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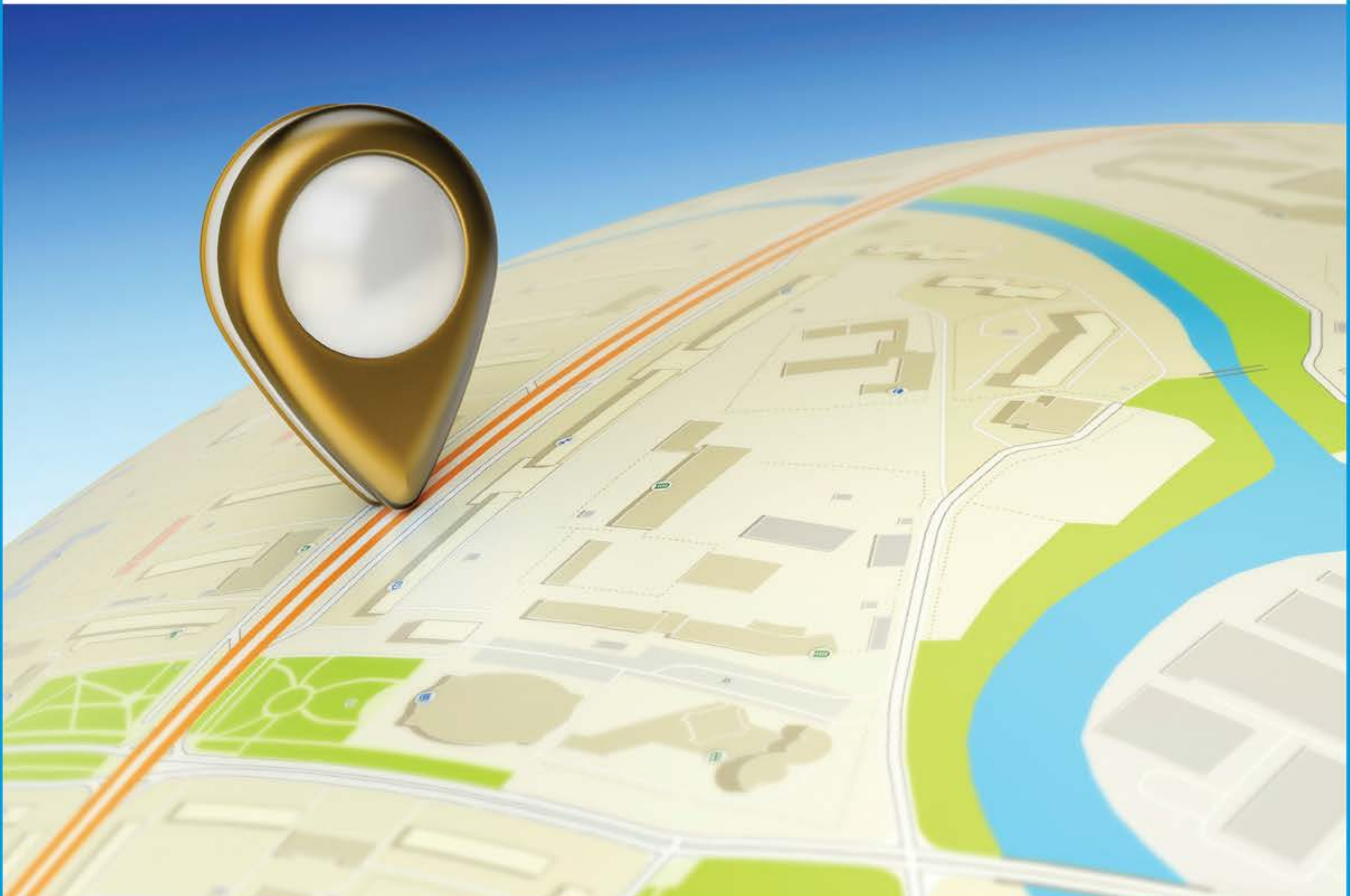
CORPORATE FINANCIAL Accounting



Corporate Financial Accounting 16e

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***Corporate Financial Accounting*, 16th edition**
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Throughout this text, real-world companies are used in the narrative, illustrations, and end-of-chapter assignments. These companies are identified in boldface color type, and any data presented was adapted from or based upon annual reports, Securities and Exchange Commission filings, or other publicly available sources. Any other individuals or companies used in illustrations and homework are fictional, and any resemblance to actual persons, living or dead, businesses or companies is entirely coincidental.

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Preface

Roadmap for Success

Warren/Jones *Corporate Financial Accounting*, *16e*, provides a sound pedagogy for giving students a solid foundation in business and accounting. Warren/Jones covers the fundamentals in an inclusive manner that motivates students to learn by showing how accounting is important to their careers and business.

Inclusivity

A major objective of Warren/Jones *Corporate Financial Accounting, 16e,* is to create an inclusive learning experience for all students that recognizes the wide diversity in student demographics, abilities, and experiences. This edition has been revised with a learner-centric approach that understands and acknowledges that a student's learning experience may be influenced by a variety of mental, sensory, and physical factors. As a result, this edition and its ancillaries have been designed to create an accessible learning experience for all students.

This edition also recognizes that students have unique backgrounds and perspectives. As a result, chapter content, illustrations, and homework are designed to be respectful and inclusive of differences in student race, ethnicity, sexual orientation, gender, religion, age, and culture. The authors welcome suggestions and comments on how to be even more inclusive in future editions.

New Features

This revision includes a range of new features that help Warren/Jones provide students with the context to see how accounting is valuable to their careers and business. These new features include:

- Using Data Analytics
- Take It Further data analytic cases
- Journal entries with T accounts
- Illustration of why accrual accounting is required by GAAP

Data Analytics

Using Data Analytics examples have been added to each chapter, which describe an application of data analytics to each chapter's content.

Using Data Analytics

Sales

Retail businesses, such as **Target Corporation (TGT)**, use data analytics to answer questions such as the following:

- What are our best-selling products?
- What products are generating returns?
- What percent of our customers are using self-checkouts?
- What time of the day do we have the most sales?
- What percent of our customers use credit cards?
- What percent of our customers use debit cards?

Target has used data (predictive) analytics to improve the retail experience of its customers as well as to increase its sales. For example, Target uses data analytics to decide which products should earn shelf space in its brick-and-mortar stores and which are best serviced with its online sales app.

See TIF 5-8 for a homework assignment using data analytics.

Source: Dina Gerdeman, "On Target: Rethinking the Retail Website," *Forbes*, December 4, 2018, www.forbes.com/sites/hbsworkingknowledge/2018/12/04/on-target-rethinking-the-retail-website/#2690a20916fb.

