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FINANCIAL ACCOUNTING

Eleventh Edition

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ELEVENTH EDITION



FINANCIAL ACCOUNTING

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Cornell University

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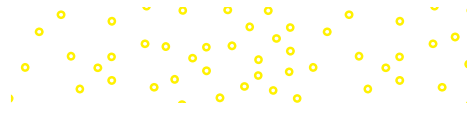
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FINANCIAL ACCOUNTING

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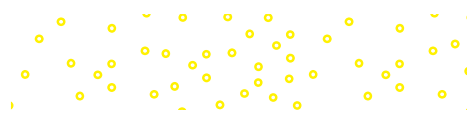
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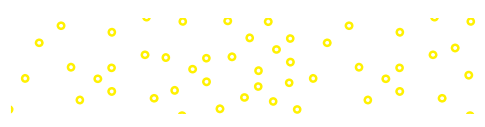
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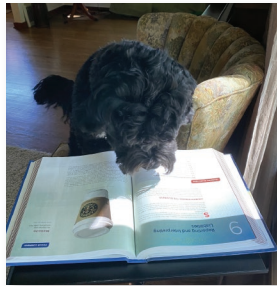


To: Herman and Doris Hargenrater
Oscar and Selma Libby
Laura Libby, Brian Plummer, and Bennett Plummer
Abby, Grace, Claire, Joanne, and Richard Hodge
Dan Short

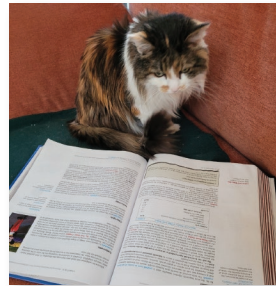
We truly appreciate the continued support of all our *Financial Accounting* team members, including our special helpers.



Courtesy of Patricia Libby



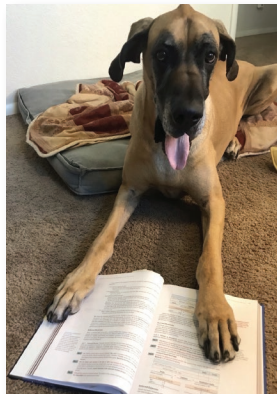
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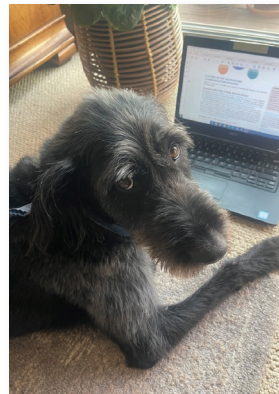
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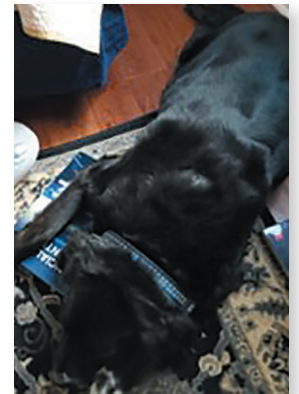
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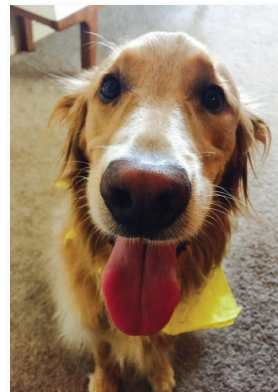
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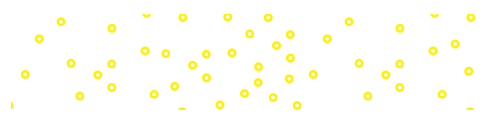
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Courtesy of Lauren Schur



ABOUT THE AUTHORS

ROBERT LIBBY



Courtesy of Robert Libby

Robert Libby is the David A. Thomas Professor of Accounting and Accounting Area Coordinator at Cornell University, where he teaches the introductory financial

accounting course. He previously taught at the University of Illinois, Pennsylvania State University, the University of Texas at Austin, the University of Chicago, and the University of Michigan. He received his BS from Pennsylvania State University, where he was selected as the 2018 Outstanding Accounting Alumnus, and his MAS and PhD from the University of Illinois; he also completed the CPA exam (Illinois).

Bob was selected as the AAA Outstanding Educator in 2000 and received the AAA Outstanding Service Award in 2006 and the AAA Notable Contributions to the Literature Award in 1985 and 1996. He has received the Core Faculty Teaching Award multiple times at Cornell. Bob is a widely published author and researcher specializing in behavioral accounting. He has published numerous articles in *The Accounting Review*; *Journal of Accounting Research*; *Accounting, Organizations, and Society*; and other accounting journals. He has held a variety of offices, including vice president, in the American Accounting Association, and he is a member of the American Institute of CPAs.

PATRICIA A. LIBBY



Courtesy of Patricia Libby

Patricia Libby is Professor Emeritus of accounting at Ithaca College, where she taught the undergraduate and graduate financial accounting courses. She previously taught graduate and undergraduate financial accounting at Eastern Michigan University and the

University of Texas at Austin. Before entering academia, she was an auditor with Price Waterhouse (now PricewaterhouseCoopers) and a financial administrator at the University of Chicago. She was also faculty advisor to Beta Alpha Psi (Mu Alpha chapter), the National Association of Black Accountants (Ithaca College chapter), and Ithaca College Accounting Association.

Patricia received her BS from Pennsylvania State University, her MBA from DePaul University, and her PhD from the University of Michigan; she also successfully completed the CPA exam (Illinois). She has published articles in *The Accounting Review*, *Issues in Accounting Education*, and *The Michigan CPA*.

FRANK HODGE



Christine Moody

Frank Hodge is the Orin & Janet Smith Dean at the University of Washington's Foster School of Business.

Frank joined the faculty at the University of Washington in 2000. He earned his MBA and PhD degrees from Indiana University. He has won over 30 teaching awards at the University of Washington teaching financial accounting and financial statement analysis to undergraduate students, full-time MBA students, executive MBA students, and intercollegiate athletic administrators. Frank's research focuses on how individuals use accounting information to make investment decisions and how technology influences their information choices. Frank was one of six members of the Financial Accounting Standards Research Initiative team and has presented his research at the Securities and Exchange Commission. He has published articles in *The Accounting Review*; *Journal of Accounting Research*; *Contemporary Accounting Research*; *Accounting, Organizations, and Society*; and several other journals. Frank lives in Seattle with his wife and two daughters.

A TRUSTED LEADER FOR STUDENTS AND INSTRUCTORS

The award-winning author team of Bob Libby, Pat Libby, and Frank Hodge continue *Financial Accounting's* best-selling tradition of helping the instructor and student become partners in learning. Libby/Libby/Hodge uses a remarkable learning approach that keeps students engaged and involved in the material from the first day of class.

Libby/Libby/Hodge's *Financial Accounting* maintains its leadership by focusing on four key attributes:

THE PIONEERING REAL-WORLD COMPANIES APPROACH

The Libby/Libby/Hodge authors' trademark focus company approach is the best method for helping students understand financial statements and the real-world implications of financial accounting for future managers. **This approach shows that accounting is relevant and motivates students by explaining accounting in a real-world context.** Throughout each chapter, the material is integrated around a familiar focus company, its decisions, and its financial statements. This provides the perfect setting for discussing the importance of accounting and how businesses use accounting information. No other book matches this seamless integration of the real world.

