Investing and Financing Decisions and the Accounting System

Steve Ells is a classically trained chef who is often called one of the most innovative men in the world of food. He is the founder, chairman of the board, and co-chief executive officer of Chipotle Mexican Grill, a leader in the fastest-growing segment of the restaurant industry, now called "fast-casual." In 1993, this entrepreneur opened his first restaurant in a former Dolly Madison ice cream store in Denver, Colorado. His vision was a restaurant that serves food fast but uses higher-quality fresh ingredients and cooking techniques found in finer restaurants. As of December 31, 2011, the Chipotle chain had over 1,230 restaurants in the United States, two in Toronto, Canada, and two in London, England. It plans to open about 160 additional restaurants in 2012.

How did Chipotle grow so fast? It did so in two stages. First, in 1999, McDonald's Corporation became the majority stockholder by investing about $360 million in Chipotle. This provided funding for its tremendous early growth from 19 stores to nearly 490 restaurants

Learning Objectives

After studying this chapter, you should be able to:

2-1 Define the objective of financial reporting, the elements of the balance sheet, and the related key accounting assumptions and principles. p. 43

2-2 Identify what constitutes a business transaction and recognize common balance sheet account titles used in business. p. 47

2-3 Apply transaction analysis to simple business transactions in terms of the accounting model: Assets = Liabilities + Stockholders' Equity. p. 49

2-4 Determine the impact of business transactions on the balance sheet using two basic tools: Journal entries and T-accounts. p. 54

2-5 Prepare a trial balance and simple classified balance sheet, and analyze the company using the current ratio. p. 64

2-6 Identify investing and financing transactions and demonstrate how they impact cash flows. p. 68

chapter 2

FOCUS COMPANY:

Chipotle Mexican Grill

EXPANDING ONE OF THE HOTTEST CHAINS BUILT ON SUSTAINABILITY

www.chipotle.com

by the end of 2005. Then, in January 2006, Chipotle "went public." In its IPO or initial public offering, it issued stock to the public for the first time. That stock is listed on the New York Stock Exchange as CMG. McDonald's also sold its ownership in Chipotle for nearly $1.4 billion—a handsome profit of over $1 billion. Comparing its balance sheet from 2005 to 2011 highlights the company's amazing 264 percent growth since becoming a public company:

(in millions of dollars)

	Assets	=	Liabilities	+	Stockholders' Equity
End of 2011	$1,425		$381		$1,044
End of 2005	392		83		309
Change	+ $1,033		+ $298		+ $ 735

This growth was stimulated in part by Ells's evolving vision that "fresh is not enough anymore." He has committed Chipotle to serving naturally raised pork, chicken, and beef; using no-trans-fat cooking oil; serving cheese and sour cream products that are free of synthetic bovine growth hormones; using certified organic beans and locally grown organic produce when in season; and serving preservative-free corn and flour tortillas. In an even more dramatic show of commitment to sustainability, in 2009, Chipotle built the first-ever free-standing restaurant to receive the highest rating (LEED Platinum) from the U.S. Green Building Council,[1] a start toward other sustainable renovations and projects. In 2011, the company created the Chipotle Cultivate Foundation to expand philanthropic work surrounding sustainable agriculture.

As it continues to evolve, Chipotle's recent annual report states its vision is now "to change the way people think about and eat fast food." The belief is that providing good food and service is good business.

UNDERSTANDING THE BUSINESS

The "fast-casual" segment of the $1.7 trillion restaurant industry generates more than $23 billion in sales annually.[2] What identifies a restaurant as fast-casual? Typically, customers still order at the register as in a fast-food restaurant, but there are usually no drive-thru options and the food is made to order and served in modern and upscale surroundings. Checks typically range between $8 and $16. The largest fast-casual restaurant chain is Chipotle Mexican Grill, followed by Panera Bread Company.

Franchising is common in chain restaurants. The largest restaurant to use franchising is Subway, with over 39,000 restaurants—all franchised. Franchising involves selling the right to use or sell a product or service to another. This is an easy way for someone to start his or her own business because the franchisor (the seller, such as Panera Bread) often provides site location, design, marketing, and management training support in exchange for initial franchise fees and ongoing royalty fees usually based on weekly sales. At Panera Bread, for example, only 48 percent of the stores are company-owned.

Unlike most restaurant chains, however, Chipotle does not franchise the business. All restaurants are company-owned. Developing a new site, usually on rented property, costs about $800,000. In 2011, Chipotle spent over $140 million on new and renovated property and equipment. The creation of new restaurants to meet consumer demand for healthier food options explains most of the changes in Chipotle's assets and liabilities from year to year. To understand how the result of Chipotle Mexican Grill's growth strategy is communicated in the balance sheet, we must answer the following questions:

- What business activities cause changes in the balance sheet amounts from one period to the next?
- How do specific business activities affect each of the balance sheet amounts?
- How do companies keep track of the balance sheet amounts?

In this chapter, we focus on some typical asset acquisition activities (often called **investing activities**), along with related **financing activities,** such as borrowing funds from creditors or selling stock to investors to provide the cash necessary to acquire the assets. We examine those activities that affect only balance sheet amounts. Operating activities that affect both the income statement and the balance sheet are covered in Chapters 3 and 4. To begin, let's return to the basic concepts introduced in Chapter 1.

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[1]See **http://www.greenbeanchicago.com/wind-turbine-green-flyash-restaurant-chipotle/** and **https://www.usgbc.org/ShowFile.aspx?DocumentID=6953** for more information.

[2]Sources: **http://mexican-taco-fast-food-restaurant.franchise-business-tips.com/industry** and **http://www.fastcasual.com/infographic.php?id=4**.

ORGANIZATION of the Chapter

Overview of Accounting Concepts	What Business Activities Cause Changes in Financial Statement Amounts?	How Do Transactions Affect Accounts?	How Do Companies Keep Track of Account Balances?	How Is the Balance Sheet Prepared and Analyzed?
• Concepts Emphasized in Chapter 2	• Nature of Business Transactions • Accounts	• Principles of Transaction Analysis • Analyzing Chipotle's Transactions	• The Direction of Transaction Effects • Analytical Tools • Transaction Analysis Illustrated	• Classified Balance Sheet • Ratio Analysis in Decision-Making • Current Ratio

OVERVIEW OF ACCOUNTING CONCEPTS

Because learning and remembering **how** the accounting process works is much easier if you know **why** it works a certain way, we begin by discussing key accounting terms and concepts. They are part of a **conceptual framework** developed over many years and synthesized by the Financial Accounting Standards Board (FASB) to provide a structure for developing accounting standards. Exhibit 2.1 provides an overview of the key concepts in the framework that will be discussed in each of the next four chapters. A clear understanding of these accounting concepts will be helpful as you study, and they will also help you in future chapters as we examine more complex business activities.

Concepts Emphasized in Chapter 2

LEARNING OBJECTIVE 2-1

Define the objective of financial reporting, the elements of the balance sheet, and the related key accounting assumptions and principles.

Objective of Financial Reporting

The **primary objective of financial reporting to external users** is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. The users of accounting information are all expected to have a reasonable understanding of accounting concepts and procedures—which may be one of the reasons you are studying accounting. Of course, as we discussed in Chapter 1, many other groups, such as suppliers and customers, also use external financial statements.

Most users are interested in information to help them **assess the amount, timing, and uncertainty of a business's future cash inflows and outflows.** For example, creditors and potential creditors need to assess an entity's ability to (1) pay interest on a loan over time and also (2) pay back the principal on the loan when it is due. Investors and potential investors want to assess the entity's ability to (1) pay dividends in the future and (2) be successful so that the stock price rises, enabling investors to sell their stock for more than they paid. Information about a company's economic resources, claims against its resources, and activities that change these items provides insight into cash flows and a company's financial strengths and weaknesses.

PRIMARY OBJECTIVE OF FINANCIAL REPORTING TO EXTERNAL USERS is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.

EXHIBIT 2.1

Financial Accounting and Reporting Conceptual Framework

Objective of Financial Reporting to External Users: (in Ch. 2)
To provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity
➢ **Pervasive Cost-Benefit Constraint:** Benefits of providing information should outweigh its costs.

Fundamental Qualitative Characteristics of Useful Information: (in Ch. 2)
Relevance (including materiality) and Faithful Representation

Attributes that Enhance Qualitative Characteristics:
Comparability (including consistency), Verifiability, Timeliness, and Understandability

Elements to Be Measured and Reported:
Assets, Liabilities, Stockholders' Equity, Investments by Owners, and Distributions to Owners (in Ch. 2)
Revenues, Expenses, Gains, and Losses (in Ch. 3)
Comprehensive Income (in Ch. 5)

Recognition, Measurement, and Disclosure Concepts:
Assumptions: Separate Entity, Continuity (Going Concern), and Stable Monetary Unit (in Ch. 2)
Time Period (in Ch. 3)
Principles: Mixed-Attribute Measurement (in Ch. 2)
Revenue Realization and Expense Matching (in Ch. 3)
Full Disclosure (in Ch. 5)

Qualitative Characteristics of Useful Information

For accounting information to be useful, it must be relevant and be a faithful representation. **Relevant information** is capable of influencing decisions by allowing users to assess past activities and/or predict future activities. To be reported, the information should also be material in amount depending on the nature of the item and company. **Faithful representation** requires that the information be complete, neutral, and free from error. Comparability, verifiability, timeliness, and understandability are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented. For example, our discussions of ratio analysis will emphasize the importance of comparing ratios for the same company over time, as well as with those of competitors. Such comparisons are valid only if the information is prepared on a consistent and comparable basis. These characteristics of useful information guide the FASB in deciding what financial information should be reported.

RELEVANT INFORMATION can influence a decision; it is timely and has predictive and/or feedback value.

FAITHFUL REPRESENTATION requires that the information be complete, neutral, and free from error.

SEPARATE-ENTITY ASSUMPTION states that a business's activities are accounted for separately from those of its owners.

CONTINUITY (GOING-CONCERN) ASSUMPTION states that businesses are assumed to continue into the foreseeable future.

STABLE MONETARY UNIT ASSUMPTION states that accounting information should be measured and reported in the national monetary unit without any adjustment for changes in purchasing power.

MIXED-ATTRIBUTE MEASUREMENT MODEL is applied to measuring different assets and liabilities.

Recognition and Measurement Concepts

Before we discuss accountants' precise definitions for the elements of the balance sheet, we should consider three assumptions and a measurement concept that underlie much of our application of these definitions. First we make the **separate-entity assumption,** which states that each business's activities must be accounted for separately from the activities of its owners, all other persons, and other entities. This means, for example, that, when an owner purchases property for personal use, the property is not an asset of the business. Second, under the **continuity assumption** (sometimes called the **going-concern assumption**), unless there is evidence to the contrary, we assume that the business will continue operating into the foreseeable future, long enough to meet its contractual commitments and plans. This means, for example, that if there was a high likelihood of bankruptcy, then its assets should be valued and reported on the balance sheet as if the company were to be liquidated (that is, discontinued, with all of its assets sold and all debts paid). Under the **stable monetary unit assumption,** each business entity accounts for and reports its financial results primarily in terms of the national monetary unit (e.g., dollars in the United States, yen in Japan, and euros in Germany), without any adjustment for changes in purchasing power (e.g., inflation).

Finally, accountants measure the elements of the balance sheet using what is called a **mixed-attribute measurement model.** Most balance sheet elements are recorded at their cash-equivalent value on the date of the transaction. This is called the **historical cost principle** or **cost principle.** For example, assets are initially recorded at the cash paid plus the dollar value of all noncash considerations on the exchange date. We will discuss the conditions under which these values are adjusted to other amounts, such as their market value, starting in Chapter 6 of this text. With these assumptions in mind, we are now ready to discuss accountants' precise definitions of the elements of the balance sheet.

Elements of the Balance Sheet

The four financial statements—balance sheet, income statement, statement of stockholders' (shareholders' or owners') equity, and statement of cash flows—along with the notes to the statements provide the structure for the information communicated to users. As we learned in Chapter 1, assets, liabilities, and stockholders' equity are the elements of a corporation's balance sheet. The conceptual framework defines them as follows.

Assets are probable future economic benefits owned or controlled by an entity as a result of past transactions or events. In other words, they are the economic resources the entity acquired to use in operating the company in the future. As shown in Chipotle's balance sheet presented in Exhibit 2.2, most companies list assets **in order of liquidity,** or how soon an asset is expected by management to be turned into cash or used. Notice that several of Chipotle's assets are categorized as **current assets.** Current assets are those resources that Chipotle will use or turn into cash within one year (the next 12 months). Chipotle's current assets include Cash, Short-Term Investments, Accounts Receivable (due from customers and others), Supplies (to make the food), and Prepaid Expenses (for rent, insurance, and advertising paid in advance of use). For manufacturers that produce and sell goods and merchandisers who sell already completed goods, Inventory (for goods to be sold) would also be listed after Accounts Receivable. Inventory is always considered a current asset, regardless of how long it takes to produce and sell the inventory. These are typical titles used by most entities.

ASSETS are probable future economic benefits owned or controlled by an entity as a result of past transactions or events.

CURRENT ASSETS are assets that will be used or turned into cash within one year. Inventory is always considered a current asset regardless of the time needed to produce and sell it.

All other assets are considered long term (or noncurrent). That is, they are to be used or turned into cash after the coming year. For Chipotle, that includes Property and Equipment (land, buildings, and equipment) and Investments (in other companies). Intangibles (nonphysical assets such as trademarks and patents) may also be listed. Although Chipotle has intangibles, for simplicity in this chapter, intangible assets have been combined with Property and Equipment. Intangibles are discussed in detail in Chapter 8.

Liabilities are defined as probable future sacrifices of economic benefits arising from present obligations of a business as a result of past transactions or events. In other words, they are probable obligations to pay cash or provide goods or services arising from past transactions. Entities that a company owes money to are called **creditors.** Chipotle's balance sheet includes four liabilities: Accounts Payable (to suppliers), Accrued Expenses Payable (for wages, utilities, taxes, and interest on debt), Unearned Revenue (for unredeemed gift cards that have been purchased by customers), and Notes Payable (to banks and other creditors). These and other liabilities will be discussed in more detail in subsequent chapters.