Take It Further Data Analytic Cases

Take It Further data analytic cases have been added to several chapters. These TIF cases use a dataset related to the chapter content that requires a student to analyze and develop reports using Excel and Tableau. The chapters with TIF data analytic cases are as follows:

Chapter 5:	Accounting for Retail Businesses
TIF 5-8	"Sales analysis" (Excel application)
Chapter 6:	Inventories
TIF 6-5	"Out-of-stock items" (Excel application)
Chapter 7:	Internal Control and Cash
TIF 7-6	"Inventory losses and potential controls" (Tableau application)
Chapter 8:	Receivables
TIF 8-6	"Collectability of receivables by customer type" (Excel application)
Chapter 9:	Long-Term Assets: Fixed and Intangible
TIF 9-5	"Equipment maintenance, downtime, and costs" (Excel and Tableau applications)
Chapter 10:	Liabilities: Current, Installment Notes, and Contingencies"
TIF 10-6	"Supplier (vendor) analyses" (Excel application)

The following is the data analytic case for Chapter 5.

USING DATA ANALYTICS

TIF 5-8 Data Analytics: Sales analysis
Michelle Horowitz is the manager of AAAA Office Supplies, a locally owned office supply store for schools and businesses. Michelle is concerned about the large variety of products the store carries, which ties up storage space and working capital. Michelle has asked you to analyze the store's inventory and sales to determine if there are products that may be worth discontinuing.

Michelle has asked you for the following:

1. A list of the quantity of each product sold for a recent month.
2. Recommendations for any products that should be discontinued.

Go to CengageNOWv2 to complete this assignment.

Journal Entries with T Accounts

T accounts with debit and credit postings are included with journal entries throughout *Corporate Financial Accounting, 16e*. The accounting equation and T accounts are shown in a smaller font so that the presentation is still focused on the journal entry. That is, the presentation is designed to subtly reinforce student learning without detracting from a journal entry focus. Examples of this new presentation follow:

Purchase of $9,250 of inventory on account.

Inventory	9,250	
Accounts Payable—Thomas Corporation		9,250
Purchased inventory on account.		

Assets	=	Liabilities	+	Stockholders' Equity
Inventory		Accounts Payable		
9,250 |		| 9,250		

Discarding of fully depreciated equipment.

Accumulated Depreciation—Equipment	4,800	
Loss on Disposal of Equipment	1,200	
Equipment		6,000
To write off equipment discarded.		

Assets		=	Liabilities	+	Stockholders' Equity
Equipment	Accumulated Depreciation				Loss on Disposal of Equipment
| 6,000	4,800 |				1,200 |

Issuance of preferred stock and common stock at par value for cash.

Cash	1,500,000	
Preferred Stock		500,000
Common Stock		1,000,000
Issued preferred stock and common stock at par for cash.		

Assets	=	Liabilities	+	Stockholders' Equity	
Cash				Preferred Stock	Common Stock
1,500,000 |				| 500,000	| 1,000,000

The preceding presentation has the following pedagogical advantages:

- Students can see the impact of the journal entry on the elements of the accounting equation.
- Students can see the impact of the journal entry on the financial statements.
  - The impact on the balance sheet is shown by the accounting equation.
  - The impact on the income statement is shown by revenue and expense T accounts under Stockholders' Equity.
  - The impact on the statement of stockholders' equity is shown by common stock, retained earnings, and dividend T accounts under Stockholders' Equity.
  - The impact on the statement of cash flows is shown by the cash T account under Assets.
- The presentation reinforces the rules of debit and credit.
- The accounting equation is illustrated as the foundation (framework) for all financial accounting systems.
- The presentation is consistent with today's accounting systems where posting to accounts is often done at the same time journal entries are recorded.

Why Accrual Accounting is Required

Why the accrual basis of accounting is required by GAAP has been added to Chapter 4. This section uses the NetSolutions illustrations from Chapters 1–4 as a basis for the following exhibit.

Exhibit 20
Accrual versus Cash Basis of Accounting for NetSolutions

	Accrual Basis of Accounting				
			Increase (Decrease)		Interpretation
	December	November	Amount	Percent	
Revenues	$9,460	$7,500	$1,960	26.1%	NetSolutions is profitable and rapidly expanding.
Expenses	(5,405)	(4,450)	955	21.5%	
Net income (loss)	$4,055	$3,050	1,005	33.0%	

	Cash Basis of Accounting				
			Increase (Decrease)		Interpretation
	December	November	Amount	Percent	
Revenues	$6,980	$7,500	$ (520)	(6.9)%	NetSolutions is in trouble with declining revenues and increasing expenses, which generated a net loss. This suggests that NetSolutions may not be able to continue as a viable company without significant operational changes.
Expenses	(7,915)	(4,600)	3,315	72.1%	
Net income (loss)	$ (935)	$2,900	(3,835)	(132.2)%	

This exhibit illustrates that accrual accounting is required by GAAP because it better matches revenues and expenses and, thus, is a better indicator of a company's profitability.

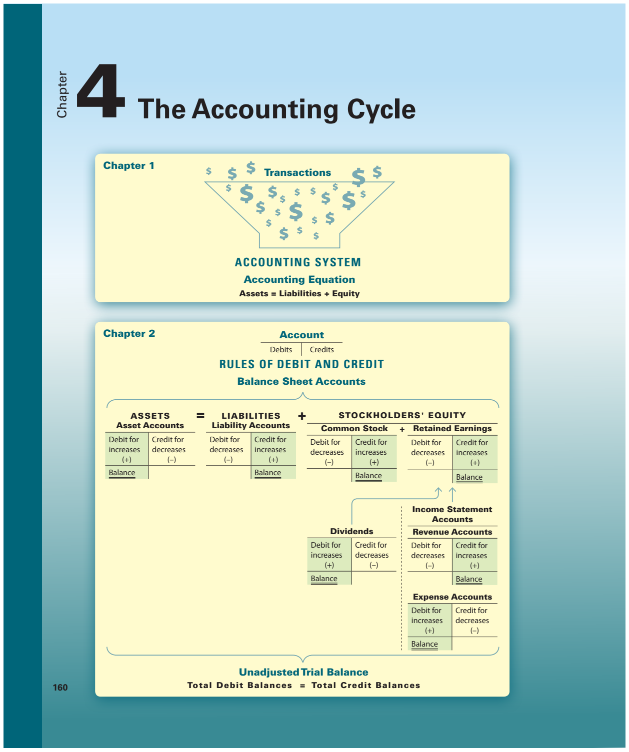
Existing Features

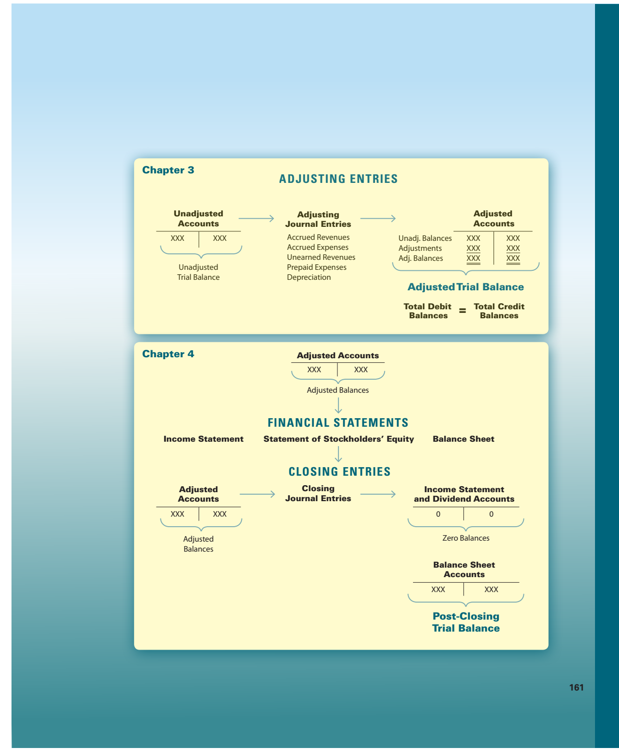
Some existing features from previous editions include:

