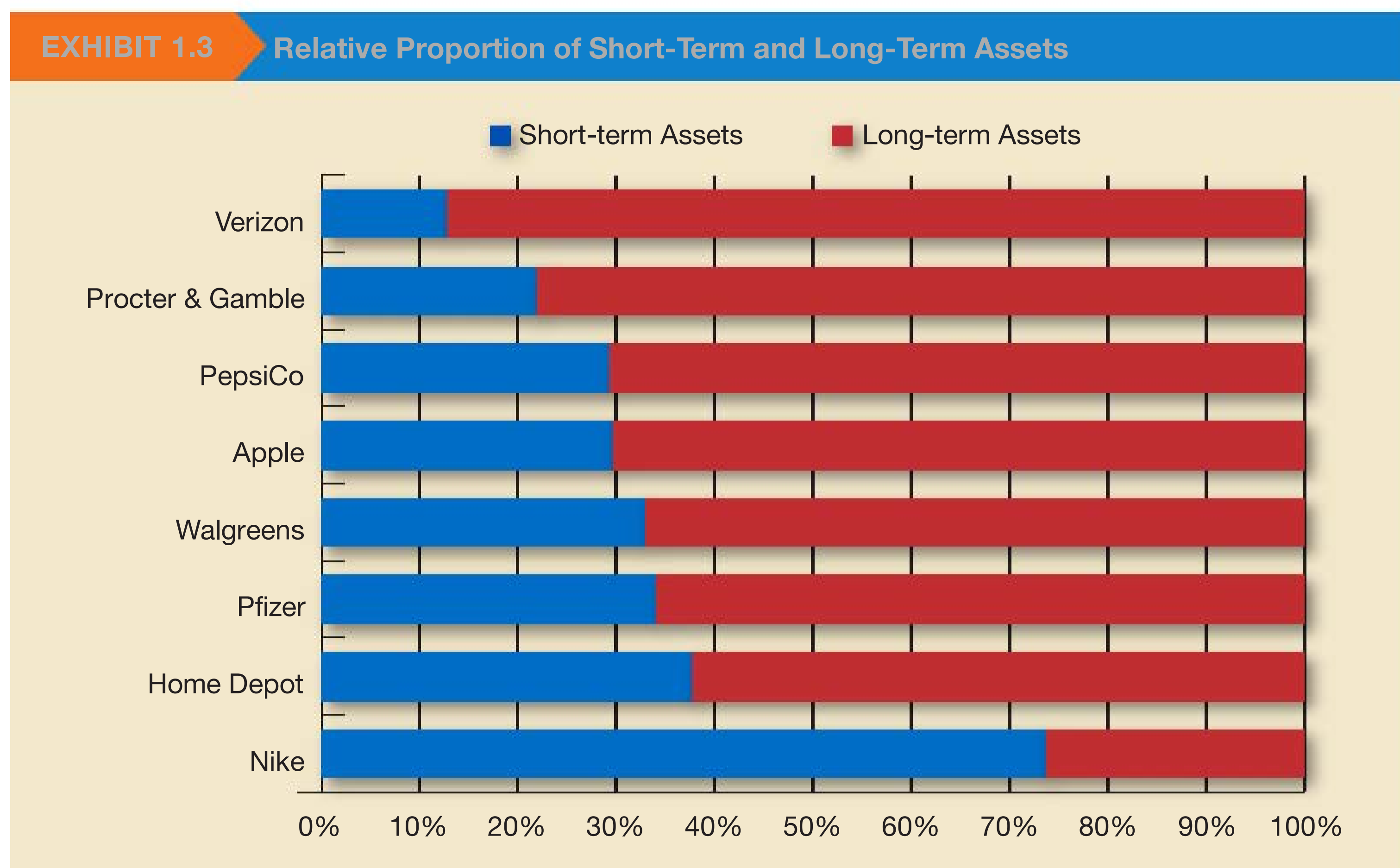
Some assets that a company invests in are used quickly. For instance, a retail clothing store hopes to sell its spring and summer merchandise before purchasing more inventory for the fall and winter. Other assets are acquired for long-term use. Buildings are typically used

for several decades. The relative proportion of short-term and long-term investments depends on the type of business and the strategic plan that the company adopts. For example, Nike has relatively few long-term assets because it outsources most of the production of its products to other companies.