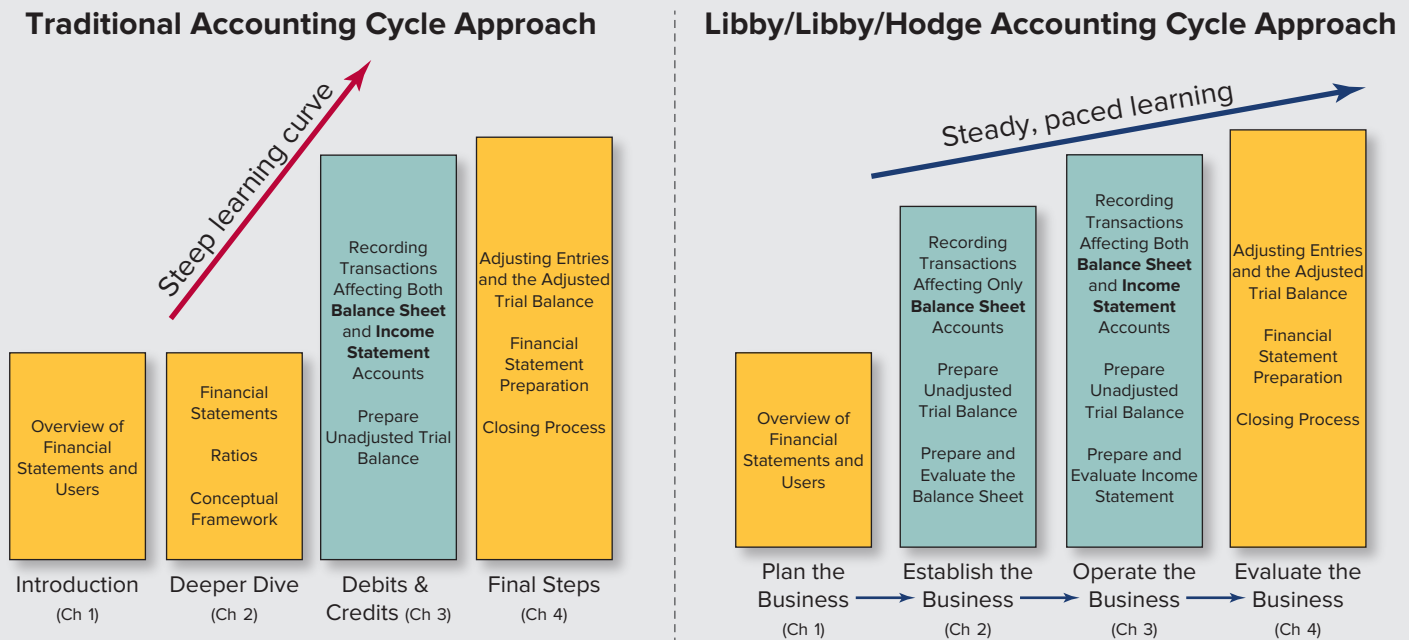
A BUILDING-BLOCK APPROACH TO TEACHING TRANSACTION ANALYSIS

Faculty agree the accounting cycle is the most critical concept to learn and master for students studying financial accounting, regardless of their career aspirations. Libby/Libby/Hodge believes students struggle with the accounting cycle when transaction analysis is covered in one chapter. If students are exposed to the accounting equation, journal entries, and T-accounts for both balance sheet and income statement accounts in a single chapter, many are left behind and are unable to grasp material in the remaining chapters.

The market-leading Libby/Libby/Hodge approach spreads transaction analysis coverage over two chapters so that students have the time to master the material. In Chapter 2 of *Financial Accounting*, students are exposed to the accounting equation and transaction analysis for investing and financing transactions that affect only balance sheet accounts. This provides students with the opportunity to learn the basic structure and tools used in accounting in a simpler setting. In Chapter 3, students are exposed to more complex operating transactions that also affect income statement accounts. **By slowing down the introduction**



of transactions and giving students time to practice and gain mastery, this building-block approach leads to greater student success in their study of later topics in financial accounting such as adjusting entries. Research has shown that the accounting cycle approach used in this textbook yields learning gains that outpace approaches used in other textbooks by a significant margin.



THE RIGHT BALANCE OF TRANSACTION ANALYSIS AND FINANCIAL STATEMENT ANALYSIS

A clear understanding of how transactions affect financial statements is key for sound decision-making utilizing these statements. Accountants, auditors, analysts, managers, creditors, and investors must all be aware of the effect of measuring and reporting financial activities and the power of financial statement analysis. Our balanced focus on transaction analysis and financial statement analysis based on real companies optimally prepares students regardless of their career aspirations.

POWERFUL TECHNOLOGY FOR TEACHING AND STUDY

Students have different learning styles and conflicting time commitments, so they want technology tools that will help them study more efficiently and effectively. The eleventh edition includes the best technology available with Connect's latest features—Concept Overview Videos, Integrated Excel, General Ledger problems, and other new study, practice, and assessment materials.

MARKET-LEADING PEDAGOGY AND CONTENT

Financial Accounting, 11e, offers a host of pedagogical tools that complement the different ways you like to teach and the ways your students like to learn. Some offer information and tips that help you present a complex subject; others highlight issues relevant to what your students read online and see in their other coursework. Either way, *Financial Accounting*'s pedagogical support will make a real difference in your course and in your students' learning.

FINANCIAL ANALYSIS

Interpreting Assets, Liabilities, and Stockholders' Equity on the Balance Sheet

Assessment of **Le-Nature's** assets is important to its creditors, **Wells Fargo Bank** and others, and its stockholders because assets provide a basis for judging whether the company has sufficient resources avail-

DATA ANALYTICS

How Data Analytics Are Affecting What Auditors Do

Modern data analytics are changing the world of auditing. The availability of more data from clients' enterprise-wide accounting systems, which combine the various record-keeping functions within an organization, has

ENVIRONMENTAL, SOCIAL, & GOVERNANCE (ESG) REPORTING

Being a Global Citizen

FedEx publishes an ESG report at sustainability.fedex.com that "covers FedEx corporate social responsibility (CSR) strategies, goals, programs, and progress." Its *2020 Global Citizenship*

A QUESTION OF ETHICS

Volume Discounts/Rebates and Earnings Misstatements at Monsanto

In 2016, the SEC found that agribusiness company **Monsanto** had materially misstated company rev-

KEY RATIO ANALYSIS

Net Profit Margin Ratio

FOCUS ON CASH FLOWS

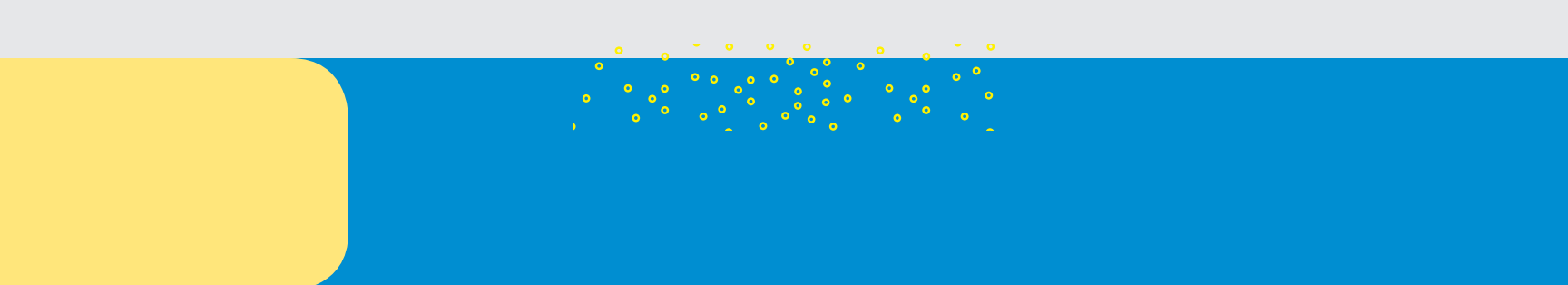
Working Capital and Cash Flows

Many working capital accounts have a direct relationship to income-producing activities. Accounts

INTERNATIONAL PERSPECTIVE

The International Accounting Standards Board and Global Accounting Standards





FINANCIAL ANALYSIS BOXES—These features tie important chapter concepts to real-world decision-making examples. They also highlight alternative viewpoints and add to the critical-thinking and decision-making focus of the text.

DATA ANALYTICS BOXES—This feature introduces students to how companies analyze and use data for both business decisions and accounting applications.

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) REPORTING BOXES—Most large public companies have started to publish an ESG report. These boxes illustrate how ESG reports help investors assess the long-term consequences of the company’s broader business strategy.

A QUESTION OF ETHICS BOXES—These boxes appear throughout the text, conveying the importance and the consequences of acting responsibly in business practice.

“Ethics and financial analysis boxes are excellent. Examples with real companies that students have heard of or even been to are key to their learning and understanding.”

—Laurie Dahlin, Worcester State University

FOCUS ON CASH FLOWS BOXES—Each of the first 11 chapters includes a discussion and analysis of changes in the cash flows of the focus company and explores the decisions that caused those changes.

KEY RATIO ANALYSIS BOXES—Each box presents ratio analysis for the focus company in the chapter as well as for comparative companies. Cautions also are provided to help students understand the limitations of certain ratios.

INTERNATIONAL PERSPECTIVE BOXES—These boxes highlight the emergence of global accounting standards (IFRS) at a level appropriate for the introductory student.