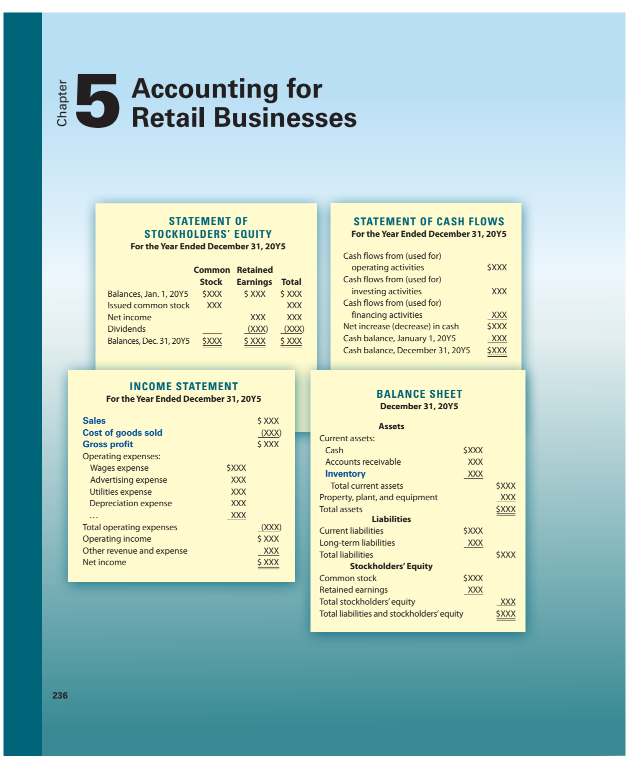
- **Stepwise approach to accounting cycle**
- **Presentation style** designed around the way students learn
- A Schema, or roadmap, at the start of each chapter.
- Links to the Opening Company
- Pathway Challenges
- Check Up Corners
- Analysis for Decision Making
- Make a Decision

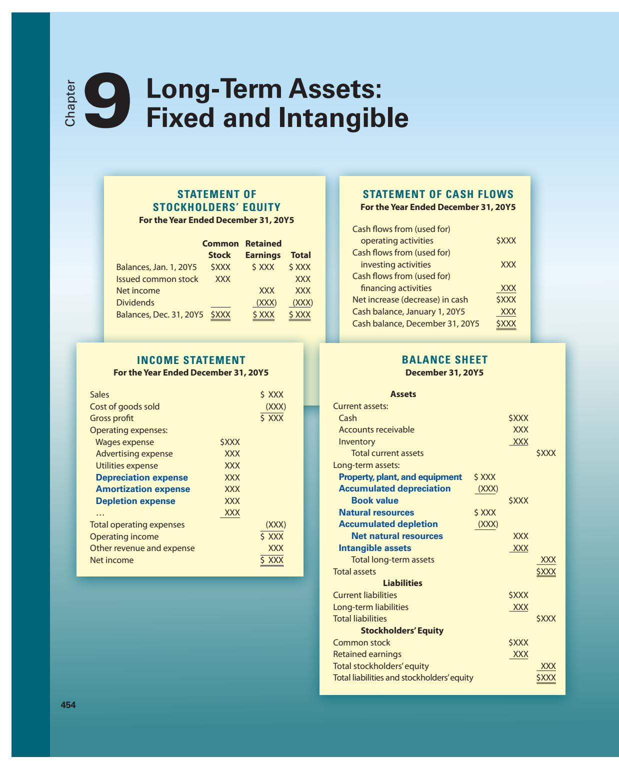
Schema

Each chapter begins with a schema that shows students what they are going to learn and how it is connected to the larger picture. In the early chapters, the schema illustrates how the steps in the accounting cycle are interrelated. In later chapters, the schema shows how each chapter's topics are connected to the financial statements. The following are examples of the schema for Chapters 4, 5, and 9.









Link to Opening Company

Links to the "opening company" of each chapter calls out examples of how the concepts introduced in the chapter are connected to the opening company. This shows how accounting is used in the real world by companies. When a real-world public company is first mentioned, its stock (ticker) symbol is shown in parentheses. Doing so facilitates students' ability to access additional information about the company, including its stock price and website.

Dollar Tree, Inc.

When you are low on cash but need to pick up party supplies, housewares, or other consumer items, where do you go? Many shoppers are turning to **Dollar Tree, Inc. (DLTR)**, a leading operator of discount variety stores with more than 15,000 stores in North America. Its stores operate under the brand names Dollar Tree and Family Dollar. All merchandise is $1 at Dollar Tree stores, while Family Dollar offers merchandise for $10 or less. The stores typically carry more than 7,000 items, consisting of basic, everyday items as well as seasonal, closeout, and promotional items.

The accounting for a retailer, like Dollar Tree, is more complex than for a service company. This is because a service company sells only services and has no inventory. Dollar Tree must design its accounting system to not only record the receipt of goods for resale, but also to keep track of what merchandise is available for sale as well as where the merchandise is located. In addition, Dollar Tree must record the sales and cost of the goods sold for each of its stores. Finally, Dollar Tree must record such data as delivery costs, merchandise discounts, and merchandise returns.

This chapter focuses on the accounting principles and concepts for a retail business. In doing so, the basic differences between retail and service company activities are highlighted. The financial statements of a retail business and accounting for merchandise transactions are also described and illustrated.

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237

On a recent income statement, **Dollar Tree** reported the following (in billions):

Sales	$ 22.8
Cost of goods sold	(15.9)
Gross profit	$ 6.9
Operating expenses	(7.9)
Operating income (loss)	$ (1.0)

On its balance sheet, it reported inventory of $3.5 billion.

Link to Dollar Tree

Dollar Tree normally receives cash from credit card sales within three business days, and thus records credit card sales as cash sales.

Link to Dollar Tree

Link to Dollar Tree

Although all sales are final, **Dollar Tree** will "exchange" any unopened item with the original receipt.

Pathways Challenges

Pathways Challenge encourages students' interest in accounting and emphasizes the critical thinking aspect of accounting. A suggested answer to the Pathways Challenge is provided at the end of the chapter.

Pathways Challenge

This is Accounting!

Economic Activity

Verizon Communications Inc. (VZ) is the largest wireless service provider in the United States with over 114 million retail subscribers. To deliver its products and services, Verizon must have access to spectrum—the radio frequencies that carry sound, data, and video to wireless devices. However, spectrum is a limited resource that the Federal Communications Commission (FCC) licenses to businesses for a period of 10 years, subject to renewal. In a recent year, Verizon acquired almost $10 billion in wireless licenses.

