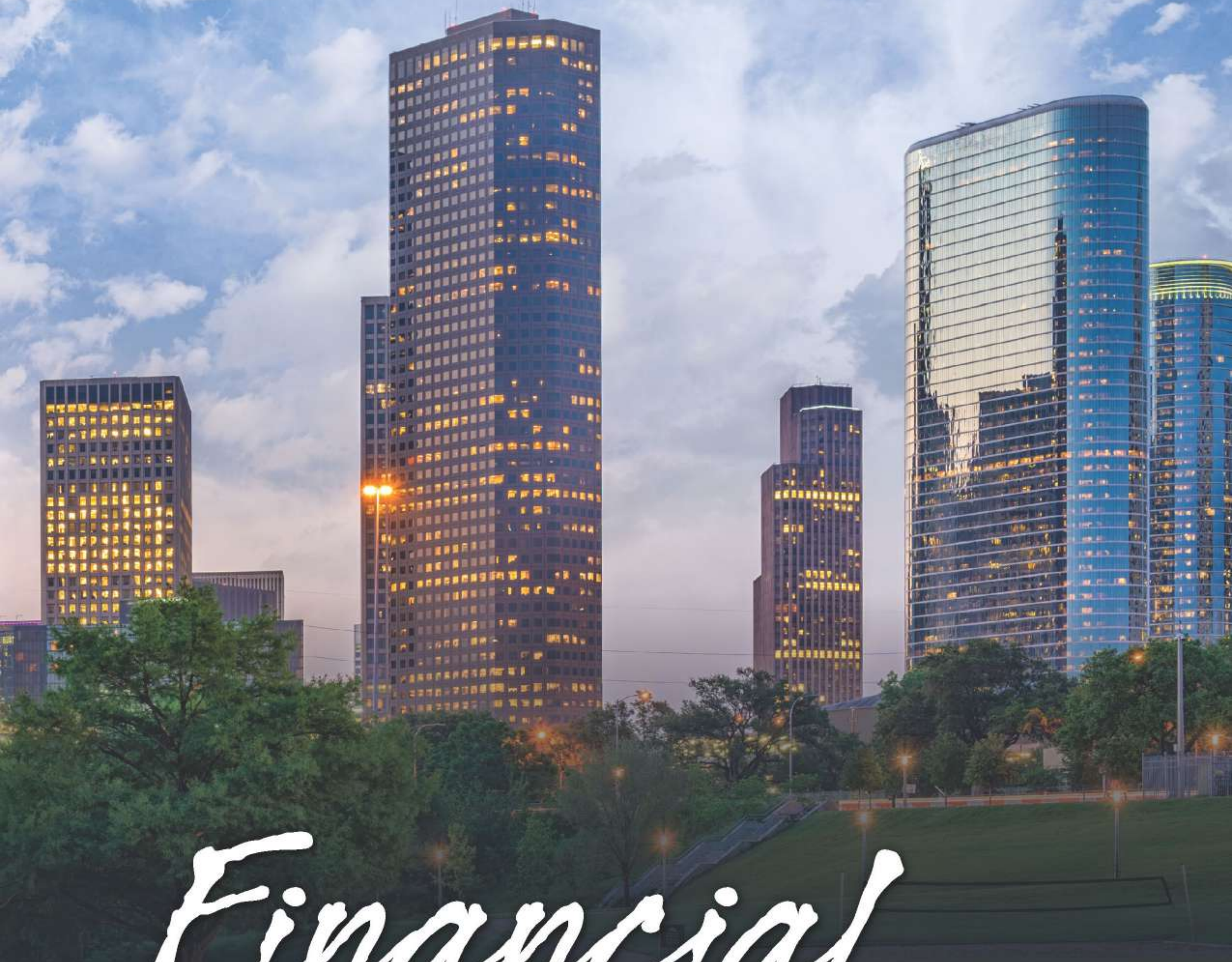
Michelle **Hanlon** Robert **Magee** Glenn **Pfeiffer** Thomas **Dyckman**



Financial Accounting

Sixth Edition

SIXTH EDITION

Financial Accounting

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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

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

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

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About the Authors

The combined skills and expertise of Michelle Hanlon, Bob Magee, Glenn Pfeiffer, and Tom Dyckman 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.