“An excellent introduction to financial accounting that flows in a more logical manner than most texts. The extensive variety and amount of supporting materials allows for customization of the course, and the integration of key concepts such as ethics and cash flows enhance student understanding of the topics.”

—Joy Gray, Bentley University

PRACTICE IS KEY TO SUCCESS IN FINANCIAL ACCOUNTING

PAUSE FOR FEEDBACK AND SELF-STUDY QUIZ

Research shows that students learn best when they are actively engaged in the learning process. This active learning feature engages the student, provides interactivity, and promotes efficient learning. These quizzes ask students to pause at strategic points throughout each chapter to ensure they understand key points before moving ahead.

Chapter 07-1—Guided Help

In this video, we will work through a new exercise to determine the missing dollar amounts for the income statement of Miller Company for each of the given independent cases (Hint: In case B, work from the bottom up.).

| | Case A | Case B |
|--------------------------|---------|---------|
| Net sales revenue | \$9,600 | \$? |
| Beginning inventory | \$1,200 | \$5,500 |
| Purchases | 6,000 | ? |
| Goods available for sale | ? | 15,400 |
| Ending inventory | 2,200 | 4,000 |
| Cost of goods sold | ? | 11,400 |
| Gross profit | ? | 1,700 |
| Expenses | 900 | ? |
| Pretax income | \$3,700 | \$ 500 |

...for the income statement of Miller Company for each of the given independent cases (Hint: In case B, work from the bottom up.).

SMARTBOOK

Within Connect, SmartBook brings these features to life by interleaving reading with active practice. As students read, SmartBook encourages them to answer questions to demonstrate their knowledge—then, based on their answers, highlights those areas where students need more practice.

PAUSE FOR FEEDBACK

Inventory should include all items owned that are held for resale. Costs flow into inventory when goods are purchased or manufactured. They flow out (as an expense) when they are sold or disposed of. The cost of goods sold equation describes these flows.

SELF-STUDY QUIZ

- Assume the following facts for **Harley-Davidson's** Motorclothes leather baseball jacket product line for the year 2022.
 - Beginning inventory: 400 units at unit cost of \$75.
 - Purchases: 600 units at unit cost of \$75.
 - Sales: 700 units at a sales price of \$100 (cost per unit \$75).
 Using the cost of goods sold equation, compute the dollar amount of **goods available for sale, ending inventory, and cost of goods sold** of leather baseball jackets for the period.

| | |
|--|--|
| Beginning inventory | |
| + Purchases of merchandise during the year | |
| Goods available for sale | |
| – Ending inventory | |
| Cost of goods sold | |
- Assume the following facts for **Harley-Davidson's** Motorclothes leather baseball jacket product line for the year 2023.
 - Beginning inventory: 300 units at unit cost of \$75.
 - Ending inventory: 600 units at unit cost of \$75.
 - Sales: 1,100 units at a sales price of \$100 (cost per unit \$75).
 Using the cost of goods sold equation, compute the dollar amount of **purchases** of leather baseball jackets for the period. Remember that if three of these four values are known, the cost of goods sold equation can be used to solve for the fourth value.

| | |
|--|--|
| Beginning inventory | |
| + Purchases of merchandise during the year | |
| – Ending inventory | |
| Cost of goods sold | |

After you have completed your answers, check them below.

GUIDED HELP 7-1

For additional step-by-step video instruction on using the cost of goods sold equation to compute relevant income statement amounts, go to mhhe.com/libby_gb7-1.

Related Homework: M7-4, E7-2, E7-3, E7-4

| | |
|---|----------|
| 1. Beginning inventory (400 × \$75) | \$30,000 |
| + Purchases of merchandise during the year (600 × \$75) | 45,000 |
| Goods available for sale (1,000 × \$75) | 75,000 |
| – Ending inventory (300 × \$75) | 22,500 |
| Cost of goods sold (700 × \$75) | \$52,500 |

Solutions to SELF-STUDY QUIZ



| | |
|-------------------------------|------------------------------------|
| 2. BI = 300 × \$75 = \$22,500 | BI + P – EI = CGS |
| EI = 600 × \$75 = \$45,000 | \$22,500 + P – \$45,000 = \$82,500 |
| CGS = 1,100 × \$75 = \$82,500 | P = \$105,000 (1,400 × \$75) |

GUIDED HELP VIDEOS

To provide students with immediate help understanding key concepts, our unique Guided Help videos provide narrated, animated, step-by-step walk-throughs for each numerical Self-Study Quiz that students can view at any time through their mobile device or online. These videos also save office hour time! We also include a Related Homework list for each Self-Study Quiz to help the students move on to their homework assignments.

COMPREHENSIVE PROBLEMS

Selected chapters include problems that cover topics from earlier chapters to refresh, reinforce, and build an integrative understanding of the course material. For practice with the completing the accounting cycle, there are two comprehensive problems in Chapter 4 that are complemented in Connect by General Ledger questions. These help students see how transactions flow from the general journal through to the financial statements.



COMPREHENSIVE PROBLEMS (CHAPTERS 1-4)

Recording Transactions (Including Adjusting and Closing Entries), Preparing Financial Statements, and Performing Ratio Analysis

COMP4-1
LO4-1, 4-2, 4-3, 4-4
H & H Tool

Brothers Herm and Steve Hargenrater began operations of their tool and die shop (**H & H Tool**) on January 1, 1987, in Meadville, PA. The annual reporting period ends December 31. Assume that the trial balance on January 1, 2023, was as follows:

| | Debit | Credit |
|---|-------|--------|
| Trial Balance at January 1, 2023 | | |
| <i>(dollars in millions, except number of shares and par value)</i> | | |
| Cash | 6 | |
| Accounts receivable | 5 | |
| Supplies | 13 | |
| Land | | |
| Equipment | 78 | |
| Accumulated depreciation (on equipment) | | 8 |
| Other noncurrent assets (not detailed to simplify) | | 7 |
| Accounts payable | | |
| Wages payable | | |
| Interest payable | | |
| Dividends payable | | |
| Income taxes payable | | |
| Long-term notes payable | | |
| Common stock (8 million shares, \$0.50 par value) all year | | 4 |
| Additional paid-in capital | | 80 |
| Retained earnings | | 17 |
| Service revenue | | |

CASES AND PROJECTS

This section includes annual report cases, financial reporting and analysis cases, critical thinking cases, financial reporting and analysis projects, and business analytics and data visualization exercises. The real-world company analysis theme is continued in this section, giving students practice comparing Target and Walmart among other relevant companies. In each chapter, CP1 presents **auto-gradable** questions based on Target's annual report, CP2 includes **auto-gradable** questions based on Walmart's report, and CP3 provides **auto-gradable** questions comparing key ratio(s) discussed in the chapter for Target and Walmart.

CASES AND PROJECTS


Annual Report Cases

CP7-1
LO7-1, 7-2, 7-4, 7-5
Target Corporation

Finding Financial Information

Refer to the financial statements of **Target** given in Appendix B at the end of this book. All dollar amounts in the statements and answers are in millions.

Required:

- How much inventory does the company hold at the end of the most recent year?
 - \$44,949
 - \$8,992
 - \$20,756
 - \$10,653
 - None of the above
- Estimate the amount of inventory that the company purchased during the current year. (Hint: Use the cost of goods sold equation and ignore "certain buying, occupancy, and warehousing expenses.")
 - \$67,838
 - \$10,653

Finding Financial Information
CP10-2
LO10-1, 10-2, 10-6, 10-8
Walmart

Refer to the financial statements and footnotes of **Walmart** given in Appendix C at the end of this book. All dollar amounts are in millions.

Required:

- What is the amount of cash Walmart paid for interest during the most recent fiscal year? _____
- What is the amount of long-term debt that Walmart issued during the most recent fiscal year? _____
- What is the amount of Walmart's long-term debt that will mature in fiscal year 2024? _____
- What is the amount of cash Walmart paid to retire long-term debt during the most recent fiscal year? _____
- For the most recent fiscal year, compute the debt-to-equity ratio for Walmart. (Round your answer to two decimal places) _____

Comparing Companies within an Industry

Refer to the financial statements of Target (Appendix B) and Walmart (Appendix C) and the Industry Ratio Report (Appendix D) at the end of this book.