Similar to how assets are reported in order of liquidity, liabilities are usually listed on the balance sheet **in order of maturity** (how soon an obligation is to be paid). Liabilities that Chipotle will need to pay or settle within the coming year (with cash, goods, other current assets, or services) are classified as **current liabilities.** Distinguishing current assets and current liabilities assists external users of the financial statements in assessing the amounts and timing of future cash flows.

LIABILITIES are probable future sacrifices of economic benefits arising from present obligations of a business as a result of past transactions or events.

CURRENT LIABILITIES are obligations that will be settled by providing cash, goods, other current assets, or services within the coming year.

Stockholders' equity (also called **shareholders' equity** or **owners' equity**) is the residual interest in the assets of the entity after subtracting liabilities. It is a combination of the financing provided by the owners and by business operations.

STOCKHOLDERS' EQUITY (SHAREHOLDERS' OR OWNERS' EQUITY) is the residual interest in assets of the entity after subtracting liabilities.

- **Financing Provided by Owners** is referred to as **contributed capital.** Owners invest in the business by providing cash and sometimes other assets and receive in exchange shares of stock as evidence of ownership. The largest investors in Chipotle Mexican Grill are financial institutions (mutual funds, pension funds, etc.). The directors and executive officers also own stock as do other corporate employees and the general public.

EXHIBIT 2.2

Chipotle Mexican Grill, Inc., Balance Sheet

Classification	CHIPOTLE MEXICAN GRILL, INC. Consolidated Balance Sheet* December 31, 2011 (in thousands of dollars, except per share data)		EXPLANATIONS
			"Consolidated" means all subsidiaries are combined
			Point in time for which the balance sheet was prepared
	ASSETS		
	Current Assets:		
Current assets	Cash	$ 401,200	
Current assets	Short-term investments	55,000	*Ownership of other companies' stocks and bonds*
Current assets	Accounts receivable	8,400	*Payments due from customers and others*
Current assets	Supplies	8,900	*Food, beverage, and packaging supplies on hand*
Current assets	Prepaid expenses	27,700	*Rent, advertising, and insurance paid in advance*
	Total current assets	501,200	
Noncurrent assets	Property and equipment (net)	795,900	*Cost of land, buildings, and equipment to be used*
Noncurrent assets	Long-term investments	128,200	*Ownership of other companies' stocks and bonds*
	Total assets	$1,425,300	
	LIABILITIES AND STOCKHOLDERS' EQUITY		
	Current Liabilities:		
Current liabilities	Accounts payable	$ 46,400	*Payments due to suppliers*
Current liabilities	Accrued expenses payable	93,100	*Utilities, interest, taxes, and wages due to employees*
Current liabilities	Unearned revenue	18,000	*Unredeemed gift cards*
	Total current liabilities	157,500	
Noncurrent liabilities	Notes payable	223,600	*Written obligations due beyond the next 12 months*
	Total liabilities	381,100	
	Stockholders' Equity:		
	Common stock ($0.01 par per share)	300	*Total par value of stock issued by company to investors*
	Additional paid-in capital	372,400	*Excess of amount received over par value of stock issued*
	Retained earnings	671,500	*Undistributed earnings reinvested in the company*
	Total stockholders' equity	1,044,200	
	Total liabilities and stockholders' equity	$1,425,300	

**The information has been adapted from actual statements and simplified for this chapter.*

RETAINED EARNINGS are the cumulative earnings of a company that have not been distributed to the owners and are reinvested in the business.

- **Financing Provided by Operations** is referred to as **earned capital** or **retained earnings.**[3] When companies earn profits, they can be distributed to owners as dividends or reinvested in the business. The portion of profits reinvested in the business is called retained earnings. Companies with a growth strategy often pay little or no dividends to retain funds for expansion. A look at Chipotle's balance sheet (Exhibit 2.2) indicates that its growth has been financed by substantial reinvestment of earnings ($671.5 million).

PAUSE FOR FEEDBACK

We just learned the elements of the balance sheet (assets, liabilities, and stockholders' equity) and how assets and liabilities are usually classified (current or noncurrent). Current assets (including inventory) are expected to be used or turned into cash within the next 12 months and current liabilities are expected to be paid or satisfied within the next 12 months with cash, services, or other current assets.

[3]Retained earnings can increase only from profitable operations, but they decrease when a firm has a loss or pays dividends.

SELF-STUDY QUIZ

The following is a list of items from a recent balance sheet of The Wendy's Company. Indicate on the line provided whether each of the following is usually categorized on the balance sheet as a current asset (CA), noncurrent asset (NCA), current liability CL), noncurrent liability (NCL), or stockholders' equity (SE).

___ *a.* Retained Earnings	___ *d.* Inventories	___ *g.* Accounts Receivable
___ *b.* Prepaid Expenses	___ *e.* Additional Paid-in Capital	___ *h.* Long-Term Debt
___ *c.* Accounts Payable	___ *f.* Properties (buildings and equipment)	___ *i.* Accrued Expenses Payable

After you have completed your answers, check them with the solutions at the bottom of the page.

Unrecorded but Valuable Assets and Liabilities

FINANCIAL ANALYSIS

Many very valuable intangible **assets,** such as trademarks, patents, and copyrights that are developed inside a company (not purchased), are **not reported** on the balance sheet. For example, General Electric's balance sheet reveals no listing for the GE trademark because it was developed internally over time through research, development, and advertising (it was not purchased). Likewise, the Coca-Cola Company does not report any asset for its patented Coke formula, although it does report more than $2 billion in various trademarks that it has purchased.

Nearly all companies have some form of off-balance-sheet financing—obligations **not reported** as **liabilities** on the balance sheet. For many companies, renting facilities or equipment can fall into this category, and can be quite significant. For example, Delta Air Lines included in a note to the financial statements in a recent annual report that over $10.8 billion in future cash flows of aircraft rental leases were not reported on the balance sheet as debt, an amount equal to 24 percent of its total liabilities that were reported on the balance sheet. This also illustrates the importance of reading the notes, not just the financial statements, when analyzing a company's financial information and predicting future cash flows.

Now that we have reviewed the basic elements of the balance sheet and related recognition and measurement concepts as part of the conceptual framework, let's see what economic activities cause changes in the amounts reported on the balance sheet.

WHAT BUSINESS ACTIVITIES CAUSE CHANGES IN FINANCIAL STATEMENT AMOUNTS?

LEARNING OBJECTIVE 2-2

Identify what constitutes a business transaction and recognize common balance sheet account titles used in business.

Nature of Business Transactions

Accounting focuses on certain events that have an economic impact on the entity. Those events that are recorded as part of the accounting process are called **transactions.** The first step in translating the results of business events to financial statement numbers is determining which events to include. As the definitions of assets and liabilities indicate, only economic resources and debts **resulting from past transactions** are recorded on the balance sheet. Transactions include two types of events:

A TRANSACTION is (1) an exchange of assets or services for assets, services, or promises to pay between a business and one or more external parties to a business or (2) a measurable internal event such as adjustments for the use of assets in operations.

1. **External events:** These are **exchanges** of assets, goods, or services by one party for assets, services, or promises to pay (liabilities) from one or more other parties. Examples include the purchase of a machine from a supplier, sale of merchandise to customers, borrowing cash from a bank, and investment of cash in the business by the owners.

Solution to SELF-STUDY QUIZ

a. SE; *b.* CA; *c.* CL; *d.* CA; *e.* SE; *f.* NCA; *g.* CA; *h.* NCL; *i.* CL

2. **Internal events:** These include certain events that are not exchanges between the business and other parties but nevertheless have a direct and measurable effect on the entity. Examples include using up insurance paid in advance and using buildings and equipment over several years.

Throughout this textbook, the word *transaction* is used in the broad sense to include both types of events.

Some important events that have a future economic impact on a company, however, are **not** reflected in the financial statements. In most cases, signing a contract is not considered to be an accounting transaction because it involves **only the exchange of promises,** not of assets such as cash, goods, services, or property. For example, assume that Chipotle signs an employment contract with a new regional manager. From an accounting perspective, no transaction has occurred because no exchange of assets, goods, or services has been made. Each party to the contract has exchanged promises—the manager agrees to work; Chipotle agrees to pay the manager for the work. For each day the new manager works, however, the exchange of services for pay results in a transaction that Chipotle must record. Because of their importance, long-term employment contracts, leases, and other commitments may need to be disclosed in notes to the financial statements.

Accounts

An ACCOUNT is a standardized format that organizations use to accumulate the dollar effect of transactions on each financial statement item.

To accumulate the dollar effect of transactions on each financial statement item, organizations use a standardized format called an **account.** The resulting balances are kept separate for financial statement purposes. To facilitate the recording of transactions, each company establishes a **chart of accounts,** a list of all account titles and their unique numbers. The accounts are usually organized by financial statement element, with asset accounts listed first, followed by liability, stockholders' equity, revenue, and expense accounts in that order. Exhibit 2.3 lists various account titles that are quite common and are used by most companies. The exhibit also provides special notes to help you in learning account titles. When you are completing assignments and are unsure of an account title, refer to this listing for help.

Every company creates its own chart of accounts to fit the nature of its business activities. For example, a small lawn care service may have an asset account titled Lawn Mowing

EXHIBIT 2.3

Typical Account Titles

Assets	Liabilities	Stockholders' Equity	Revenues	Expenses
Cash	Accounts Payable	Common Stock	Sales Revenue	Cost of Goods Sold
Short-Term Investments	Accrued Expenses Payable	Additional Paid-in Capital	Fee Revenue	Wages Expense
Accounts Receivable	Notes Payable	Retained Earnings	Interest Revenue	Rent Expense
Notes Receivable	Taxes Payable		Rent Revenue	Interest Expense
Inventory (to be sold)	Unearned Revenue		Service Revenue	Depreciation Expense
Supplies	Bonds Payable			Advertising Expense
Prepaid Expenses				Insurance Expense
Long-Term Investments				Repair Expense
Equipment				Income Tax Expense
Buildings				
Land				
Intangibles				

Accounts with "receivable" in the title are always assets; they represent amounts owed by (receivable from) customers and others to the business.

Prepaid Expenses is always an asset; it represents amounts paid in advance by the company to others for future benefits, such as future insurance coverage, rental of property, or advertising.

Accounts with "payable" in the title are always liabilities and represent amounts owed by the company to be paid to others in the future.

Accounts with "unearned" in the title are always liabilities representing amounts paid in the past to the company by others who expect future goods or services from the company.

Title revenue accounts by their source followed by the word "revenue."

Title expense accounts by what was incurred or used followed by the word "expense," except for inventory sold, which is titled Cost of Goods Sold.

Equipment, but a large corporation such as Dell is unlikely to report such an account. These differences in accounts will become more apparent as we examine the balance sheets of various companies. Because each company has its own chart of accounts, you should **not** try to memorize a typical chart of accounts, but understand the nature of each typical account. Then when you see a company that uses a slightly different title, you will understand what it means. For example, some companies use the terms Trade Accounts Receivable (same as Accounts Receivable) or Merchandise Inventory (same as Inventory). In homework problems, you will either be given the account names or be expected to select appropriate names, similar to the ones in Exhibit 2.3. Once you select a name for an account, you must use that exact name in all transactions affecting that account.

The accounts you see in the financial statements of most large corporations are actually summations (or aggregations) of a number of specific accounts in their recordkeeping system. For example, Chipotle keeps separate accounts for food, beverage, and packaging supplies, but combines them under **Supplies** on the balance sheet. Equipment, buildings, and land are also combined into an account called **Property and Equipment.** Since our aim is to understand financial statements reported by actual entities, we will focus on aggregated accounts.

HOW DO TRANSACTIONS AFFECT ACCOUNTS?

LEARNING OBJECTIVE 2-3

Apply transaction analysis to simple business transactions in terms of the accounting model: Assets = Liabilities + Stockholders' Equity.

Managers' business decisions often result in transactions that affect the financial statements. For example, decisions to expand the number of stores, advertise a new product, change an employee benefit package, and invest excess cash would all affect the financial statements. Sometimes these decisions have unintended consequences as well. The decision to purchase additional inventory for cash in anticipation of a major sales initiative, for example, will increase inventory and decrease cash. But if there is no demand for the additional inventory, the lower cash balance will also reduce the company's ability to pay its other obligations.

Because business decisions often involve an element of risk, managers should understand exactly how transactions impact the financial statements. The process for determining the effects of transactions is called **transaction analysis.**

Principles of Transaction Analysis

Transaction analysis is the process of studying a transaction to determine its economic effect on the entity in terms of the accounting equation (also known as the **fundamental accounting model**). We outline the process in this section of the chapter and create a visual tool representing the process (the transaction analysis model). The basic accounting equation and two principles are the foundation for this model. Recall from Chapter 1 that the basic accounting equation for a business that is organized as a corporation is as follows:

TRANSACTION ANALYSIS is the process of studying a transaction to determine its economic effect on the fundamental accounting model.

Assets (A) = Liabilities (L) + Stockholders' Equity (SE)

The two principles underlying the transaction analysis process follow:

- Every transaction affects at least two accounts; correctly identifying those accounts and the direction of the effect (whether an increase or a decrease) is critical.
- The accounting equation must remain in balance after each transaction.

Success in performing transaction analysis depends on a clear understanding of these principles. Study the following material well.

Dual Effects

The idea that every transaction has **at least two effects** on the basic accounting equation is known as the **dual effects** concept.[4] Most transactions with external parties involve an

[4]From this concept, accountants have developed what is known as the *double-entry system* of recordkeeping.

exchange by which the business **entity both receives something and gives up something in return.** For example, suppose Chipotle purchased tomatoes for cash. In this exchange, Chipotle would receive food supplies (an increase in an asset) and in return would give up cash (a decrease in an asset).

A	=	L	+	SE
+/−				

Transaction	Chipotle Received	Chiptole Gave
Purchased tomatoes for cash	**Supplies** (asset account increased)	**Cash** (asset account decreased)


+

−

In analyzing this transaction, we determined that the accounts affected were Supplies and Cash. However, most supplies are purchased on credit (that is, money is owed to suppliers). In that case, Chipotle would engage in *two* separate transactions at different points in time:

A	=	L	+	SE
+		+		

Transaction	Chipotle Received	Chipotle Gave
Purchased tomatoes on credit	**Supplies** (asset account increased)	**Accounts Payable** A promise to pay later (liability account increased)


+


+

A	=	L	+	SE
−		−		

Transaction	Chipotle Received	Chipotle Gave
Eventual payment of cash owed to the suppliers	**Accounts Payable** A promise was eliminated (liability account decreased)	**Cash** (asset account decreased)

−

−

Not all important business activities result in a transaction that affects the financial statements. Most importantly, signing a contract involving **the exchange of two promises to perform** (e.g., you promise to work and I promise to pay you) **does not result in an accounting transaction** that is recorded. For example, if Chipotle sent an order for more tomatoes to its food supplier and the supplier accepted the order but did not fill it immediately, no transaction took place. As soon as the food is delivered to Chipotle, however, the supplier has given up its inventory in exchange for a promise from Chipotle to pay for the items in the near future, and Chipotle has exchanged its promise to pay for the supplies it receives. Because a **promise** has been exchanged for **goods,** a transaction has taken place. Both Chipotle and the supplier's statements will be affected.

