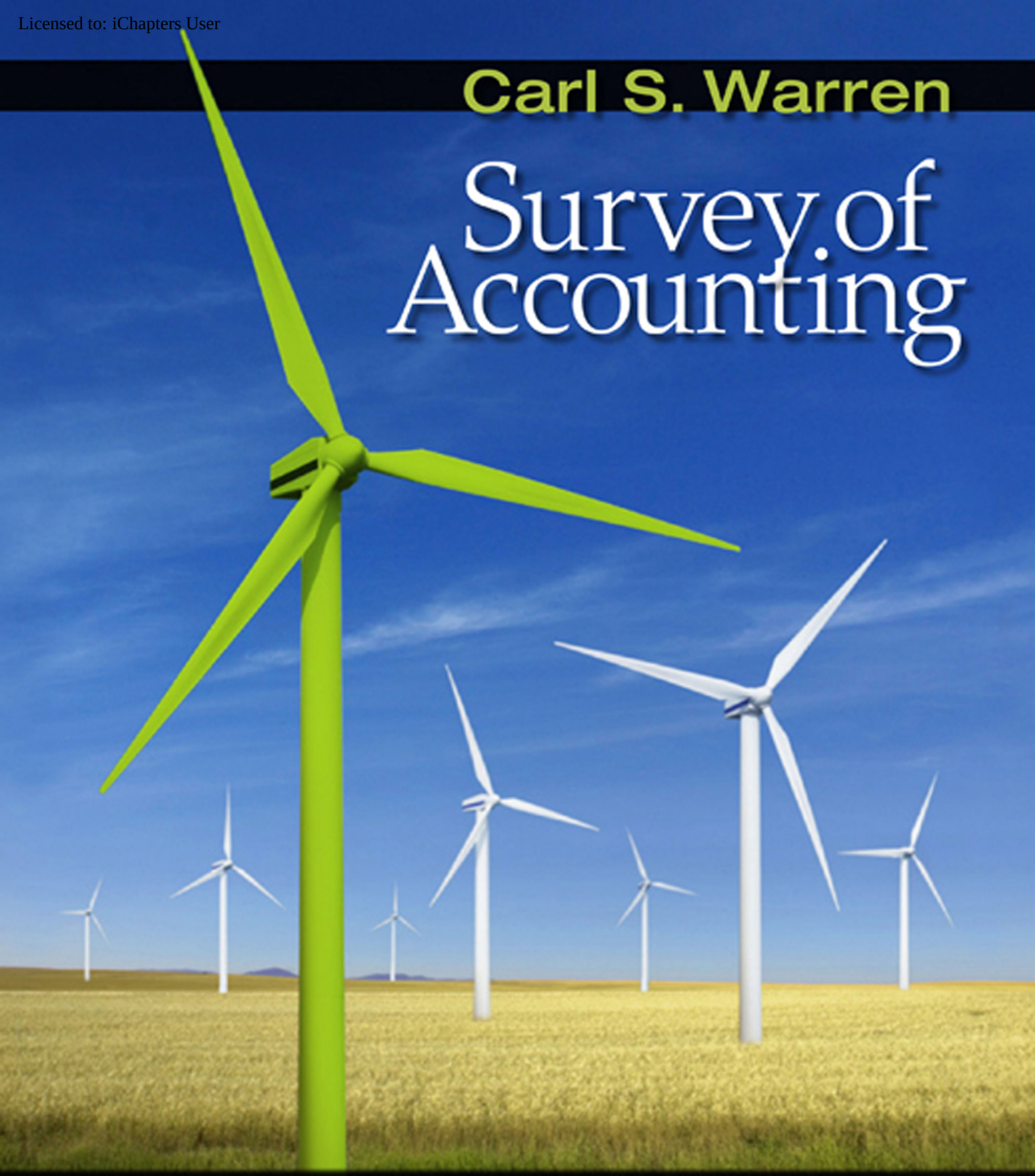
Carl S. Warren

Survey of Accounting



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Survey of Accounting, Fourth Edition
Carl S. Warren

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CHAPTER 1

The Role of Accounting in Business

Learning Objectives

After studying this chapter, you should be able to:

Obj 1
Describe the types and forms of businesses, how businesses make money, and business stakeholders.

Obj 2
Describe the three business activities of financing, investing, and operating.

Obj 3
Define accounting and describe its role in business.

Obj 4
Describe and illustrate the basic financial statements and how they interrelate.

Obj 5
Describe eight accounting concepts underlying financial reporting.

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. Although having our 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 more money for the owners.

An example of such a successful company is the ***The Hershey Company***, founded by Milton Hershey in the early 1900s. The Hershey Company is America's leading chocolate manufacturer, producing more than a billion pounds of chocolate products each year. In addition to Hershey chocolate bars, the company sells candy under such brands as Reese's, Twizzlers®, York®, Almond Joy®, and Kit Kat®.

As we begin our study of accounting in this chapter, we will first discuss the nature, types, and activities of businesses, such as Hershey's. In doing so, we describe business stakeholders, such as the owners, customers, and employees. We conclude the chapter by discussing the role of accounting in business, including financial statements, basic accounting concepts, and how to use financial statements to evaluate a business's performance.

Obj 1

Describe the types and forms of businesses, how businesses make money, and business stakeholders.

The Nature of Business

You are familiar with many large companies, such as ***General Motors***, ***Barnes & Noble***, and ***AT&T***. You are also familiar with many local businesses, such as gas stations, grocery stores, and restaurants. You may work for one of these businesses. But what do they have in common that identifies them as businesses?

In general, a **business** 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.[1] Businesses come in all sizes, from a local coffeehouse to General Motors, which sells several billion dollars worth of cars and trucks each year. The customers of a business are individuals or other businesses who purchase goods or services in exchange for money or other items of value. In contrast, a church is not a business because those who receive its services are not obligated to pay for them.

The objective of most businesses is to maximize profits by providing goods or services that meet customer needs. Profit is the difference between the amount received from customers for goods or services provided and the amount paid for the inputs used to provide the goods or services. Some businesses operate with an objective other than to maximize profits. The objective of such not-for-profit businesses is to provide some benefit to society, such as medical research or conservation of natural resources. In other cases, governmental units such as cities operate water works or sewage treatment plants on a not-for-profit basis. Our focus in this text will be on businesses operated to earn a profit. However, many of the concepts and principles also apply to not-for-profit businesses.

Types of Businesses

There are three different types of businesses that are operated for profit: manufacturing, merchandising, and service businesses. Each type of business has unique characteristics.

Manufacturing businesses change basic inputs into products that are sold to individual customers. Examples of manufacturing businesses and some of their products are shown below.

Manufacturing Business	*Product*
General Motors	Automobiles, trucks, vans
General Mills	Breakfast cereals
Boeing	Jet aircraft
Nike	Athletic shoes
Coca-Cola	Beverages
Sony	Stereos, televisions, radios

Merchandising businesses also sell products to customers. However, they do not make the products but purchase them from other businesses (such as manufacturers). In this sense, merchandisers bring products and customers together. Examples of merchandising businesses and some of the products they sell are shown below.

Merchandising Business	*Product*
Wal-Mart	General merchandise
Toys"R"Us	Toys
Barnes & Noble	Books
Best Buy	Consumer electronics
Amazon.com	Books

[1]A list of key terms appears at the end of each chapter in the text.

Service businesses provide services rather than products to customers. Examples of service businesses and the types of services they offer are shown below.

Service Business	*Service*
Disney	Entertainment
Delta Air Lines	Transportation
Marriott	Hospitality and lodging
Merrill Lynch	Financial
Google	Internet search

Forms of Business

A business is normally organized as one of four different forms: proprietorship, partnership, corporation, or limited liability company. A **proprietorship** is owned by one individual. More than 70% of the businesses in the United States are organized as proprietorships. The popularity of this form is due to the ease and low cost of organizing. The primary disadvantage of proprietorships is that the financial resources available to the business are limited to the individual owner's resources. Small local businesses such as hardware stores, repair shops, laundries, restaurants, and maid services are often organized as proprietorships.

As a business grows and requires more financial and managerial resources, it may become a partnership. A **partnership** is owned by two or more individuals. Like proprietorships, small local businesses such as automotive repair shops, music stores, beauty shops, and men's and women's clothing stores may be organized as partnerships. Currently, about 10% of the businesses in the United States are organized as partnerships.

Like proprietorships, a partnership may outgrow its ability to finance its operations. As a result, it may become a corporation. A **corporation** is organized under state or federal statutes as a separate legal entity. The ownership of a corporation is divided into shares of stock. A corporation issues the stock to individuals or other businesses, who then become owners or stockholders of the corporation.

A primary advantage of the corporate form is the ability to obtain large amounts of resources by issuing shares of stock, which are ownership rights in the corporation. For this reason, most companies that require large investments in equipment and facilities are organized as corporations. For example, Toys"R"Us has raised over $800 million by issuing shares of common stock to finance its operations. Other examples of corporations include ***Yahoo!***, ***Ford***, ***Apple Computer***, ***Coca-Cola***, and ***Starbucks***.

About 20% of the businesses in the United States are organized as corporations. However, since most large companies are organized as corporations, over 90% of the total dollars of business receipts are received by corporations. Thus, corporations have a major influence on the economy.

A **limited liability company (LLC)** combines attributes of a partnership and a corporation in that it is organized as a corporation, but it can elect to be taxed as a partnership. In addition, its owners' (or members') liability is limited to their investment in the business.

In addition to the ease of formation and ability to raise large amounts of capital, the legal liability, taxes, and limitation on life are important considerations in choosing a form of business organization. For sole proprietorships and partnerships, the owners have unlimited liability to creditors and for other debts of the company. For corporations and limited liability companies, the owners' liability is limited to the amount invested in the company. Corporations are taxed as separate legal entities, while the income of sole

proprietorships, partnerships, and limited liability companies is passed through to the owners and taxed on the owners' tax returns. As separate legal entities, corporations also continue on, regardless of the lives of the individual owners. In contrast, sole proprietorships, partnerships, and limited liability companies may terminate their existence with the death of an individual owner.

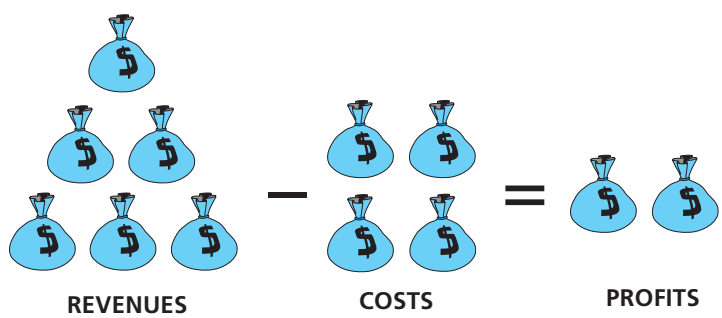
The characteristics of sole proprietorships, partnerships, corporations, and limited liability companies discussed in this section are summarized here.

Organizational Form	*Ease of Formation*	*Legal Liability*	*Taxation*	*Limitation on Life of Entity*	*Access to Capital*
Proprietorship	Simple	No limitation	Nontaxable (pass-through) entity	Yes	Limited
Partnership	Simple	No limitation	Nontaxable (pass-through) entity	Yes	Average
Corporation	Complex	Limited liability	Taxable entity	No	Extensive
Limited Liability Company	Moderate	Limited liability	Nontaxable (pass-through) entity by election	Yes	Average

The three types of businesses we discussed earlier—manufacturing, merchandising, and service—may be either proprietorships, partnerships, corporations, or limited liability companies. However, businesses that require a large amount of resources, such as many manufacturing businesses, are corporations. Likewise, most large retailers such as ***Wal-Mart, Sears,*** and ***JC Penney*** are corporations. Because most large businesses are corporations, they tend to dominate the economic activity in the United States. For this reason, we focus our attention in this text on the corporate form of organization. However, many of the concepts and principles that we discuss also apply to proprietorships and partnerships.

How Do Businesses Make Money?

The goal of a business is to make money by providing goods or services to customers. How does it decide which products or services to offer its customers? For example, should Best Buy offer warranty and repair services to its customers? Many factors influence this decision. Ultimately, however, the decision is based on how the business plans to gain an advantage over its competitors, and in doing so, make money and maximize its profits. *Profits* are the excess of revenues from selling services or products over the cost of providing those services or products as illustrated below.



Businesses try to maximize their profits by generating high revenues, low costs, and thus, high profits. However, a business's competitors are also trying to do the same and, thus, a business can only maximize its profits by gaining an advantage over its competitors. So, how can a business accomplish this?

Generally, businesses gain an advantage over their competitors by using either a low-cost or a premium-price emphasis. Under a *low-cost emphasis,* a business designs and produces products or services at a lower cost than its competitors. Wal-Mart and ***Southwest Airlines*** are examples of businesses with a low-cost emphasis. Such businesses sell no-frills, standardized products and services.