Critical Thinking/Judgment

How should Verizon account for its acquisition of wireless licenses?
What is the useful life of a wireless license?
Should Verizon expense (amortize) the cost of its wireless licenses?

Suggested answer at end of chapter.

Pathways Challenge

This is Accounting!

Information/Consequences

Because a wireless license does not exist physically, **Verizon**'s **(VZ)** wireless licenses are intangible assets. All of the costs of acquiring a wireless license should be recorded as an asset. In a recent year, Verizon reported almost $87 billion of wireless licenses, representing 35% of its total assets.

Even though the FCC license is granted for a 10-year period, Verizon considers this license to have an indefinite useful life. This is because the license is subject to renewal at a low cost and, historically, the FCC has renewed Verizon's licenses.

Verizon does not expense (amortize) the cost of its wireless licenses. Instead, the licenses are reviewed for any impaired value.

Suggested Answer

Check Up Corners

Throughout each chapter, **Check Up Corners** provide students with step-by-step guidance on how to solve problems. Problem-solving tips help students avoid common errors.

Check Up Corner 9-2 Selling Fixed Assets

On the first day of the year, Firefall Company purchased equipment at a cost of $340,000. The equipment was expected to have a useful life of four years, a residual value of $20,000, and is depreciated at a straight-line rate of 25%. Firefall sold the equipment at the beginning of the fourth year when the balance in the accumulated depreciation account was $240,000. Journalize the entry to record the sale if the equipment was sold for:

a. $95,000

b. $105,000

Solution:

a. Equipment sold for $95,000:

Cash	95,000	
Accumulated Depreciation—Equipment	240,000	
Loss on Sale of Equipment	5,000	
Equipment		340,000

Selling Price – Book Value =
$95,000 – $100,000

Accumulated Depreciation at the End of Year 3

b. Equipment sold for $105,000:

Cash	105,000	
Accumulated Depreciation—Equipment	240,000	
Equipment		340,000
Gain on Sale of Equipment		5,000

Selling Price – Book Value =
$105,000 – $100,000

Check Up Corner

Analysis for Decision Making

Analysis for Decision Making highlights how businesses use accounting information to make decisions and evaluate the health of a business. This provides students with context of why accounting is important to a business.

Analysis for Decision Making

Fixed Asset Turnover Ratio

Objective 7
Describe and illustrate the fixed asset turnover ratio to assess the efficiency of a company's use of its fixed assets.

The **fixed asset turnover ratio** measures the number of sales dollars earned per dollar of fixed assets. The higher the ratio, the more efficiently a company is using its fixed assets in generating sales. The ratio is computed as follows:

$$\text{Fixed Asset Turnover Ratio} = \frac{\text{Sales}}{\text{Average Book Value of Fixed Assets}}$$

To illustrate, the following data (in millions) were taken from a recent financial statement of **McDonald's Corporation (MCD)**:

Sales	$21,076.5
Fixed assets (net):	
Beginning of year	22,842.7
End of year	24.160.0

McDonald's fixed asset turnover ratio for the year is computed as follows (rounded to one decimal place):

$$\begin{aligned}\text{Fixed Asset Turnover Ratio} &= \frac{\text{Sales}}{\text{Average Book Value of Fixed Assets}}\\ &= \frac{\$21{,}076.5}{(\$22{,}842.7 + \$24{,}160.0) \div 2}\\ &= \frac{\$21{,}076.5}{\$23{,}501.4} = 0.9\end{aligned}$$

Is 0.9 efficient? To answer this question, McDonald's fixed asset turnover ratio can be compared to other quick-service restaurant companies, as shown in Exhibit 13. **Yum! Brands (YUM)** operates KFC, Pizza Hut, and Taco Bell quick-service restaurants. The other restaurants are likely familiar by name.

Make a Decision

Make a Decision in the end-of-chapter material gives students a chance to analyze and compare real companies.

Make a Decision
Fixed Asset Turnover Ratio

MAD 9-1 Analyze and compare Amazon.com and Netflix **Obj. 7**

Amazon.com, Inc. (AMZN) is the world's leading Internet retailer of merchandise and media. Amazon also designs and sells electronic products, such as e-readers. **Netflix, Inc. (NFLX)** is one of the world's leading Internet television networks. Both companies compete in the digital media and streaming space. However, Netflix is more narrowly focused in the digital streaming business than is Amazon.

Sales and average book value of fixed assets information (in millions) are provided for Amazon and Netflix for a recent year as follows:

	Amazon.com	Netflix
Sales	$177,866	$20,156
Average book value of fixed assets	67,251	492

a. Compute the fixed asset turnover ratio for each company. Round to one decimal place.
b. Which company is more efficient in generating sales from fixed assets?
c. Interpret your results.

MAD 9-2 Analyze and compare Alaska Air, Delta Air Lines, and Southwest Airlines **Obj. 7**

Alaska Air Group (ALK), **Delta Air Lines (DAL)**, and **Southwest Airlines (LUV)** reported the following financial information (in millions) in a recent year:

	Alaska Air Group	Delta Air Lines	Southwest Airlines
Sales	$8,781	$47,007	$22,428
Average book value of fixed assets	6,842	29,823	18,275

a. Determine the fixed asset turnover ratio for each airline. Round to one decimal place.
b. Based on the fixed asset turnover ratio, which airline appears to be the most efficient in the use of its fixed assets?
c. The most important fixed asset to an airline is the aircraft. Given this, what factors might influence the efficient use of fixed assets for an airline?

Student Learning Aids

This edition includes a variety of student learning aids in addition to the Check Up Corners, including the following:

- At the end of each chapter, **Let's Review** is a new chapter summary and self-assessment feature that is designed to help busy students prepare for an exam. It includes a summary of each learning objective's key points, key terms, multiple-choice questions, exercises, and a sample problem that students may use to practice.
- Sample multiple-choice questions allow students to practice with the type of assessments they are likely to see on an exam.
- Short exercises and a longer problem allow students to apply their knowledge.
- **Answers** provided at the end of the Let's Review section let students check their knowledge immediately.

Instructor and Student Resources

Additional instructor and student resources for this product are available online. Instructor assets include an Educator's Guide, PowerPoint® slides, and a test bank powered by Cognero®. Student assets include data sets and online appendices. Sign up or sign in at www.cengage.com to search for and access this product and its online resources.

New Appendixes

Two new end-of-text appendixes have been added to this edition.

Appendix B: Selected Topics. This appendix allows instructors the flexibility to cover a variety of topics that might be relevant to their students. The topics include the following:

Topic 1: Investments
Topic 2: Foreign Currency Transactions
Topic 3: Corporate Taxes
Topic 4: Reporting Unusual Items and Comprehensive Income
Topic 5: Revenue Recognition
Topic 6: International Accounting Standards

Each topic is designed as a self-contained learning module with its own assignment materials. The modules have been written so that instructors have the flexibility of covering one or more of the modules at a variety of different places in their course depending upon their students' needs.