Balancing the Accounting Equation

Notice in the tomato purchase illustrations on the previous page that the accounting equation next to each transaction remained in balance. The accounting equation must remain in balance after each transaction. That is, total assets (resources) must equal total liabilities and stockholders' equity (claims to resources). If all correct accounts have been identified and the appropriate direction of the effect on each account has been determined, the equation should remain in balance.

Systematic transaction analysis for investing and financing activities includes the following steps:

Step 1: **Ask → What was received and what was given?**

- **Identify the account affected by title** (e.g., Cash and Notes Payable). Remember: *Make sure that at least two accounts change.*
- **Classify them by type of account:** Asset (A), Liability (L), or Stockholders' Equity (SE) (e.g., Cash is an asset).
- **Determine the direction of the effect:** Did the account increase (+) or decrease (−)?

Step 2: **Verify → Is the accounting equation in balance? (A = L + SE)**

Analyzing Chipotle's Transactions

To illustrate the use of the transaction analysis process, let's consider transactions of Chipotle that are also common to most businesses. Remember that this chapter presents transactions that affect only the balance sheet accounts. Assume that Chipotle engages in the **following events during the first quarter of 2012,** the first three months following the balance sheet in Exhibit 2.2. Account titles are from that balance sheet, and remember that, for simplicity, all amounts are in **thousands:**

(a) **Chipotle issued 10,000 additional shares of common stock, receiving $62,300 in cash from investors.** Each share of common stock usually has a nominal (low) **par value** printed on the face of the certificate. Par value is a legal amount per share established by the board of directors; it has no relationship to the market price of the stock. Its significance is that it establishes the minimum amount that a stockholder must contribute. Chipotle's common stock has a par value of $.01 per share. When a corporation issues common (capital) stock, the amount received affects two separate accounts: The **Common Stock** account for the number of shares times the par value per share, and **Additional Paid-in Capital** (also called Paid-in Capital or Contributed Capital in Excess of Par) for the excess received above par.

PAR VALUE is a legal amount per share established by the board of directors; it represents the minimum amount a stockholder must contribute and has no relationship to the market price of the stock.

COMMON STOCK is the account that is equal to the number of shares issued by a corporation times the par value per share.

ADDITIONAL PAID-IN CAPITAL (Paid-in Capital, Contributed Capital in Excess of Par) is the amount of capital contributed by the shareholders less the par value of the stock.

Step 1: **What was received and what was given (account name, type of account, amount, and direction of effect)?**

Received: Cash (+A) $62,300

Given: Additional stock shares:
Common Stock (+SE) $100 *(10,000 shares × $.01 per share)*
Additional Paid-in Capital (+SE) $62,200 *($62,300 − $100)*

Assets				=	Liabilities		+	Stockholders' Equity		
Cash	Short-term Investments	Property & Equipment	Long-term Investments		Dividends Payable	Notes Payable		Common Stock	Additional Paid-in Capital	Retained Earnings
(a) +62,300				=				+100	+62,200	

Step 2: **Is the accounting equation in balance?** **Assets $62,300 = Liabilities $0 + Stockholders' Equity $62,300**

***(b)* Chipotle borrowed $2,000 from its local bank, signing a note to be paid in three years.**

Step 1: What was received and what was given (account name, type of account, amount, and direction of effect)?

Received: Cash (+A) $2,000

Given: A written promise to repay the loan: Notes Payable (+L) $2,000

	Assets				=	Liabilities		+	Stockholders' Equity		
	Cash	Short-term Investments	Property & Equipment	Long-term Investments		Dividends Payable	Notes Payable		Common Stock	Additional Paid-in Capital	Retained Earnings
(a)	+62,300				=				+100	+62,200	
(b)	**+2,000**				=		**+2,000**				

Step 2: Is the accounting equation in balance? Assets $2,000 = Liabilities $2,000 + Stockholders' Equity $0

Companies that need cash to buy or build additional facilities often seek funds by selling stock to investors as in transaction (*a*) or by borrowing from creditors as in transaction (*b*). Any transactions with stockholders (usually issuing additional stock and paying dividends) and transactions with banks (borrowing and repaying loans) are **financing** activities.

***(c)* Chipotle purchased new ovens, counters, refrigerators, and other equipment costing $63,100; paid $55,100 in cash and signed a note for the rest.**

Step 1: What was received and what was given (account name, type of account, amount, and direction of effect)?

Received: Property & Equipment (+A) $63,100

Given: Cash (−A) $55,100
Notes Payable (+L) $8,000

	Assets				=	Liabilities		+	Stockholders' Equity		
	Cash	Short-term Investments	Property & Equipment	Long-term Investments		Dividends Payable	Notes Payable		Common Stock	Additional Paid-in Capital	Retained Earnings
(a)	+62,300				=				+100	+62,200	
(b)	+2,000				=		+2,000				
(c)	**−55,100**		**+63,100**		=		**+8,000**				

Step 2: Is the accounting equation in balance? Assets $8,000 = Liabilities $8,000 + Stockholders' Equity $0

Purchasing and selling property and equipment and investments in the stock of other companies are **investing** activities. In the investing transaction *(c)*, notice that more than two accounts were affected.

***(d)* Chipotle paid $400 to the local bank on the amount borrowed in (*b*) above (ignore interest).**

Step 1: What was received and what was given (account name, type of account, amount, and direction of effect)?

Received: Reduction in bank loan:
Notes Payable (−L) $400

Given: Cash (−A) $400

	Assets				=	Liabilities		+	Stockholders' Equity		
	Cash	Short-term Investments	Property & Equipment	Long-term Investments		Dividends Payable	Notes Payable		Common Stock	Additional Paid-in Capital	Retained Earnings
(a)	+62,300				=				+100	+62,200	
(b)	+2,000				=		+2,000				
(c)	−55,100		+63,100		=		+8,000				
(d)	**−400**				=		**−400**				

Step 2: Is the accounting equation in balance? Assets −$400 = Liabilities −$400 + Stockholders' Equity $0

(e) **Chipotle purchased the stock of other companies, paying $60,400 in cash.** The company intends to hold $20,900 of the stock as long-term investments and the rest as short-term investments.

Step 1: What was received and what was given (account name, type of account, amount, and direction of effect)?

Received: Short-term investments (+A) $39,500
Long-term investments (+A) $20,900

Given: Cash (−A) $60,400

	Assets				=	Liabilities		+	Stockholders' Equity		
	Cash	Short-term Investments	Property & Equipment	Long-term Investments		Dividends Payable	Notes Payable		Common Stock	Additional Paid-in Capital	Retained Earnings
(a)	+62,300				=				+100	+62,200	
(b)	+2,000				=		+2,000				
(c)	−55,100		+63,100		=		+8,000				
(d)	−400				=		−400				
(e)	**−60,400**	**+39,500**		**+20,900**	=						

Step 2: Is the accounting equation in balance? Assets $0 = Liabilities $0 + Stockholders' Equity $0

(f) Chipotle does not pay dividends, but instead reinvests profits into growing the business. However, for illustration purposes, **assume Chipotle's board of directors declared that the Company will pay $3,000 in cash as dividends to shareholders next quarter.**

Step 1: What was received and what was given (account name, type of account, amount, and direction of effect)?

Received: Lower claim from stockholders
Retained Earnings (−SE) $3,000

Given: Dividends Payable (+L) $3,000

	Assets				=	Liabilities		+	Stockholders' Equity		
	Cash	Short-term Investments	Property & Equipment	Long-term Investments		Dividends Payable	Notes Payable		Common Stock	Additional Paid-in Capital	Retained Earnings
(a)	+62,300				=				+100	+62,200	
(b)	+2,000				=		+2,000				
(c)	−55,100		+63,100		=		+8,000				
(d)	−400				=		−400				
(e)	−60,400	+39,500		+20,900	=						
(f)					=	**+3,000**					**−3,000**
	−51,600	**+39,500**	**+63,100**	**+20,900**		**+3,000**	**+9,600**		**+100**	**+62,200**	**−3,000**

Step 2: Is the accounting equation in balance? Assets $0 = Liabilities $3,000 + Stockholders' Equity −$3,000
Overall effects of *(a)–(f)*: Assets $71,900 = Liabilities $12,600 + Stockholders' Equity $59,300
$71,900 = $71,900

PAUSE FOR **FEEDBACK**

Transaction analysis involves identifying accounts (by title) affected in a transaction, recognizing that at least two accounts are affected, classifying the accounts (asset, liability, or stockholders' equity), and determining the direction of the effect on the account (increase or decrease). If all accounts and effects are correct, then the fundamental accounting equation (A = L + SE) will remain in balance. **Practice is the most effective way to develop your transaction analysis skills.**

SELF-STUDY **QUIZ**

Review the analysis in events (*a*) through (*f*) above, complete the analysis of the following transactions, and indicate the effects in the chart below. Answer from the standpoint of the business.

(a) **Paul Knepper contributes $50,000 cash to establish Florida Flippers, Inc., a new scuba business organized as a corporation; in exchange, he receives 25,000 shares of stock with a par value of $0.10 per share.**

Step 1: Identify and classify accounts and effects.
Received: ______________________ **Given:** ______________________
Step 2: Is the accounting equation in balance? **Yes or No?** ________

(b) **Florida Flippers buys a small building near the ocean for $250,000, paying $25,000 cash and signing a 10-year note payable for the rest.**

Step 1: Identify and classify accounts and effects.
Received: ______________________ **Given:** ______________________
Step 2: Is the accounting equation in balance? **Yes or No?** ________

	Assets		=	Liabilities	+	Stockholders' Equity	
	Cash	Building		Notes Payable		Common Stock	Additional Paid-in Capital
(a)			=				
(b)			=				

After you have completed your answers, check them with the solutions at the bottom of the page. If your answers did not agree with ours, we recommend that you go back to each event to make sure that you have completed each of the steps of transaction analysis.

LEARNING OBJECTIVE 2-4
Determine the impact of business transactions on the balance sheet using two basic tools: Journal entries and T-accounts.

HOW DO COMPANIES KEEP TRACK OF ACCOUNT BALANCES?

For most organizations, recording transaction effects and keeping track of account balances in the manner just presented is impractical. To handle the multitude of daily transactions that a business generates, companies establish accounting systems, usually computerized, that follow a cycle. Exhibit 2.4 presents the primary activities of the **accounting cycle** performed **during the accounting period** separately from those that occur at the **end of the accounting period.** In Chapters 2 and 3, we will illustrate transactions during Chipotle's first quarter of 2012. In

Solution to SELF-STUDY QUIZ

(*a*) Step 1: Received: Cash (+A) $50,000; Given: Common Stock (+SE) $2,500 and Additional Paid-in Capital (+SE) $47,500.
Step 2: Yes. The equation remains in balance; Assets (on the left) and Stockholders' Equity (on the right) increase by the same amount, $50,000.

(*b*) Step 1: Received: Building (+A) $250,000; Given: Cash (−A) $25,000 and Notes Payable (+L) $225,000.
Step 2: Yes. Assets (on the left) increase by $225,000 and Liabilities (on the right) increase by $225,000.

	Assets		=	Liabilities	+	Stockholders' Equity	
	Cash	Building		Notes Payable		Common Stock	Additional Paid-in Capital
(a)	+50,000		=			+2,500	+47,500
(b)	−25,000	+250,000	=	+225,000			

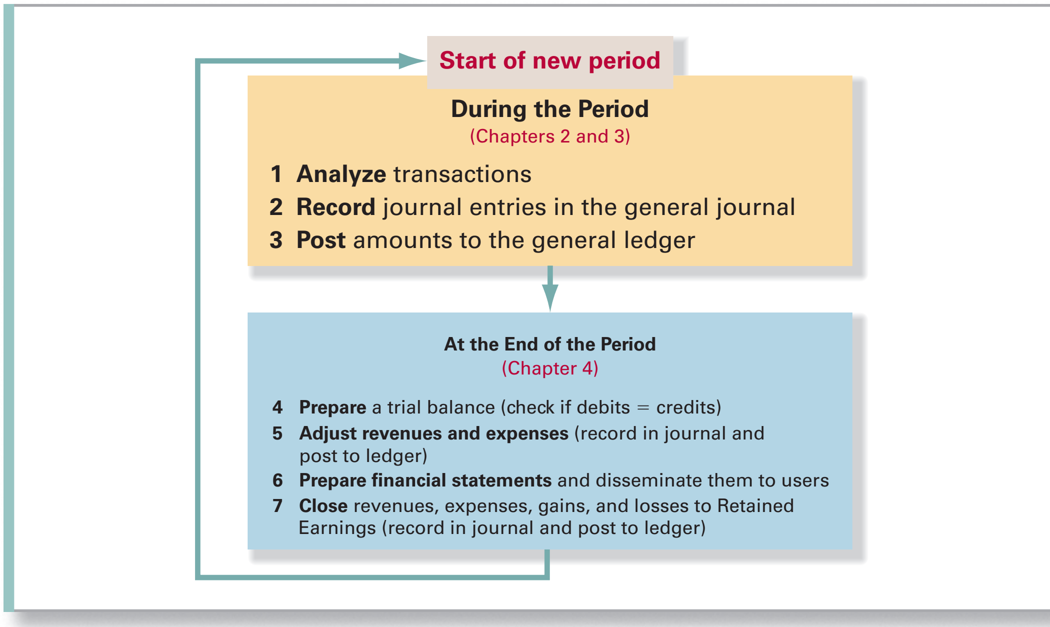


EXHIBIT 2.4

The Accounting Cycle

Chapter 4, we will complete the accounting cycle by discussing and illustrating activities at the end of the period to adjust the records, prepare financial statements, and finally close the accounting records.