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 undergraduates, MBA students, Executive MBA students, and Masters of Finance 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 financial accounting and taxation. 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 two other textbooks—*Intermediate Accounting* and *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 and international 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 Emeritus 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 has taught 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.

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*.

Preface

Welcome to the sixth edition of *Financial Accounting* and, to adopters of the first five 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	**CVS Health Corporation**	**Chapter 10**	**Delta Air Lines**
Chapter 5	**PepsiCo**	**Chapter 11**	**Pfizer**
Chapter 6	**Microsoft Corporation**	**Chapter 12**	**Alphabet, Inc.**

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, Microsoft reports current accounts receivable, net of allowance for doubtful accounts, of $26,481 million at June 30, 2018, and $22,431 million at June 30, 2017. In its MD&A (Management Discussion and Analysis), the company provides the following information.

The allowance for doubtful accounts reflects our best estimate of probable losses inherent in the accounts receivable balance. We determine the allowance based on known trouble accounts, historical experience, and other currently available evidence.

Activity in the allowance for doubtful accounts was as follows:

(In millions) Year Ended June 30,	2018	2017	2016
Balance, beginning of period	$361	$409	$289
Charged to costs and other	134	58	175
Write-offs	(98)	(106)	(55)
Balance, end of period	$397	$361	$409

Allowance for doubtful accounts included in our consolidated balance sheets:

June 30,	2018	2017	2016
Accounts receivable, net allowance for doubtful accounts	$377	$345	$392
Other long-term assets	20	16	17
Total	$397	$361	$409

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

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.

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

Analysis Tool Gross Profit Margin (GPM) Ratio

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

Applying the Gross Profit Margin Ratio to Home Depot

$$\textbf{2015: } \frac{(\$88{,}519 - \$58{,}254)}{\$88{,}519} = 0.342 \text{ or } 34.2\%$$

$$\textbf{2016: } \frac{(\$94{,}595 - \$62{,}282)}{\$94{,}595} = 0.342 \text{ or } 34.2\%$$

$$\textbf{2017: } \frac{(\$100{,}904 - \$66{,}548)}{\$100{,}904} = 0.340 \text{ or } 34.0\%$$

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.

LO3

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

P5-45. Comparing Profitability Ratios for Competitors
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.	$27,390	$19,258	$76,450	£30,186	$52,546
Cost of sales.	12,337	6,066	25,354	10,342	11,240
SG&A expense.	9,117	4,687	21,420	9,672	14,784
R&D expense	2,235	6,411	10,554	4,476	7,657
Interest expense.	904	196	934	734	1,270
Net income	477	975	1,300	2,169	21,355

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 19.25% in 2017. Assume a tax rate of 35% for the others.)

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.

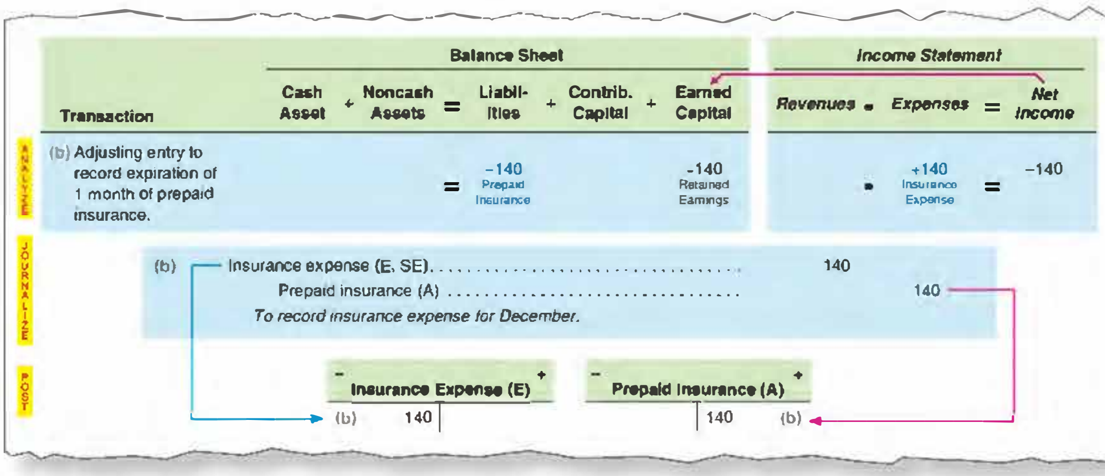
c. Compare the relative profitability of these pharmaceutical companies.