Under a *premium-price emphasis,* a business tries to design and produce products or services that serve unique market needs, allowing it to charge premium prices. For example, customers may perceive a product or service as unique based upon quality, reliability, image, or design. ***John Deere***, ***Tommy Hilfiger***, and ***BMW*** are examples of businesses that charge premium prices for their products. To illustrate, John Deere emphasizes the reliability of its lawn equipment, Tommy Hilfiger emphasizes the unique image of its clothing, and BMW emphasizes the unique driving style and prestige of its automobiles.

Since businesses are highly competitive, it is difficult for them to sustain a competitive advantage over time. For example, a primary concern of a business using a low-cost emphasis is that a competitor may copy its low-cost methods or develop technological advances that enable it to achieve even lower costs. A primary concern of a business using a premium-price emphasis is that a competitor may develop products with characteristics perceived as more desirable by customers.

Examples of how businesses use the low-cost and premium-price emphases to try to gain advantages over one another include the following:

- Local pharmacies try to develop personalized relationships with their customers. By doing so, they are able to charge premium (higher) prices. In contrast, Wal-Mart's pharmacies use the low-cost emphasis and compete on cost.
- Grocery stores such as ***Kroger*** and ***Safeway*** also try to develop personalized relationships with their customers. One way they do this is by issuing magnetic cards to preferred customers to establish brand loyalty. The cards also allow the stores to track consumer preferences and buying habits for use in purchasing and advertising campaigns. In doing so, Kroger and Safeway hope to compete on a premium-price basis against Wal-Mart Supercenters, which use a low-cost emphasis.

INTEGRITY, OBJECTIVITY, AND ETHICS IN BUSINESS

A Good Corporate Citizen

Many argue that it is good business for a company to be a good corporate citizen and contribute to the welfare of the society and the local community in which it operates. The Hershey Company has a long history of such involvement that includes the establishment and operation of the Milton Hershey School for disadvantaged children. The school is funded by an endowment of over $5 billion of The Hershey Company's stock. In addition, Hershey gives nonprofit, charitable organizations cash awards of $200 for each employee who can document 100 hours of volunteer work for the organization. Hershey also recently donated $500,000 over 5 years to scholarships for minority students in south-central Pennsylvania. The money will be used to fund scholarships of $5,000 a year for 20 students living within the region.

Sources: Bill Sutton, "Donations to Aid Minority Students," *The Patriot-News*, November 12, 2004, and "Hershey Throws Greenline a Kiss," *The Commercial Appeal*, September 26, 2004.

- ***Honda*** advertises the reliability and quality ratings of its automobiles and is thus able to charge premium prices. Similarly, ***Volvo's*** premium-price emphasis uses safety as the unique characteristic of its automobiles. In contrast, ***Hyundai*** and ***Kia*** use a low-cost emphasis.
- ***Harley-Davidson*** emphasizes that its motorcycles are "Made in America" and promotes its "rebel" image in implementing a premium-price emphasis. This allows Harley-Davidson to charge higher prices for its motorcycles than does Honda, ***Yamaha***, or ***Suzuki***.

Some well-known businesses struggle to find their competitive advantages. For example, JC Penney and Sears have difficulty competing on low costs against Wal-Mart, ***Goody's Family Clothing***, ***Kohl's***, ***T.J. Maxx***, and ***Target***. At the same time, JC Penney and Sears have difficulty charging premium prices for their merchandise against competitors such as ***The Gap***, ***Old Navy***, ***Eddie Bauer***, and ***Talbot's***. Likewise, Delta Air Lines and ***United Airlines*** have difficulty competing against low-cost airlines such as Southwest and ***JetBlue***. At the same time, Delta and United don't offer any unique services for which their passengers are willing to pay a premium price.

Exhibit 1 summarizes the characteristics of the low-cost and premium-price emphases. Common examples of businesses that employ each emphasis are also listed.

EXHIBIT 1 *Business Emphasis and Industries*

	Industry					
Business Emphasis	***Airline***	***Freight***	***Automotive***	***Retail***	***Financial Services***	***Hotel***
Low cost	Southwest	Union Pacific	Saturn	Sam's Clubs	Ameritrade	Super 8
Premium price	Virgin Atlantic	FedEx	BMW	Talbot's	Morgan Stanley	Ritz-Carlton

Business Stakeholders

A company's business emphasis, often termed a strategy, directly affects its economic performance. For example, ***Kmart*** was unsuccessful in implementing a business emphasis that would allow it to compete effectively against Wal-Mart. The result was that Kmart filed for bankruptcy protection in early 2002, and Kmart stakeholders, including employees, creditors, and stockholders, suffered.

HOW BUSINESSES MAKE MONEY

Where's Rudolph?

In future years, holiday shoppers won't find as many seasonal products as they have in the past. For example, The Hershey Company has decided not to rely as heavily on seasonal products such as Christmas-colored candies. Hershey and other retailers don't want to be stuck with excess seasonal, time-limited products that they might have to discount heavily in after-holiday sales. Instead, retailers are using "limited edition" items during the year that don't have natural time boundaries. Customers are often willing to pay premium prices for such limited editions, which also increases demand for the original brands and showcases innovative products. For example, Hershey's sales rose last year with the aid of limited edition white chocolate Reese's and inside-out Reese's.

Source: Pallavi Gogoi, "Avoiding Retail's Post-Holiday Blues," *BusinessWeek Online,* November 23, 2004.

A **business stakeholder** is a person or entity that has an interest in the economic performance and well-being of a business. For example, stockholders, suppliers, customers, and employees are all stakeholders in a corporation. Business stakeholders can be classified into one of the four categories illustrated in Exhibit 2 below.

EXHIBIT 2 *Business Stakeholders*

Business Stakeholder	*Interest in the Business*	*Examples*
Capital market stakeholders	Providers of major financing for the business	Banks, owners, stockholders
Product or service market stakeholders	Buyers of products or services and vendors to the business	Customers and suppliers
Government stakeholders	Collect taxes and fees from the business and its employees	Federal, state, and city governments
Internal stakeholders	Individuals employed by the business	Employees and managers

Capital market stakeholders provide the major financing for a business in order for it to begin and continue its operations. Banks and other long-term creditors have an economic interest in recovering the amount they loaned the business plus interest. Owners and stockholders want to maximize the economic value of their investments. Capital market stakeholders expect to receive a return on their investments proportionate to the degree of risk they are taking. Since banks and long-term creditors have first preference to the assets in case the business fails, their risk is less than that of the owners; thus, their overall return is lower.

Product or service market stakeholders include customers who purchase the business's products or services as well as the vendors who supply inputs to the business. Customers have an economic interest in the continued success of the business. For example, in the early 2000s, customers of the Internet provider ***@home.com*** were initially unable to retrieve their e-mail or connect with the Internet when @home.com declared bankruptcy. Customers who purchase advance tickets on Delta Air Lines have an economic interest in whether Delta will continue in business. Similarly, suppliers are stakeholders in the continued success of their customers. Suppliers may invest in technology or other capital equipment to meet a customer's buying and manufacturing specifications. If a customer fails or cuts back on purchases during downturns, suppliers may see their business decline also. This was the case for ***Delphi***, a major supplier to General Motors, during GM's downturn in 2005.

Various governments have an interest in the economic performance of businesses. As a result, city and state governments often provide incentives for businesses to locate within their jurisdictions. City, county, state, and federal governments collect taxes from businesses within their jurisdictions. The better a business does, the more taxes the government can collect. In addition, workers are taxed on their wages. In contrast, workers who are laid off and unemployed can file claims for unemployment compensation, which results in a financial burden for the government.

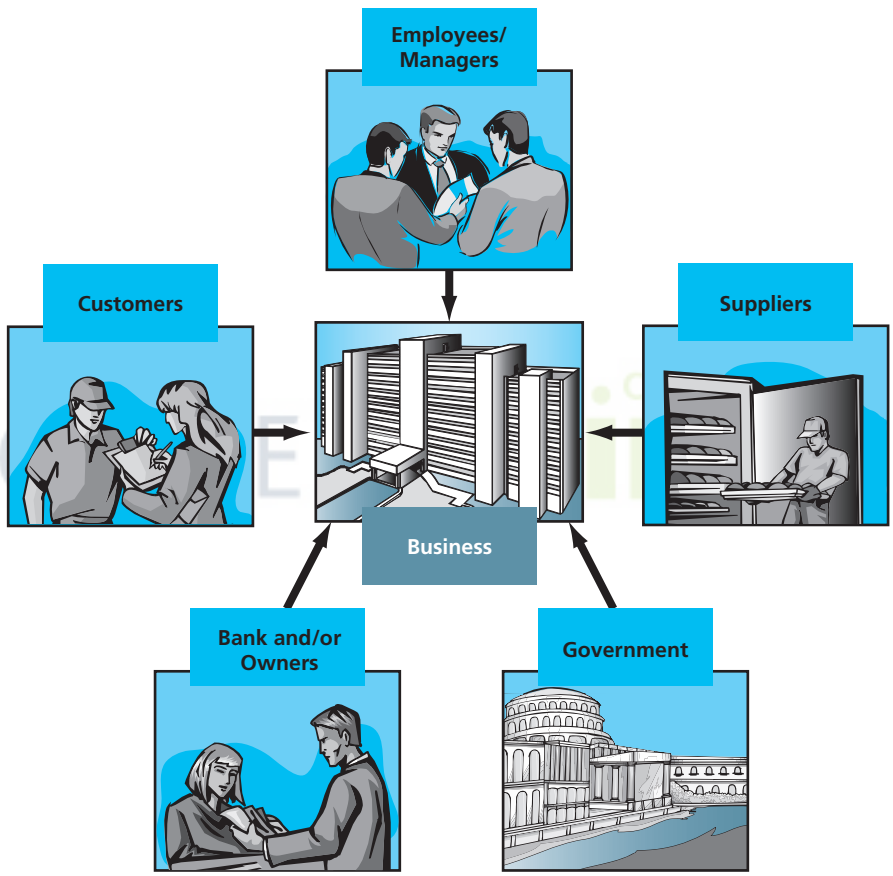
Internal stakeholders include individuals employed by the business. The managers are those individuals who the owners have authorized to operate the business. Managers are primarily evaluated on the economic performance of the business. The managers of businesses that perform poorly are often fired by the owners. Thus, managers have an incentive to maximize the economic value of the business. Owners may offer managers salary contracts that are tied directly to how well the business performs. For

example, a manager might receive a percentage of the profits or a percentage of the increase in profits.

Employees provide services to the company they work for in exchange for pay. Thus, employees have an interest in the economic performance of the business because their jobs depend upon it. During business downturns, it is not unusual for a business to lay off workers for extended periods of time. In the extreme, a business may fail and the employees may lose their jobs permanently. Employee labor unions often use the good economic performance of a business to argue for wage increases. In contrast, businesses often use poor economic performance to argue for employee concessions such as wage decreases.

Some examples of business stakeholders mentioned in the prior paragraphs are illustrated below.

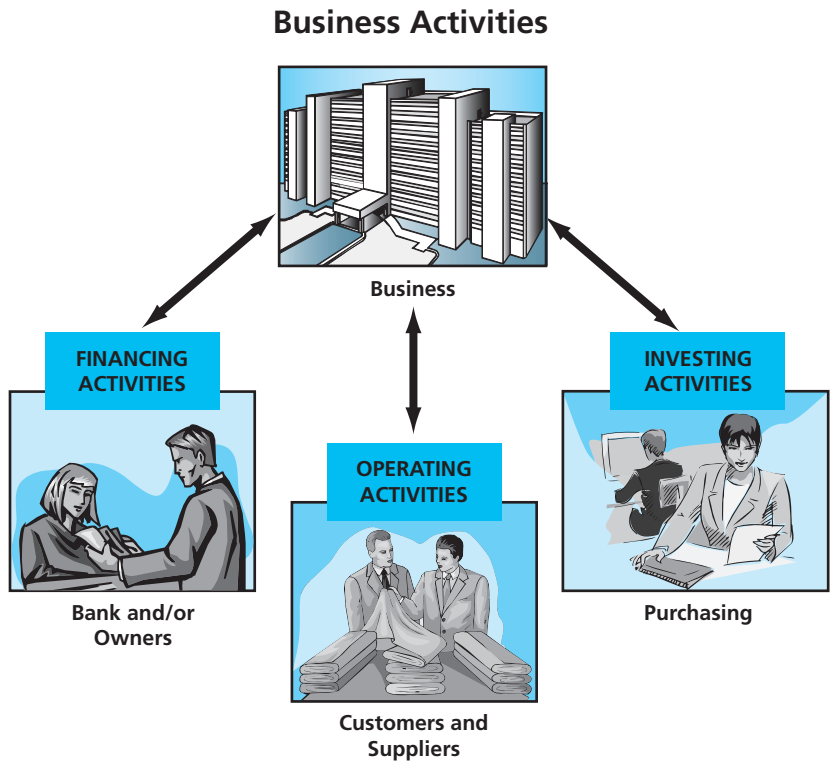
Stakeholders



Obj 2 Business Activities

Describe the three business activities of financing, investing, and operating.