The **ACCOUNTING CYCLE** is the process followed by entities to analyze and record transactions, adjust the records at the end of the period, prepare financial statements, and prepare the records for the next cycle.

During the accounting period, transactions that result in exchanges between the company and other external parties are analyzed to determine the accounts and effects. The effects are recorded first in the **general journal,** a listing in chronological order of each transaction's effects. To determine account balances, the accounts are updated by posting the effects listed in the general journal to the respective accounts in the **general ledger,** a record of effects to and balances of each account.

These formal records are based on two very important tools used by accountants: journal entries and T-accounts. From the standpoint of accounting systems design, these analytical tools are a more efficient way to reflect the effects of transactions, determine account balances, and prepare financial statements. As future business managers, you should develop your understanding and use of these tools in financial analysis. For those studying accounting, this knowledge is the foundation for an understanding of the accounting system and future accounting coursework. After we explain how to perform transaction analysis using these tools, we illustrate their use in financial analysis.

The Direction of Transaction Effects

As we saw earlier in this chapter, transaction effects increase and decrease assets, liabilities, and stockholders' equity accounts. To reflect these effects efficiently, we need to structure the transaction analysis model in a manner that shows the **direction** of the effects. As shown in Exhibit 2.5, each account is set up as a "T" with the following structure:

- **Increases in asset accounts are on the left** because assets are on the left side of the accounting equation (A = L + SE).
- **Increases in liability and stockholders' equity accounts are on the right** because they are on the right side of the accounting equation (A = L + SE).

Also notice that:

- The term **debit** (dr for short) always refers to the **left** side of the T.
- The term **credit** (cr for short) always refers to the **right** side of the T.

DEBIT (dr) refers to the left side of a T-account.

CREDIT (cr) refers to the right side of a T-account.

EXHIBIT 2.5

Basic Transaction Analysis Model

ASSETS (many accounts)		=	LIABILITIES (many accounts)		+	STOCKHOLDERS' EQUITY		
						Contributed Capital (2 accounts)	*Earned Capital* (1 account)	
+	−		−	+		**Common Stock and Additional Paid-in Capital**	**Retained Earnings**	
Debit	**Credit**		**Debit**	**Credit**		+ **Credit** Investment by owners	− **Debit** Dividends declared	+ **Credit** Net income *(expanded in Ch. 3)*

As a consequence:

- Asset accounts increase on the left (debit) side and they normally have debit balances. (It would be highly unusual for an asset account, such as Inventory, to have a negative (credit) balance.)
- Liability and stockholders' equity accounts increase on the right (credit) side and they normally have credit balances.

In summary:

Assets	=	**Liabilities**	+	**Stockholders' Equity**
+ with Debits		+ with Credits		+ with Credits
Accounts have debit balances		Accounts have credit balances		Accounts have credit balances

In Chapter 3, we will add revenue and expense account effects to Retained Earnings in our model. Until then, as you are learning to perform transaction analysis, **you should refer to the transaction analysis model in Exhibit 2.5 often until you can construct it on your own without assistance.**

Many students have trouble with accounting because they forget that the term **debit** is simply the **left** side of an account and the term **credit** is simply the **right** side of an account. Perhaps someone once told you that you were a credit to your school or your family. As a result, you may think that credits are good and debits are bad. Such is not the case. Just remember that **debit is on the left** and **credit is on the right.**

If you have identified the correct accounts and effects through transaction analysis, the accounting equation will remain in balance. **The total dollar value of all debits will equal the total dollar value of all credits** in a transaction. For an extra measure of assurance, add this equality check (Debits = Credits) to the transaction analysis process.

PAUSE FOR **FEEDBACK**

From Exhibit 2.5, we learned that each account can increase and decrease. In the transaction analysis model, the effect of a transaction on each element can be represented with a T with one side increasing and the other side decreasing. Asset accounts on the left side of the fundamental accounting equation increase their balances on the left side of the T. Liability and stockholders' equity accounts are on the right side of the fundamental accounting equation and increase their balance on the right side of the T. In accounting, the left side of the T is called the debit side and the right is called the credit side. Most accounts have a balance on the positive side.

SELF-STUDY QUIZ

The following is a list of accounts from a balance sheet of The Wendy's Company. Indicate on the line provided whether each of the following usually has a debit (DR) or credit (CR) balance.

____ Accounts Payable	____ Properties (land, buildings, and equipment)	____ Cash
____ Retained Earnings	____ Inventories	____ Long-Term Debt
____ Accrued Expenses Payable	____ Notes Receivable (due in five years)	____ Accounts Receivable

After you have completed your answers, check them with the solutions at the bottom of the page.

Analytical Tools

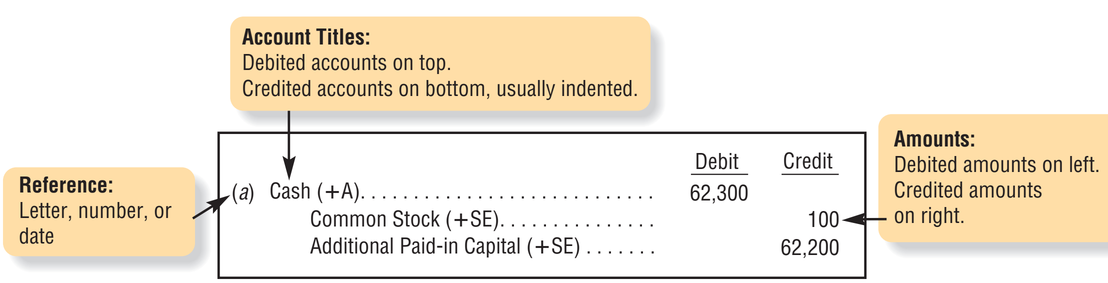
The Journal Entry

In a bookkeeping system, transactions are recorded in chronological order in a **general journal** (or simply, journal). After analyzing the business documents (such as purchase invoices, receipts, and cash register tapes) that describe a transaction, the bookkeeper enters the effects on the accounts in the journal using debits and credits. The **journal entry,** then, is an accounting method for expressing the effects of a transaction on accounts. It is written in a debits-equal-credits format. To illustrate, we refer back to event (*a*) in Chipotle's transaction analyis on page 51.

A **JOURNAL ENTRY** is an accounting method for expressing the effects of a transaction on accounts in a debits-equal-credits format.

(*a*) Chipotle issued 10,000 additional shares of common stock, receiving $62,300 in cash from investors. Par value of the stock is $0.01 per share.

The journal entry for event (*a*) in the Chipotle's illustration is as follows:



Notice the following:

- It is useful to include a date or some form of reference for each transaction. The debited accounts are written first (on top) with the amounts recorded in the left column. The credited accounts are written below the debits and are usually indented in manual records; the credited amounts are written in the right column. The order of the debited accounts or credited accounts does not matter, as long as the debits are on top and the credits are on the bottom and indented to the right.
- Total debits ($62,300) equal total credits ($100 + $62,200 = $62,300).
- Three accounts are affected by this transaction. Any journal entry that affects more than two accounts is called a **compound entry.** Many transactions in this and subsequent chapters require a compound journal entry.
- As you can see in the illustration of a formal bookkeeping system in Exhibit 2.6, an additional line is written below the journal entry as an explanation of the transaction. For simplicity, explanations will not be included in this text.

While you are learning to perform transaction analysis, use the symbols A, L, and SE next to each account title, as in the preceding journal entry. Specifically identifying accounts as assets (A), liabilities (L), or stockholders' equity (SE) clarifies the transaction analysis and makes journal entries easier to write. For example, if Cash is to be increased, we write Cash (+A). Throughout subsequent chapters, we include the direction of the effect along with the symbol to

Column 1: CR; CR; CR Column 2: DR; DR; DR Column 3: DR; CR; DR

Solutions to SELF-STUDY QUIZ

EXHIBIT 2.6

Posting Transaction Effects from the Journal to the Ledger

General Journal — Page G1

Date	Account Titles and Explanation	Ref.	Debit	Credit
	(in thousands)			
1-2-12	Cash	101	62,300	
	Common Stock	301		100
	Additional Paid-in Capital	302		62,200
	(*Investment by stockholders.*)			

General Ledger — CASH — 101

Date	Explanation	Ref.	Debit	Credit	Balance
	Balance				401,200
1-2-12		G1	62,300		463,500

General Ledger — COMMON STOCK — 301

Date	Explanation	Ref.	Debit	Credit	Balance
	Balance				300
1-2-12		G1		100	400

General Ledger — ADDITIONAL PAID-IN CAPITAL — 302

Date	Explanation	Ref.	Debit	Credit	Balance
	Balance				372,200
1-2-12		G1		62,200	434,400

help you understand the effects of each transaction on the financial statements. In transaction (*a*) on the previous page, we can see that assets are affected by +\$62,300 and stockholders' equity accounts are affected by +\$62,300. The accounting equation A = L + SE remains in balance.

A note of caution: Many students try to memorize journal entries without understanding or using the transaction analysis model. As more detailed transactions are presented in subsequent chapters, the task becomes increasingly more difficult. In the long run, **memorizing, understanding, and using the transaction analysis model** presented here will save you time and prevent confusion.

The T-Account

By themselves, journal entries do not provide the balances in accounts. After the journal entries have been recorded, the bookkeeper **posts** (transfers) the dollar amounts to each account affected by the transaction to determine the new account balances. (In most computerized accounting systems, this happens automatically.)

As a group, the accounts are called a **general ledger.** In the manual accounting system used by some small organizations, the ledger is often a three-ring binder with a separate page for each account. In a computerized system, accounts are stored on a disk. See Exhibit 2.6 for an illustration of a journal page and the related ledger pages. Note that the cash effects from the journal entry have been posted to the Cash ledger page.

The T-ACCOUNT is a tool for summarizing transaction effects for each account, determining balances, and drawing inferences about a company's activities.

One very useful tool for summarizing the transaction effects and determining the balances for individual accounts is a **T-account,** a simplified representation of a ledger account. Exhibit 2.7 shows the T-accounts for Chipotle's Cash and Common Stock accounts based on Event (*a*). Notice that, for Cash, which is classified as an asset, increases are shown on the left and decreases appear on the right side of the T-account. For Common Stock, however, increases are shown on the right and decreases on the left since Common Stock is a stockholders' equity

EXHIBIT 2.7

T-Accounts Illustrated

Start with a beginning balance.

Use the same reference as in the journal entry.

+ Cash (A) −		
Beg. balance	401,200	
(*a*)	62,300	
End. balance	463,500	

− Common Stock (SE) +		
	300	Beg. balance
	100	(*a*)
	400	End. balance

Draw a line across the T when you are ready to compute the ending balance.

Put the ending balance amount on the side of the T-account that it represents (e.g., + side if it is a positive number).

account. Many small businesses still use handwritten or manually maintained accounts in this T-account format. Computerized systems retain the concept but not the format of the T-account.

In Exhibit 2.7, notice that the ending balance is indicated on the positive side with a double underline. To find the account balances, we can express the T-accounts as equations:

	Cash	Common Stock
Beginning balance	$401,200	$ 300
+ "+" side	+ 62,300	+100
− "−" side	− 0	− 0
Ending balance	$463,500	$ 400

A word on terminology: The words **debit** and **credit** may be used as verbs, nouns, and adjectives. For example, we can say that Chipotle's Cash account was debited (verb) when stock was issued to investors, meaning that the amount was entered on the left side of the T-account. Or we can say that a credit (noun) was entered on the right side of an account. Common Stock may be described as a credit account (adjective). These terms will be used instead of **left** and **right** throughout the rest of this textbook. The next section illustrates the steps to follow in analyzing the effects of transactions, recording the effects in journal entries, and determining account balances using T-accounts.

Inferring Business Activities from T-Accounts

FINANCIAL ANALYSIS

T-accounts are useful primarily for instructional and analytical purposes. In many cases, we will use T-accounts to determine what transactions a company engaged in during a period. For example, the primary transactions affecting Accounts Payable for a period are purchases of assets on account from suppliers and cash payments to suppliers. If we know the beginning and ending balances of Accounts Payable and all the amounts that were purchased on credit during a period, we can determine the amount of cash paid. A T-account analysis would include the following:

− Accounts Payable (L) +		
	600	Beg. bal.
Cash payments to suppliers ?	1,500	Purchases on account
	300	End. bal.

Solution:

Beginning Balance	+	Purchases on Account	−	Cash Payments to Suppliers	=	Ending Balance
$600	+	$1,500	−	?	=	$ 300
		$2,100	−	?	=	$ 300
				?	=	$1,800

Transaction Analysis Illustrated

In this section, we will use the quarterly investing and financing transactions for Chipotle Mexican Grill (events [*a*] to [*f*]) that were analyzed earlier to demonstrate recording journal entries and posting effects to the relevant T-accounts. We also check that the accounting equation remains in balance and that debits equal credits. In the T-accounts, the amounts from Chipotle's December 31, 2011, balance sheet (Exhibit 2.2) have been inserted as the beginning balances.

Study this illustration carefully, including the explanations of transaction analysis. Careful study is **essential** to an understanding of (1) the accounting model, (2) transaction analysis, (3) the dual effects of each transaction, and (4) the dual-balancing system. The most effective way to learn these critical concepts, which are basic to material throughout the rest of the text, is to practice, practice, practice.

(a) **Chipotle issued 10,000 additional shares of common stock ($0.01 par value per share), receiving $62,300 in cash from investors.**

Debits = Credits

	Debit	Credit
(a) Cash (+A)	62,300	
Common Stock (+SE)		100
Additional Paid-in Capital (+SE)		62,200

Equation in balance

Assets		=	Liabilities		+	Stockholders' Equity	
Cash	+62,300					Common Stock	+100
						Additional Paid-in-Capital	+62,200

Effects posted

+ Cash (A) −	
1/1/12 401,200	
(a) **62,300**	

− Common Stock (SE) +	
	300 1/1/12
	100 ***(a)***

− Additional Paid-in Capital (SE) +	
	372,400 1/1/12
	62,200 ***(a)***

The effects reflected in the journal entry have been posted to the appropriate T-accounts. Notice that if an account was debited such as Cash, that effect was written in the debit column of the Cash T-account. Similarly, if an account was credited such as Common Stock, that effect was written in the credit column of the T-account. Also notice that the beginning balances for the first quarter of 2012 are taken from the December 31, 2011, balance sheet (Exhibit 2.2) and are indicated on the positive side of the account—assets have debit balances and liabilities and stockholders' equity accounts have credit balances.