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.



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.

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

General Electric (GE) was one of the biggest dividend payers in the U.S. However, in 2017, the company cut its dividend in half, from 24 cents/share to 12 cents per share, in an effort to save cash—about $4 billion per year. GE's dividend cut was one of the largest in the history of the S&P 500 and the biggest since the great recession era (2009). Even after this dividend cut, it was projected that about 85% of the company's free cash flow would go toward dividends, which illuminates the change in the company and its business over time. The stock price fell around 7% on the day the dividend cut was announced and almost 6% the next day (though other negative news was simultaneously announced so not all of the price drop was likely due to the dividend news). In December of 2018, the company slashed the dividend further to only 1 cent 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. Each review has a corresponding Guided Example video, available to students in myBusinessCourse (our online learning and homework system).

CHAPTER-END REVIEW

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 2015, 2016, and 2017 10-K reports.

($ millions)	2017	2016	2015
Revenue	$34,837	$34,274	$32,619
Cost of goods sold	25,130	24,734	23,460
Gross profit	$ 9,707	$ 9,540	$ 9,159
Balance Sheet:			
Inventory	$ 1,877	$ 1,722	$ 1,741
Notes to financial statements			
LIFO reserve	$ 465	$ 442	$ 447

REQUIRED

1. Compute the gross profit margin for each year, 2015 through 2017, and the inventory turnover ratio for 2016 and 2017.
2. What amount for cost of goods sold and gross profit would Publix report in 2016 and 2017 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 2016 and 2017 assuming that FIFO had been used to value inventory.

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

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.

ness of the issuing company.

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:

<table>
<tr><th></th><th>15 Week
Semester-Course</th><th>10 Week
Quarter-Course</th><th>6 Week
Mini-Course</th><th>1 Week
Intensive-Course</th></tr>
<tr><td>Chapter 1</td><td>Week 1</td><td>Week 1</td><td>Week 1</td><td rowspan="2">Day 1</td></tr>
<tr><td>Chapter 2</td><td>Week 2 & 3</td><td>Week 2</td><td>Week 1 & 2</td></tr>
<tr><td>Chapter 3</td><td>Week 3 & 4</td><td>Week 3 & 4</td><td>Week 2 & 3</td><td>Day 2</td></tr>
<tr><td>Chapter 4</td><td>Week 5 & 6</td><td>Week 4 & 5</td><td>Optional</td><td>Optional</td></tr>
<tr><td>Chapter 5</td><td>Week 6 & 7</td><td>Optional</td><td>Optional</td><td>Optional</td></tr>
<tr><td>Chapter 6</td><td>Week 7 & 8</td><td>Week 6</td><td>Week 3</td><td>Day 3</td></tr>
<tr><td>Chapter 7</td><td>Week 9</td><td>Week 7</td><td>Week 4</td><td rowspan="2">Day 4</td></tr>
<tr><td>Chapter 8</td><td>Week 10</td><td>Week 8</td><td>Week 5</td></tr>
<tr><td>Chapter 9</td><td>Week 11 & 12</td><td>Week 9</td><td>Week 6</td><td>Day 5</td></tr>
<tr><td>Chapter 10</td><td>Week 12 & 13</td><td>Week 10</td><td>Week 6
(optional)</td><td>Skim</td></tr>
<tr><td>Chapter 11</td><td>Week 14</td><td>Optional</td><td>Optional</td><td>Optional</td></tr>
<tr><td>Chapter 12</td><td>Week 15</td><td>Optional</td><td>Optional</td><td>Optional</td></tr>
</table>