The graph in **Exhibit 1.3** compares the relative proportion of short-term and long-term assets held by Nike and seven other companies, several of which are featured in later chapters. Nike has adopted a business model that requires very little investment in long-term resources. A majority of its investments are short-term assets. In contrast, **Verizon**, **PepsiCo**, and **Procter & Gamble** all rely heavily on long-term investments. These companies hold relatively small proportions of short-term assets. This mix of long-term and short-term assets is described in more detail in Chapter 2.

***Real Companies** and **Institutions** are highlighted in bold, blue font.*

EXHIBIT 1.3 Relative Proportion of Short-Term and Long-Term Assets



Financing Activities

Investments in resources require funding, and **financing activities** refer to the methods companies use to fund those investments. *Financial management* is the planning of resource needs, including the proper mix of financing sources.

Companies obtain financing from two sources: equity (owner) financing and creditor (nonowner) financing. *Equity financing* refers to the funds contributed to the company by its owners along with any income retained by the company. One form of equity financing is the cash raised from the sale (or issuance) of stock by a corporation. *Creditor* (or debt) *financing* is funds contributed by nonowners, which create *liabilities*. **Liabilities** are obligations the company must repay in the future. One example of a liability is a bank loan. We draw a distinction between equity and creditor financing for an important reason: creditor financing imposes a legal obligation to repay, usually with interest, and failure to repay amounts borrowed can result in adverse legal consequences such as bankruptcy. In contrast, equity financing does not impose an obligation for repayment.

Exhibit 1.4 compares the relative proportion of creditor and equity financing for Nike and other companies. PepsiCo uses liabilities to finance 75% of its resources. In contrast, **Walgreen Co.** relies more heavily on its equity financing, receiving 45% of its financing from creditors. Nike has the lowest proportion of creditor financing in this sample of companies with just 42% of its assets financed by nonowners.