Regardless of whether the company is ***Microsoft*** or ***General Electric***, all businesses are engaged in the activities of financing, investing, and operating, as shown at the top of the next page. First, a business must obtain the necessary funds to finance the costs to organize, pay legal fees, and pay other startup costs. Next, a business must invest funds in the necessary assets such as buildings and equipment to begin operations. For example, Milton Hershey invested in the German chocolate-making machinery he saw at the Chicago International Exposition. Finally, a business must utilize its assets and



resources to implement its business emphasis. Milton Hershey's business emphasis was to mass-produce chocolate candies at an affordable cost.

As we will discuss later in this chapter, a major role of accounting is to provide stakeholders with information on the financing, investing, and operating activities of businesses. Financial statements are one source of such information.

Financing Activities

Financing activities involve obtaining funds to begin and operate a business. Businesses seek financing through the use of capital markets. This financing may take the form of borrowing or issuing shares of ownership. Most major businesses use both means of financing.

When a business borrows money, it incurs a liability. A **liability** is a legal obligation to repay the amount borrowed according to the terms of the borrowing agreement. For example, when you use your credit card, you incur an obligation to pay the issuer (bank). When a business borrows from a vendor or supplier, the liability is called an **account payable**. In such cases, the business is buying on credit and promising to pay according to the terms set forth by the vendor or supplier. Most vendors and suppliers require payment within a relatively short time, such as 30 days. As of December 31, 2006, The Hershey Company reported approximately $156 million of accounts payable.

A business may borrow money by issuing bonds. *Bonds* are sold to investors and normally require repayment with interest at a specific time in the future. Bonds are a type of long-term financing, with a face amount that is normally due after several years have passed. In contrast, the interest on bonds is normally paid semiannually. Bond obligations are reported as **bonds payable**, and any interest that is due is reported as **interest payable**. Examples of well-known companies that have bonds outstanding include American Telephone and Telegraph (AT&T), John Deere, and ***Xerox***.

Most large corporations also borrow money by issuing a note payable. A **note payable** requires payment of the amount borrowed plus interest. Notes payable may be issued either on a short-term or a long-term basis.

A business may finance its operations by issuing shares of ownership. For a corporation, shares of ownership are issued in the form of shares of stock. Although corporations may issue a variety of different types of stock, the basic type of stock issued to owners is called **common stock**. For our purposes, we will use the term **capital stock** to include all the types of stock a corporation may issue.[2] Investors who purchase the stock are referred to as **stockholders**.

The claims of creditors and stockholders on the corporation's resources are different. The resources owned by a business (corporation) are called its **assets**. In case of a corporation's liquidation or bankruptcy, creditors have first claim on its assets. Only after the creditors' claims are satisfied can the stockholders obtain corporate assets. In addition, while creditors expect to receive timely payments of their claims, which may include interest, stockholders are not entitled to regular payments. However, many corporations distribute earnings to stockholders on a regular basis as long as the claims of creditors are being satisfied. These distributions of earnings to stockholders are called **dividends**.

Investing Activities

Once financing has been obtained, a business uses **investing activities** to obtain the necessary assets to start and operate the business. Depending upon the nature of the business, a variety of different assets must be purchased. For example, Milton Hershey purchased the German chocolate-making machinery and later constructed a building to house the Hershey operations. In addition to machinery and buildings, other assets could include computers, office furnishings, trucks, and automobiles. Although most assets have physical characteristics, such as equipment, some assets are intangible in nature. For example, a business may purchase patent rights for use in a manufacturing process or product.

A business may acquire assets through financing activities when the business acquires cash through borrowing or issuing shares of stock. Cash is used to purchase assets through investing activities, such as in the preceding paragraph. Finally, assets may be acquired through operating activities, as we will describe in the next section.

Assets may take a variety of different forms. For example, tangible assets include cash, land, property, plant, and equipment. Assets may also include intangible items, such as rights to patents and rights to payments from customers. Rights to payments from customers are called **accounts receivable**. Other intangible assets, such as goodwill, copyrights, or patents, are often grouped together and reported as **intangible assets**. A business may also prepay for items such as insurance or rent. Such items, which are assets until they are consumed, are normally reported as **prepaid expenses**.

Operating Activities

Once resources have been acquired, a business uses **operating activities** to implement its business emphasis. Hershey's emphasis was to mass-produce and distribute chocolate candies at affordable prices. When Hershey sold its chocolates, it received revenue from its customers. **Revenue** is the increase in assets from selling products or services. Revenues are often identified according to their source. For example, revenues received from selling products are called *sales.* Revenues received from providing services are called *fees.*

[2]Types of stock are discussed in Chapter 8, "Liabilities and Stockholders' Equity."

To earn revenue, a business incurs costs, such as wages of employees, salaries of managers, rent, insurance, advertising, freight, and utilities. Costs used to earn revenue are called **expenses**. Depending upon the nature of the cost, expenses may be identified in a variety of ways. For example, the cost of products sold is often referred to as the *cost of merchandise sold, cost of sales,* or *cost of goods sold.* Other expenses are often classified as either *selling expenses* or *administrative expenses*. Selling expenses include those costs directly related to the selling of a product or service. For example, selling expenses include such costs as sales salaries, sales commissions, freight, and advertising costs. Administrative expenses include other costs not directly related to the selling, such as officer salaries and other costs of the corporate office.

As we will discuss later in this chapter, by comparing the revenues for a period with the related expenses, you can determine whether the business earned net income or incurred a net loss. A **net income** results when revenues exceed expenses. A **net loss** results when expenses exceed revenues.

What Is Accounting and Its Role in Business?

Obj 3

Define accounting and describe its role in business.

How do stakeholders get information about the financing, investing, and operating activities of a business? This is the role of accounting. Accounting provides information for managers to use in operating the business. In addition, accounting provides information to other stakeholders to use in assessing the economic performance and condition of the business.

In a general sense, **accounting** can be defined as an information system that provides reports to stakeholders about the economic activities and condition of a business. We will focus our discussions in this text on accounting and its role in business. However, many of the concepts in this text also apply to individuals, governments, and other types of organizations. For example, individuals must account for activities such as hours worked, checks written, and bills due. Stakeholders for individuals include creditors, dependents, and the government. A main interest of the government is making sure that individuals pay the proper taxes.

Accounting is sometimes called the "language of business." This is because accounting is the means by which business information is communicated to the stakeholders. For example, accounting reports summarizing the profitability of a new product help Coca-Cola's management decide whether to continue offering the new product for sale. Likewise, financial analysts use accounting reports in deciding whether to recommend the purchase of Coca-Cola's stock. Banks use accounting reports in deciding the amount of credit to extend to Coca-Cola. Suppliers use accounting reports in deciding whether to offer credit for Coca-Cola's purchases of supplies and raw materials. State and federal governments use accounting reports as a basis for assessing taxes on Coca-Cola.

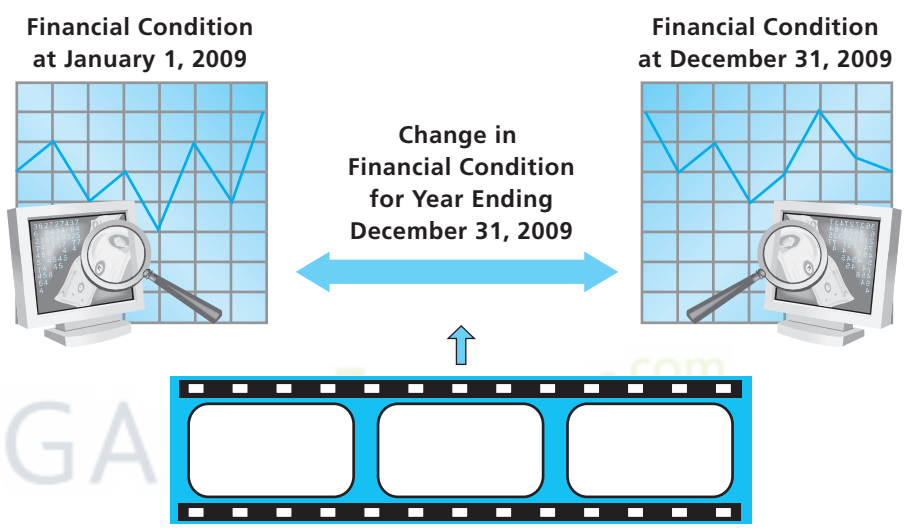
As we described above, accounting serves many purposes for business. A primary purpose is to summarize the financial performance of the firm for external users, such as banks and governmental agencies. The branch of accounting that is associated with preparing reports for users external to the business is termed *financial accounting.* Accounting also can be used to guide management in making decisions about the business. This branch of accounting is called *managerial accounting.* Financial and managerial accounting overlap in many areas. For example, financial reports for external users are often used by managers in considering the impact of their decisions.

In this text, we focus on financial accounting. The two major objectives of financial accounting are:

1. To report the financial condition of a business at a point in time.
2. To report changes in the financial condition of a business over a period of time.

The relationship between the two financial accounting objectives is shown in Exhibit 3. You may think of the first objective as a still photograph (snapshot) of the business and the second objective as a moving picture (video) of the business. The first objective measures the financial status of a business. This measure is used by stakeholders to evaluate the business's financial health at a point in time. The second objective measures the change in the financial condition of a business for a period of time. This measure is used by stakeholders to predict how a business may perform in the future.

EXHIBIT 3 *Objectives of Financial Accounting*



The objectives of accounting are satisfied by (1) recording the economic events affecting a business and then (2) summarizing the impact of these events on the business in financial reports, called **financial statements**. We will describe and illustrate the basic financial statements next.

Obj 4

Describe and illustrate the basic financial statements and how they interrelate.

Financial Statements

Financial statements report the financial condition of a business at a point in time and changes in the financial condition over a period of time. The four basic financial statements and their relationship to the two objectives of financial accounting are listed below.[3]

Financial Statement	*Financial Accounting Objective*
Income statement	Reports change in financial condition
Retained earnings statement	Reports change in financial condition
Balance sheet	Reports financial condition
Statement of cash flows	Reports change in financial condition

[3]Instead of the retained earnings statement, companies often prepare a statement of stockholders' equity. This statement reports changes in retained earnings as well as changes in other stockholders' equity items. We describe and illustrate the statement of stockholders' equity in a later chapter, after we have discussed stockholders' equity in more detail.

The income statement is normally prepared first, followed by the retained earnings statement, the balance sheet, and the statement of cash flows. The nature of each statement is described below.

- **Income statement**—A summary of the revenue and the expenses for a specific period of time, such as a month or a year.
- **Retained earnings statements**—A summary of the changes in the earnings retained in the corporation for a specific period of time, such as a month or a year.
- **Balance sheet**—A list of the assets, liabilities, and stockholders' equity as of a specific date, usually at the close of the last day of a month or a year.
- **Statement of cash flows**—A summary of the cash receipts and cash payments for a specific period of time, such as a month or a year.

In the next section, we describe and illustrate the preceding four financial statements for The Hershey Company. Our objective in this section is to introduce you to the financial statements that we will be studying throughout this text. In later chapters, we will expand upon these concepts and terminology. The four financial statements are illustrated in Exhibits 4–7. The data for the statements were adapted from the annual report of The Hershey Company.[4]

Income Statement

The income statement reports the change in financial condition due to the operations of a business. The time period covered by the income statement may vary depending upon the needs of the stakeholders. Public corporations are required to file quarterly and annual income statements with the Securities and Exchange Commission. The income statement shown in Exhibit 4 for The Hershey Company is for the year ended December 31, 2006.

EXHIBIT 4 *Income Statement: The Hershey Company*

THE HERSHEY COMPANY
Income Statement
For the Year Ended December 31, 2006 (in millions)

Revenues:		
Sales		$4,944
Expenses:		
Cost of sales	$3,077	
Selling and administrative	860	
Interest	116	
Income taxes	317	
Business realignment and asset impairment expenses	15	4,385
Net income		$ 559

Since the focus of business operations is to generate revenues, the income statement begins by listing the revenues for the period. During 2006, Hershey generated sales of over $4.9 billion. These sales are listed under the revenue caption. You should note that the numbers shown in Exhibit 4 are expressed in millions of dollars. It is common for large corporations to express their financial statements in thousands or millions of dollars.

[4]The financial statements for The Hershey Company can be found at **http://www.hersheys.com** by clicking on "Investor Relations."

Following the revenues, the expenses that were used in generating the revenues are listed. For Hershey, these expenses include cost of sales, selling and administrative, interest, income taxes, and business realignment and asset impairment expenses. By reporting the expenses and the related revenues for a period, the expenses are said to be matched against the revenues. This is known in accounting as the *matching concept*. We will further discuss this concept later in this chapter.