NEW IN THE 6TH EDITION

- The authors have added a brief introduction to **Data Analytics** in Chapter 1 and **Appendix B** at the end of the book, which provides a more in-depth exploration of Data Analytics.
- **Updated Standards:** As appropriate, the text and assignments have been updated to reflect the latest FASB standards:
  - The new **Revenue Recognition** standard is reflected in Chapter 6 and throughout the book where appropriate
  - Inventory coverage in Chapter 7 was revised to reflect the new standard on **lower-of-cost-or-net realizable value**
  - Chapter 10 reflects the new **Lease** standard
  - Chapter 12 reflects the new **Investments** standard
- **Tax Cut and Jobs Act:** In addition to the new FASB standards, the 6th edition reflects the Tax Cut and Jobs Act of 2017. The tax section in Chapter 10 reflects the new tax law.
- **CVS Health Corporation** replaced Golden Enterprises as the focus company of Chapter 4.
- **Microsoft** replaced Cisco as the focus company of Chapter 6.
- The parent company of Google, **Alphabet**, is now the focus company of Chapter 12.
- 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
- **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 more assignments and resources. In addition, the Guided Examples and eLectures have been revised and improved.

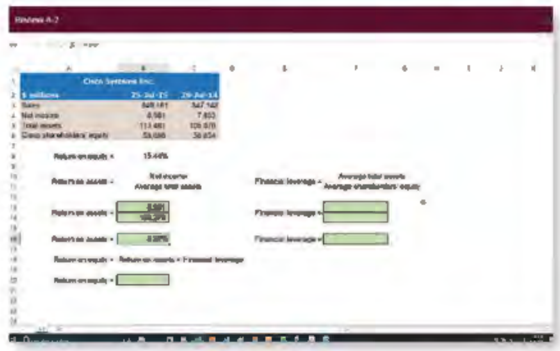
TECHNOLOGY THAT IMPROVES LEARNING AND COMPLEMENTS FACULTY INSTRUCTION

myBusinessCourse is an online learning and assessment program intended to complement your textbook and faculty instruction. Access to **myBusinessCourse** is FREE ONLY with the purchase of a new textbook, but can be purchased separately.

MBC is ideal for faculty seeking opportunities to augment their course with an online component. MBC is also a turnkey solution for online courses. The following are some of the features of MBC.

95% students who used MBC, responded that MBC helped them learn accounting.*

Increase Student Readiness



- **Demos** apply each chapter's learning objectives and concepts to a problem. Consistent with the text and created by the authors, these videos are ideal for remediation and online instruction.
- **Reviews** are narrated video demonstrations created by the authors that show students how to solve the Review problems from the textbook.
- Immediate feedback with **auto-graded homework**.
- **Test Bank** questions that can be incorporated into your assignments.
- Instructor **gradebook** with immediate grade results.

Make Instruction Needs-Based

- Identify where your students are struggling and customize your instruction to address their needs.
- Gauge how your entire class or individual students are performing by viewing the easy-to-use gradebook.
- Ensure your students are getting the additional reinforcement and direction they need between class meetings.

86% of students said they would encourage their professor to continue using MBC in future terms.*

Provide Instruction and Practice 24/7

- Assign homework from your Cambridge Business Publishers' textbook and have MBC grade it for you automatically.
- With our Videos, your students can revisit accounting topics as often as they like or until they master the topic.
- Make homework due before class to ensure students enter your classroom prepared.
- For an additional fee, upgrade MBC to include the eBook and you have all the tools needed for an online course.

Integrate with LMS

myBusinessCourse integrates with many learning management systems, including **Canvas**, **Blackboard**, **Moodle**, **D2L**, **Schoology**, and **Sakai**. Your gradebooks sync automatically.

ADDITIONAL RESOURCES

Financial Accounting Bootcamp

This interactive tutorial is intended for use in programs that either require or would like to offer a tutorial that can be used as a refresher of topics introduced in the first financial accounting course. It is designed as an asynchronous, interactive, self-paced experience for students. Available Learning Modules (You Select) follow.

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)
6. Excel and Time-Value of Money Basics (approximate completion time 2 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 Illinois—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. 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

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**

myBusinessCourse: An online learning and assessment program intended to complement your textbook and classroom instruction (see page xi for more details). Access to myBusinessCourse is FREE with the purchase of a new textbook and can also be purchased separately.