Required:

- Compute the debt-to-equity ratio for both companies for the most recent fiscal year. (Round your answer to two decimal places)

Target = Walmart =

CONTINUING PROBLEM

The continuing case revolves around Penny's Pool Service & Supply, Inc., and its largest supplier, Pool Corporation, Inc. In the first five chapters, the continuing case follows the establishment, operations, and financial reporting for Penny's. In Chapter 5, Pool Corporation, a real publicly traded corporation, is introduced in more detail. The Pool Corporation example is then extended to encompass each new topic in the remaining chapters.

CONTINUING PROBLEM


CON8-1
LO8-2, 8-3, 8-5

Asset Acquisition, Depreciation, and Disposal

Pool Corporation, Inc., is the world's largest wholesale distributor of swimming pool supplies and equipment. Assume Pool Corporation purchased for cash new loading equipment for the warehouse on January 1 of Year 1, at an invoice price of \$72,000. It also paid \$2,000 for freight on the equipment, \$1,300 to prepare the equipment for use in the warehouse, and \$800 for insurance to cover the equipment during operation in Year 1. The equipment was estimated to have a residual value of \$3,300 and be used over three years or 24,000 hours.

WHAT'S NEW IN THE 11th EDITION?

This edition is new in look, content, features, and resources to enhance learning by students and use by instructors.

Overall in Each Chapter:

- Greater focus on reporting by students' favorite tech companies including **Google, Facebook, Apple, Tesla, Amazon, Zoom, Microsoft** and others.
- Updated real company information throughout the edition to reflect the most recent annual report data.
- **New** marginal **TIP** feature to add clarity and remind students of important information, mostly in the text, but also in end-of-chapter assignments in early chapters to guide students in problem-solving.
- Moved marginal definitions of key terms to end-of-chapter Key Terms section with “rollover” feature in the ebook.
- **New Related Homework** after each Pause for Feedback Self-Study Quiz.
- **New Guided Help video** for each Self-Study Quiz involving numbers or calculations that are similar to popular assignments.
- **New** graphic highlighting key formulae.
- **New** Excel screen shots for trial balances, amortization schedules, and elsewhere.
- Increased use of company and individual names in end-of-chapter content to reflect more diversity.
- **New** parallel Alternate Problems to Problems that are also now available as algorithmic auto-graded *Connect* assignments.
- **New** end-of-book Annual Report Cases companies: **Target** and **Walmart**.
- **New** questions for Cases and Projects 1 through 3 in each chapter to allow for auto-grading, primarily using multiple-choice and fill-in-the-blank questions, often requiring an explanation for the choice.
- **New** structured project questions in *You as Analyst: Online Company Research*. Flexibility is created to allow instructors to assign it as an individual or a team project.
- **New** auto-graded **data analytics** exercises on *Connect* titled *Business Analytics and Data Visualization* for most chapters.

Chapter 1

- **New** exhibit illustrating relationship between the income statement, statement of stockholders' equity, and balance sheet.
- **New** Self-Study Quiz and **Guided Help video** on the structure of the income statement, statement of stockholders' equity, and balance sheet.
- Added initial discussion of **internal controls** to Chapter 1.
- **New** concise discussion of the conceptual framework (moved from Chapter 2).
- **New** end-of-chapter Demonstration Case based on the financial statements of **Best Buy**.

Chapter 2

- **New** **Chipotle Mexican Grill** transactions for illustration that closely match with the actual first quarter 2020 results.
- **New** introductory discussion of operating lease right-of-use assets and related liabilities.

- **New** exhibit on the steps for transaction analysis for investing and financing activities that includes an example in the exhibit.
- Modified the accounting cycle graphic to add clarity.
- **New Guided Help video** on current ratio computation and analysis.
- **New** comparison company: **Shake Shack**.
- Added an exercise using real company information for **Alphabet, Inc.**, parent company of **Google**.

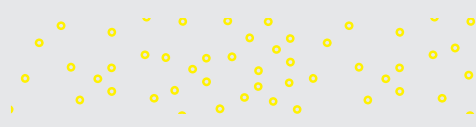
Chapter 3

- **New** **Chipotle Mexican Grill** transactions for illustration that closely match with the actual first quarter 2020 results.
- Briefly discussed the impact of the pandemic on Chipotle (in opening discussion and Understanding the Business).
- Renewed focus on accrual basis accounting with clarity on businesses that use cash basis accounting.

- Modified the simplified EPS formula to add clarity and consistency throughout the text.
- Integrated five-step revenue recognition principle with examples using real companies **Chipotle Mexican Grill** and **Apple**.
- **New Guided Help video** on identifying the accounts and amounts when recognizing revenues in the proper period.
- **New** exhibit on the transaction analysis steps for any transaction, with an example added to the exhibit.
- Modified several assignments: Added new transactions and updated real company information.
- Separated the analysis of cash flow requirements from recording of transactions in several assignments.

Chapter 4

- All **Chipotle Mexican Grill** illustrations updated to reflect most recent annual report data.



- Modified the Accounting Cycle graphic to add clarity.
- **New** Exhibit 4.2 on the types of adjustments, which also lists typical accrual and deferral accounts.
- **New** Exhibit 4.3 on the adjustment process, specifying the accounts to be adjusted and illustrating journal entries.
- **New** exhibit on the interrelationships of the financial statements, combining two graphics from the prior edition.
- **New** graphic illustrating the closing process.
- Changed E4-2 to the trial balance of **Facebook, Inc.** and AP4-1 to the trial balance of **Tesla, Inc.**
- Revised the continuing problem (CON4-1) for Penny’s Pool Service & Supply to start with an unadjusted trial balance for completing the accounting cycle, making the assignment capable of being auto-graded using Excel and *Connect*.

Chapter 5

- Updated all internet-based sources of financial information.
- **New Environmental, Social, and Governance (ESG) Reporting** feature added with discussion of **Apple’s** ESG report.
- **New Yahoo! Finance** illustration of information available about Apple.
- **New Guided Help video** providing step-by-step instruction on how to determine the effects of transactions on key balance sheet and income statement subtotals.
- **New Guided Help video** providing step-by-step instruction on how to determine the effects of transactions of key performance ratios.
- **New** end-of-chapter Demonstration Case based on the financial statements of **Microsoft**.
- **New** end-of-chapter exercises and problems based on the financial statements of **Salesforce.com, Sonos, Inc., Consolidated Edison, Nordstrom, Inc.,** and other companies.

Chapter 6

- Updated the Focus Company **Skechers’** illustrations.
- **New Guided Help video** providing step-by-step instruction on accounting for credit card discounts and sales discounts.

- Revised discussions of errors in bad debt estimates to include the effects of the pandemic on **Skechers’** bad debts.
- **New** end-of-chapter exercises and problems based on the financial statements of **SAP, Adobe, General Mills, VF Corporation,** and other companies.
- Revised discussion of **internal control** of cash.

Chapter 7

- Updated the Focus Company **Harley-Davidson’s** real company illustrations.
- **New** simplified discussion of how companies with perpetual inventory systems report using the LIFO cost flow assumption.
- **New Guided Help video** providing step-by-step instruction on converting ending inventory, cost of goods sold, and pretax income from LIFO to FIFO.
- **New Guided Help video** providing step-by-step instruction on correcting the income statement for errors in ending inventory.

Chapter 8

- **New** Focus Company: **FedEx Corporation** integrated in the chapter.
- **New** Understanding the Business section on package and cargo delivery industry.
- Briefly mentioned impact of pandemic in Key Ratio analysis.
- **New** discussion of operating lease right-of-use assets by airline and other industries as a method of acquisition.
- **New** comparison company **UPS** in fixed asset turnover ratio analysis.
- Revised Pause for Feedback on acquiring operational assets that more closely matches end-of-chapter assignments.
- **New Guided Help video** on recording the purchase of long-lived assets.
- **New** block on **Environmental, Social, and Governance (ESG) Reporting** with an excerpt from FedEx’s *2020 Global Citizenship Report*.
- **New** discussion of **internal controls** for fixed assets.
- Illustrated depreciation schedules using Excel spreadsheets.
- Revised asset impairment test steps and illustrated applying the steps to Delta Air Lines’ impairment measurement due to the pandemic.

- **New** illustration of determining goodwill using the purchase of **Tableau Software, Inc.** by **Salesforce.com, Inc.**
- Revised section on licenses and operating rights related to landing and take-off slots as intangible operating rights of airlines.