When revenues exceed expenses for a period, the business has *net income*. If expenses exceed revenues, the business has a *net loss*. Reporting net income means that the business increased its net assets through its operations. That is, the assets created by the revenues coming into the business exceeded the assets used in generating the revenues. The objective of most businesses is to maximize net income or profit. A net loss means that the business decreased its net assets through its operations. While a business might survive in the short run by reporting net losses, in the long run a business must report net income to survive.

During 2006, Hershey earned net income of almost $560 million. Is this good or bad? Certainly, net income is better than a net loss. However, the stakeholders must assess the economic performance of the corporation according to their own standards. For example, a creditor might be satisfied that the net income is sufficient to assure that it will be repaid. On the other hand, a stockholder might not be satisfied if the corporation's profitability is less than its competitors' profitability. Throughout this text, we describe various methods of assessing corporate performance.

Retained Earnings Statement

The retained earnings statement reports changes in financial condition due to changes in retained earnings during a period. **Retained earnings** is the portion of a corporation's net income that is retained in the business. A corporation may retain all of its net income for use in expanding operations, or it may pay a portion or all of its net income to stockholders as dividends. For example, high-growth companies like Google Inc. and ***Sirius Satellite Radio*** do not distribute dividends to stockholders; instead, they retain profits for future expansion. In contrast, more mature corporations like Coca-Cola or General Electric routinely pay their stockholders a regular dividend. Thus, investors such as retirees who desire the comfort of a routine dividend payment might invest in Coca-Cola or General Electric. In contrast, younger and more aggressive growth-oriented investors might invest in Google or Sirius.

Since retained earnings depend upon net income, the time period covered by the retained earnings statement is the same period as the income statement. Thus, the retained earnings statement for Hershey shown in Exhibit 5 is for the year ended December 31, 2006.

EXHIBIT 5 *Retained Earnings Statement: The Hershey Company*

THE HERSHEY COMPANY
Retained Earnings Statement
For the Year Ended December 31, 2006 (in millions)

Retained earnings, January 1, 2006		$3,641
Add net income	$559	
Less dividends	235	
Increase in retained earnings		324
Retained earnings, December 31, 2006		$3,965

You should note that dividends are reported in Hershey's retained earnings statement rather than in the income statement. This is because dividends are not an expense, but are a distribution of net income to stockholders. During 2006, Hershey distributed (declared) dividends of $235 million and retained $324 million of its net income in the business. Thus, Hershey's retained earnings increased from $3,641 million to $3,965 million during 2006.

Balance Sheet

The balance sheet reports the financial condition as of a point in time. This is in contrast to the income statement, the retained earnings statement, and the statement of cash flows that report changes in financial condition. The financial condition of a business as of a point in time is measured by its total assets and claims or rights to those assets. Thus, the financial condition of a business can be represented as follows:

Assets = Claims (Rights to the Assets)

The claims on a business's assets consist of rights of creditors who have loaned money or extended credit to the business and the rights of stockholders who have invested in the business. As we discussed earlier, the rights of creditors are liabilities. The rights of stockholders are referred to as **stockholders' equity**, which is sometimes referred to as **owners' equity**. Thus, the assets and the claims on those assets can be presented in equation form as follows:

Assets = Liabilities + Stockholders' Equity

This equation is called the **accounting equation**. As we shall discover in later chapters, accounting information systems are developed using this equation as their foundation.

The balance sheet, sometimes called the statement of financial condition, is prepared using the framework of the accounting equation. That is, assets are listed first and added to arrive at total assets. Liabilities are then listed and added to arrive at total liabilities. Stockholders' equity items are listed next and added to arrive at total stockholders' equity. Finally, the total assets must equal the combined total liabilities and stockholders' equity. In other words, the accounting equation must balance; hence, the name *balance sheet.* The balance sheet for The Hershey Company as of December 31, 2006, is shown in Exhibit 6.

As of December 31, 2006, Hershey had total assets of $4.2 billion, of which creditors had claims of $3.5 billion and stockholders had claims of $0.7 billion. One use of the balance sheet by creditors is to determine whether the corporation's assets are sufficient to ensure that they will be paid their claims. In Hershey's case, as of December 31, 2006, the assets of the corporation exceed the creditors' claims by $0.7 billion. Therefore, the creditors are reasonably assured that their claims will be repaid.

Statement of Cash Flows

The statement of cash flows reports the change in financial condition due to the changes in cash during a period. During 2006, Hershey's net cash increased by $30 million, as shown in Exhibit 7.

Earlier in this chapter, we discussed the three business activities of financing, investing, and operating. Any changes in cash must be related to one of these three activities. Thus, the statement of cash flows is organized by reporting the changes in each of these three activities, as shown in Exhibit 7.

EXHIBIT 6 *Balance Sheet: The Hershey Company*

THE HERSHEY COMPANY
Balance Sheet
December 31, 2006 (in millions)

Assets	
Cash	$ 97
Accounts receivable	523
Inventories	649
Prepaid expenses	149
Property, plant, and equipment	1,651
Intangibles	642
Other assets	447
Total assets	$ 4,158
Liabilities	
Accounts payable	$ 156
Accrued liabilities	454
Notes and other debt	2,579
Income taxes payable	286
Total liabilities	$ 3,475
Stockholders' Equity	
Capital stock	$ 360
Retained earnings	3,965
Repurchased stock and other equity items	(3,642)
Total stockholders' equity	$ 683
Total liabilities and stockholders' equity	$ 4,158

EXHIBIT 7 *Statement of Cash Flows: The Hershey Company*

THE HERSHEY COMPANY
Statement of Cash Flows
For the Year Ended December 31, 2006 (in millions)

Net cash flows from operating activities	$ 723
Cash flows from investing activities:	
Investments in property, plant, and equipment	$(216)
Net cash flows used in investing activities	$(216)
Cash flows from financing activities:	
Cash receipts from financing activities, including debt	$ 544
Dividends paid to stockholders	(235)
Repurchase of stock	(622)
Other, including repayment of debt	(164)
Net cash flows used in financing activities	$(477)
Net increase in cash during 2006	$ 30
Cash as of January 1, 2006	67
Cash as of December 31, 2006	$ 97

In the statement of cash flows, the net cash flows from operating activities is reported first, because cash flows from operating activities are a primary analysis focus for most business stakeholders. For example, creditors are interested in determining whether the company's operating activities are generating enough positive cash flow to repay their debts. Likewise, stockholders are interested in the company's ability to pay dividends. A business cannot survive in the long term unless it generates positive cash flows from operating activities. Thus, employees, managers, and other stakeholders interested in the long-term viability of the business also focus upon the cash flows from operating activities. During 2006, Hershey's operations generated a positive net cash flow of $723 million.

Because of the impact investing activities have on the operations of a business, the cash flows from investing activities are presented following the cash flows from operating activities section. Any cash receipts from selling property, plant, and equipment would be reported in this section. Likewise, any purchases of property, plant, and equipment would be reported as cash payments. Companies that are expanding rapidly, such as startup companies, will normally report negative net cash flows from investing activities. In contrast, companies that are downsizing or selling segments of the business may report positive net cash flows from investing activities.

As shown in Exhibit 7, Hershey reported negative net cash flows from investing activities of $216 million. This negative net cash flow was from the purchase of property, plant, and equipment. Thus, it appears that Hershey is expanding operations.

Cash flows from financing activities are reported next. Any cash receipts from issuing debt or stock would be reported in this section as cash receipts. Likewise, paying debt or dividends would be reported as cash payments. Business stakeholders can analyze cash flows from financing activities to determine whether a business is changing its financing policies.

Hershey paid dividends of $235 million and repaid debt of $164 million. Cash of $544 million was received from financing activities that included additional borrowing from creditors. Finally, Hershey purchased its own stock at a cost of $622 million. A company may purchase its own stock if the corporate management believes its stock is undervalued or for providing stock to employees or managers as part of an incentive (stock option) plan.[5]

The statement of cash flows is completed by determining the increase or decrease in cash flows for the period by adding the net cash flows from operating, investing, and financing activities. Hershey reported a net increase in cash of $30 million. This increase or decrease is added to or subtracted from the cash at the beginning of the period to determine the cash as of the end of the period. Thus, Hershey began the year with $67 million in cash and ended the year with $97 million in cash.

So what does the statement of cash flows reveal about The Hershey Company during 2006? The statement reveals that Hershey generated over $723 million in cash flows from its operations while using cash to expand its operations and pay dividends to stockholders. Overall, Hershey appears to be in a strong operating position to generate cash and pay its creditors.

Integrated Financial Statements

As we mentioned earlier, financial statements are prepared in the order of the income statement, retained earnings statement, balance sheet, and statement of cash flows. Preparing them in this order is important because the financial statements are integrated.

[5]We will discuss the accounting for a company's purchase of its own stock in a later chapter.

EXHIBIT 8 *Integrated Financial Statements*

The Hershey Company
Balance Sheet
December 31, 2006

Assets	=	Liabilities	+	Stockholders' Equity
Cash $ 97		.		.
.		.		.
.		.		$3,965 Retained Earnings
$4,158	=	$3,475	+	$ 683

$4,158
Total Liabilities + Stockholders' Equity

The Hershey Company
Statement of Cash Flows
For the Year Ended Dec. 31, 2006

Operating act.	$ 723
Investing act.	(216)
Financing act.	(477)
Increase in cash	$ 30
Cash, Jan. 1	67
Cash, Dec. 31	$ 97

The Hershey Company
Income Statement
For the Year Ended Dec. 31, 2006

Revenues	$4,944
Expenses	4,385
Net income	$ 559

The Hershey Company
Retained Earnings Statement
For the Year Ended Dec. 31, 2006

Retained earnings, Jan. 1		$3,641
Add: Net income	$559	
Less: Dividends	235	324
Retained earnings, Dec. 31		$3,965

Based upon The Hershey Company's financial statements in Exhibits 4–7, this integration is shown in Exhibit 8 as follows:[6]

1. The income and retained earnings statements are integrated. The net income or net loss appearing on the income statement also appears on the retained earnings statement as either an addition (net income) to or deduction (net loss) from the beginning retained earnings. To illustrate, Hershey's net income of $559 million is also reported on the retained earnings statement as an addition to the beginning retained earnings.
2. The retained earnings statement and the balance sheet are integrated. The retained earnings at the end of the period on the retained earnings statement also appears on the balance sheet as a part of stockholders' equity. To illustrate, Hershey's retained earnings of $3,965 million as of December 31, 2006, is also reported on the balance sheet.
3. The balance sheet and statement of cash flows are integrated. The cash on the balance sheet also appears as the end-of-period cash on the statement of cash flows. To illustrate, the cash of $97 million reported on Hershey's balance sheet is also reported as the end-of-period cash on the statement of cash flows.

The preceding integration is important in analyzing financial statements and the possible impact of economic events or transactions on a business. In addition, this integration serves as a check on whether the financial statements have been prepared correctly. For example, if the ending cash on the statement of cash flows doesn't agree with the balance sheet cash, then an error exists.

[6]Depending upon the method of preparing cash flows from operating activities, net income may also appear on the statement of cash flows. This link and the method of preparing the statement of cash flows, called "the indirect method," is illustrated in a later chapter. In addition, as we will illustrate in Chapter 2, cash flows from operating activities may equal net income.

Obj 5

Describe eight accounting concepts underlying financial reporting.

Accounting Concepts

In the preceding section, we described and illustrated the four basic corporate financial statements. Just as the rules of football determine the proper manner of scoring touchdowns, accounting "rules," called **generally accepted accounting principles (GAAP)**, determine the proper content of financial statements. GAAP are necessary so that stakeholders can compare the financial condition and operating results across companies and across time. If the management of a company could prepare financial statements as they saw fit, the comparability between companies and across time periods would be difficult, if not impossible. In other words, this would be like allowing a football team to determine the point-count for a touchdown every time it scored.

As shown on the following page, GAAP support and determine the content of the financial statements. GAAP are established in the United States by the **Financial Accounting Standards Board (FASB)**.[7] In establishing GAAP, the FASB publishes *Statements of Financial Accounting Standards.* The FASB establishes GAAP by relying on eight supporting accounting concepts.

Understanding these concepts that support the FASB pronouncements is essential for analyzing and interpreting financial statements. We discuss these concepts next. We conclude this section by describing recent financial reporting frauds, the accounting concepts that were violated, and underlying contributing factors.

Business Entity Concept

A business entity could be an individual, a not-for-profit organization such as a church, or a for-profit company such as a real estate agency. The **business entity concept** applies accounting to a specific entity for which stakeholders need economic data. Once the entity is identified, the accountant can determine which economic data and activities should be analyzed, recorded, and summarized in the financial statements for stakeholders.

The accounting for The Hershey Company, a for-profit corporation, is separated from the accounting for other entities. For example, the accounting for transactions and events of individual stockholders, creditors, or other Hershey stakeholders are not included in The Hershey Company's financial statements. Only the transactions and events of the corporation as a separate entity are included in Hershey's financial statements.