(b) **Chipotle borrowed $2,000 from its local bank, signing a note to be paid in three years.**

Debits = Credits

	Debit	Credit
(b) Cash (+A)	2,000	
Notes Payable (+L)		2,000

Equation in balance

Assets		=	Liabilities		+	Stockholders' Equity
Cash	+2,000		Notes Payable	+2,000		

Effects posted

+ Cash (A) −	
1/1/12 401,200	
(a) 62,300	
(b) **2,000**	

− Notes Payable (L) +	
	223,600 1/1/12
	2,000 ***(b)***

***(c)* Chipotle purchased new ovens, counters, refrigerators, and other equipment costing $63,100; paid $55,100 in cash and signed a note for the rest.**

	Debit	Credit
(c) Property and Equipment (+A)	63,100	
Cash (−A)		55,100
Notes Payable (+L)		8,000

Debits = Credits

Assets		=	Liabilities		+	Stockholders' Equity
Property and Equipment	+63,100		Notes Payable	+8,000		
Cash	−55,100					

Equation in balance

+ Cash (A) −			
1/1/12	401,200	**55,100**	***(c)***
(a)	62,300		
(b)	2,000		

+ Property and Equipment (net) (A) −		
1/1/12	795,900	
(c)	**63,100**	

− Notes Payable (L) +		
	223,600	1/1/12
	2,000	*(b)*
	8,000	***(c)***

Effects posted

***(d)* Chipotle paid $400 to the local bank on the amount borrowed in *(b)* above (ignore interest).**

	Debit	Credit
(d) Notes Payable (−L)	400	
Cash (−A)		400

Debits = Credits

Assets		=	Liabilities		+	Stockholders' Equity
Cash	−400		Notes Payable	−400		

Equation in balance

+ Cash (A) −			
1/1/12	401,200	55,100	*(c)*
(a)	62,300	**400**	***(d)***
(b)	2,000		

− Notes Payable (L) +			
		223,600	1/1/12
(d)	**400**	2,000	*(b)*
		8,000	*(c)*

Effects posted

***(e)* Chipotle purchased the stock of other companies, paying $60,400 in cash.** The company intends to hold $20,900 of the stock as long-term investments and the rest as short-term investments.

	Debit	Credit
(e) Short-term Investments (+A)	39,500	
Long-term Investments (+A)	20,900	
Cash (−A)		60,400

Debits = Credits

Assets		=	Liabilities		+	Stockholders' Equity
Short-term Investments	+39,500					
Long-term Investments	+20,900					
Cash	−60,400					

Equation in balance

+ Cash (A) −			
1/1/12	401,200		
(a)	62,300	55,100	*(c)*
(b)	2,000	400	*(d)*
		60,400	***(e)***

+ Short-term Investments (A) −		
1/1/12	55,000	
(e)	**39,500**	

+ Long-term Investments (A) −		
1/1/12	128,200	
(e)	**20,900**	

Effects posted

(f) Chipotle does not pay dividends, but instead reinvests profits into growing the business. However, for illustration purposes, **assume Chipotle's board of directors declared that the Company will pay $3,000 in cash as dividends to shareholders next quarter.**

Debits = Credits

	Debit	Credit
(f) Retained Earnings (−SE)	3,000	
Dividends Payable (+L)		3,000

Equation in balance

Assets	=	Liabilities		+	Stockholders' Equity	
		Dividends Payable	+3,000		Retained Earnings	−3,000

Effects posted

− Dividends Payable (L) +

		0	1/1/12
		3,000	***(f)***

− Retained Earnings (SE) +

		671,500	1/1/12
(f)	**3,000**		

Now we determine the balances in the T-accounts that changed during the quarter:

\+ Cash (A) −

1/1/12	401,200		
(a)	62,300	55,100	*(c)*
(b)	2,000	400	*(d)*
		60,400	*(e)*
	349,600		

\+ Short-term Investments (A) −

1/1/12	55,000		
(e)	39,500		
	94,500		

Property and + Equipment (net) (A) −

1/1/12	795,900		
(c)	63,100		
	859,000		

\+ Long-term Investments (A) −

1/1/12	128,200		
(e)	20,900		
	149,100		

− Notes Payable (L) +

		223,600	1/1/12
(c)	400	2,000	*(b)*
		8,000	*(c)*
		233,200	

− Dividends Payable (L) +

		0	1/1/12
		3,000	*(f)*
		3,000	

− Common Stock (SE) +

		300	1/1/12
		100	*(a)*
		400	

− Additional Paid-in Capital (SE) +

		372,400	1/1/12
		62,200	*(a)*
		434,600	

− Retained Earnings (SE) +

		671,500	1/1/12
(f)	3,000		
		668,500	

PAUSE FOR **FEEDBACK**

Accountants analyze and then record transactions in the general journal in chronological order in journal entry form. Debited accounts are written on top with amounts in the left column and credited accounts are written on the bottom with amounts in the right column. Then the effects are posted in the general ledger (similar to a T-account). Each page of the ledger represents a different account that has a debit (left) side and a credit (right) side. To post transaction effects, the amount for each account in a journal entry is written in the appropriate debit or credit column on the ledger page to obtain account balances. Refer to Exhibit 2.5 for the transaction analysis model.

SELF-STUDY **QUIZ**

Record the following transactions and post the effects to the T-accounts. Because this is a new company, all T-accounts start with a beginning balance of $0.

(a) **Paul Knepper contributes $50,000 cash to establish Florida Flippers, Inc., a new scuba business organized as a corporation; he receives in exchange 25,000 shares of stock with a $0.10 per share par value.**

		Debit	Credit
(a) ________________ ( )		______	
________________ ( )			______
________________ ( )			______

(b) **Florida Flippers buys a small building near the ocean for $250,000, paying $25,000 in cash and signing a 10-year note payable for the rest.**

		Debit	Credit
(b) ________________ ( )		______	
________________ ( )			______
________________ ( )			______

Cash		Property and Equipment		Notes Payable		Common Stock		Additional Paid-in Capital	
Beg. 0		Beg. 0			0 Beg.		0 Beg.		0 Beg.

After you have completed your answers, check them with the solutions at the bottom of the page.

GUIDED **HELP**

For additional step-by-step video instruction on analyzing, recording, and posting transaction effects and classifying accounts, go to the URL or scan the QR code in the margin with your smartphone or iPad.

www.mhhe.com/libby8e

Solutions to SELF-STUDY QUIZ

(a)	Cash (+A)	50,000		
	Common Stock (+SE)		2,500	[25,000 shares × $0.10 par]
	Additional Paid-in Capital (+SE).		47,500	
(b)	Property and Equipment (+A).	250,000		
	Cash (−A)		25,000	
	Notes Payable (+L).		225,000	

+ Cash −		+ Property and Equipment −		− Notes Payable +		− Common Stock +		− Additional Paid-in Capital +	
Beg. 0		Beg. 0			0 Beg.		0 Beg.		0 Beg.
(a) 50,000	25,000 *(b)*	*(b)* 250,000			225,000 *(b)*		2,500 *(a)*		47,500 *(a)*
25,000		250,000			225,000		2,500		47,500

LEARNING OBJECTIVE 2-5

Prepare a trial balance and simple classified balance sheet, and analyze the company using the current ratio.

A TRIAL BALANCE is a list of all accounts with their balances to provide a check on the equality of the debits and credits.

HOW IS THE BALANCE SHEET PREPARED AND ANALYZED?

Although no operating activities occurred yet (they will be illustrated in Chapter 3), it is possible to create a balance sheet based solely on the investing and financing activities recorded above. Usually, businesses will create a **trial balance** spreadsheet first for internal purposes before preparing statements for external users. A trial balance lists the names of the T-accounts in one column, usually in financial statement order (assets, liabilities, stockholders' equity, revenues, and expenses), with their ending debit or credit balances in the next two columns. Debit balances are indicated in the left column and credit balances are indicated in the right column. Then the two columns are totaled to provide a check on the equality of the debits and credits. Errors in a computer-generated trial balance may exist if wrong accounts and/or amounts are used in the journal entries.[5]

Chipotle's trial balance follows. The account balances that did not change are taken from the December 31, 2011, balance sheet in Exhibit 2.2. The accounts that did change due to the investing and financing transactions illustrated in this chapter are shaded; their balances are taken from the T-accounts summarized on page 62.

CHIPOTLE MEXICAN GRILL—TRIAL BALANCE
(based on investing and financing transactions during the first quarter ended March 31, 2012)

(in thousands)	Debit	Credit
Cash	349,600	
Short-term investments	94,500	
Accounts receivable	8,400	
Supplies	8,900	
Prepaid expenses	27,700	
Property and equipment (net)	859,000	
Long-term investments	149,100	
Accounts payable		46,400
Accrued expenses payable		93,100
Dividends payable		3,000
Unearned revenue		18,000
Notes payable		233,200
Common stock		400
Additional paid-in capital		434,600
Retained earnings		668,500
Total	**1,497,200**	**1,497,200**

[5]In homework assignments, if you have an error in your trial balance (the two column totals are not equal), errors can be traced and should be corrected before adjusting the records. To find errors, reverse your steps. Check that:

- You copied the ending balances in all of the T-accounts (both amount and whether a debit or credit) correctly to the trial balance.
- You computed the ending balances in the T-accounts correctly.
- You posted the transaction effects correctly from the journal entries to the T-accounts (amount, account, and whether a debit or credit).
- You prepared the journal entries correctly (amount, account, and whether a debit or credit).

EXHIBIT 2.8

Chipotle Mexican Grill's First Quarter 2012 Balance Sheet (based on investing and financing activities only)

CHIPOTLE MEXICAN GRILL, INC.
Consolidated Balance Sheets
(in thousands of dollars, except per share data)

	March 31, 2012	**December 31, 2011**
ASSETS		
Current Assets:		
Cash	$ 349,600	$ 401,200
Short-term investments	94,500	55,000
Accounts receivable	8,400	8,400
Supplies	8,900	8,900
Prepaid expenses	27,700	27,700
Total current assets	489,100	501,200
Property and equipment (net)	859,000	795,900
Long-term investments	149,100	128,200
Total assets	**$1,497,200**	**$1,425,300**
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 46,400	$ 46,400
Accrued expenses payable	93,100	93,100
Dividends payable	3,000	—
Unearned revenue	18,000	18,000
Total current liabilities	160,500	157,500
Notes payable	233,200	223,600
Total liabilities	393,700	381,100
Stockholders' Equity:		
Common stock ($0.01 par)	400	300
Additional paid-in capital	434,600	372,400
Retained earnings	668,500	671,500
Total stockholders' equity	1,103,500	1,044,200
Total liabilities and stockholders' equity	**$1,497,200**	**$1,425,300**

Classified Balance Sheet

The balance sheet in Exhibit 2.8 was prepared from the trial balance on page 64. As a formal statement for external users, it needs a good heading (name of the company, title of the statement, date, and if the dollars are in thousands or millions). Notice in Exhibit 2.8 several additional features:

- The assets and liabilities are **classified** into two categories: **current** and **noncurrent.** Current assets are those to be used or turned into cash within the upcoming year, whereas noncurrent assets are those that will last longer than one year. Current liabilities are those obligations to be paid or settled within the next 12 months with current assets.
- Dollar signs are indicated at the top and bottom of the asset section and top and bottom of the liabilities and shareholders' equity section. More than that tends to look messy.
- The statement includes **comparative data.** That is, it compares the account balances at December 31, 2011, with those at March 31, 2012. When multiple periods are presented, the most recent balance sheet amounts are usually listed on the left.
- Unlike Chipotle, most companies do not provide a total liabilities line on the balance sheet. To determine total liabilities on those statements, add total current liabilities and each of the noncurrent liabilities.

INTERNATIONAL PERSPECTIVE — Understanding Foreign Financial Statements

Although IFRS differ from GAAP, they use the same system of analyzing, recording, and summarizing the results of business activities that you have learned in this chapter. One place where IFRS differ from GAAP is in the formatting of financial statements.

Financial statements prepared using GAAP and IFRS include the same elements (assets, liabilities, revenues, expenses, etc.). However, a single, consistent format has not been mandated. Consequently, various formats have evolved over time, with those in the U.S. differing from those typically used internationally. The formatting differences include:

	GAAP	IFRS
Balance Sheet Order	**Assets:**	**Assets:**
	Current	Noncurrent
Similar accounts are shown,	Noncurrent	Current
but the order of liquidity	**Liabilities:**	**Stockholders' Equity**
(for assets) and the order of	Current	**Liabilities:**
maturity (for liabilities) differ	Noncurrent	Noncurrent
	Stockholders' Equity	Current

On the balance sheet, GAAP begins with current items whereas IFRS begins with noncurrent items. Consistent with this, **assets are listed in decreasing order of liquidity under GAAP, but internationally are usually listed in increasing order of liquidity.** IFRS similarly emphasize longer-term financing sources by listing equity before liabilities and, within liabilities, by listing noncurrent liabilities before current liabilities (**decreasing time to maturity**). The key to avoiding confusion is to be sure to **pay attention to the subheadings** in the statement. Any account under the heading "liabilities" must be a liability.

Ratio Analysis in Decision-Making

Why do the classifications of current and noncurrent on the balance sheet matter? Users of financial information compute a number of ratios in analyzing a company's past performance and financial condition as input in predicting its future potential. How ratios change over time and how they compare to the ratios of the company's competitors or industry averages provide valuable information about a company's strategies for its operating, investing, and financing activities. We introduce here the first of many ratios that will be presented throughout the rest of this textbook, with a final summary of ratio analysis in Chapter 13.

KEY RATIO ANALYSIS — Current Ratio

? ANALYTICAL QUESTION

Does the company have the short-term resources to pay its short-term debt?

% RATIO AND COMPARISONS

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

The 2011 ratio for Chipotle is (dollars in thousands):

$$\frac{\$501{,}200}{\$157{,}500} = 3.182$$

COMPARISONS OVER TIME Chipotle Mexican Grill, Inc.		
2011	**2010**	**2009**
3.182	3.301	2.912

COMPARISONS WITH COMPETITORS	
Panera Bread, Inc.	Fiesta Restaurant Group, Inc.
2011	**2011**
1.482	0.691
Vies for top fast-casual restaurant	Owns Pollo Tropical and Taco Cabana

INTERPRETATIONS

In General The current ratio is a very common ratio. Creditors and security analysts use the current ratio to measure the ability of the company to pay its short-term obligations with short-term assets. Generally, the higher the ratio, the more cushion a company has to pay its current obligations if future economic conditions take a downturn. While a ratio above 1.0 normally suggests good liquidity, today, many strong companies use sophisticated management techniques to minimize funds invested in current assets and, as a result, have current ratios below 1.0. Likewise, when compared to others in the industry, too high of a ratio may suggest inefficient use of resources.