Chapter 9

- **New** and more vibrant real company pictures and illustrations of Focus Company **Starbucks**.
- Updated company names used in examples and end-of-chapter material to reflect more diversity.
- **New** comparison company **Monster Beverages**.
- Updated discussion of deferred revenue using Starbucks’s “stored value cards” account and associated mobile app as an example.
- **New** real-world excerpt focused on a California lawsuit claiming that Starbucks’s coffee has chemicals in it that requires a warning, and whether this lawsuit is a contingent liability.
- Added **Peloton** and **Beyond Meats** in end-of-chapter material.

Chapter 10

- **New** and more vibrant real company bond illustrations of Focus Company **Amazon**.
- Updated company names used in examples and end-of-chapter material to reflect more diversity.
- **New data analytics** box that highlights the role artificial intelligence plays in bond investing.
- Added **Apple** in end-of-chapter material.

Chapter 11

- **New** Focus Company: **Microsoft** integrated throughout the chapter with new pictures and updated illustrations.
- Updated company names used in examples and end-of-chapter material to reflect more diversity.
- **New Environmental, Social, and Governance (ESG) Reporting** feature added with discussion of **Microsoft’s** ESG report.
- **New** discussion of how some states (e.g., the state of Washington) do not allow treasury stock and the effects this has on financial statements.





- **New** comparison company **IBM**.
- **New** real-world excerpt focused on **Microsoft**'s equity compensation.
- Streamlined the chapter supplement that covers accounting for the equity of sole proprietorships and partnerships.
- Added **Zoom Video Communications** and **Facebook** in end-of-chapter material.

Chapter 12

- Updated the Focus Company **National Beverage** and all real company illustrations.

Chapter 13

- **New** and more vibrant real company pictures and illustrations of Focus Company **The Home Depot**.
- Updated company names used in examples and end-of-chapter material to reflect more diversity.
- Revised ratio titles to succinctly link to titles used in all previous chapters.

- Changed end-of-chapter material to include **Apple, Peabody Energy, Tesla, Boeing, Zoom Video Communications**, and **A-Mark Precious Metals**.
- **New Environmental, Social, and Governance (ESG) Reporting** feature added with discussion of **The Home Depot**'s ESG report.

Appendix A

- Updated the Focus Company **The Walt Disney Company**'s illustrations.
- Added marginal illustrations of the timing of transactions regarding held-to-maturity, trading securities, and available-for-sale debt and equity investments.
- **New Guided Help video** on recording transactions related to debt investments as trading securities and available-for-sale securities.
- **New** Pause for Feedback with a Self-Study Quiz on applying the fair value method to passive investments in equity securities.

- **New Guided Help video** on recording transactions related to applying the equity method for investments when there is significant influence.
- Added real world excerpt from **The Walt Disney Company**'s annual report regarding the impact of the pandemic and the impairment of goodwill.

Connect

- New Integrated Excel Activities - pair the power of Microsoft Excel® with the power of Connect® in a seamless live integration.
- New Tableau Dashboard Activities - easily introduce students to Tableau®. Students learn to gather the information they need from a live embedded Tableau dashboard. No prior knowledge of Tableau® is needed.
- New Alternative Problems - all the alternative problems in the text can now be found and auto-graded in Connect®.





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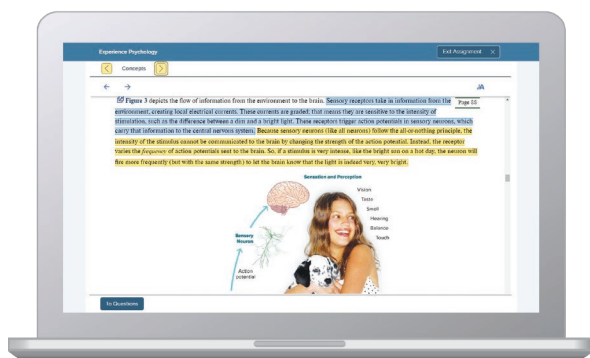
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"I really liked this app—it made it easy to study when you don't have your textbook in front of you."

- Jordan Cunningham,
Eastern Washington University



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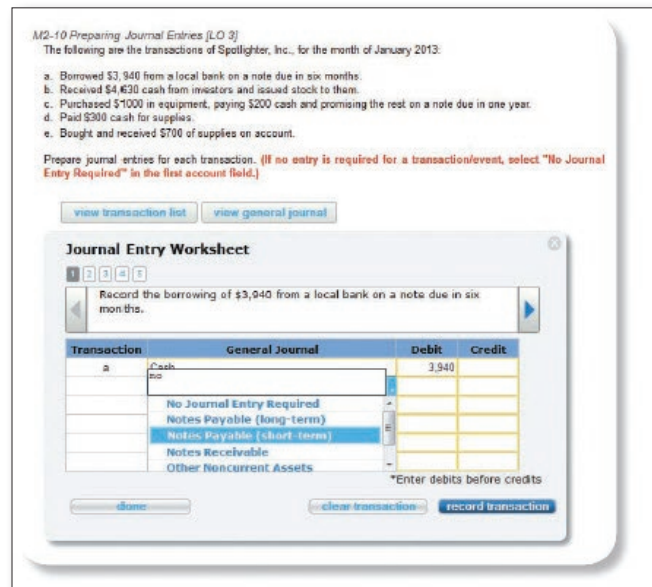


Online Assignments

Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. Connect grades homework automatically and gives immediate feedback on any questions students may have missed. The extensive assignable, gradable end-of-chapter content includes a general journal application that looks and feels more like what you would find in a general ledger software package.

End-of-chapter **auto-gradable** questions in Connect include

- Mini-Exercises
- Exercises
- Problems
- Alternate Problems
- Comprehensive Problems
- Continuing Problems
- Cases and Projects
- General Ledger Problems
- Excel Application Exercises
- Tableau Dashboard Activities



Courtesy of Noelle Bathurst

General Ledger Problems

General Ledger Problems provide a much-improved student experience when working with accounting cycle questions, offering improved navigation and less scrolling. Students can audit their mistakes by easily linking back to their original entries and can see how the numbers flow through the various financial statements. Many General Ledger Problems include an analysis tab that allows students to demonstrate their critical thinking skills and a deeper understanding of accounting concepts.

Each journal entry is posted automatically to the general ledger. Use the drop-down button to view the unadjusted, adjusted, or post-closing balances.

Post-closing ▾

| Cash | | | | Accounts Receivable | | | |
|--------------|-------|--------|---------|---------------------|-------|--------|---------|
| Date | Debit | Credit | Balance | Date | Debit | Credit | Balance |
| Jan 01, 2015 | | | 3 | Jan 01, 2015 | | | 5 |
| Mar 01, 2015 | 12 | | 15 | | | | |
| Mar 02, 2015 | | 9 | 6 | | | | |
| Apr 03, 2015 | 23 | | 29 | | | | |
| Jul 04, 2015 | | 10 | 19 | | | | |
| Nov 06, 2015 | | 13 | 6 | | | | |

| Supplies | | | | Land | | | |
|--------------|-------|--------|---------|--------------|-------|--------|---------|
| Date | Debit | Credit | Balance | Date | Debit | Credit | Balance |
| Jan 01, 2015 | | | 12 | Jan 01, 2015 | | | 0 |
| Oct 05, 2015 | 18 | | 30 | Mar 02, 2015 | 9 | | 9 |

| Equipment | | | | Accumulated Depreciation—Equipment | | | |
|--------------|-------|--------|---------|------------------------------------|-------|--------|---------|
| Date | Debit | Credit | Balance | Date | Debit | Credit | Balance |
| Jan 01, 2015 | | | 60 | Jan 01, 2015 | | | 5 |

| Software | | | | Accumulated Amortization | | | |
|--------------|-------|--------|---------|--------------------------|-------|--------|---------|
| Date | Debit | Credit | Balance | Date | Debit | Credit | Balance |
| Jan 01, 2015 | | | 15 | Jan 01, 2015 | | | 5 |
| Jul 04, 2015 | 10 | | 25 | | | | |

| Accounts Payable | | | | Notes Payable (short-term) | | | |
|------------------|-------|--------|---------|----------------------------|-------|--------|---------|
| Date | Debit | Credit | Balance | Date | Debit | Credit | Balance |
| Jan 01, 2015 | | | 5 | Jan 01, 2015 | | | 0 |
| Oct 05, 2015 | | 18 | 23 | Mar 01, 2015 | | 12 | 12 |
| Nov 06, 2015 | 13 | | 10 | | | | |

| Common Stock | | | | Retained Earnings | | | |
|--------------|-------|--------|---------|-------------------|-------|--------|---------|
| Date | Debit | Credit | Balance | Date | Debit | Credit | Balance |
| Jan 01, 2015 | | | 71 | Jan 01, 2015 | | | 8 |
| Apr 03, 2015 | | 23 | 94 | | | | |

Notice the dropdown below that gives the options to select the unadjusted, adjusted or post-closing trial balance. The option you choose will be the values used to populate the income statement and balance sheet tabs. Do not complete and review the financial statements until you have verified that total debits equal total credits.