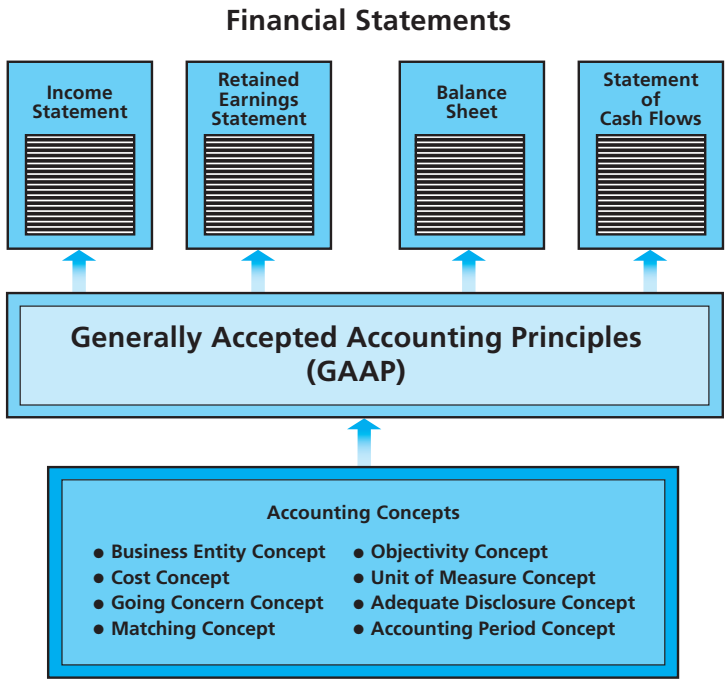
Cost Concept

The **cost concept** determines the amount initially entered into the accounting records for purchases. For example, assume that Hershey purchased land for $2 million as a site for a future plant. The cost of the land to Hershey is the amount that would be entered into the accounting records. The seller may have been asking $2.3 million for the land up to the time of the sale. The land may have been assessed for property tax purposes at $1.5 million. A month after purchasing the land, Hershey may have received an offer of $2.4 million for the land. The only amount that affects the accounting records and the financial statements is the $2 million purchase price.

Going Concern Concept

In most cases, the amount of time that a business will be able to continue in operation is not known, so an assumption must be made. A business normally expects to continue operating for an indefinite period of time. This is called the **going concern concept**.

[7]The Securities and Exchange Commission (SEC) also has authority to set accounting principles for publicly held corporations. In almost all cases, the SEC adopts the principles established by the FASB.



The going concern concept affects the recording of transactions and thus affects the financial statements. For example, the going concern concept justifies the use of the cost concept for recording purchases, such as the land purchased by Hershey in the preceding example. In this example, Hershey plans to build a plant on the land. Since Hershey does not plan to sell the land, reporting changes in the market value of the land is irrelevant. That is, the amount Hershey could sell the land for if it discontinued operations or went out of business is not important because Hershey plans to continue its operations.

If, however, there is strong evidence that a business is planning to discontinue its operations, then the accounting records should show the values expected to be received. For example, the assets and liabilities of businesses in receivership or bankruptcy are valued from a quitting concern or liquidation point of view, rather than from the going concern point of view.

Matching Concept

In accounting, revenues for a period are matched with the expenses incurred in generating the revenues. Under this **matching concept**, revenues are normally recorded at the time of the sale of the product or service. This recording of revenues is often referred to as *revenue recognition*. At the point of sale, the sale price has been agreed upon, the buyer acquires ownership of the product or acquires the service, and the seller has a legal claim against the buyer for payment.

The following excerpt from the notes to Hershey's annual report describes when Hershey records sales:

> The Corporation records sales when . . . a . . . customer order with a fixed price has been received, . . . the product has been shipped, . . . there is no further obligation to assist in the resale of the product, and collectibility (of the account receivable) is reasonably assured.

Objectivity Concept

The **objectivity concept** requires that entries in the accounting records and the data reported on financial statements be based on objective evidence. If this concept is ignored, the confidence of users of the financial statements cannot be maintained. For example, evidence such as invoices and vouchers for purchases, bank statements for the amount of cash in the bank, and physical counts of supplies on hand support the accounting records. Such evidence is objective and verifiable. In some cases, judgments, estimates, and other subjective factors may have to be used in preparing financial statements. In such situations, the most objective evidence available should be used.

Unit of Measure Concept

In the United States, the **unit of measure concept** requires that all economic data be recorded in dollars. Other relevant, nonfinancial information may also be recorded, such as terms of contracts. However, it is only through using dollar amounts that the various transactions and activities of a business can be measured, summarized, reported, and compared. Money is common to all business transactions and thus is the unit of measurement for reporting.

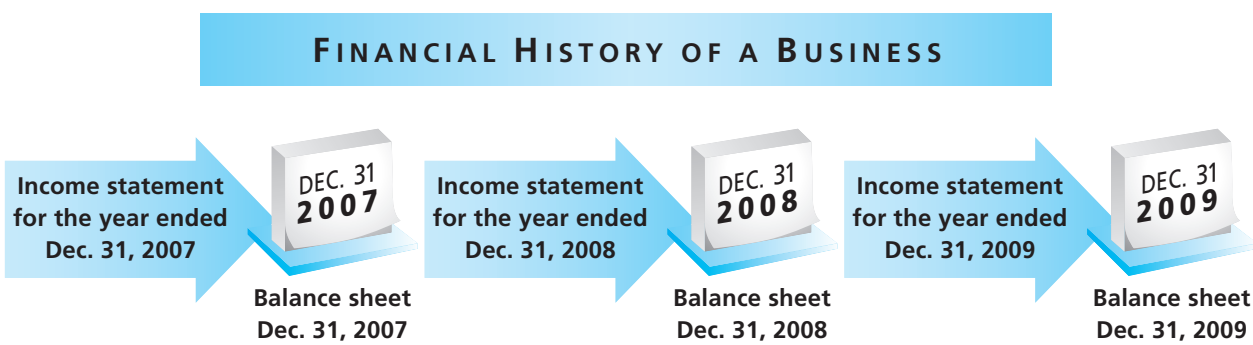
Adequate Disclosure Concept

Financial statements, including related footnotes and other disclosures, should contain all relevant data a reader needs to understand the financial condition and performance of a business. This is called the **adequate disclosure concept**. Nonessential data should be excluded in order to avoid clutter. For example, the balance of each cash account is usually not reported separately. Instead, the balances are grouped together and reported as one total.

Accounting Period Concept

The process in which accounting data are recorded and summarized in financial statements is a period process. Data are recorded, and the income statement, retained earnings statement, and statement of cash flows are prepared for a period of time such as a month or a year. The balance sheet is then prepared as of the end of the period. After the accounting process is completed for one period, a new period begins and the accounting process is repeated for the new period. This process is based on the **accounting period concept**. Hershey's financial statements shown in Exhibits 4–7 illustrate the accounting period concept for the year ending December 31, 2006.

The financial history of a business may be shown by a series of balance sheets and income statements. If the life of a business is expressed by a line moving from left to right, this series of financial statements may be graphed as follows:



Responsible Reporting

The reliability of the financial reporting system is important to the economy and for the ability of businesses to raise money from investors. That is, stockholders and creditors require accurate financial reporting before they will invest their money. Scandals and financial reporting frauds in the early 2000s threatened the confidence of U.S. investors. Exhibit 9 is a partial list of some of the financial reporting frauds and abuses.

The companies listed in Exhibit 9 were caught in the midst of ethical lapses that led to fines, firings, and criminal or civil prosecution. The second column of Exhibit 9 identifies the accounting concept that was violated in committing these unethical business practices. For example, the ***WorldCom*** fraud involved reporting various expense items as though they were assets. This is a violation of the matching concept and resulted in overstating income and assets. The third column of the table identifies some of the results of these events. In most cases, senior and midlevel executives lost their jobs and

EXHIBIT 9 *Accounting Fraud in the 2000s*

Company	*Concept Violated*	*Result*
Adelphia	*Business Entity Concept:* Rigas family treated the company assets as their own.	Bankruptcy. Rigas family members convicted of fraud and lost their investment in the company.
AIG	*Business Entity Concept:* Compensation transactions with an off-shore company that should have been disclosed on AIG's books.	CEO (Chief Executive Officer) resigned. AIG paid $126 million in fines.
AOL and **PurchasePro**	*Matching Concept:* Back-dated contracts to inflate revenues.	Civil charges filed against senior executives of both companies. $500 million fine.
Computer Associates	*Matching Concept:* Fraudulently inflating revenues.	CEO and senior executives indicted. Five executives pled guilty. $225 million fine.
Enron	*Business Entity Concept:* Treated transactions as revenue, when they should have been treated as debt.	Bankruptcy. Criminal charges against senior executives. Over $60 billion in stock market losses.
Fannie Mae	*Accounting Period Concept:* Managing earnings by shifting expenses between periods.	CEO and CFO fired. $9 billion in restated earnings.
HealthSouth	*Matching Concept:* $4 billion in false entries to overstate revenues.	Senior executives face regulatory *and* civil charges.
Quest	*Matching Concept:* Improper recognition of $3 billion in revenue.	CEO and six other executives charged with "massive financial fraud." $250 million SEC fine.
Tyco	*Adequate Disclosure Concept:* Failure to disclose secret loans to executives that were subsequently forgiven.	CEO forced to resign and was convicted in criminal proceedings.
WorldCom	*Matching Concept:* Improperly treated expenses as assets.	Bankruptcy. Criminal conviction of CEO and CFO. Over $100 billion in stock market losses. Directors fined $18 million.
Xerox	*Matching Concept:* Recognized $3 billion in revenue in periods earlier than should have been recognized.	$10 million fine to SEC. Six executives fined $22 million.

were sued by upset investors. In some cases, the executives also were criminally prosecuted and are serving prison terms.

What went wrong for these companies and executives? The answer to this question involves the following three factors:

1. Individual character
2. Firm culture
3. Laws and enforcement

Individual Character Executives often face pressures from senior managers to meet company and analysts' expectations. In many of the cases in Exhibit 9, executives initially justified small violations to avoid such pressures. However, these small lies became big lies as the hole was dug deeper and deeper. By the time the abuses were discovered, the misstatements became sufficient to wreck lives and ruin businesses. For example, David Myers, the former controller of WorldCom, in testifying about his recording of improper transactions, stated the following:

> "I didn't think that it was the right thing to do, but I had been asked by Scott (Sullivan, the VP of Finance) to do it."[8]

Individual character is important. It embraces honesty, integrity, and fairness in the face of pressure to hide the truth.

Firm Culture By their behavior and attitude, senior managers of a company set the firm culture. As explained by one author, when leaders of companies are put on a pedestal, "they begin to believe they and their organizations are one-of-a-kind, that they're changing the face of the industry. They desire entitlements beyond any other C.E.O.'s (chief executive officers)."[9] In most of the firms shown in Exhibit 9, the senior managers created a culture of greed and indifference to the truth. This culture flowed down to lower-level managers, creating an environment of shortcuts, greed, and lies that ultimately resulted in financial fraud.

Laws and Enforcement Many blamed the lack of laws and enforcement for contributing to the financial reporting abuses described in Exhibit 9. For example, Eliot Spitzer, attorney general of New York, stated the following:

> "A key lesson from the recent scandals is that the checks on the system simply have not worked. The honor code among CEOs didn't work. Board oversight didn't work. Self-regulation was a complete failure."[10]

As a result, Congress enacted new laws, and enforcement efforts have increased since the early 2000s. For example, the Sarbanes-Oxley Act of 2002 (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, enhanced financial disclosures, and corporate accountability.

[8]Susan Pulliam, "Crossing the Line: At Center of Fraud, WorldCom Official Sees Life Unravel," *The Wall Street Journal,* March 24, 2005, p. A1.

[9]Tim Race, "New Economy Executives Are Smitten, and Undone by Their Own Images," *New York Times*, July 7, 2002. Quote attributed to Professor Jay A. Conger.

[10]Eliot Spitzer, "Strong Law Enforcement Is Good for the Economy," *The Wall Street Journal*, April 5, 2005, p. A18.

Key Points

1. Describe the types and forms of businesses, how businesses make money, and business stakeholders.

The three types of businesses operated for profit include manufacturing, merchandising, and service businesses. Such businesses may be organized as proprietorships, partnerships, corporations, and limited liability companies. A business may make money (profits) by gaining an advantage over its competitors using a low-cost or a premium-price emphasis. Under a *low-cost emphasis*, a business designs and produces products or services at a lower cost than its competitors. Under a *premium-price emphasis*, a business tries to design products or services that possess unique attributes or characteristics for which customers are willing to pay more. A business's economic performance is of interest to its stakeholders. Business stakeholders include four categories: capital market stakeholders, product or service market stakeholders, government stakeholders, and internal stakeholders.

2. Describe the three business activities of financing, investing, and operating.

All businesses engage in financing, investing, and operating activities. Financing activities involve obtaining funds to begin and operate a business. Investing activities involve obtaining the necessary resources to start and operate the business. Operating activities involve using the business's resources according to its business emphasis.