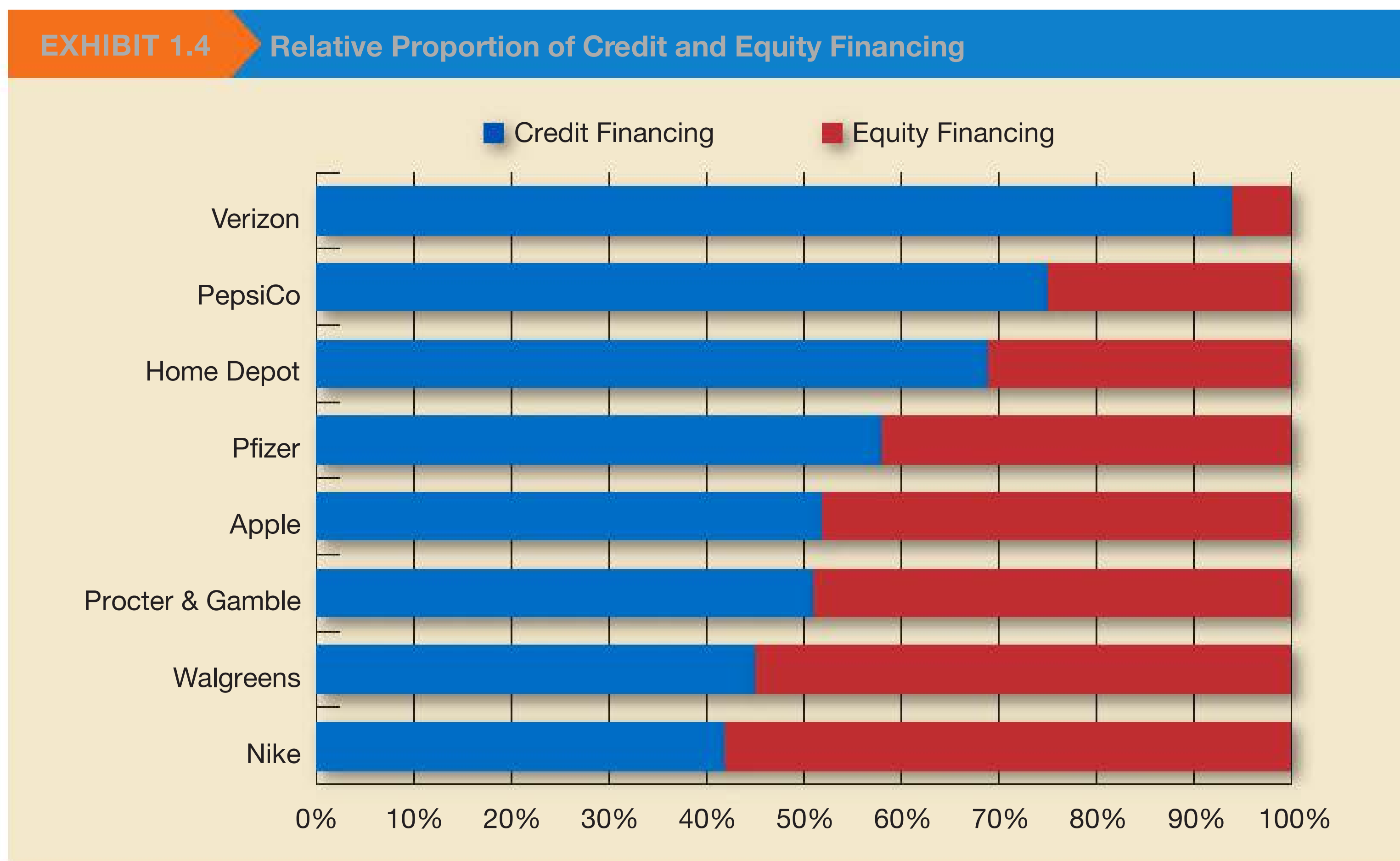


EXHIBIT 1.4 Relative Proportion of Credit and Equity Financing

***Infographics** are used to convey difficult concepts and procedures.*

As discussed in the previous section, companies acquire resources, called assets, through investing activities. The cash to acquire these resources is obtained through financing activities, which consist of owner financing, called equity, and creditor financing, called liabilities (or debt). Thus, we have the following basic relation: *investing equals financing*. This equality is called the **accounting equation**, which is expressed as:

$$\text{Investing} = \text{Creditor Financing} + \text{Owner Financing}$$

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

At fiscal year-end 2014, the accounting equation for Nike was as follows ($ millions):

$$\$18{,}594 = \$7{,}770 + \$10{,}824$$

By definition, the accounting equation holds for all companies at all times. This relation is a very powerful tool for analyzing and understanding companies, and we will use it often throughout the text.

Operating Activities

Operating activities refer to the production, promotion, and selling of a company's products and services. These activities extend from a company's input markets, involving its suppliers, and to its output markets, involving its customers. Input markets generate *operating expenses* (or *costs*) such as inventory, salaries, materials, and logistics. Output markets generate *operating revenues* (or *sales*) from customers. Output markets also generate some operating expenses such as for marketing and distributing products and services to customers. When operating revenues exceed operating expenses, companies report *operating income*, also called *operating profit* or *operating earnings*. When operating expenses exceed operating revenues, companies report operating losses.

Revenue is the increase in equity resulting from the sale of goods and services to customers. The amount of revenue is determined *before* deducting expenses. An **expense** is the cost incurred to generate revenue, including the cost of the goods and services sold to customers as well as the cost of carrying out other business activities. **Income**, also called *net income*, equals revenues minus expenses, and is the net increase in equity from the company's operating activities.

$$\text{Income} = \text{Revenues} - \text{Expenses}$$

For fiscal year 2014, Nike reported revenues of almost $28 billion, yet its reported income was a fraction of that amount—just under $2.7 billion.

Business Insights *offer recent examples from the business news and popular press.*

BUSINESS INSIGHT

Each year, *Fortune* magazine ranks the 500 largest corporations in the United States based on total revenues. For 2013, which is based on fiscal 2012 financial results, Nike ranked 126th on the *Fortune 500* list with revenues of just over $24 billion. The company also ranked 97th in profits, with net income of approximately $2.2 billion. For comparison, the largest corporation was **Wal-Mart Stores**, with revenues of $469.1 billion and $17 billion in net income. (Source: http://fortune.com/fortune500/2013/)