Post-closing ▾

| H & H TOOL, INC | | |
|------------------------------------|--------|--------|
| Trial Balance | | |
| December 31, 2015 | | |
| Account Title | Debit | Credit |
| Cash | | 6 |
| Accounts Receivable | | 5 |
| Supplies | 30 | |
| Land | 9 | |
| Equipment | 60 | |
| Accumulated Depreciation—Equipment | | 6 |
| Software | | 25 |
| Accumulated Amortization | | 5 |
| Accounts Payable | | 10 |
| Notes Payable (short-term) | | 12 |
| Common Stock | | 94 |
| Retained Earnings | | 8 |
| Total | \$ 135 | \$ 135 |

NEW!

Concept Overview Videos

The **Concept Overview Videos** provide engaging narratives of all chapter learning objectives in an assignable and interactive online format. They follow the structure of the text and are organized to match the specific learning objectives within each chapter of *Financial Accounting*. These short presentations provide additional explanation and enhancement of material from the text chapter, allowing students to learn, study, and practice with instant feedback, at their own pace.

Required Information
[The following information applies to the questions displayed below.]

In this module, you will learn how to prepare a trial balance and a classified balance sheet. A trial balance checks on the equality of debit and credit balances. A classified balance sheet separately classifies assets as current if they will be used up or turned into cash within one year. Liabilities are classified as current if they will be paid, settled, or fulfilled within one year.

Preparing a Trial Balance

| NOODLECARE STUDIOS, INC. Trial Balance At August 31 | |
|---|---------------|
| Debit | Credit |
| Cash | 20,000 |
| Supplies | 600 |
| Equipment | 8,600 |
| Software | 8,000 |
| Logo/trademarks | 300 |
| Accounts Payable | 18,000 |
| Notes Payable | 20,000 |
| Common Stock | 16,000 |
| Total | 48,200 |

Total balance provides a check on debits = credits = equality

Ending balances in T-accounts

Debits = credits on trial balance → balance sheet will not balance

Knowledge Check 01
Chico Company's trial was in balance at the end of the period and showed the following accounts:

| | |
|------------------|--------|
| Accounts Payable | 25,200 |
| Cash | 40,200 |

Tableau Dashboard Activities

Tableau Dashboard Activities easily introduce students to Tableau, allowing them to explore live dashboards directly integrated into Connect. These activities include auto-graded questions focused on both calculations and analysis. No prior knowledge of Tableau is needed.

NEW!

Integrated Excel

New! Integrated Excel assignments pair the power of Microsoft Excel with the power of Connect. A seamless integration of Excel within Connect, Integrated Excel questions allow students to work in live, auto-graded Excel spreadsheets—no additional logins, no need to upload or download files. Instructors can choose to grade by formula or solution value, and students receive instant cell-level feedback via integrated Check My Work functionality.

Excel: McGraw Hill Excel Question - Saved

Presented below are incomplete financial statements for Maria Communications Company.

Required:
Solve for the missing amounts.
Note: When an amount on one financial statement is again shown on another statement, you MUST reference the cell from the earlier statement rather than calculate the amount, thus indicating the relationship between the two statements.
(All formulas must return positive values.)

| MARIA COMMUNICATIONS Company Income Statement For the Month Ended March 31 | |
|--|----------|
| Sales Revenues | \$34,500 |
| Expenses: | |
| Rent Expense | 2,000 |
| Wages Expense | 4,800 |
| Utilities Expense | 800 |
| Income Tax Expense | 800 |
| Net Income | \$4,100 |

McGraw Hill
Check Answers
Check My Work
Legend
Graded cell: Leave blank if no answer is needed.
Scratchpad: Use as a non-graded workspace

Guided Examples

The **Guided Examples, also known as Hints**, in Connect provide a narrated, animated, step-by-step walk-through of select exercises similar to those assigned. These short presentations can be turned on or off by instructors and provide reinforcement when students need it most.

“It is a great textbook that comes with a great online work system to enhance students’ learning effectiveness. Connect is user-friendly, provides many good practice opportunities, and links well with e-book.”

—Wan-Ting Wu, University of Massachusetts Boston



ACKNOWLEDGMENTS

Many dedicated instructors have devoted their time and effort to help us make each edition better. We would like to acknowledge and thank all of our colleagues who have helped guide our development decisions for this and previous editions. This text would not be the success it is without the help of all of you.

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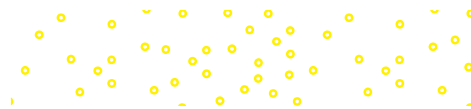
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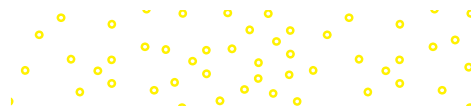
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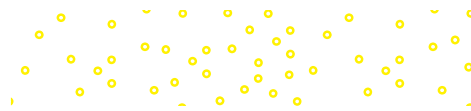
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MBA COMPANION (Available online in Connect and in McGraw Hill's Create)

Leases, Income Taxes, and Retirement Obligations

Under Armour

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1

chapter

Financial Statements and Business Decisions

Le-Nature's Inc. designed its business strategy to ride the growing wave of interest in noncarbonated beverages. And apparently its strategy was a huge success. Its financial statements reported growth in sales from \$156 to \$275 million in just three years. How did this small family-run business compete with the likes of Coke and Pepsi in this growing market? The business press suggested the first key to its success was manufacturing a broad range of products that fit into the fastest growing “healthy” segments: flavored waters, teas, and fruit drinks. Founder and CEO Gregory Podlucky said that an obsessive drive for quality and efficiency was just as critical. Matching customers’ concerns for the environment and healthy living, Le-Nature’s was praised as one of the first companies to switch to environmentally friendlier PET plastic bottles and to employ safe in-bottle pasteurization. Its 21st-century manufacturing operation in Latrobe, Pennsylvania, produced everything that goes into its products, from the injection-molded PET bottles to the final packaging. Complete control over the whole process assures quality and provides the flexibility to respond quickly to changes in customers’ demands. When convenience stores moved to larger-sized drinks or school cafeterias switched from carbonated beverages to healthier drinks, Le-Nature’s could change its production to meet the customers’ needs. The company even opened a second new state-of-the-art manufacturing facility in Arizona to meet the apparent growing demand.

But here is the twist: Just three short months later, investigators discovered that Le-Nature’s phenomenal sales growth was more fiction than fact. How could this apparent success story portrayed in the financial statements really be one of the most remarkable frauds in history?

Chapter 1 concentrates on the key financial statements that businesspeople rely upon when they evaluate a company’s performance as well as the importance of accurate financial statements in making our economic system work. We discuss these issues in the context of Le-Nature’s rise and fall.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- 1-1** Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers). p. 6
- 1-2** Identify the role of generally accepted accounting principles (GAAP) in determining financial statement content and managers’, directors’, and auditors’ responsibilities for ensuring the accuracy of the financial statements. p.17



James F. Quinn/KRT/Newscom

Le-Nature's Inc.

USING FINANCIAL
STATEMENT
INFORMATION TO
MANAGE GROWTH

Accounting knowledge will be valuable to you only if you can apply it in the real world. Learning is also easier when it takes place in real contexts. So at the beginning of each chapter, we always provide some background about the business that will provide the context for the chapter discussion.

UNDERSTANDING THE BUSINESS

Le-Nature's Inc., our focus company for this chapter, was founded by Gregory Podlucky and his brother Jonathan, who initially were the sole owners or **stockholders** of the company. They were also the managers of the company. Using expertise gained working at their parents' brewery (**Stoney's Beer**), the brothers were early believers in the trend toward healthier, noncarbonated beverages. Like most entrepreneurs, their growth ambitions quickly outpaced their own financial resources. So they turned to banks, including **Wells Fargo Bank** and other lenders, to finance additional manufacturing facilities and equipment. Different units of Wells Fargo continued to arrange lending to Le-Nature's as the need arose, becoming its largest lender or **creditor**. Creditors make money on the loans by charging **interest**. The Podlucky's also convinced others to buy stock in Le-Nature's. These individuals became part owners or stockholders along with the Podlucky's. The stockholders hoped to receive a portion of what the company earned in the form of cash payments called **dividends** and to eventually sell their share of the company at a higher price than they paid. Creditors are more willing to lend and stock prices usually rise when creditors and investors expect the company to do well in the future. Both groups estimate future performance, in part, based on information in the company's financial statements.