3. Define accounting and describe its role in business.

Accounting is an information system that provides reports to stakeholders about the economic activities and condition of a business. Accounting is the "language of business."

4. Describe and illustrate the basic financial statements and how they interrelate.

The principal financial statements of a corporation are the income statement, the retained earnings statement, the balance sheet, and the statement of cash flows. The income statement reports a period's net income or net loss, which also appears on the retained earnings statement. The ending retained earnings reported on the retained earnings statement is also reported on the balance sheet. The ending cash balance is reported on the balance sheet and the statement of cash flows.

5. Describe eight accounting concepts underlying financial reporting.

The eight accounting concepts discussed in this chapter include the business entity, cost, going concern, matching, objectivity, unit of measure, adequate disclosure, and accounting period concepts.

Key Terms

Account payable
Accounting
Accounting equation
Accounting period concept
Accounts receivable
Adequate disclosure concept
Assets
Balance sheet
Bonds payable
Business
Business entity concept
Business stakeholder
Capital stock
Common stock
Corporation
Cost concept
Dividends
Expenses
Financial Accounting Standards Board (FASB)
Financial statements
Financing activities
Generally accepted accounting principles (GAAP)
Going concern concept
Income statement
Intangible assets
Interest payable
Investing activities
Liabilities
Limited liability company (LLC)
Manufacturing
Matching concept
Merchandising
Net income
Net loss

Note payable
Objectivity concept
Operating activities
Owners' equity
Partnership
Prepaid expenses
Proprietorship
Retained earnings
Retained earnings statement
Revenue
Service
Statement of cash flows
Stockholders
Stockholders' equity
Unit of measure concept

Illustrative Problem

The financial statements at the end of Spratlin Consulting's first month of operations follow.

SPRATLIN CONSULTING
Income Statement
For the Month Ended June 30, 2008

Fees earned		$36,000
Operating expenses:		
Wages expense	$12,000	
Rent expense	7,640	
Utilities expense	(a)	
Miscellaneous expense	1,320	
Total operating expenses		23,120
Net income		$ (b)

SPRATLIN CONSULTING
Retained Earnings Statement
For the Month Ended June 30, 2008

Net income for June	$ (c)
Less dividends	(d)
Retained earnings, June 30, 2008	$ (e)

SPRATLIN CONSULTING
Balance Sheet
June 30, 2008

Assets	
Cash	$ 5,600
Land	50,000
Total assets	$ (f)
Liabilities	
Accounts payable	$ 1,920
Stockholders' Equity	
Capital stock	(g)
Retained earnings	(h)
Total stockholders' equity	$ (i)
Total liabilities and stockholders' equity	$ (j)

(continued)

SPRATLIN CONSULTING
Statement of Cash Flows
For the Month Ended June 30, 2008

Cash flows from operating activities:		
Cash received from customers	$36,000	
Deduct cash payments for operating expenses	(k)	
Net cash flows from operating activities		$14,800
Cash flows from investing activities:		
Cash payments for acquisition of land		(l)
Cash flows from financing activities:		
Cash received from issuing capital stock	$48,000	
Deduct dividends	7,200	
Net cash flows from financing activities		(m)
Net cash flow and June 30, 2008 cash balance		$ (n)

Instructions

By analyzing how the four financial statements are integrated, determine the proper amounts for (a) through (n).

Solution

a. Utilities expense, $2,160 ($23,120 − $12,000 − $7,640 − $1,320)
b. Net income, $12,880 ($36,000 − $23,120)
c. Net income, $12,880 (same as b)
d. Dividends, $7,200 (from statement of cash flows)
e. Retained earnings, $5,680 ($12,880 − $7,200)
f. Total assets, $55,600 ($5,600 + $50,000)
g. Capital stock, $48,000 (from the statement of cash flows)
h. Retained earnings, $5,680 (same as e)
i. Total stockholders' equity, $53,680 ($48,000 + $5,680)
j. Total liabilities and stockholders' equity, $55,600 ($1,920 + $53,680) (same as f)
k. Cash payments for operating expenses, $21,200 ($36,000 − $14,800)
l. Cash payments for acquisition of land, $50,000 (from balance sheet)
m. Net cash flows from financing activities, $40,800 ($48,000 − $7,200)
n. Net cash flow and June 30, 2008 cash balance, $5,600 ($14,800 − $50,000 + $40,800)

Self-Examination Questions

(Answers appear at the end of chapter.)

1. A profit-making business operating as a separate legal entity and in which ownership is divided into shares of stock is known as a:
   A. proprietorship.
   B. service business.
   C. partnership.
   D. corporation.

2. The resources owned by a business are called:
   A. assets.
   B. liabilities.
   C. the accounting equation.
   D. stockholders' equity.

3. A listing of a business entity's assets, liabilities, and stockholders' equity as of a specific date is:
   A. a balance sheet.
   B. an income statement.
   C. the retained earnings statement.
   D. a statement of cash flows.
4. If total assets are $20,000 and total liabilities are $12,000, the amount of stockholders' equity is:
   A. $32,000.
   B. ($32,000).
   C. ($8,000).
   D. $8,000.
5. If revenue was $45,000, expenses were $37,500, and dividends were $10,000, the amount of net income or net loss would be:
   A. $45,000 net income.
   B. $7,500 net income.
   C. $37,500 net loss.
   D. $2,500 net loss.

Class Discussion Questions

1. What is the objective of most businesses?
2. What is the difference between a manufacturing business and a merchandising business? Give an example of each type of business.
3. What is the difference between a manufacturing business and a service business? Is a restaurant a manufacturing business, a service business, or both?
4. Why are most large companies like ***Microsoft***, ***Pepsi***, ***Caterpillar,*** and ***AutoZone*** organized as corporations?
5. Both ***KIA*** and ***Porsche*** produce and sell automobiles. Describe and contrast the business emphasis of KIA and Porsche.
6. Assume that a friend of yours operates a family-owned pharmacy. A ***Super Wal-Mart*** is scheduled to open in the next several months that will also offer pharmacy services. What business emphasis would your friend use to compete with the Super Wal-Mart pharmacy?
7. What services does ***eBay*** offer to its customers?
8. A business's stakeholders can be classified into capital market, product or service market, government, and internal stakeholders. Will the interests of all the stakeholders within a classification be the same? Use bankers and stockholders of the capital market as an example in answering this question.
9. The three business activities are financing, investing, and operating. Using ***United Airlines***, give an example of a financing, investing, and operating activity.
10. What is the role of accounting in business?
11. Briefly describe the nature of the information provided by each of the following financial statements: the income statement, the retained earnings statement, the balance sheet, and the statement of cash flows. In your descriptions, indicate whether each of the financial statements covers a period of time or is for a specific date.
12. For the year ending February 3, 2007, ***The Limited Inc.*** had revenues of $10,671 million and total expenses of $9,995 million. Did The Limited (a) incur a net loss or (b) realize net income?
13. What particular item of financial or operating data appears on both the income statement and the retained earnings statement? What item appears on both the balance sheet and the retained earnings statement? What item appears on both the balance sheet and statement of cash flows?
14. Becky Woods is the owner of City Delivery Service. Recently, Becky paid interest of $4,000 on a personal loan of $50,000 that she used to begin the business. Should City Delivery Service record the interest payment? Explain.
15. On March 10, Reliable Repair Service extended an offer of $75,000 for land that had been priced for sale at $90,000. On March 25, Reliable Repair Service accepted the seller's counteroffer of $80,000. Describe how Reliable Repair Service should record the land.
16. Land with an assessed value of $475,000 for property tax purposes is acquired by a business for $600,000. Seven years later, the plot of land has an assessed value of $550,000 and the business receives an offer of $900,000 for it. Should the monetary amount assigned to the land in the business records now be increased?

Exercises

E1-1

Types of businesses

Obj 1

Indicate whether each of the following companies is primarily a service, merchandise, or manufacturing business. If you are unfamiliar with the company, you may use the Internet to locate the company's home page or use the finance Web site of Yahoo.com.

1. ***Alcoa***
2. ***AT&T***
3. ***Boeing***
4. ***Caterpillar***
5. ***Citigroup***
6. ***CVS***
7. ***Dow Chemical***
8. ***FedEx***
9. ***First Republic Bank***
10. ***Ford Motor***
11. ***The Gap***
12. ***Hilton Hotels***
13. ***H&R Block Inc.***
14. ***Procter & Gamble***
15. ***Sears Roebuck***

E1-2

Business emphasis

Obj 1

Identify the primary business emphasis of each of the following companies as (a) a low-cost emphasis or (b) a premium-price emphasis. If you are unfamiliar with the company, you may use the Internet to locate the company's home page or use the finance Web site of Yahoo.com.

1. ***BMW***
2. ***Charles Schwab***
3. ***Circuit City Stores***
4. ***Coca-Cola***
5. ***Dollar General***
6. ***Goldman Sachs Group***
7. ***Home Depot***
8. ***Maytag***
9. ***Nike***
10. ***Office Depot***
11. ***Sara Lee***
12. ***Southwest Airlines***

E1-3

Accounting equation

Obj 4

✓ Coca-Cola, $16,920

The total assets and total liabilities of ***Coca-Cola*** and ***PepsiCo*** are shown here.

	Coca-Cola (in millions)	*PepsiCo (in millions)*
Assets	$29,963	$29,930
Liabilities	13,043	14,483

Determine the stockholders' equity of each company.

E1-4

Accounting equation

Obj 4

✓ eBay, $10,905

The total assets and total liabilities of ***eBay Inc.*** and ***Estée Lauder Inc.*** are shown here.

	eBay Inc. (in millions)	*Estée Lauder Inc. (in millions)*
Assets	$13,494	$3,784
Liabilities	2,589	2,162

Determine the stockholders' equity of each company.

E1-5

Accounting equation

Obj 4

✓ a. $190,000

Determine the missing amount for each of the following:

	Assets	=	*Liabilities*	+	*Stockholders' Equity*
a.	X	=	$ 70,000	+	$120,000
b.	$ 45,000	=	X	+	$ 10,000
c.	$320,000	=	$115,000	+	X

E1-6
Accounting equation
Obj 4
✓ a. $4,138

Determine the missing amounts (in thousands) for the condensed balance sheets shown below.

	The Limited	*FedEx Corporation*	*Ford Motor Co.*
Assets	$7,093	$ (b)	$278,554
Liabilities	(a)	11,179	282,019
Stockholders' equity	2,955	11,511	(c)

E1-7
Net income and dividends
Obj 4

The income statement of a corporation for the month of November indicates a net income of $200,000. During the same period, $225,000 in cash dividends were paid.

Would it be correct to say that the business incurred a net loss of $25,000 during the month? Discuss.

E1-8
Net income and stockholders' equity for four businesses
Obj 4
✓ Company E: Net income, $80,000

Four different companies, E, F, G, and H, show the same balance sheet data at the beginning and end of a year. These data, exclusive of the amount of owners' equity, are summarized as follows:

	Total Assets	*Total Liabilities*
Beginning of the year	$600,000	$240,000
End of the year	960,000	520,000

On the basis of the above data and the following additional information for the year, determine the net income (or loss) of each company for the year. (*Hint:* First determine the amount of increase or decrease in stockholders' equity during the year.)

Company E: No additional capital stock was issued, and no dividends were paid.
Company F: No additional capital stock was issued, but dividends of $48,000 were paid.
Company G: Capital stock of $120,000 was issued, but no dividends were paid.
Company H: Capital stock of $120,000 was issued, and dividends of $48,000 were paid.

E1-9
Accounting equation and income statement
Obj 4
✓ 1. $3,375,600

Staples, Inc., is a leading office products distributor, with retail stores in the United States, Canada, Asia, Europe, and South America. The following financial statement data were adopted from Staples' financial statements as of February 3, 2007 and January 28, 2006:

	2007 (in thousands)	*2006 (in thousands)*
Total assets	$ 8,397,265	$7,676,589
Total liabilities	(1)	3,251,118
Total stockholders' equity	5,021,665	(2)
Sales	18,160,789	
Cost of goods sold	12,966,788	
Selling and administrative expenses	3,716,517	
Other income and (expense)	(5,835)	
Income tax expense	497,972	

a. Determine the missing data indicated for (1) and (2).
b. Using the income statement data for 2007, determine the amount of net income or loss.

E1-10
Balance sheet items
Obj 4

From the following list of selected items taken from the records of Metro Appliance Service as of a specific date, identify those that would appear on the balance sheet.

1. Accounts Payable
2. Capital Stock
3. Cash
4. Fees Earned
5. Land
6. Supplies
7. Supplies Expense
8. Utilities Expense
9. Wages Expense
10. Wages Payable

E1-11
Income statement items
Obj 4

Based on the data presented in Exercise 1-10, identify those items that would appear on the income statement.