FINANCIAL STATEMENTS

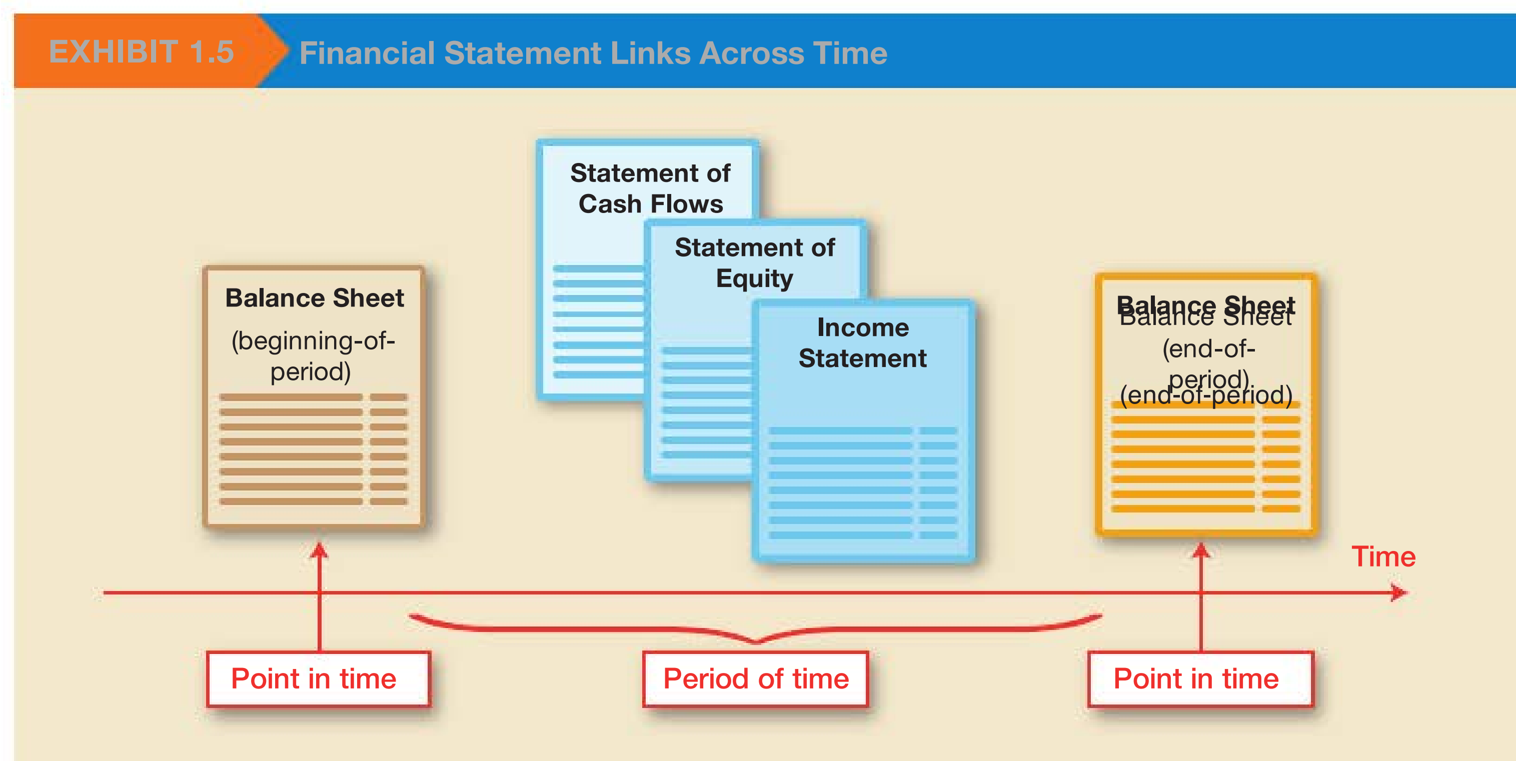
LO3 Introduce the four key financial statements including the balance sheet, income statement, statement of stockholders' equity, and statement of cash flows.

Four financial statements are used to periodically report on a company's business activities. These statements are:

- **balance sheet**, which lists the company's investments and sources of financing using the accounting equation;
- **income statement**, which reports the results of operations;
- **statement of stockholders' equity**, which details changes in owner financing;
- **statement of cash flows**, which details the sources and uses of cash.

Exhibit 1.5 shows how these statements are linked across time. A balance sheet reports on a company's position at a point in time. The income statement, statement of stockholders' equity, and the statement of cash flows report on performance over a period of time. The three statements in the middle of **Exhibit 1.5** (period-of-time statements) link the balance sheet from the beginning of a period to the balance sheet at the end of a period.

EXHIBIT 1.5 Financial Statement Links Across Time



A one-year, or annual, reporting period is common, which is called the *accounting*, or *fiscal year*. Semiannual, quarterly, and monthly reporting periods are also common. *Calendar-year* companies have a reporting period that begins on January 1 and ends on December 31. **Pfizer**, **Google**, and **Verizon** are examples of calendar-year companies. Some companies choose a fiscal year ending on a date other than December 31. Seasonal businesses, such as retail stores, often choose a fiscal year that ends when sales and inventories are at their lowest level. For example, **Home Depot**, the retail home improvement store chain, ends its fiscal year on the Sunday closest to February 1, after the busy holiday season. Nike has a May 31 fiscal year. The heading of each statement identifies the: (1) company name, (2) statement title, and (3) date or time period of the statement.

FYI The heading of each financial statement includes who, what, and when.