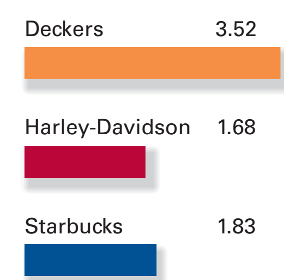
Focus Company Analysis Over time, the current ratio for Chipotle shows a high level of liquidity, well above 1.0, and the ratio has varied slightly around the 3.1 level since 2009. Chipotle has high growth strategies requiring cash to fund expansion.

Compared with competitors, Panera Bread, vying with Chipotle as the top fast-casual restaurant, also maintains a current ratio above 1.0, and both companies report cash as the largest current asset. The ratio for Chipotle is much higher than for Fiesta Restaurant Group, which reports a current ratio below 1.0. Fiesta Restaurant Group owns and franchises two quick-service brands: Pollo Tropical, featuring a tropical and Caribbean-style menu, and Taco Cabana, offering Mexican fast-food. Fiesta expects growth, but franchising (that is, selling rights to others to operate restaurants under the company brands) does not require the cash flow levels needed for company-owned facilities. It is also likely that all of these companies have sophisticated cash management systems that enable them to maintain lower cash balances.

Reuters reports that the restaurant industry has an average current ratio of 1.19. Compared to the industry average, Chipotle and Panera Bread have sufficient current assets to pay short-term obligations (adequate liquidity), while Fiesta Restaurant Group has a ratio below 1.0, suggesting the company will rely on sufficient cash flows generated during the year to meet current obligations.

A Few Cautions The current ratio may be a misleading measure of liquidity if significant funds are tied up in assets that cannot be easily converted into cash. A company with a high current ratio might still have liquidity problems if the majority of its current assets consists of slow-moving inventory. Analysts also recognize that managers can manipulate the current ratio by engaging in certain transactions just before the close of the fiscal year. In most cases, for example, the current ratio can be improved by paying creditors immediately prior to the preparation of financial statements.

Selected Focus Companies' Current Ratios



PAUSE FOR **FEEDBACK**

Yum! Brands

We just learned that the current ratio measures a company's ability to pay short-term obligations with short-term assets—a liquidity measure. It is computed by dividing current assets by current liabilities. A ratio above 1.0 is normally considered good, although some may need a higher ratio and others with good cash management systems can have a ratio below 1.0 (i.e., more current liabilities than current assets).

SELF-STUDY QUIZ

Yum! Brands, Inc., is the world's largest quick-service restaurant company that develops, franchises, and operates 37,000 units in more than 120 countries and territories through three restaurant concepts (KFC, Pizza Hut, and Taco Bell). The company reported the following balances on its recent balance sheets (in millions). Compute Yum! Brands's current ratio for the three years.

(dollars in millions)

	Current Assets	Current Liabilities	Current Ratio
December 31, 2011	$2,321	$2,450	________
December 31, 2010	2,313	2,448	________
December 31, 2009	1,208	1,653	________

What do these results suggest about Yum! Brands's liquidity in the current year and over time?

After you have completed your answers, check them with the solutions at the bottom of the page.

FOCUS ON CASH FLOWS

Investing and Financing Activities

LEARNING OBJECTIVE 2-6

Identify investing and financing transactions and demonstrate how they impact cash flows.

As discussed in Chapter 1, companies report cash inflows and outflows over a period in their **statement of cash flows,** which is divided into three categories: operating, investing, and financing activities:

- Operating activities are covered in Chapter 3.
- Investing activities include buying and selling noncurrent assets and investments.
- Financing activities include borrowing and repaying debt, including short-term bank loans, issuing and repurchasing stock, and paying dividends.

Only transactions affecting cash are reported on the statement. An important step in constructing and analyzing the statement of cash flows is identifying the various transactions as operating (**O**), investing (**I**), or financing (**F**). Let's analyze the Cash T-account for Chipotle's transactions in this chapter. Refer to transactions *(a)*–*(f)* illustrated on pages 60 to 62, and remember, **you must see cash in the transaction for it to affect the statement of cash flows.**

		+ Cash (A)		−			
		1/1/12	401,200				
From investors	**+F**	*(a)*	62,300	55,100	*(c)*	**−I**	**For noncurrent assets**
From bank	**+F**	*(b)*	2,000	400	*(d)*	**−F**	**To bank**
				60,400	*(e)*	**−I**	**For investments in other companies**
			349,600				

Solutions to SELF-STUDY QUIZ

Current Ratio:

December 31, 2011	$2,321	÷	$2,450	=	0.947
December 31, 2010	2,313	÷	2,448	=	0.945
December 31, 2009	1,208	÷	1,653	=	0.731

Yum! Brands's current ratio is below 1.0 over the three years, suggesting the company has a low level of liquidity—insufficient current assets to settle short-term obligations. However, as a cash-oriented business and with a strong cash management system, Yum! Brands's current ratio below 1.0 is not a concern.

PAUSE FOR **FEEDBACK**

Apple, Inc.

As we discussed, every transaction affecting cash can be classified either as an operating (discussed in Chapter 3), investing, or financing effect. Investing effects relate to purchasing/selling investments or property and equipment or lending funds to/receiving repayment from others. Financing effects relate to borrowing or repaying banks, issuing stock to investors, repurchasing stock from investors, or paying dividends to investors.

SELF-STUDY **QUIZ**

Indicate whether the following transactions from a recent annual statement of cash flows for Apple, Inc., were investing (I) or financing (F) activities and the direction of their effects on cash (+ for increases; − for decreases):

Transactions	Type of Activity (I or F)	Effect on Cash Flows (+ or −)
1. Purchased investments	________	________
2. Issued common stock	________	________
3. Acquired property, plant, and equipment	________	________
4. Sold investments	________	________
5. Purchased intangible assets (e.g., patents)	________	________

After you have completed your answers, check them with the solutions at the bottom of this page.

DEMONSTRATION **CASE**

On April 1, 2014, three ambitious college students started Terrific Lawn Maintenance Corporation. A summary of transactions completed through April 7, 2014, for Terrific Lawn Maintenance Corporation follows:

a. Issued 500 shares of stock (1,500 shares in total) with a par value of $0.10 per share to each of the three investors in exchange for $9,000 cash.

b. Acquired rakes and other hand tools (equipment) with a list price of $690 for $600; paid the hardware store $200 cash and signed a three-month note for the balance.

c. Ordered three lawn mowers and two edgers from XYZ Lawn Supply, Inc., for $4,000.

d. Purchased four acres of land for the future site of a storage garage; paid cash, $5,000.

e. Received the mowers and edgers that had been ordered, signing a note to pay XYZ Lawn Supply in full in 18 months.

f. Sold for $1,250 one acre of land to the city for a park. Accepted a note from the city for payment by the end of the month.

g. One of the owners borrowed $3,000 from a local bank for personal use.

Required:

1. Set up T-accounts for Cash, Notes Receivable (from the city), Equipment (hand tools and mowing equipment), Land, Short-term Notes Payable (to the hardware store), Long-term Notes Payable, (to the equipment supply company), Common Stock, and Additional Paid-in Capital. Beginning balances are $0; indicate these beginning balances in the T-accounts. Analyze each transaction using the process outlined in the chapter with the transaction analysis model, and prepare journal entries in chronological order. Enter the effects of the transactions in the appropriate T-accounts; identify each amount with its letter in the preceding list. Compute ending balances for each T-account.

1. I − 2. F + 3. I − 4. I + 5. I −

Solutions to SELF-STUDY QUIZ

Assets (many accounts)		=	Liabilities (many accounts)		+	Stockholders' Equity		
						Contributed Capital (2 accounts)	*Earned Capital* (1 account)	
+ Debit	− Credit		− Debit	+ Credit		Common Stock and Additional Paid-in Capital	Retained Earnings	
						+ Credit Investment by owners	− Debit Dividends declared	+ Credit Net income

2. Use the balances in the T-accounts developed in the previous requirement to prepare a classified balance sheet for Terrific Lawn Maintenance Corporation at April 7, 2014.

3. Identify transactions (*a*)–(*g*) as investing or financing activities affecting cash flows and the direction of each effect. Use +I for investing inflow, −I for investing outflow, +F for financing inflow, and −F for financing outflow.

Check your answers with the solution in the following section.

SUGGESTED SOLUTION

1. Transaction Analysis:

	Received:	Given:
a.	Cash (+A) $9,000	Common Stock (+SE) $150 *(1,500 shares × $0.10 par value per share)* Additional Paid-in Capital (+SE) $8,850 *($9,000 − $150)*
b.	Equipment (+A) $600	Cash (−A) $200 Short-term Notes Payable (+L) $400
c.	Not a transaction—a promise to pay for a promise to deliver from the supplier	
d.	Land (+A) $5,000	Cash (−A) $5,000
e.	Equipment (+A) $4,000	Long-term Notes Payable (+L) $4,000
f.	Notes Receivable (+A) $1,250	Land (−A) $1,250 *(1/4 of the $5,000 cost of the land)*
g.	Not a transaction of the business—separate-entity assumption	

Journal Entries	Debit	Credit
(a) Cash (+A)	9,000	
Common Stock (+SE)		150
Additional Paid-in Capital (+SE)		8,850
(b) Equipment (+A)	600	
Cash (−A)		200
Short-term Notes Payable (+L)		400
(c) No transaction		
(d) Land (+A)	5,000	
Cash (−A)		5,000
(e) Equipment (+A)	4,000	
Long-term Notes Payable (+L)		4,000
(f) Notes Receivable (+A)	1,250	
Land (−A)		1,250
(g) No transaction		

Equality Checks for All
Debits = Credits
Equation balances

	A	=	L	+	SE
(a)	+ 9,000				+ 9,000
(b)	+ 400		+ 400		
(d)	+/− 5,000				
(e)	+ 4,000		+ 4,000		
(f)	+/− 1,250				

T-Accounts:

+ Cash (A) −			
4/1/14	0		
(a)	9,000	200	*(b)*
		5,000	*(d)*
	3,800		

+ Notes Receivable (A) −			
4/1/14	0		
(f)	1,250		
	1,250		

+ Equipment (A) −			
4/1/14	0		
(b)	600		
(e)	4,000		
	4,600		

+ Land (A) −			
4/1/14	0		
(d)	5,000	1,250	*(f)*
	3,750		

Short-term − Notes Payable (L) +			
		0	4/1/14
		400	*(b)*
		400	

Long-term − Notes Payable (L) +			
		0	4/1/14
		4,000	*(c)*
		4,000	

− Common Stock (SE) +			
		0	4/1/14
		150	*(a)*
		150	

Additional Paid-in − Capital (SE) +			
		0	4/1/14
		8,850	*(a)*
		8,850	

2. Classified Balance Sheet:

TERRIFIC LAWN MAINTENANCE CORPORATION
Balance Sheet
April 7, 2014

Assets	
Current Assets:	
Cash	$ 3,800
Notes receivable	1,250
Total current assets	5,050
Equipment	4,600
Land	3,750
Total assets	**$13,400**
Liabilities and Stockholders' Equity	
Current Liabilities:	
Short-term notes payable	$ 400
Total current liabilities	400
Long-term notes payable	4,000
Total liabilities	4,400
Stockholders' Equity:	
Common stock ($0.10 par)	150
Additional paid-in capital	8,850
Total stockholders' equity	9,000
Total liabilities and stockholders' equity	**$13,400**

3. Cash Flows:

+ Cash (A) −			
4/1/14	0		
(a)	9,000	200	*(b)*
		5,000	*(d)*
	3,800		

Only transactions *(a), (b),* and *(d)* affect cash flows (as shown in the Cash T-account).

(a) +F for $9,000

(b) −I for $200

(d) −I for $5,000

CHAPTER **TAKE-AWAYS**

2-1. Define the objective of financial reporting, the elements of the balance sheet, and the related key accounting assumptions and principles. **p. 43**

Objective:

- The primary objective of financial reporting to external users is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.

Qualitative characteristics of useful financial information:

- Relevance (including materiality) that allows users to assess past activities and/or predict future activities.
- Faithful representation requires information to be complete, neutral, and free from error.
  - To enhance the qualitative characteristics, information should also be comparable (to other companies and over time), verifiable, timely, and understandable.

Key recognition, measurement, and disclosure concepts:

Assumptions—

- Separate-entity assumption—transactions of the business are accounted for separately from transactions of the owner.
- Continuity (going-concern) assumption—a business is expected to continue to operate into the foreseeable future.
- Stable monetary unit assumption—financial information is reported in the national monetary unit without adjustment for changes in purchasing power.

Principles—

- Mixed-attribute measurement model—most balance sheet elements are recorded following the historical cost (or cost) principle—financial statement elements should be recorded at the cash-equivalent cost on the date of the transaction; however, these values may be adjusted to other amounts such as market value depending on certain conditions.

Elements of the balance sheet:

- Assets—probable future economic benefits owned or controlled by the entity as a result of past transactions.
- Liabilities—probable future sacrifices of economic benefits arising from present obligations of a business as a result of past transactions.

- Stockholders' equity—residual interest of owners in the assets of the entity after settling liabilities; the financing provided by the owners (contributed capital) and by business operations (earned capital).

2-2. Identify what constitutes a business transaction and recognize common balance sheet account titles used in business. **p. 47**

- An exchange of cash, goods, or services for cash, goods, services, or promises between a business and one or more external parties to a business (not the exchange of a promise for a promise),

or

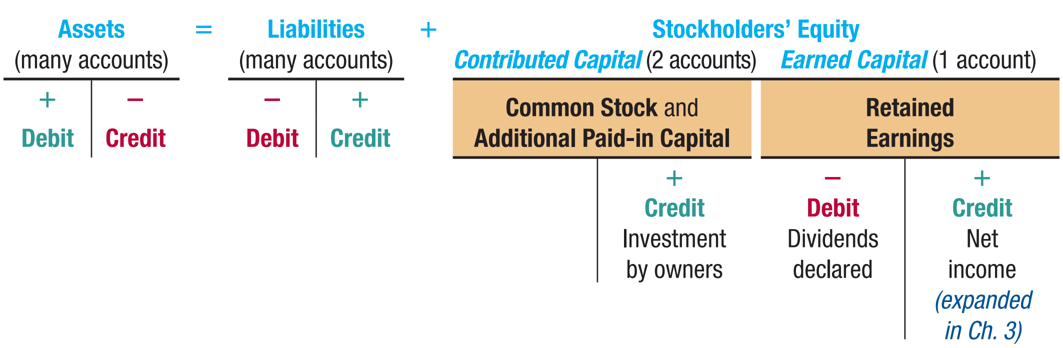
- A measurable internal event, such as adjustments for the use of assets in operations.