E1-12
Financial statement items
Obj 4

Identify each of the following items as (a) an asset, (b) a liability, (c) revenue, (d) an expense, or (e) a dividend:

1. Amounts due from customers
2. Amounts owed vendors
3. Cash on hand
4. Cash paid to stockholders
5. Cash sales
6. Equipment
7. Note payable owed to the bank
8. Rent paid for the month
9. Sales commissions paid to salespersons
10. Wages paid to employees

E1-13
Retained earnings statement
Obj 4
SPREADSHEET
✓ Retained earnings, June 30, 2008: $478,800

Financial information related to Fresca Company for the month ended June 30, 2008, is as follows:

Net income for June	$ 93,800
Dividends during June	25,000
Retained earnings, June 1, 2008	410,000

Prepare a retained earnings statement for the month ended June 30, 2008.

E1-14
Income statement
Obj 4
SPREADSHEET
✓ Net income: $156,000

Boutique Services was organized on May 1, 2008. A summary of the revenue and expense transactions for May follows:

Fees earned	$375,000
Wages expense	140,000
Miscellaneous expense	4,000
Rent expense	60,000
Supplies expense	15,000

Prepare an income statement for the month ended May 31.

E1-15
Missing amounts from balance sheet and income statement data
Obj 4
✓ (a) $78,150

One item is omitted in each of the following summaries of balance sheet and income statement data for four different corporations, W, X, Y, and Z.

	W	X	Y	Z
Beginning of the year:				
Assets	$360,000	$250,000	$160,000	$ (d)
Liabilities	216,000	130,000	121,600	450,000
End of the year:				
Assets	447,000	350,000	144,000	930,000
Liabilities	195,000	110,000	128,000	510,000
During the year:				
Additional issue of capital stock	(a)	50,000	16,000	150,000
Dividends	24,000	16,000	(c)	225,000
Revenue	118,650	(b)	184,000	420,000
Expenses	64,800	64,000	196,000	480,000

Determine the missing amounts, identifying them by letter. [*Hint:* First determine the amount of increase or decrease in owners' (stockholders') equity during the year.]

E1-16

Balance sheets, net income

Obj 4

SPREADSHEET

✓ b. $90,850

Financial information related to Midas Interiors for March and April 2008 is as follows:

	March 31, 2008	*April 30, 2008*
Accounts payable	$ 30,800	$ 33,200
Accounts receivable	68,000	78,250
Capital stock	37,500	37,500
Retained earnings	?	?
Cash	120,000	204,000
Supplies	6,000	5,000

a. Prepare balance sheets for Midas Interiors as of March 31 and as of April 30, 2008.
b. Determine the amount of net income for April, assuming that no additional capital stock was issued and no dividends were paid during the month.
c. Determine the amount of net income for April, assuming that no additional capital stock was issued but dividends of $25,000 were paid during the month.

E1-17

Financial statements

Obj 4

Each of the following items is shown in the financial statements of ***ExxonMobil Corporation.*** Identify the financial statement (balance sheet or income statement) in which each item would appear.

a. Accounts payable
b. Cash equivalents
c. Crude oil inventory
d. Equipment
e. Exploration expenses
f. Income taxes payable
g. Investments
h. Long-term debt
i. Marketable securities
j. Notes and loans payable
k. Operating expenses
l. Prepaid taxes
m. Retained earnings
n. Sales
o. Selling expenses

E1-18

Statement of cash flows

Obj 4

Indicate whether each of the following cash activities would be reported on the statement of cash flows as (a) an operating activity, (b) an investing activity, or (c) a financing activity.

1. Sold excess office equipment
2. Paid rent
3. Paid for office equipment
4. Issued capital stock
5. Sold services
6. Paid for advertising
7. Paid officers' salaries
8. Issued a note payable
9. Paid rent
10. Paid dividends

E1-19

Statement of cash flows

Obj 4

Indicate whether each of the following activities would be reported on the statement of cash flows as (a) an operating activity, (b) an investing activity, or (c) a financing activity.

1. Cash received from investment by stockholders
2. Cash received from fees earned
3. Cash paid for land
4. Cash paid for expenses

E1-20

Statement of cash flows

Obj 4

SPREADSHEET

✓ Net cash flows from operating activities, $109,080

Eduardo Inc. was organized on July 1, 2009. A summary of cash flows for July follows.

Cash receipts:	
Cash received from customers	$169,200
Cash received for capital stock	648,000
Cash received from note payable	72,000
Cash payments:	
Cash paid out for expenses	$ 60,120
Cash paid out for purchase of equipment	540,000
Cash paid as dividends	36,000

Prepare a statement of cash flows for the month ended July 31, 2009.

E1-21

Using financial statements

Obj 4

A company's stakeholders often differ in their financial statement focus. For example, some stakeholders focus primarily on the income statement, while others may focus primarily on the statement of cash flows or the balance sheet. For each of the following situations, indicate which financial statement would be the likely focus for the stakeholder. Choose either the income statement, balance sheet, or the statement of cash flows and justify your choice.

Situation One: Assume that you are considering investing in eBay (capital market stakeholder).

Situation Two: Assume that you are considering purchasing a personal computer from ***Dell.***

Situation Three: Assume that you are a banker for Citigroup (capital market stakeholder), considering whether to grant a major credit line (loan) to Wal-Mart. The credit line will allow Wal-Mart to borrow up to $400 million for a 5-year period at the market rate of interest.

Situation Four: Assume that you are employed by Sara Lee Corporation (product market stakeholder) and are considering whether to extend credit for a 60-day period to a new grocery store chain that has recently opened throughout the Midwest.

Situation Five: Assume that you are considering taking a job (internal stakeholder) with either Sears or JC Penney.

E1-22

Financial statement items

Obj 4

Starbucks Corporation purchases and roasts high-quality whole bean coffees and sells them, along with fresh, rich-brewed coffees and a variety of other complementary items, primarily through company-operated retail stores.

The following items were adapted from the annual report of Starbucks Corporation for the period ending October 1, 2006:

	In thousands
1. Accounts payable	$ 340,937
2. Accounts receivable	224,271
3. Accrued taxes payable	94,010
4. Additions to property, plant, and equipment	771,230
5. Inventories	636,222

		In thousands
6.	Cost of sales	$3,178,791
7.	Depreciation and amortization expenses	387,211
8.	General and administrative expenses	473,023
9.	Income tax expense	324,770
10.	Net cash provided by operating activities	1,131,633
11.	Net sales	7,786,942
12.	Other income (loss)	106,228
13.	Other expenses	277,301
14.	Property, plant, and equipment	2,287,899
15.	Retained earnings (October 1, 2006)	2,151,084
16.	Store operating expenses	2,687,815

Using the following notations, indicate on which financial statement you would find each of the preceding items. (*Note:* An item may appear on more than one statement.)

IS	Income statement
RE	Retained earnings statement
BS	Balance sheet
SCF	Statement of cash flows

E1-23

Income statement

Obj 4

✓ Net income, $564,259

Based on the ***Starbucks Corporation*** financial statement data shown in Exercise 1-22, prepare an income statement for the year ending October 1, 2006.

E1-24

Financial statement items

Obj 4

Though the ***McDonald's*** menu of hamburgers, cheeseburgers, the Big Mac®, Quarter Pounder®, the Filet-O-Fish®, and Chicken McNuggets® is easily recognized, McDonald's financial statements may not be as familiar. The following items were adapted from a recent annual report of McDonald's Corporation:

1. Accounts payable
2. Accrued interest payable
3. Capital stock outstanding
4. Cash
5. Cash provided by operations
6. Food and packaging costs used in operations
7. Income tax expense
8. Interest expense
9. Inventories
10. Long-term debt payable
11. Net income
12. Net increase in cash
13. Notes payable
14. Notes receivable
15. Occupancy and rent expense
16. Payroll expense
17. Prepaid expenses not yet used in operations
18. Property and equipment
19. Retained earnings
20. Sales

Identify the financial statement on which each of the preceding items would appear. An item may appear on more than one statement. Use the following notations:

IS	Income statement
RE	Retained earnings statement
BS	Balance sheet
SCF	Statement of cash flows

E1-25

Financial statements

Obj 4

✓ Correct amount of total assets is $195,000

Pacific Realty, organized August 1, 2009, is owned and operated by Dawn Cordell. How many errors can you find in the following financial statements for Pacific Realty, prepared after its first month of operations? Assume that the cash balance on August 31, 2009, is $46,600 and that cash flows from operating activities is reported correctly.

PACIFIC REALTY
Income Statement
August 31, 2009

Sales commissions		$308,400
Operating expenses:		
Office salaries expense	$172,600	
Rent expense	31,200	
Miscellaneous expense	2,200	
Automobile expense	7,900	
Total operating expenses		213,900
Net income		$134,500

DAWN CORDELL
Retained Earnings Statement
August 31, 2008

Retained earnings, August 1, 2009	$ 17,800
Less dividends during August	12,000
	$ 5,800
Net income for the month	134,500
Retained earnings, August 31, 2009	$140,300

Balance Sheet
For the Month Ended August 31, 2009

Assets		
Cash		$ 46,600
Accounts payable		12,500
Land		60,000
Total assets		$119,100
Liabilities		
Accounts receivable		$ 81,200
Prepaid expenses		7,200
Stockholders' Equity		
Capital stock	$100,000	
Retained earnings	140,300	240,300
Total liabilities and stockholders' equity		$328,700

Statement of Cash Flows
August 31, 2009

Cash flows from operating activities:		
Cash received from customers	$227,200	
Cash paid for operating expenses	208,600	
Net cash flow from operating activities		$ 18,600
Cash flows from financing activities:		
Cash received from issuance of capital stock	$100,000	
Dividends paid to stockholders	(12,000)	
Net cash flow from financing activities		88,000
Net cash flow and cash balance as of August 31, 2009		$106,600

E1-26
Accounting concepts
Obj 5

Match each of the following statements with the appropriate accounting concept. Some concepts may be used more than once, while others may not be used at all. Use the notations shown to indicate the appropriate accounting concept.

Accounting Concept	*Notation*
Accounting period concept	P
Adequate disclosure concept	D
Business entity concept	B
Cost concept	C
Going concern concept	G
Matching concept	M
Objectivity concept	O
Unit of measure concept	U

Statements

1. Personal transactions of owners are kept separate from the business.
2. Changes in the use of accounting methods from one period to the next are described in the notes to the financial statements.
3. This concept supports relying on an independent actuary (statistician), rather than the chief operating officer of the corporation, to estimate a pension liability.
4. Assume that a business will continue forever.
5. This concept justifies recording only transactions that are expressed in dollars.
6. Material litigation involving the corporation is described in a footnote.
7. If this concept was ignored, the confidence of users in the financial statements could not be maintained.
8. Monthly utilities costs are reported as expenses along with the monthly revenues.
9. The changes in financial condition are reported at the end of the month.
10. Land worth $800,000 is reported at its original purchase price of $220,000.

E1-27
Business entity concept
Obj 5

Glacier Sports sells hunting and fishing equipment and provides guided hunting and fishing trips. Glacier Sports is owned and operated by Ben Chambless, a well-known sports enthusiast and hunter. Ben's wife, Julie, owns and operates Fashion Boutique, a women's clothing store. Ben and Julie have established a trust fund to finance their children's college education. The trust fund is maintained by San Marcos City Bank in the name of the children, Renee and Keith.

For each of the following transactions, identify which of the entities listed should record the transaction in its records.

Entities	
G	Glacier Sports
S	San Marcos City Bank
F	Fashion Boutique
X	None of the above

1. Julie purchased two dozen spring dresses from a San Marcos designer for a special spring sale.
2. Ben paid for dinner and a movie to celebrate their fifteenth wedding anniversary.
3. Ben paid a local doctor for his annual physical, which was required by the workmens' compensation insurance policy carried by Glacier Sports.
4. Ben received a cash advance from customers for a guided hunting trip.
5. Julie deposited a $4,000 personal check in the trust fund at San Marcos City Bank.
6. Julie purchased mutual fund shares as an investment for the children's trust.
7. Ben paid for an advertisement in a hunters' magazine.

(continued)

8. Julie donated several dresses from inventory for a local charity auction for the benefit of a women's abuse shelter.
9. Julie paid her dues to the YWCA.
10. Ben paid a breeder's fee for a Brittany spaniel to be used as a hunting guide dog.

Problems

P1-1

Income statement, retained earnings statement, and balance sheet

Obj 4

SPREADSHEET

✓ 1. Net income: $222,200

The amounts of the assets and liabilities of Aloha Travel Service at November 30, 2008, the end of the current year, and its revenue and expenses for the year are listed below. The retained earnings were $140,000, and the capital stock was $60,000 at December 1, 2007, the beginning of the current year. Dividends of $120,000 were paid during the current year.

Accounts payable	$ 48,800
Accounts receivable	125,400
Cash	212,200
Fees earned	1,052,800
Miscellaneous expense	11,800
Rent expense	151,200
Supplies	13,400
Supplies expense	28,400
Taxes expense	22,400
Utilities expense	90,000
Wages expense	526,800

Instructions

1. Prepare an income statement for the current year ended November 30, 2008.
2. Prepare a retained earnings statement for the current year ended November 30, 2008.
3. Prepare a balance sheet as of November 30, 2008.