EXHIBIT 1.1

The Accounting System and Decision Makers



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The Accounting System

Managers (often called **internal decision makers**) need information about the company's business activities to manage the operating, investing, and financing activities of the firm. Stockholders and creditors (often called **external decision makers**) need information about these same business activities to assess whether the company will be able to pay back its debts with interest and pay dividends. All businesses must have an **accounting** system that collects and processes financial information about an organization's business activities and reports that information to decision makers. Le-Nature's **business activities** included:

- **Financing Activities:** borrowing or paying back money to lenders and receiving additional funds from stockholders or paying them dividends.
- **Investing Activities:** buying or selling items such as plant and equipment used in the production of beverages.
- **Operating Activities:** the day-to-day process of purchasing raw tea and other ingredients from suppliers, manufacturing beverages, delivering them to customers, collecting cash from customers, and paying suppliers.

Exhibit 1.1 outlines the two parts of the accounting system. Internal managers typically require continuous, detailed information because they must plan and manage the day-to-day operations of the organization. Developing accounting information for internal decision makers, called **managerial** or **management accounting**, is the subject of a separate accounting course. The focus of this text is

accounting for external decision makers, called **financial accounting**, and the four basic financial statements and related disclosures that are periodically produced by that system.

Why Study Financial Accounting?

No matter what your business career goals, you can't get away from financial accounting. You may want to work for an investment firm, a bank, or an accounting firm that would be involved in the financing of companies like **Le-Nature's**. We will focus much of our discussion on the perspectives of **investors**, **creditors**, and **preparers** of financial statements. However, you might not be aware that managers within the firm also make direct use of financial statements. For example, **marketing managers** and **credit managers** use customers' financial statements to decide whether to extend credit to their customers. **Supply chain managers** analyze suppliers' financial statements to see whether the suppliers have the resources to meet demand and invest in future development. Both the employees' unions and company **human resource managers** use financial statements as a basis for contract negotiations over pay rates. Financial statement figures even serve as a basis for calculating employee bonuses. Regardless of the functional area of management in which you are employed, you will use financial statement data.

We begin with a brief but comprehensive overview of the information reported in the four basic financial statements and the people and organizations involved in their preparation and use. This overview provides a context in which you can learn the more detailed material presented in the chapters that follow. Then we will discuss the parties that are responsible for the accuracy of financial statements as well as the consequences of misstated financial statements. Le-Nature's stockholders and creditors used its financial statements to learn more about the company before making their investment and lending decisions. In doing so, they assumed that the statements accurately represented Le-Nature's financial condition.

Your Goals for Chapter 1

To understand the way in which creditors and stockholders used Le-Nature's financial statements, we must first understand what specific information is presented in the four basic financial statements for a company such as Le-Nature's. **PLEASE NOTE: Rather than trying to memorize the definitions of every term used in this chapter, try to focus your attention on learning the general content, structure, and use of the statements. Specifically:**

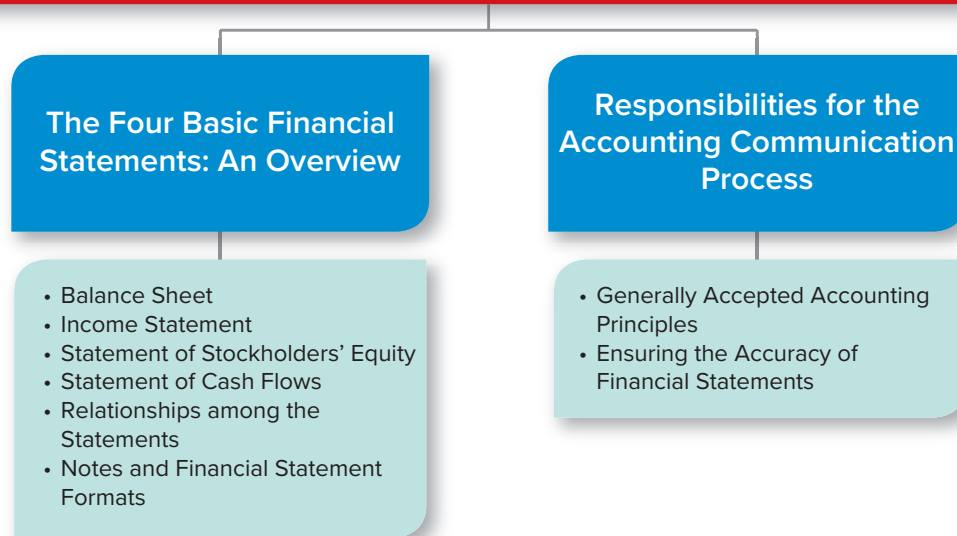
Content: the categories of items (often called **elements**) reported on each of the four statements.

Structure: the **equation** that shows how the elements within the statement are organized and related.

Use: how the information is **used** by stockholders and creditors to make investment and lending decisions.

The Pause for Feedback–Self-Study Quizzes at key points in the chapter will help you assess whether you have reached these goals. If you have difficulty with the Self-Study Quizzes, Guided Help videos provide narrated, animated, step-by-step walk-throughs at key points to help you with the material. Remember that because this chapter is an overview, each concept discussed here will be discussed again in Chapters 2 through 5.

ORGANIZATION OF THE CHAPTER



LEARNING OBJECTIVE 1-1

Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers).

THE FOUR BASIC FINANCIAL STATEMENTS: AN OVERVIEW

Four financial statements are normally prepared by profit-making organizations for use by investors, creditors, and other external decision makers.

1. On its **balance sheet**, **Le-Nature's** reports the economic resources it owns and the sources of financing for those resources.
2. On its **income statement**, **Le-Nature's** reports its ability to sell goods for more than their cost to produce and sell.
3. On its **statement of stockholders' equity**, **Le-Nature's** reports additional contributions from or payments to investors and the amount of income the company reinvested for future growth.
4. On its **statement of cash flows**, **Le-Nature's** reports its ability to generate cash and how it was used.

The four basic statements can be prepared at any point in time (such as the end of the year, quarter, or month) and can apply to any time span (such as one year, one quarter, or one month). Like most companies, **Le-Nature's** prepared financial statements for external users (investors and creditors) at the end of each quarter (known as **quarterly reports**) and at the end of the year (known as **annual reports**).

The Balance Sheet

The purpose of the **balance sheet (statement of financial position)** is to report the financial position (amount of assets, liabilities, and stockholders' equity) of an accounting entity at a particular point in time. We can learn a great deal about what the balance sheet reports just by reading the statement from the top. The balance sheet **Le-Nature's Inc.** presented to creditors and stockholders is shown in Exhibit 1.2.

| LE-NATURE'S INC. Balance Sheet At December 31, 2020 ¹ (in millions of dollars) | |
|--|-----------------------|
| Assets: | |
| Cash | \$ 10.6 |
| Accounts receivable | 6.6 |
| Inventories | 51.2 |
| Property, plant, and equipment | 459.0 |
| Total assets | <u>\$527.4</u> |
| Liabilities and stockholders' equity: | |
| Liabilities | |
| Accounts payable | \$ 26.0 |
| Notes payable to banks | 381.7 |
| Total liabilities | <u>407.7</u> |
| Stockholders' equity | |
| Common stock | 55.7 |
| Retained earnings | 64.0 |
| Total stockholders' equity | <u>119.7</u> |
| Total liabilities and stockholders' equity | <u>\$527.4</u> |

The notes are an integral part of these financial statements.