Appendix C: Nike Annual Report (10-K). This appendix includes excerpts from a recent Nike annual report (10-K). New to this appendix are student assignments for each chapter. An instructor could use all of the chapter assignments as an "annual report" project. The annual report assignments are referenced at the end of each chapter following the Take It Further section.

Chapter Changes and Improvements

The following chapter changes and improvements have been made in this edition:

Chapter 1

- Why It Matters boxes from prior edition have been relabeled as Business Insight boxes.
- New section on Business Activities has been added, including a related exhibit.
- Exhibit 3 has been updated with new and more current examples of accounting and business frauds.
- New Business Insight box on "Business Strategies" has been added.
- Exhibit 11 is new and illustrates the interrelationships of the financial statements with the balance sheet as the connecting link.

Chapter 3

- The opening company has been changed from Pandora Media, Inc., which is now a subsidiary of Sirius XM, to Netflix, Inc.
- The chapter Links have been changed to relate to Netflix.

Chapter 4

- The discussion of NetSolutons' financial statements has been changed to include a brief discussion of the statement of cash flows, which is shown in a new appendix to the chapter. This provides instructors the flexibility to cover all four of NetSolutions' financial statements if they choose to do so.
- A new section and learning objective have been added to the end of the chapter on why the accrual basis of accounting is required by GAAP.
- The appendix on reversing entries has been moved to an online appendix.

Chapter 5

- The discussion of the Nature of Retail Businesses has been changed to reference business-to-business (B2B) and business-to-customer (B2C) transactions.
- The accounting for purchase discounts has been changed to use the gross method of accounting for purchase discounts.
- The accounting for sales to customers using debit cards has been added to this edition.
- The accounting for sales coupons and rebates has been added to the chapter. This discussion replaces the prior edition's discussion of the accounting for sales discounts, which has been moved to an end-of-chapter appendix.
- The end-of-chapter Appendix 1 illustrates the accounting for sales discounts for gross and net methods. This discussion has been simplified so that adjusting entries are not required.
- The discussion of sales returns, refunds, and allowances has been revised so that the end-of-period adjusting entry is illustrated before examples illustrating customer returns, refunds, and allowances.
- A new exhibit (Exhibit 7) has been added that summarizes the journal entries for customer sales returns, refunds, and allowances.

Chapter 6

- New Business Insight box on radio frequency identification (RFID) has been added.
- Revised section on the effect of inventory errors on financial statements.

Chapter 7

- Updated Ethics in Action box on employee fraud.
- Updated Business Insight box to include remote deposits.

Chapter 8

- Updated discussion of the allowance method for uncollectible accounts to reflect the new standard on current expected credit losses.

Chapter 10

- Updated W-4 Form to reflect recent changes.

Chapter 12

- New exhibit on the effects of dividends and stock splits has been added.

Chapter 14

- The opening company has been changed from Nike to The Walt Disney Company.
- Appendix on the reporting of unusual items was moved to Appendix B: Special Topics.
- Appendix on the concepts of fair value and comprehensive income was moved to Appendix B: Special Topics.

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CengageNOWv2 is a powerful course management and online homework resource that provides control and customization to optimize the student learning experience. Included are many proven resources, such as algorithmic activities, a test bank, course management tools, reporting and assessment options, and much more.

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The *Cengage Mobile App* lets students study wherever and whenever the mood strikes. Now available with *CengageNOWv2,* it features a full interactive eBook—readable online or off—with 24/7 course access and study tools to power on-the-go learning. Plus, the app allows you to engage your students with instant in-class polling and take attendance with a tap. Find details at **www.cengage.com/mobile-app/**.

EXCEL ONLINE

Excel Online

Cengage and Microsoft have partnered in CengageNOWv2 to provide students with a uniform, authentic Excel experience. It provides instant feedback, built-in video tips, and easily accessible spreadsheet work. These features allow you to spend more time teaching accounting applications and less time troubleshooting Excel.

These new algorithmic activities offer pre-populated data directly in Microsoft Excel Online. Each student receives his or her own version of the problem to perform the necessary data calculations in Excel Online. Their work is constantly saved in Cengage cloud storage as a part of homework assignments in CengageNOWv2. It's easily retrievable so students can review their answers without cumbersome file management and numerous downloads/uploads.

MindTap eReader

The MindTap eReader for Warren/Jones *Corporate Financial Accounting* is the most robust digital reading experience available. Hallmark features include:

- Fully optimized for the iPad.
- Note taking, highlighting, and more.
- Embedded digital media.
- The MindTap eReader also features ReadSpeaker®, an online text-to-speech application that vocalizes, or "speech-enables," online educational content. This feature is ideally suited for both instructors and learners who would like to listen to content instead of (or in addition to) reading it.

About the Authors

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Carl S. Warren

Dr. Carl S. Warren is Professor Emeritus of Accounting at the University of Georgia, Athens. Dr. Warren has taught classes at the University of Georgia, University of Iowa, Michigan State University, and University of Chicago. He has focused his teaching efforts on principles of accounting and auditing. Dr. Warren received his PhD from Michigan State University and his BBA and MA from the University of Iowa. During his career, Dr. Warren published numerous articles in professional journals, including *The Accounting Review, Journal of Accounting Research, Journal of Accountancy, The CPA Journal*, and *Auditing: A Journal of Practice and Theory*. Dr. Warren has served on numerous committees of the American Accounting Association, the American Institute of Certified Public Accountants, and the Institute of Internal Auditors. He has consulted with numerous companies and public accounting firms. His outside interests include handball, golfing, skiing, backpacking, motorcycling, and fly-fishing. He also enjoys interacting with his five grandchildren, Bella and Mila (twins), Jeremy, and Brooke and Robbie (twins).

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Jefferson P. Jones

Dr. Jefferson P. Jones is an Associate Professor of Accounting in the School of Accountancy at Auburn University where he teaches financial accounting and applied financial research. He received his Bachelor's in Accounting and Master of Accountancy degrees from Auburn University and his PhD from Florida State University. Dr. Jones has received numerous teaching awards, including the Auburn University Beta Alpha Psi Outstanding Teaching Award (eight times); the Auburn University Outstanding Master of Accountancy Professor Teaching Award (five times); the Auburn University Outstanding Distance Master of Accountancy Teaching Award (three times); and the Auburn University College of Business McCartney Teaching Award. In addition, he has made numerous presentations around the country on research and pedagogical issues. Dr. Jones has public accounting experience as an auditor with Deloitte and Touche, holds a CPA certificate in the state of Alabama (inactive), and is a member of the American Accounting Association, the American Institute of Certified Public Accountants (AICPA), and the Alabama Society of CPAs (ASCPA). His research interests focus on financial accounting, specifically investigating the quality of reported accounting information, and accounting education. He has published articles in numerous journals, including *Advances in Accounting*, *Review of Quantitative Finance and Accounting*, *Issues in Accounting Education*, *International Journal of Forecasting*, and *The CPA Journal*. When not at work, Dr. Jones enjoys playing golf and watching college football.