P1-2

Missing amounts from financial statements

Obj 4

SPREADSHEET

✓ j. $121,320

The financial statements at the end of La Jolla Realty's first month of operations are shown below.

LA JOLLA REALTY
Income Statement
For the Month Ended April 30, 2008

Fees earned		$56,400
Operating expenses:		
Wages expense	$ (a)	
Rent expense	5,760	
Supplies expense	4,800	
Utilities expense	3,240	
Miscellaneous expense	1,980	
Total operating expenses		28,680
Net income		$ (b)

LA JOLLA REALTY
Retained Earnings Statement
For the Month Ended April 30, 2008

Net income for April	$ (c)	
Less dividends	(d)	
Retained earnings, April 30, 2008		$ (e)

LA JOLLA REALTY
Balance Sheet
April 30, 2008

Assets		
Cash		$35,400
Supplies		2,400
Land		(f)
Total assets		$ (g)
Liabilities		
Accounts payable		$ 2,880
Stockholders' Equity		
Capital stock	$ (h)	
Retained earnings	(i)	(j)
Total liabilities and stockholders' equity		$ (k)

LA JOLLA REALTY
Statement of Cash Flows
For the Month Ended April 30, 2008

Cash flows from operating activities:		
Cash received from customers	$ (l)	
Deduct cash payments for expenses and payments to creditors	28,200	
Net cash flows from operating activities		$ (m)
Cash flows from investing activities:		
Cash payments for acquisition of land		86,400
Cash flows from financing activities:		
Cash received from issuing capital stock	$108,000	
Deduct dividends	14,400	
Net cash flows from financing activities		(n)
Net cash flow and April 30, 2008 cash balance		$ (o)

Instructions

1. Would you classify a realty business like La Jolla Realty as a manufacturing, merchandising, or service business?
2. By analyzing the interrelationships between the financial statements, determine the proper amounts for (a) through (o).

P1-3

Income statement, retained earnings statement, and balance sheet

Obj 4

SPREADSHEET

✓ 1. Net income, $1,377

The following financial data were adapted from the annual report of ***Best Buy Inc.*** for the period ending March 3, 2007:

	In millions
Accounts payable	$ 5,745
Capital stock	694
Cash	3,793
Cost of goods sold	27,165
Income tax expense	752
Inventories	4,028
Investments	318
Goodwill and other intangible assets	1,000
Other assets	945
Other liabilities	1,624
Other revenue (net)	130
Property, plant, and equipment	2,938
Receivables	548

(continued)

	In millions
Sales	35,934
Selling, general, and administrative expenses	6,770

Instructions

1. Prepare Best Buy's income statement for the year ending March 3, 2007.
2. Prepare Best Buy's retained earnings statement for the year ending March 3, 2007. (*Note:* The retained earnings at March 3, 2006, was $4,304. During the year, Best Buy paid dividends of $174.)
3. Prepare a balance sheet as of March 3, 2007, for Best Buy.

P1-4

Statement of cash flows

Obj 4

SPREADSHEET

✓ Net increase in cash, $2,901

The following cash data were adapted from the annual report of ***Apple Computer Inc.*** for the period ended September 30, 2006. The cash balance as of September 30, 2005, was $3,491 (in millions).

	In millions
Receipts from capital stock	$ 324
Payments for property, plant, and equipment	657
Receipts from sale of other investments (net)	1,014
Net cash flows from operating activities	2,220

Instructions

Prepare Apple's statement of cash flows for the year ended September 30, 2006.

P1-5

Financial statements, including statement of cash flows

Obj 4

SPREADSHEET

✓ 1. Net income, $236,250

eWare Corporation began operations on January 1, 2009, as an online retailer of computer software and hardware. The following financial statement data were taken from eWare's records at the end of its first year of operations, December 31, 2009.

Accounts payable	$ 31,500
Accounts receivable	50,400
Capital stock	262,500
Cash	?
Cash payments for operating activities	735,000
Cash receipts from operating activities	878,850
Cost of sales	420,000
Dividends	26,250
Income tax expense	147,000
Income taxes payable	21,000
Interest expense	15,750
Inventories	94,500
Note payable (due in 2015)	105,000
Property, plant, and equipment	396,900
Retained earnings	?
Sales	929,250
Selling and administrative expense	110,250

Instructions

1. Prepare an income statement for the year ended December 31, 2009.
2. Prepare a retained earnings statement for the year ended December 31, 2009.
3. Prepare a balance sheet as of December 31, 2009.
4. Prepare a statement of cash flows for the year ended December 31, 2009.

Activities

A1-1

Integrity, objectivity, and ethics at The Hershey Company

ETHICS

The management of ***The Hershey Company*** has asked union workers in two of their highest cost Pennsylvania plants to accept higher health insurance premiums and take a wage cut. The worker's portion of the insurance cost would double from 6% of the premium to 12%. In addition, workers hired after January 2000 would have their hourly wages cut by $4, which would be partially offset by a 2% annual raise. Management says that the plants need to be more cost competitive. The management has indicated that if the workers accept the proposal that the company would invest $30 million to modernize the plants and move future projects to the plants. Management, however, has refused to guarantee more work at the plants if the workers approve the proposal. If the workers reject the proposal, management implies that they would move future projects to other plants and that layoffs might be forthcoming. Do you consider management's actions ethical?

Source: Susan Govzdas, "Hershey to Cut Jobs or Wages," *Central Penn Business Journal,* September 24, 2004.

A1-2

Ethics and professional conduct in business

GROUP

ETHICS

Monica Orgeta, president and owner of Star Enterprises, applied for a $250,000 loan from Carmel National Bank. The bank requested financial statements from Star Enterprises as a basis for granting the loan. Monica has told her accountant to provide the bank with a balance sheet. Monica has decided to omit the other financial statements because there was a net loss during the past year.

In groups of three or four, discuss the following questions:

1. Is Monica behaving in a professional manner by omitting some of the financial statements?
2. a. What types of information about their businesses would owners be willing to provide bankers? What types of information would owners not be willing to provide?
   b. What types of information about a business would bankers want before extending a loan?
   c. What common interests are shared by bankers and business owners?

A1-3

How businesses make money

GROUP

Assume that you are the chief executive officer for ***Pilgrim's Pride Corporation***, a national poultry producer. The company's operations include hatching chickens through the use of breeder stock and feeding, raising, and processing the mature chicks into finished products. The finished products include breaded chicken nuggets and patties and deboned, skinless, and marinated chicken. Pilgrim's Pride Corporation sells its products to schools, military services, fast-food chains, and grocery stores.

In groups of four or five, discuss the following business emphasis and risk issues:

1. In a commodity business like poultry production, what do you think is the dominant business emphasis? What are the implications in this dominant emphasis for how you would run Pilgrim's Pride Corporation?
2. Identify at least two major business risks for operating Pilgrim's Pride Corporation.
3. How could Pilgrim's Pride Corporation try to differentiate its products?

A1-4

Net income versus cash flow

On January 3, 2009, Dr. Abraham Brody established Second Opinion, a medical practice organized as a professional corporation. The following conversation occurred the following September between Dr. Brody and a former medical school classmate, Dr. Janice Martin, at an American Medical Association convention in Paris, France.

Dr. Martin: Abraham, good to see you again. Why didn't you call when you were in Las Vegas? We could have had dinner together.

(continued)

Dr. Brody: Actually, I never made it to Las Vegas this year. My wife and kids went up to our Lake Tahoe condo twice, but I got stuck in New York. I opened a new consulting practice this January and haven't had any time for myself since.

Dr. Martin: I heard about it . . . Second . . . something . . . right?

Dr. Brody: Yes, Second Opinion. My wife chose the name.

Dr. Martin: I've thought about doing something like that. Are you making any money? I mean, is it worth your time?

Dr. Brody: You wouldn't believe it. I started by opening a bank account with $40,000, and my August bank statement has a balance of $120,000. Not bad for eight months—all pure profit.

Dr. Martin: Maybe I'll try it in Las Vegas. Let's have breakfast together tomorrow and you can fill me in on the details.

Comment on Dr. Brody's statement that the difference between the opening bank balance ($40,000) and the August statement balance ($120,000) is pure profit.

A1-5

The accounting equation

Obtain the annual reports for three well-known companies, such as ***Ford Motor Co., General Motors***, ***IBM***, ***Microsoft***, or ***Amazon.com.*** These annual reports can be obtained from the library, the company's Web site under "Investor Relations," **http://finance.yahoo.com** (type in the company name for Get Quotes), or the company's 10-K filing with the Securities and Exchange Commission at **http://www.sec.gov/**.

To obtain annual report information, click on "Search for Company Filings." Next, click on "Historical EDGAR Archives." Key in the company name. EDGAR will list the reports available for the company. Click on the 10-K (or 10-K405) report for the year you want to download. If you wish, you can save the whole 10-K report to a file and then open it with your word processor.

Examine the balance sheet for each company and determine the total assets, liabilities, and stockholders' equity. Verify that total assets equal the total of the liabilities plus stockholders' equity.

A1-6

Hershey's annual report

The financial statements of ***The Hershey Company*** are shown in Exhibits 4 through 7 of this chapter. Based upon these statements, answer the following questions.

1. What are Hershey's sales (in millions)?
2. What is Hershey's cost of sales (in millions)?
3. What is Hershey's net income (in millions)?
4. What is Hershey's percent of the cost of sales to sales? Round to one decimal place.
5. The percent that a company adds to its cost of sales to determine the selling price is called a markup. What is Hershey's markup percent? Round to one decimal place.
6. What is the percentage of net income to sales for Hershey? Round to one decimal place.

A1-7

Income statement analysis

The following data (in thousands of dollars) were adapted from the December 31, 2006, financial statements of ***Tootsie Roll Industries Inc.:***

Sales	$495,990
Cost of goods sold	310,507
Net income	65,919

1. What is Tootsie Roll's percent of the cost of sales to sales? Round to one decimal place.
2. The percent a company adds to its cost of sales to determine selling price is called a markup. What is Tootsie Roll's markup percent? Round to one decimal place.
3. What is the percentage of net income to sales for Tootsie Roll? Round to one decimal place.
4. Compare your answer to (3) with that of The Hershey Company in Activity 1-6. What are your conclusions?

A1-8
Financial analysis of Enron Corporation

Enron Corporation, headquartered in Houston, Texas, provides products and services for natural gas, electricity, and communications to wholesale and retail customers. Enron's operations are conducted through a variety of subsidiaries and affiliates that involve transporting gas through pipelines, transmitting electricity, and managing energy commodities. The following data were taken from Enron's December 31, 2000, financial statements:

	In millions
Total revenues	$100,789
Total costs and expenses	98,836
Operating income	1,953
Net income	979
Total assets	65,503
Total liabilities	54,033
Total stockholders' equity	11,470
Net cash flows from operating activities	4,779
Net cash flows from investing activities	(4,264)
Net cash flows from financing activities	571
Net increase in cash	1,086

At the end of 2000, the market price of Enron's stock was approximately $83 per share. As of April 17, 2005, Enron's stock was selling for $0.03 per share.

Review the preceding financial statement data and search the Internet for articles on Enron Corporation. Briefly explain why Enron's stock dropped so dramatically in such a short time.

Answers to Self-Examination Questions

1. **D** A corporation, organized in accordance with state or federal statutes, is a separate legal entity in which ownership is divided into shares of stock (answer D). A proprietorship (answer A) is an unincorporated business owned by one individual. A service business (answer B) provides services to its customers. It can be organized as a proprietorship, partnership, or corporation. A partnership (answer C) is an unincorporated business owned by two or more individuals.

2. **A** The resources owned by a business are called assets (answer A). The debts of the business are called liabilities (answer B), and the equity of the owners is called stockholders' equity (answer D). The relationship between assets, liabilities, and stockholders' equity is expressed as the accounting equation (answer C).

3. **A** The balance sheet is a listing of the assets, liabilities, and stockholders' equity of a business at a specific date (answer A). The income statement (answer B) is a summary of the revenue and expenses of a business for a specific period of time. The retained earnings statement (answer C) summarizes the changes in retained earnings during a specific period of time. The statement of cash flows (answer D) summarizes the cash receipts and cash payments for a specific period of time.

4. **D** The accounting equation is:

   Assets = Liabilities + Stockholders' Equity

   Therefore, if assets are $20,000 and liabilities are $12,000, stockholders' equity is $8,000 (answer D), as indicated in the following computation:

Assets	**= Liabilities + Stockholders' Equity**
+$20,000	**= +$12,000 + Stockholders' Equity**
+$20,000 − $12,000	**= Stockholders' Equity**
+$8,000	**= Stockholders' Equity**

5. **B** Net income is the excess of revenue over expenses, or $7,500 (answer B). If expenses exceed revenue, the difference is a net loss. Dividends are the opposite of the stockholders investing in the business and do not affect the amount of net income or net loss.