An account is a standardized format that organizations use to accumulate the dollar effects of transactions related to each financial statement item. Typical balance sheet account titles include the following:

- *Assets:* Cash, Accounts Receivable, Inventory, Prepaid Expenses, Investments, Property (buildings and land) and Equipment, and Intangibles (rights without physical substance).
- *Liabilities:* Accounts Payable, Notes Payable, Accrued Expenses Payable, Unearned Revenues, and Taxes Payable.
- *Stockholders' Equity:* Common Stock, Additional Paid-in Capital, and Retained Earnings.

2-3. Apply transaction analysis to simple business transactions in terms of the accounting model: Assets = Liabilities + Stockholders' Equity. **p. 49**

To determine the economic effect of a transaction on an entity in terms of the accounting equation, each transaction must be analyzed to determine the accounts (at least two) that are affected. In an exchange, the company receives something and gives up something. If the accounts, direction of the effects, and amounts are correctly analyzed, the accounting equation will stay in balance. The transaction analysis model is:



Systematic transaction analysis includes (1) determining the accounts that were received and were given in the exchange, including the type of each account (A, L, or SE), amounts, and direction of the effect, and (2) determining that the accounting equation remains in balance.

2-4. Determine the impact of business transactions on the balance sheet using two basic tools: Journal entries and T-accounts. **p. 54**

- Journal entries express the effects of a transaction on accounts in a debits-equal-credits format. The accounts and amounts to be debited are listed first. Then the accounts and amounts to be credited are listed below the debits and indented, resulting in debit amounts on the left and credit amounts on the right. Each entry needs a reference (date, number, or letter).

	Debit	Credit
(*a*) Cash (+A)	62,300	
Common Stock (+SE)		100
Additional Paid-in Capital (+SE)		62,200

- T-accounts summarize the transaction effects for each account. These tools can be used to determine balances and draw inferences about a company's activities.

+ (dr) Assets	(cr) −
Beginning balance Increases	Decreases
Ending balance	

− (dr) Liabilities and	Stockholders' Equity (cr) +
Decreases	Beginning balance Increases
	Ending balance

2-5. Prepare a trial balance and simple classified balance sheet, and analyze the company using the current ratio. **p. 64**

Classified balance sheets are structured as follows:

- Assets are categorized as current assets (those to be used or turned into cash within the year, with inventory always considered a current asset) and noncurrent assets, such as long-term investments, property and equipment, and intangible assets.
- Liabilities are categorized as current liabilities (those that will be paid with current assets) and long-term liabilities.
- Stockholders' equity accounts are listed as Common Stock (number of shares × par value per share) and Additional Paid-in Capital (amount received minus par value) first, followed by Retained Earnings (earnings reinvested in the business).

The current ratio (Current Assets ÷ Current Liabilities) measures a company's liquidity, that is, the ability of the company to pay its short-term obligations with current assets.

2-6. Identify investing and financing transactions and demonstrate how they impact cash flows. **p. 68**

A statement of cash flows reports the sources and uses of cash for the period by the type of activity that generated the cash flow: operating, investing, and financing. Investing activities include purchasing and selling long-term assets and making loans and receiving principal repayments from others. Financing activities are borrowing and repaying to banks the principal on loans, issuing and repurchasing stock, and paying dividends.

In this chapter, we discussed the fundamental accounting model and transaction analysis. Journal entries and T-accounts were used to record the results of transaction analysis for investing and financing decisions that affect balance sheet accounts. In Chapter 3, we continue our detailed look at the financial statements, in particular the income statement. The purpose of Chapter 3 is to build on your knowledge by discussing the measurement of revenues and expenses and illustrating the transaction analysis of operating decisions.

KEY **RATIO**

Current ratio measures the ability of the company to pay its short-term obligations with current assets. Although a ratio above 1.0 indicates sufficient current assets to meet obligations when they come due, many companies with sophisticated cash management systems have ratios below 1.0. (p. 66):

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

FINDING FINANCIAL INFORMATION

Balance Sheet

Current Assets
- Cash
- Short-term investments
- Accounts receivable
- Notes receivable
- Inventory
- Prepaid expenses

Noncurrent Assets
- Long-term investments
- Property and equipment
- Intangibles

Current Liabilities
- Accounts payable
- Accrued expenses payable
- Short-term notes payable
- Unearned revenue

Noncurrent Liabilities
- Long-term debt (notes payable)

Stockholders' Equity
- Common Stock
- Additional paid-in capital
- Retained earnings

Income Statement

To be presented in Chapter 3

Statement of Cash Flows

Operating Activities
- To be presented in Chapter 3

Investing Activities
- + Sales of noncurrent assets and investments for cash
- − Purchases of noncurrent assets and investments for cash
- − Loans to others
- + Receipt of loan principal payments from others

Financing Activities
- + Borrowing from banks
- − Repayment of loan principal to banks
- + Issuance of stock
- − Repurchasing stock
- − Dividends paid

Notes

To be discussed in future chapters

KEY TERMS

Account p. 48
Accounting Cycle p. 54
Additional Paid-in Capital (Paid-in Capital, Contributed Capital in Excess of Par) p. 51
Assets p. 45
Common Stock p. 51
Continuity (Going-Concern) Assumption p. 44
Credit p. 55
Current Assets p. 45
Current Liabilities p. 45
Debit p. 55
Faithful Representation p. 44
Journal Entry p. 57
Liabilities p. 45
Mixed-Attribute Measurement Model p. 44
Par Value p. 51
Primary Objective of Financial Reporting to External Users p. 43
Relevant Information p. 44
Retained Earnings p. 46
Separate-Entity Assumption p. 44
Stable Monetary Unit Assumption p. 44
Stockholders' Equity (Shareholders' or Owners' Equity) p. 45
T-account p. 58
Transaction p. 47
Transaction Analysis p. 49
Trial Balance p. 64

QUESTIONS

1. What is the primary objective of financial reporting for external users?
2. Define the following:
   a. Asset
   b. Current asset
   c. Liability
   d. Current liability
   e. Additional paid-in capital
   f. Retained earnings

3. Explain what the following accounting terms mean:
   a. Separate-entity assumption
   b. Stable monetary unit assumption
   c. Continuity assumption
   d. Historical cost principle
4. Why are accounting assumptions necessary?
5. For accounting purposes, what is an account? Explain why accounts are used in an accounting system.
6. What is the fundamental accounting model?
7. Define a business transaction in the broad sense, and give an example of two different kinds of transactions.
8. Explain what *debit* and *credit* mean.
9. Briefly explain what is meant by *transaction analysis*. What are the two steps in transaction analysis?
10. What two accounting equalities must be maintained in transaction analysis?
11. What is a journal entry?
12. What is a T-account? What is its purpose?
13. How is the current ratio computed and interpreted?
14. What transactions are classified as investing activities in a statement of cash flows? What transactions are classified as financing activities?

MULTIPLE-CHOICE **QUESTIONS**

1. If a publicly traded company is trying to maximize its perceived value to decision makers external to the corporation, the company is most likely to understate which of the following on its balance sheet?
   a. Assets
   b. Common Stock
   c. Retained Earnings
   d. Liabilities
2. Which of the following is not an asset?
   a. Investments
   b. Land
   c. Prepaid Expense
   d. Additional Paid-in Capital
3. Total liabilities on a balance sheet at the end of the year are $150,000, retained earnings at the end of the year is $80,000, net income for the year is $60,000, common stock is $40,000, and additional paid-in capital is $20,000. What amount of total assets would be reported on the balance sheet at the end of the year?
   a. $290,000
   b. $270,000
   c. $205,000
   d. $15,000
4. The dual effects concept can best be described as follows:
   a. When one records a transaction in the accounting system, at least two effects on the basic accounting equation will result.
   b. When an exchange takes place between two parties, both parties must record the transaction.
   c. When a transaction is recorded, both the balance sheet and the income statement must be impacted.
   d. When a transaction is recorded, one account will always increase and one account will always decrease.
5. The T-account is a tool commonly used for analyzing which of the following?
   a. Increases and decreases to a single account in the accounting system.
   b. Debits and credits to a single account in the accounting system.
   c. Changes in specific account balances over a time period.
   d. All of the above describe how T-accounts are used by accountants.
6. Which of the following describes how assets are listed on the balance sheet?
   a. In alphabetical order
   b. In order of magnitude, lowest value to highest value
   c. From most liquid to least liquid
   d. From least liquid to most liquid

7. The Cash T-account has a beginning balance of $21,000. During the year, $100,000 was debited and $110,000 was credited to the account. What is the ending balance of Cash?
   a. $11,000 debit balance
   b. $11,000 credit balance
   c. $31,000 credit balance
   d. $31,000 debit balance
8. Which of the following statements are true regarding the balance sheet?
   1. One cannot determine the true fair market value of a company by reviewing its balance sheet.
   2. Certain internally generated assets, such as a trademark, are not reported on a company's balance sheet.
   3. A balance sheet shows only the ending balances, in a summarized format, of all balance sheet accounts in the accounting system as of a particular date.

   a. None are true.
   b. Statements 1 and 2 only are true.
   c. Statements 2 and 3 only are true.
   d. All statements are true.
9. At the end of a recent year, The Gap, Inc., reported total assets of $7,422 million, current assets of $4,309 million, total liabilities of $4,667, current liabilities of $2,128 million, and stockholders' equity of $2,755 million. What is its current ratio and what does this suggest about the company?
   a. The ratio of 1.59 suggests that The Gap has liquidity problems.
   b. The ratio of 2.02 suggests that The Gap has sufficient liquidity.
   c. The ratio of 1.59 suggests that The Gap has greater current assets than current liabilities.
   d. The ratio of 2.02 suggests that The Gap is not able to pay its short-term obligations with current assets.
10. Which of the following is *not* a financing activity on the statement of cash flows?
   a. When the company lends money.
   b. When the company borrows money.
   c. When the company pays dividends.
   d. When the company issues stock to shareholders.

For more practice with multiple-choice questions, go to the text website at **www.mhhe.com/libby8e**.

connect ACCOUNTING

MINI-**EXERCISES**

Matching Definitions with Terms

M2-1
LO2-1, 2-4

Match each definition with its related term by entering the appropriate letter in the space provided. There should be only one definition per term (that is, there are more definitions than terms).

Term	Definition
___ (1) Continuity assumption	A. = Liabilities + Stockholders' Equity.
___ (2) Historical cost principle	B. Reports assets, liabilities, and stockholders' equity.
___ (3) Credits	C. Accounts for a business separate from its owners.
___ (4) Assets	D. Increase assets; decrease liabilities and stockholders' equity.
___ (5) Account	E. An exchange between an entity and other parties.
	F. The concept that businesses will operate into the foreseeable future.
	G. Decrease assets; increase liabilities and stockholders' equity.
	H. The concept that assets should be recorded at the amount paid on the date of the transaction.
	I. A standardized format used to accumulate data about each item reported on financial statements.

M2-2 Matching Definitions with Terms
LO2-1, 2-2, 2-3, 2-4

Match each definition with its related term by entering the appropriate letter in the space provided. There should be only one definition per term (that is, there are more definitions than terms).

Term	Definition
___ (1) Journal entry	A. Accounting model.
___ (2) A = L + SE, and Debits = Credits	B. Four periodic financial statements.
___ (3) Assets = Liabilities + Stockholders' Equity	C. The two equalities in accounting that aid in providing accuracy.
___ (4) Liabilities	D. The results of transaction analysis in accounting format.
___ (5) Income statement, balance sheet, statement of stockholders' equity, and statement of cash flows	E. The account that is debited when money is borrowed from a bank.
	F. Probable future economic benefits owned by an entity.
	G. Cumulative earnings of a company that are not distributed to the owners.
	H. Every transaction has at least two effects.
	I. Probable debts or obligations to be paid with assets or services.

M2-3 Identifying Events as Accounting Transactions
LO2-2

For each of the following events, which ones result in an exchange transaction for Dittman Company (Y for yes and N for no)?

___ (1) Six investors in Dittman Company sold their stock to another investor.
___ (2) The founding owner, Megan Dittman, purchased additional stock in another company.
___ (3) The company borrowed $2,500,000 from a local bank.
___ (4) Dittman Company purchased a machine that it paid for by signing a note payable.
___ (5) The company lent $300,000 to a supplier.
___ (6) Dittman Company ordered supplies from Staples to be delivered next week.

M2-4 Classifying Accounts on a Balance Sheet
LO2-2

The following are accounts of Rosa-Perez Company:

___ (1) Accounts Payable
___ (2) Accounts Receivable
___ (3) Buildings
___ (4) Cash
___ (5) Common Stock
___ (6) Land
___ (7) Merchandise Inventory
___ (8) Income Taxes Payable
___ (9) Long-Term Investments
___ (10) Notes Payable (due in three years)
___ (11) Notes Receivable (due in six months)
___ (12) Prepaid Rent
___ (13) Retained Earnings
___ (14) Supplies
___ (15) Utilities Payable
___ (16) Wages Payable

In the space provided, classify each as it would be reported on a balance sheet. Use:

CA for current asset	CL for current liability	SE for stockholders' equity
NCA for noncurrent asset	NCL for noncurrent liability	

M2-5 Determining Financial Statement Effects of Several Transactions
LO2-3

For each of the following transactions of Dennen, Inc., for the month of January 2015, indicate the accounts, amounts, and direction of the effects on the accounting equation. A sample is provided.

a. *(Sample)* Borrowed $30,000 from a local bank.
b. Lent $10,000 to an affiliate; accepted a note due in one year.
c. Sold 100 additional shares of stock with a par value of $0.10 per share to investors for $500 cash.
d. Purchased $15,000 of equipment, paying $5,000 cash and signing a note for the rest due in one year.
e. Declared and paid $2,000 in dividends to stockholders.