Brief Contents

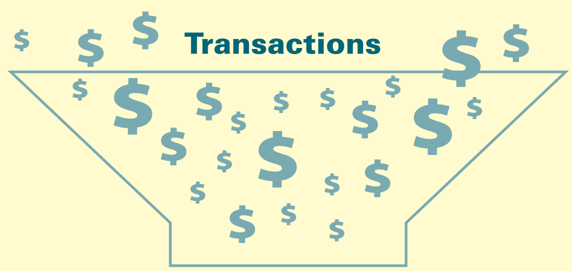
Contents

Corporate Financial Accounting 16e

Chapter

1 Introduction to Accounting and Business

Chapter 1



ACCOUNTING SYSTEM

Accounting Equation

Assets = Liabilities + Equity

Chapter 2

ANALYZING TRANSACTIONS

Chapter 3

THE ADJUSTING PROCESS

Chapter 4

THE ACCOUNTING CYCLE

Twitter, Inc.

When two teams pair up for a game of football, there is often a lot of noise. The band plays, the fans cheer, and fireworks light up the scoreboard. Obviously, the fans are committed and care about the outcome of the game. Just like fans at a football game, the owners of a business want their business to "win" against their competitors in the marketplace. While having your football team win can be a source of pride, winning in the marketplace goes beyond pride and has many tangible benefits. Companies that are winners are better able to serve customers, provide good jobs for employees, and make money for their owners.

Twitter, Inc. (TWTR) is one of the most visible companies on the Internet. It provides a real-time information network where members can post messages, called tweets, for free. Millions post tweets every day throughout the world.

Do you think Twitter is a successful company? Does it make money? How would you know? Accounting helps to answer these questions.

This textbook introduces you to accounting, the language of business. Chapter 1 begins by discussing what a business is, how it operates, and the role that accounting plays.

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Link to Twitter .... Pages 4, 6, 7, 8, 12, 13, 15, 23, 25

Analysis for Decision Making .... Page 29

What's Covered

Introduction to Accounting and Business

Nature of Business
- Types of Business (Obj. 1)
- Role of Accounting (Obj. 1)
- Ethics (Obj. 1)

Nature of Accounting
- Managerial and Financial Accounting (Obj. 1)
- Career Opportunities (Obj. 1)

Analyzing Business Transactions
- Generally Accepted Accounting Principles (Obj. 2)
- Accounting Equation (Obj. 3)
- Transactions (Obj. 4)

Financial Statements
- Income Statement (Obj. 5)
- Statement of Stockholders' Equity (Obj. 5)
- Balance Sheet (Obj. 5)
- Statement of Cash Flows (Obj. 5)

Learning Objectives

Obj. 1 Describe the nature of business and the role of accounting and ethics in business.

Obj. 2 Describe generally accepted accounting principles, including the underlying assumptions and principles.

Obj. 3 State the accounting equation and define each element of the equation.

Obj. 4 Describe and illustrate how business transactions can be recorded in terms of the resulting change in the elements of the accounting equation.

Obj. 5 Describe the financial statements of a corporation and explain how they interrelate.

Analysis for Decision Making

Obj. 6 Describe and illustrate the use of the ratio of liabilities to stockholders' equity in evaluating a company's financial condition.

Objective 1
Describe the nature of business and the role of accounting and ethics in business.

Nature of Business and Accounting

A **business**[1] is an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers. Businesses come in all sizes, from a local coffee house to **Starbucks (SBUX)**, which sells over $15 billion of coffee and related products each year.

The objective of most businesses is to earn a **profit**. Profit is the difference between the amounts received from customers for goods or services and the amounts paid for the inputs used to provide the goods or services. This text focuses on businesses operating to earn a profit. However, many of the same concepts and principles also apply to not-for-profit organizations such as hospitals, churches, and government agencies.

Types of Businesses

Three types of businesses operating for profit include service, retail, and manufacturing businesses. Some examples of each type of business follow:

- **Service businesses** provide services rather than products to customers.
  - **Delta Air Lines (DAL)** (transportation services)
  - **The Walt Disney Company (DIS)** (entertainment services)
- **Retail businesses** sell products they purchase from other businesses to customers.
  - **Walmart Inc. (WMT)** (general merchandise)
  - **Target Corporation (TGT)** (general merchandise)
- **Manufacturing businesses** change basic inputs into products that are sold to customers.
  - **Ford Motor Company (F)** (cars, trucks, vans)
  - **Merck & Co., Inc. (MRK)** (pharmaceutical drugs)

Link to Twitter **Twitter** is a service company that provides a platform for individuals to send text messages called tweets.

[1] A complete glossary of terms appears at the end of the text.

Business Activities

Businesses engage in the following three types of activities:

- Operating activities
- Investing activities
- Financing activities

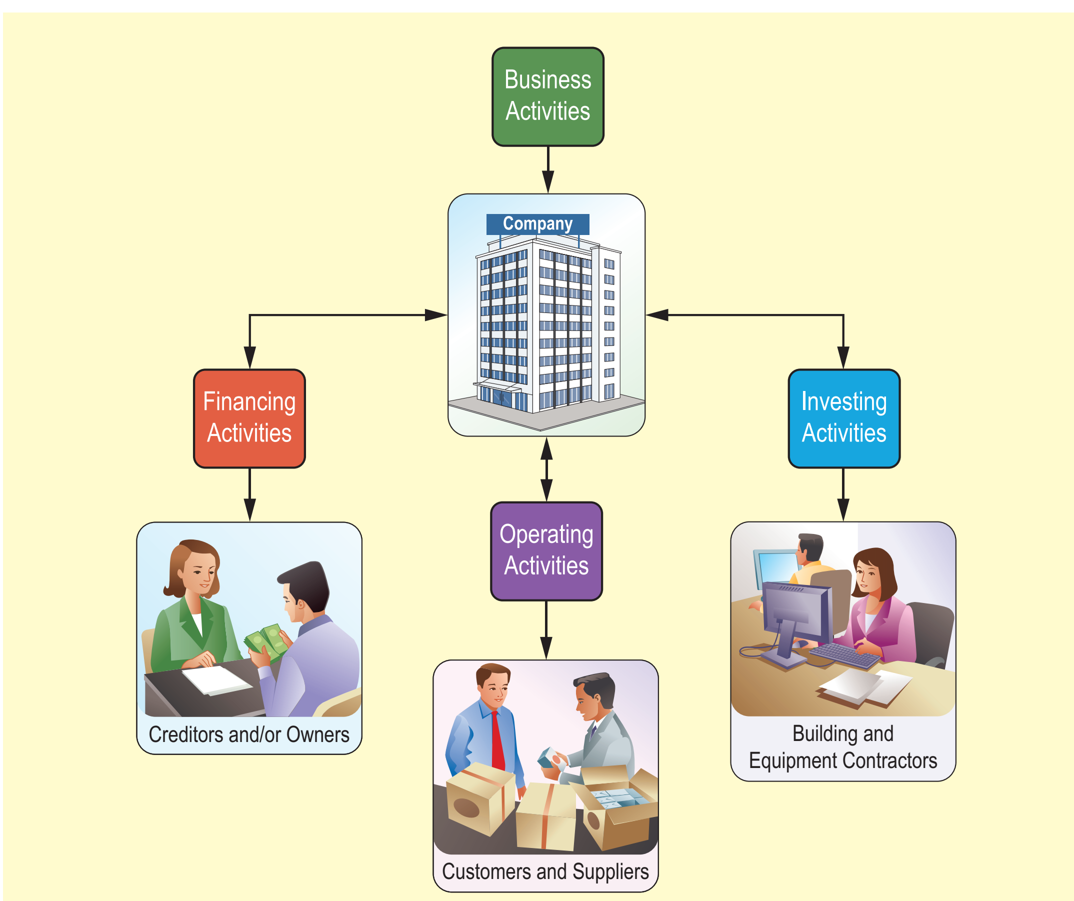
Operating activities are those activities by which the company generates revenues from customers. Operating activities include producing, marketing, and distributing a product or service to customers. For example, operating activities of **Dell Technologies Inc. (DVMT)** include product development, acquiring component parts, assembly, marketing, and distribution of its products.