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.

myBusinessCourse: An online learning and assessment program intended to complement your textbook and faculty instruction (see page xi for more details). This easy-to-use program grades assignments automatically and provides you with additional help when your instructor is not available. Access is free with new copies of this textbook (look for the page containing the access code towards the front of the book).

ACKNOWLEDGMENTS

This book has benefited greatly from the valuable feedback of focus group attendees, reviewers, students, and colleagues. We are extremely grateful to them for their help in making this project a success.

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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. 26)

NIKE
www.Nike.com

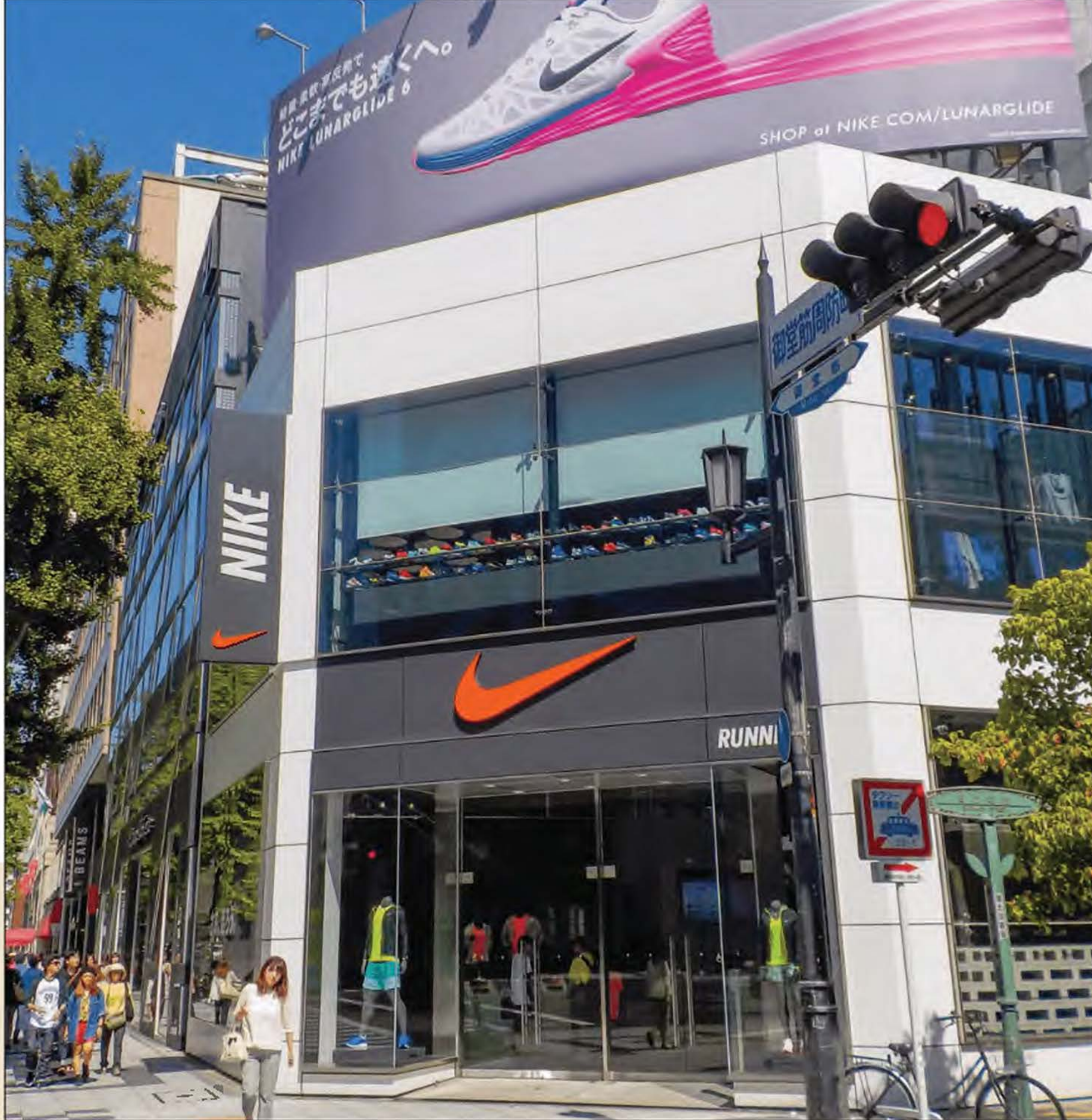
Phil Knight majored in accounting and was a member of the track team at the University of Oregon.