EXPLANATION

| | |
|---------------------------------------|---|
| <i>Name of the entity</i> | Resources controlled by the company |
| <i>Title of the statement</i> | <i>Amount of cash in the company's bank accounts</i> |
| <i>Specific date of the statement</i> | <i>Amounts owed by customers from prior sales</i> |
| <i>Unit of measure</i> | <i>Ingredients and beverages ready for sale</i> |
| | <i>Factories, production equipment, and land</i> |
| | Total amount of company's resources |
| | Sources of financing for company's resources |
| | <i>Financing supplied by creditors</i> |
| | <i>Amounts owed to suppliers for prior purchases</i> |
| | <i>Amounts owed to banks on written debt contracts</i> |
| | <i>Financing provided by stockholders</i> |
| | <i>Amounts invested in the business by stockholders</i> |
| | <i>Past earnings not distributed to stockholders</i> |
| | Total sources of financing for company's resources |

EXHIBIT 1.2

Balance Sheet

Structure

Notice that the **heading** specifically identifies four significant items related to the statement:

- 1. Name of the entity**, Le-Nature's Inc.
- 2. Title of the statement**, Balance Sheet.
- 3. Specific date of the statement**, At December 31, 2020.
- 4. Unit of measure** (in millions of dollars).

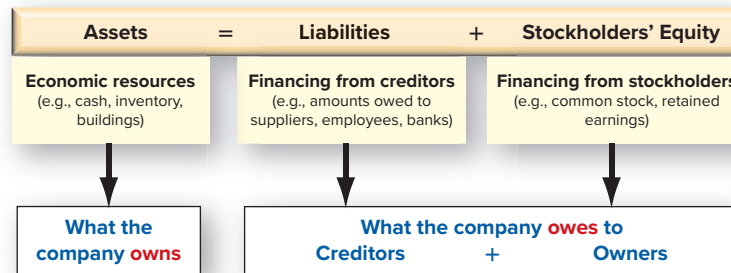
The organization for which financial data are to be collected, called an **accounting entity**, must be precisely defined. On the balance sheet, the business entity itself, not the business owners, is viewed as owning the resources it uses and being responsible for its debts. The heading of each statement indicates the time dimension of the report. The balance sheet is like a financial snapshot indicating the entity's financial position at a specific point in time—in this case, December 31, 2020—which is stated clearly on the balance sheet. Financial reports are normally denominated in the currency of the country in which they are located. U.S. companies report in U.S. dollars, Canadian companies in Canadian dollars, and Mexican companies in Mexican pesos. Le-Nature's statements report in millions of dollars. That is, they round the last six digits to the nearest **million** dollars. The listing of Cash \$10.6 on Le-Nature's balance sheet actually means \$10,600,000.

Balance Sheet

$$\begin{array}{r} \text{Assets} \\ = \\ \text{Liabilities} \\ + \\ \text{Stockholders' Equity} \end{array}$$

¹The Le-Nature's statements presented are constructed based on a simplified version of its audited 2005 statements. As we discuss in the section titled "Ensuring the Accuracy of Financial Statements," Le-Nature's statements were later found to be fraudulent. (Thus, 2020 is used in the header for illustration purposes.) The Le-Nature's fraud provides an important warning about the importance of accuracy in financial reporting.

Notice that Le-Nature's balance sheet has three major captions: assets, liabilities, and stockholders' equity. The **basic accounting equation**, often called the balance sheet equation, explains their relationship:



The basic accounting equation shows what we mean when we refer to a company's **financial position**: the **economic resources** that the company owns and the **sources of financing** for those resources.



Adrian Bradshaw/EPA/Newscom

Elements

Assets are the economic resources owned by the entity. Le-Nature's lists four items under the category Assets. The exact items listed as assets on a company's balance sheet depend on the nature of its operations. But these are common names used by many companies. The four items listed by Le-Nature's are the economic resources needed to manufacture and sell beverages to retailers and vending companies. Each of these economic resources is expected to provide future benefits to the firm. To prepare to manufacture the beverages, Le-Nature's first needed **cash** to purchase land on which to build factories and install production machinery (**property, plant, and equipment**). Le-Nature's then began purchasing ingredients and producing beverages, which led to the balance assigned to **inventories**. When Le-Nature's sells its beverages to grocery stores and others, it sells them on credit and receives promises to pay called **accounts receivable**, which are collected in cash later.

Every asset on the balance sheet is initially measured at the total cost incurred to acquire it. Balance sheets do not generally show the amounts for which the assets could currently be sold.

Liabilities and stockholders' equity are the sources of financing for the company's economic resources. **Liabilities** indicate the amount of financing provided by creditors. They are the company's debts or obligations. Under the category Liabilities, Le-Nature's lists two items. The **accounts payable** arise from the purchase of goods or services from suppliers on credit without a formal written contract (or a note). The **notes payable** to banks result from cash borrowings based on a formal written debt contract with banks.

Stockholders' equity indicates the amount of financing provided by owners of the business and reinvested earnings.² The investment of cash and other assets in the business by the stockholders is called **common stock**. The amount of earnings (profits) reinvested in the business (and thus not distributed to stockholders in the form of dividends) is called **retained earnings**.

In Exhibit 1.2, the Stockholders' Equity section reports two items. The founders and other stockholders' investment of \$55.7 million is reported as common stock. Le-Nature's total earnings (or losses incurred) less all dividends paid to the stockholders since formation of the corporation equals \$64 million and is reported as retained earnings. Total stockholders' equity is the sum of the common stock plus the retained earnings.

²A corporation is a business that is incorporated under the laws of a particular state. The owners are called **stockholders** or **shareholders**. Ownership is represented by shares of capital stock that usually can be bought and sold freely. The corporation operates as a separate legal entity, separate and apart from its owners. The stockholders enjoy limited liability; they are liable for the debts of the corporation only to the extent of their investments. Chapter Supplement A discusses forms of ownership in more detail.

FINANCIAL ANALYSIS



Interpreting Assets, Liabilities, and Stockholders' Equity on the Balance Sheet

Assessment of **Le-Nature's** assets is important to its creditors, **Wells Fargo Bank** and others, and its stockholders because assets provide a basis for judging whether the company has sufficient resources available to operate. Assets are also important because they could be sold for cash in the event that Le-Nature's goes out of business.

Le-Nature's debts are important because creditors and stockholders are concerned about whether the company has sufficient sources of cash to pay its debts. Le-Nature's debts are also relevant to Wells Fargo Bank's decision to lend money to the company because existing creditors share its claim against Le-Nature's assets. If a business does not pay its creditors, the creditors may force the sale of assets sufficient to meet their claims.

Le-Nature's stockholders' equity is important to Wells Fargo Bank because creditors' claims legally come before those of owners. If Le-Nature's goes out of business and its assets are sold, the proceeds of that sale must be used to pay back creditors before the stockholders receive any money. Thus, creditors consider stockholders' equity a protective "cushion."

PAUSE FOR FEEDBACK



We just learned the **balance sheet** is a statement of financial position that reports dollar amounts for a company's assets, liabilities, and stockholders' equity at a specific point in time. These elements are related in the basic accounting equation: **Assets = Liabilities + Stockholders' Equity**. Before you move on, complete the following questions to test your understanding of these concepts.

SELF-STUDY QUIZ

- Le-Nature's** assets are listed in one section and **liabilities** and **stockholders' equity** in another. Notice that the two sections balance in conformity with the basic accounting equation. In the following chapters, you will learn that the basic accounting equation is the basic building block for the entire accounting process. Your task here is to verify that total assets (\$527.4 million) is correct using the numbers for liabilities and stockholders' equity presented in Exhibit 1.2.

$$\text{Assets} \quad \underline{\hspace{1cm}} = \text{Liabilities} \quad \underline{\hspace{1cm}} + \text{Stockholders' Equity} \quad \underline{\hspace{1cm}}$$

- Learning which items belong in each of the balance sheet categories is an important first step in understanding their meaning. Without referring to Exhibit 1.2, mark each balance sheet item in the following list as an asset (A), a liability (L), or a stockholders' equity (SE) item.

| | |
|--|---|
| <input type="checkbox"/> Accounts payable | <input type="checkbox"/> Property, plant, and equipment |
| <input type="checkbox"/> Accounts receivable | <input type="checkbox"/> Inventories |
| <input type="checkbox"/> Cash | <input type="checkbox"/> Notes payable |
| <input type="checkbox"/> Common stock | <input type="checkbox"/> Retained earnings |

After you have completed your answers, check them below.

Related Homework: M1-1, M1-2, E1-2, E1-3

Tip

Don't skip the SELF-STUDY QUIZZES!

They are designed to help ensure you understand the material before moving on.

- Assets (\$527.4) = Liabilities (\$407.7) + Stockholders' Equity (\$119.7) (in millions).
- L, A, A, SE, A, A, L, SE (reading down the columns).

**Solution to
SELF-STUDY QUIZ**