Investing activities are those activities by which a company acquires long-term assets for use in the operating activities of the company. For example, the acquisition by **Delta Air Lines, Inc. (DAL)** of Boeing 787 and Airbus 321 airplanes is an investing activity. Likewise, the purchase of land and the construction of buildings to use for training, maintenance, flight monitoring, and corporate offices are investing activities.

Financing activities include activities by which the company obtains funds to start and operate the company. Funds are normally obtained from creditors and owners. For example, companies can obtain funds by issuing stock to the public. The payments to creditors and owners are also classified as financing activities.

The preceding business activities are summarized in Exhibit 1.

Exhibit 1
Business Activities



Role of Accounting in Business

The role of accounting in business is to provide information for managers to use in operating the business. In addition, accounting provides information to other users in assessing the economic performance and condition of the business.

note:
Accounting is an information system that provides reports to users about the economic activities and condition of a business.

Thus, **accounting** can be defined as an information system that provides reports to users about the economic activities and condition of a business. You could think of accounting as the "language of business." This is because accounting is the means by which businesses' financial information is communicated to users.

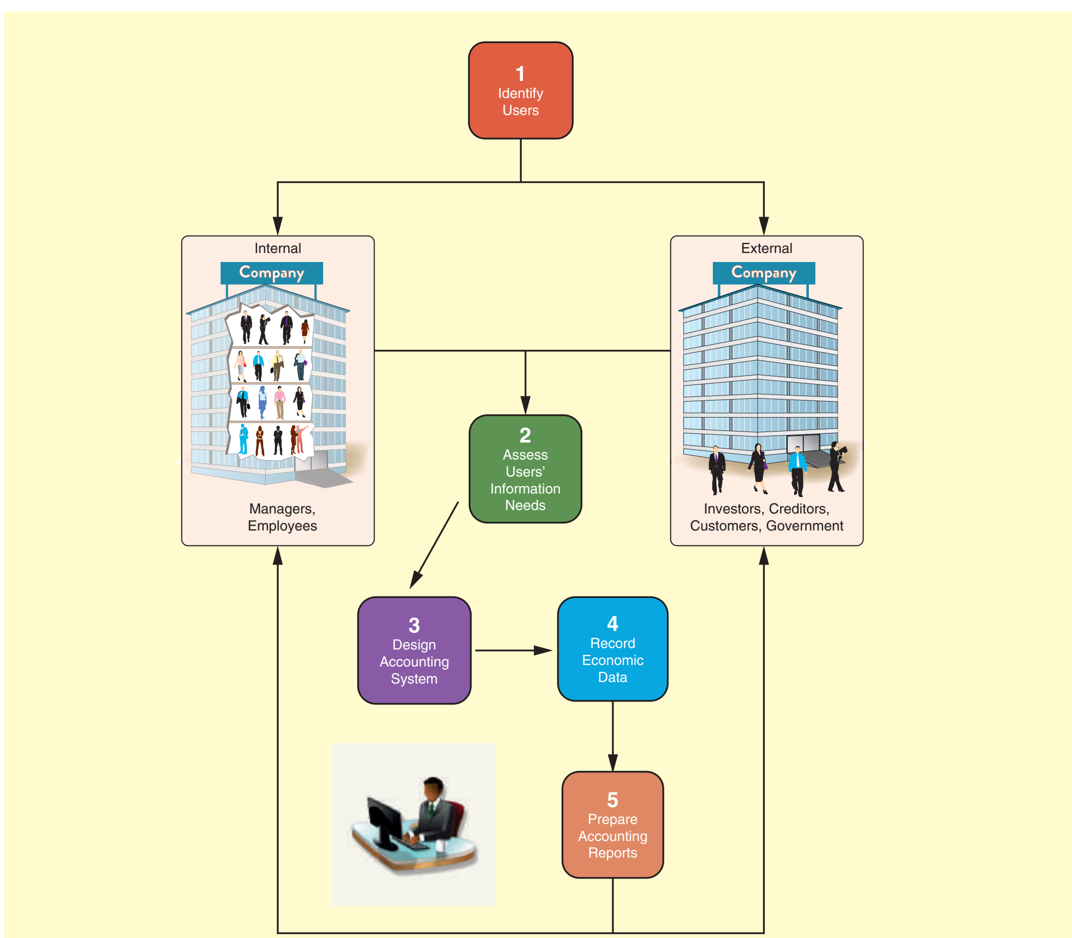
Link to Twitter **Twitter** communicates to investors in an annual report that includes accounting information.

The process by which accounting provides information to users is as follows:

1. Identify users.
2. Assess users' information needs.
3. Design the accounting information system to meet users' needs.
4. Record economic data about business activities and events.
5. Prepare accounting reports for users.

As illustrated in Exhibit 2, users of accounting information can be divided into two groups: internal users and external users.

Exhibit 2
Accounting as an Information System



Managerial Accounting Internal users of accounting information include managers and employees. These users are directly involved in managing and operating the business. The area of accounting that provides internal users with information is called **managerial accounting**, or **management accounting**.

The objective of managerial accounting is to provide relevant and timely information for managers' and employees' decision-making needs. Often, such information is sensitive and is not distributed outside the business. Examples of sensitive information might include information about customers, prices, and plans to expand the business. Managerial accountants employed by a business are employed in **private accounting**.

Financial Accounting External users of accounting information include investors, creditors, customers, and the government. These users are not directly involved in managing and operating the business. The area of accounting that provides external users with information is called **financial accounting**.

The objective of financial accounting is to provide relevant and timely information for the decision-making needs of users outside of the business. For example, financial reports on the operations and condition of the business are useful for banks and other creditors in deciding whether to lend money to the business. **General-purpose financial statements** are one type of financial accounting report that is distributed to external users. The term *general-purpose* refers to the wide range of decision-making needs that these reports are designed to serve. Later in this chapter, general-purpose financial statements are described and illustrated.

Twitter uses financial accounting to prepare and distribute general-purpose financial statements. *Link to Twitter*

Role of Ethics in Accounting and Business

ETHICS

The objective of accounting is to provide relevant, timely information for user decision making. Accountants must behave in an ethical manner so that the information they provide users will be trustworthy and, thus, useful for decision making. Managers and employees must also behave in an ethical manner in managing and operating a business. Otherwise, no one will be willing to invest in or loan money to the business.