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. Currently, the company is worth more than $120 billion. Knight is the former CEO and the Chairman, Emeritus of Nike, Inc.

Today, Nike, Inc. has sales in almost every country on the planet and, in the year ended May, 2018, Nike had total revenues of $36 billion and income of $1.9 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 Serena Williams, Michael Jordan, Tiger Woods, Maria Sharapova, Tom Brady, LeBron James, and Mike Trout, add to Nike's brand recognition.

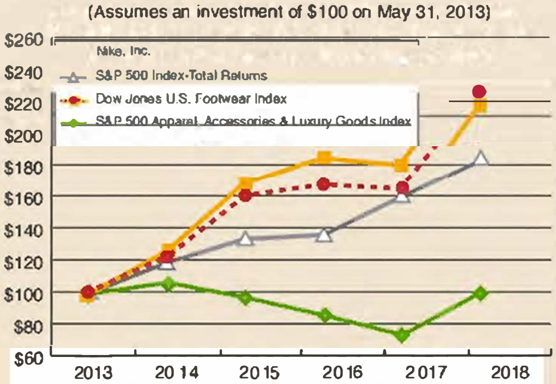
In recent years, Nike has expanded its product lines beyond the traditional offerings of athletic shoes, athletic apparel, and sports equipment to include eyewear, watches such as the *Nike+ Sportwatch GPS*, and *Fuelband*, a wearable wristband which tracks energy output. In recent years, Nike has further 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 nearly two-thirds of Nike's size in terms of sales. Perhaps this situation, along with new product developments, explains Nike's future marketing commitments that reached $10 billion as of the end of the fiscal year ended may 2018.



How does someone take a $1,000 investment and turn it into a company whose stock is worth more than $120 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, 2013)



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. 10—K Report for the year ended May 31, 2018; Business Week (October 2007. August 2009): Portland Business Journal (October 2007); Fortune (February 2012). For more on Phil Knight and Nike's history, see the book Shoe Dog (published by Scribner).

CHAPTER ORGANIZATION

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

Introducing Financial Accounting

Demand for Accounting Information	Business Activities	Financial Statements	Financial Reporting Environment	Financial Statement Analysis
• Who Uses Financial Accounting Information? • Costs and Benefits of Disclosure	• Planning Activities • Investing Activities • Financing Activities • Operating Activities	• Balance Sheet • Income Statement • Statement of Stockholders' Equity • Statement of Cash Flows • Financial Statement Linkages	• Generally Accepted Accounting Principles • Regulation and Oversight • Role of the Auditor • A Global Perspective • Conceptual Framework (Appendix 1A)	• Profitability Analysis • Credit Risk Analysis

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

eLectures MBC

DEMAND FOR ACCOUNTING INFORMATION

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

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**):[1]

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

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

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.

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.

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

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.[2] 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**.

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, partnerships, and limited liability companies 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. Many new businesses today start up as a limited liability company (LLC). An LLC allows for limited liability for the owners similar to a corporation, while at the same time allowing for more flexibility and other features that are similar to a partnership.

Most corporations begin as small, privately held businesses (sole proprietorships, partnerships, or an LLC). As their operations expand, however, they require additional capital to finance their growth. One of the principal advantages of a corporation over the other organizational forms of doing business 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*. The raising of capital from a large group of outside shareholders leads to what is known as the separation of ownership and control. For example, as Nike sold more stock, the CEO (Knight) owned a smaller amount of the shares. In cases of such separation, which exists at most publicly traded firms, the information flow from the managers to the shareholders is very important.

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

FYI Financial statements are typically required when a business requests a bank loan (unless the business is very small, then tax returns will often suffice).

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.

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.

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

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.

BUSINESS INSIGHT

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.[3] 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.