Ethics are moral principles that guide the conduct of individuals. Unfortunately, business managers and accountants sometimes behave in an unethical manner. Many of the managers of the companies listed in Exhibit 3 engaged in accounting or business fraud. These ethical violations led to fines, firings, and lawsuits. In some cases, managers were criminally prosecuted, convicted, and sent to prison.

Business Insight

Business Strategies

Businesses normally use a (1) product-differentiation or (2) low-cost strategy to gain a competitive advantage and maximize their profits.

Using a product-differentiation strategy, a company distinguishes its product(s) in such a way that it is desirable to customers and uniquely different from its competitor's. Using this strategy, a company tries to win over customers to its product(s) and establish customer loyalty. If successful, the company can charge premium prices for its products. For example, **Apple Inc. (AAPL)** uses a product-differentiation strategy in developing and marketing its products.

Using a low-cost strategy, a company offers product(s) to customers at a lower cost (price) than its competitors. The low-cost strategy is normally used for products that are uniform in nature, and thus the company cannot use a product-differentiation strategy. For example, **Southwest Airlines Co. (LUV)** uses a low-cost strategy in providing airline services to passengers.

Risks of a product-differentiation strategy are that customers may not value the uniqueness of the company's product, competitors may duplicate the product's uniqueness, or that competitors may develop even more desirable attributes for their products. Risks of the low-cost strategy are that competitors may duplicate the company's low-cost processes or that competitors may develop new processes for achieving even lower costs.

Exhibit 3 Accounting and Business Frauds

Company	Nature of Accounting or Business Fraud	Result
Countrywide	CEO misled investors.	CEO paid $22.5 million penalty and was permanently banned from serving as an officer or director of a public company.
Enron	Fraudulently inflated its financial results.	Bankruptcy. Senior executives criminally convicted. More than $60 billion in stock market losses.
Goldman Sachs	Misstated and omitted key facts from investors.	Company agreed to pay $550 million fine and reformed business practices.
Wells Fargo	Improperly opened customer accounts without their permission.	CEO fined $17.5 million and banned from banking industry for life.
Xerox Corporation	Recognized $3 billion in sales prior to when it should have been recorded.	$10 million fine to SEC. Six executives forced to pay $22 million.

What went wrong for the managers and companies listed in Exhibit 3? The answer normally involved one or both of the following two factors:

- **Failure of Individual Character:** Ethical managers and accountants are honest and fair. However, managers and accountants often face pressures from supervisors to meet company and investor expectations. In many of the cases in Exhibit 3, managers and accountants justified small ethical violations to avoid such pressures. However, these small violations became big violations as the company's financial problems became worse.
- **Culture of Greed and Ethical Indifference:** By their behavior and attitude, senior managers set the company culture. In most of the companies listed in Exhibit 3, the senior managers created a culture of greed and indifference to the truth.

As a result of the accounting and business frauds shown in Exhibit 3, Congress passed laws to monitor the behavior of accounting and business. For example, the **Sarbanes-Oxley Act (SOX)** was enacted. SOX established a new oversight body for the accounting profession called the **Public Company Accounting Oversight Board (PCAOB)**. In addition, SOX established standards for independence, corporate responsibility, and disclosure.

How does one behave ethically when faced with financial or other types of pressure? Guidelines for behaving ethically follow:[2]

1. Identify an ethical decision by using your personal ethical standards of honesty and fairness.
2. Identify the consequences of the decision and its effect on others.
3. Consider your obligations and responsibilities to those who will be affected by your decision.
4. Make a decision that is ethical and fair to those affected by it.

Link to Twitter **Twitter**'s "Code of Business Conduct and Ethics" can be found at https://investor.twitterinc.com/corporate-governance.cfm.

Opportunities for Accountants

Numerous career opportunities are available for students majoring in accounting. Currently, the demand for accountants exceeds the number of new graduates entering the job market. This is

[2] Many companies have ethical standards of conduct for managers and employees. In addition, the Institute of Management Accountants and the American Institute of Certified Public Accountants have professional codes of conduct, which can be obtained from their websites at www.imanet.org and www.aicpa.org, respectively.

partly due to the increased regulation of business caused by the accounting and business frauds shown in Exhibit 3. Also, more and more businesses have come to recognize the importance and value of accounting information.

As indicated earlier, accountants employed by a business are employed in private accounting. Private accountants have a variety of possible career options within a company. Some of these career options are shown in Exhibit 4 along with their starting salaries. As shown in Exhibit 4, several private accounting careers have certification options. Accountants who provide audit services, called *auditors*, verify the accuracy of financial records, accounts, and systems.

Exhibit 4 Accounting Career Paths and Salaries

Accounting Career Track	Description	Career Options	Annual Starting Salaries*	Certification
Private Accounting	Accountants employed by companies, government, and not-for-profit entities.	Bookkeeper	$40,000	
		Payroll clerk	$40,000	Certified Payroll Professional (CPP)
		General accountant	$49,000	
		Budget analyst	$53,000	
		Cost accountant	$65,000	Certified Management Accountant (CMA)
		Internal auditor	$48,000	Certified Internal Auditor (CIA)
		Information technology auditor	$53,000	Certified Information Systems Auditor (CISA)
Public Accounting	Accountants employed individually or within a public accounting firm in audit and tax services.		$49,000	Certified Public Accountant (CPA)

*Average salaries rounded to the nearest thousand. Salaries may vary by size of company and region.
Source: Robert Half *2020 U.S. Salary Guide (Finance and Accounting)*, Robert Half International, Inc. (RHI) (https://www.roberthalf.com/salary-guide/accounting-and-finance).

Accountants and their staff who provide services on a fee basis are said to be employed in **public accounting**. In public accounting, an accountant may practice as an individual or as a member of a public accounting firm. Public accountants who have met a state's education, experience, and examination requirements may become **Certified Public Accountants (CPAs)**. CPAs typically perform general accounting, audit, or tax services. CPAs often have slightly better starting salaries than private accountants. Career statistics indicate, however, that these salary differences tend to disappear over time. The American Institute of Certified Public Accountants (AICPA) provides information and resources for students interested in accounting at www.startheregoplaces.com.

Ethics in Action

Bernie Madoff

Bernard L. "Bernie" Madoff was sentenced to 150 years in prison for defrauding thousands of investors in one of the biggest frauds in American history. Madoff's fraud started several decades earlier when he began a "Ponzi scheme" in his investment management firm, Bernard L. Madoff Investment Securities LLC.

In a Ponzi scheme, the investment manager uses funds received from new investors to pay a return to existing investors, rather than basing returns on the investments' actual performance. As long as the investment manager is able to attract new investors, he or she will have new funds to pay existing investors and continue the fraud. While most Ponzi schemes collapse quickly when the investment manager runs out of new investors, Madoff's reputation, popularity, and personal contacts provided a steady stream of investors, which allowed the fraud to survive for decades.