Assets		=	Liabilities		+	Stockholders' Equity
a. Sample: Cash	+30,000		Notes Payable	+30,000		

Identifying Increase and Decrease Effects on Balance Sheet Elements

M2-6
LO2-4

Complete the following table by entering either the word *increases* or *decreases* in each column.

	Debit	Credit
Assets	________	________
Liabilities	________	________
Stockholders' equity	________	________

Identifying Debit and Credit Effects on Balance Sheet Elements

M2-7
LO2-4

Complete the following table by entering either the word *debit* or *credit* in each column.

	Increase	Decrease
Assets	________	________
Liabilities	________	________
Stockholders' equity	________	________

Recording Simple Transactions

M2-8
LO2-4

For each transaction in M2-5 (including the sample), write the journal entry in the proper form.

Completing T-Accounts

M2-9
LO2-4

For each transaction in M2-5 (including the sample), post the effects to the appropriate T-accounts and determine ending account balances. Beginning balances are provided.

Cash	
Beg. bal. 900	

Notes Receivable	
Beg. bal. 1,000	

Equipment	
Beg. bal. 15,100	

Notes Payable	
	Beg. bal. 3,000

Common Stock	
	Beg. bal. 1,000

Additional Paid-in Capital	
	Beg. bal. 3,000

Retained Earnings	
	Beg. bal. 10,000

Preparing a Trial Balance

M2-10
LO2-5

Complete M2-9, and then prepare a trial balance for Dennen, Inc., as of January 31, 2015.

Preparing a Simple Classified Balance Sheet

M2-11
LO2-5

Starting with the beginning balances in M2-9 and given the transactions in M2-5 (including the sample), prepare a balance sheet for Dennen, Inc., as of January 31, 2015, classified into current and noncurrent assets and liabilities.

Computing and Interpreting the Current Ratio

M2-12
LO2-5

Calculate the current ratio for Sal's Taco Company at the end of 2011 and 2012, based on the following data:

	Current Assets	Current Liabilities
End of 2011	$280,000	$155,000
End of 2012	$270,000	$250,000

What does the result suggest about the company over time? What can you say about Sal's Taco Company's ratio when compared to Chipotle's 2011 ratio?

M2-13
LO2-6

Identifying Transactions as Investing or Financing Activities on the Statement of Cash Flows

For the transactions in M2-5 (including the sample), identify each as an investing (I) activity or financing (F) activity on the statement of cash flows.

EXERCISES

E2-1
LO2-1, 2-2, 2-3, 2-4

Matching Definitions with Terms

Match each definition with its related term by entering the appropriate letter in the space provided. There should be only one definition per term (that is, there are more definitions than terms).

Term

___ (1) Transaction
___ (2) Continuity assumption
___ (3) Balance sheet
___ (4) Liabilities
___ (5) Assets = Liabilities + Stockholders' Equity
___ (6) Notes payable
___ (7) Common stock
___ (8) Historical cost principle
___ (9) Account
___ (10) Dual effects
___ (11) Retained earnings
___ (12) Current assets
___ (13) Separate-entity assumption
___ (14) Par value
___ (15) Debits
___ (16) Accounts receivable
___ (17) Stable monetary unit assumption
___ (18) Faithful representation
___ (19) Relevance
___ (20) Stockholders' equity

Definition

A. Economic resources to be used or turned into cash within one year.
B. Reports assets, liabilities, and stockholders' equity.
C. Business transactions are accounted for separately from the transactions of the owners.
D. Increase assets; decrease liabilities and stockholders' equity.
E. An exchange between an entity and other parties.
F. The concept that businesses will operate into the foreseeable future.
G. Decrease assets; increase liabilities and stockholders' equity.
H. The concept that assets should be recorded at the amount paid on the exchange date.
I. A standardized format used to accumulate data about each item reported on financial statements.
J. Amounts owed from customers.
K. The fundamental accounting model.
L. Represents the shares issued at par value.
M. The account that is credited when money is borrowed from a bank.
N. The concept that states that accounting information should be measured and reported in the national monetary unit without adjustment for changes in purchasing power.
O. Cumulative earnings of a company that are not distributed to the owners.
P. Probable debts or obligations to be settled with assets or services.
Q. Every transaction has at least two effects on the accounting equation.
R. Financing provided by owners and by business operations.
S. The concept to exercise care not to overstate assets and revenues or understate liabilities and expenses.
T. Useful information has predictive and feedback value.
U. Relatively small amounts not likely to influence users' decisions are to be recorded in the most cost-beneficial way.
V. Probable economic resources expected to be used or turned into cash beyond the next 12 months.
W. Useful information should be complete, neutral, and free from error.
X. A legal amount per share.

Identifying Account Titles

E2-2
LO2-2

The following are independent situations.

a. A new company is formed and sells 100 shares of $1 per value stock for $12 per share to investors.
b. A company purchases for $18,000 cash a new delivery truck that has a list, or sticker, price of $21,000.
c. A women's clothing retailer orders 30 new display stands for $300 each for future delivery.
d. A company orders and receives 10 personal computers for office use for which it signs a note promising to pay $25,000 within three months.
e. A construction company signs a contract to build a new $500,000 warehouse for a corporate customer. At the signing, the corporation writes a check for $50,000 to the construction company as the initial payment for the construction (receiving construction in progress). Answer from the standpoint of the corporation (not the construction company).
f. A publishing firm purchases for $40,000 cash the copyright (an intangible asset) to a manuscript for an introductory accounting text.
g. A manufacturing firm pays stockholders a $100,000 cash dividend.
h. A company purchases a piece of land for $50,000 cash. An appraiser for the buyer values the land at $52,500.
i. A manufacturing company acquires the patent (an intangible asset) on a new digital satellite system for television reception, paying $500,000 cash and signing a $400,000 note payable due in one year.
j. A local company is a sole proprietorship (one owner); its owner buys a car for $10,000 for personal use. Answer from the local company's point of view.
k. A company purchases 100 shares of Apple Inc. common stock as an investment for $5,000 cash.
l. A company borrows $1,000 from a local bank and signs a six-month note for the loan.
m. A company pays $1,500 principal on its note payable (ignore interest).

Required:

1. Indicate the appropriate account titles, if any, affected in each of the preceding events. Consider what is received and what is given.
2. At what amount would you record the truck in (*b*)? The land in (*h*)? What measurement principle are you applying?
3. For (*c*), what accounting concept did you apply? For (*j*), what accounting concept did you apply?

Classifying Accounts and Their Usual Balances

E2-3
LO2-2, 2-4

Verizon Communications, Inc.

As described in a recent annual report, Verizon Wireless provides wireless voice and data services across one of the most extensive wireless networks in the United States. Verizon now serves more than 80 million customers, making it the largest wireless service provider in the United States in terms of the total number of customers. The following are accounts from a recent balance sheet for Verizon.

(1) Accounts Receivable	(6) Long-Term Investments
(2) Retained Earnings	(7) Plant, Property, and Equipment
(3) Taxes Payable	(8) Accounts Payable
(4) Prepaid Expenses	(9) Short-Term Investments
(5) Common Stock	(10) Long-Term Debt

Required:

For each account, indicate whether the account is usually classified as a current asset (CA), noncurrent asset (NCA), current liability (CL), noncurrent liability (NCL), or stockholders' equity (SE), and whether the account usually has a debit or credit balance.

Determining Financial Statement Effects of Several Transactions

E2-4
LO2-3

The following events occurred for Johnson Company:

a. Received investment of $40,000 cash by organizers and distributed 1,000 shares of $1 par value common stock to them.
b. Purchased $15,000 of equipment, paying $3,000 in cash and signing a note for the rest.
c. Borrowed $10,000 cash from a bank.
d. Loaned $800 to an employee who signed a note.
e. Purchased $13,000 of land; paid $4,000 in cash and signed a mortgage note for the balance.

Required:
For each of the events *(a)* through *(e),* perform transaction analysis and indicate the account, amount, and direction of the effect (+ for increase and − for decrease) on the accounting equation. Check that the accounting equation remains in balance after each transaction. Use the following headings:

Event	Assets	=	Liabilities	+	Stockholders' Equity

E2-5 LO2-3

Determining Financial Statement Effects of Several Transactions

Nike, Inc., with headquarters in Beaverton, Oregon, is one of the world's leading manufacturers of athletic shoes and sports apparel. The following activities occurred during a recent year. The amounts are rounded to millions.

a. Purchased additional buildings for $172 and equipment for $270; paid $432 in cash and signed a long-term note for the rest.
b. Issued 100 shares of $2 par value common stock for $345 cash.
c. Declared $145 in dividends to be paid in the following year.
d. Purchased additional short-term investments for $7,616 cash.
e. Several Nike investors sold their own stock to other investors on the stock exchange for $84.
f. Sold $4,313 in short-term investments for $4,313 in cash.

Required:
1. For each of the events (*a*) through (*f*), perform transaction analysis and indicate the account, amount, and direction of the effect on the accounting equation. Check that the accounting equation remains in balance after each transaction. Use the following headings:

Event	Assets	=	Liabilities	+	Stockholders' Equity

2. Explain your response to event (*e*).

E2-6 LO2-4

Recording Investing and Financing Activities

Refer to E2-4.

Required:
For each of the events (*a*) through (*e*) in E2-4, prepare journal entries, checking that debits equal credits.

E2-7 LO2-4

Recording Investing and Financing Activities

Refer to E2-5.

Required:
1. For each of the events (*a*) through (*f*) in E2-5, prepare journal entries, checking that debits equal credits.
2. Explain your response to event (*e*).

E2-8 LO2-4

Analyzing the Effects of Transactions in T-Accounts

Granger Service Company, Inc., was organized by Ted Granger and five other investors. The following activities occurred during the year:

a. Received $70,000 cash from the investors; each was issued 8,400 shares of capital stock with a par value of $0.10 per share.
b. Purchased equipment for use in the business at a cost of $18,000; one-fourth was paid in cash and the company signed a note for the balance (due in six months).
c. Signed an agreement with a cleaning service to pay $120 per week for cleaning the corporate offices next year.
d. Received an additional contribution from investors who provided $3,000 in cash and land valued at $15,000 in exchange for 1,000 shares of stock in the company.
e. Lent $2,500 to one of the investors who signed a note due in six months.
f. Ted Granger borrowed $7,000 for personal use from a local bank, signing a one-year note.

Required:
1. Create T-accounts for the following accounts: Cash, Notes Receivable, Equipment, Land, Notes Payable, Common Stock, and Additional Paid-in Capital. Beginning balances are $0. For each of the preceding transactions, record the effects of the transaction in the appropriate T-accounts. Include good referencing and totals for each T-account.

2. Using the balances in the T-accounts, fill in the following amounts for the accounting equation:

   Assets $________ = Liabilities $________ + Stockholders' Equity $________

3. Explain your response to events (*c*) and (*f*).

Inferring Investing and Financing Transactions and Preparing a Balance Sheet

E2-9
LO2-4, 2-5

During its first week of operations ending January 7, 2014, FastTrack Sports Inc. completed six transactions with the dollar effects indicated in the following schedule:

Accounts	Dollar Effect of Each of the Six Transactions						Ending Balance
	1	2	3	4	5	6	
Cash	$15,000	$75,000	$(5,000)	$(4,000)	$(9,500)		
Notes receivable (short-term)				4,000			
Store fixtures					9,500		
Land			16,000			$4,000	
Notes payable (due in three months)		75,000	11,000			4,000	
Common stock (15,000 shares)	1,500						
Additional paid-in capital	13,500						

Required:

1. Write a brief explanation of transactions (1) through (6). Explain any assumptions that you made.
2. Compute the ending balance in each account and prepare a classified balance sheet for FastTrack Sports Inc. on January 7, 2014.

Inferring Investing and Financing Transactions and Preparing a Balance Sheet

E2-10
LO2-4, 2-5

During its first month of operations in March 2014, Volz Cleaning, Inc., completed six transactions with the dollar effects indicated in the following schedule:

Accounts	Dollar Effect of Each of the Six Transactions						Ending Balance
	1	2	3	4	5	6	
Cash	$45,000	$(8,000)	$(2,000)	$(7,000)	$3,000	$(4,000)	
Investments (short-term)				7,000	(3,000)		
Notes receivable (due in six months)			2,000				
Computer equipment						$4,000	
Delivery truck		35,000					
Notes payable (due in 10 years)		27,000					
Common stock (3,000 shares)	6,000						
Additional paid-in capital	39,000						

Required:

1. Write a brief explanation of transactions (1) through (6). Explain any assumptions that you made.
2. Compute the ending balance in each account and prepare a classified balance sheet for Volz Cleaning, Inc., at the end of March 2014.

Recording Journal Entries

E2-11
LO2-4

Nathanson Corporation was organized on May 1, 2014. The following events occurred during the first month.

a. Received $70,000 cash from the five investors who organized Nathanson Corporation. Each investor received 100 shares of $10 par value common stock.
b. Ordered store fixtures costing $15,000.

c. Borrowed $18,000 cash and signed a note due in two years.
d. Purchased $11,000 of equipment, paying $1,500 in cash and signing a six-month note for the balance.
e. Lent $2,000 to an employee who signed a note to repay the loan in three months.
f. Received and paid for the store fixtures ordered in (*b*).

Required:
Prepare journal entries for each transaction. (Remember that debits go on top and credits go on the bottom, indented.) Be sure to use good referencing and categorize each account as an asset (A), liability (L), or stockholders' equity (SE). If a transaction does not require a journal entry, explain the reason.

E2-12 **LO2-4** **Recording Journal Entries**

BMW Group, headquartered in Munich, Germany, manufactures several automotive brands including BMW Group, MINI, and Rolls-Royce. Financial information is reported in the euro (€) monetary unit using International Financial Reporting Standards (IFRS) as applicable to the European Union. The following activities were adapted from the annual report of the BMW Group; amounts are in millions of euros.

a. Declared €1,508 in dividends to be paid next month.
b. Ordered €2,598 of equipment.
c. Paid €852 in dividends declared in prior months.
d. Borrowed €5,899 in cash from banks.
e. Sold equipment at its cost of €53 for cash.
f. Received the equipment ordered in event (*b*), paying €2,250 in cash and signing a note for the balance.
g. Purchased investments for €2,616 cash.

Required:
Prepare journal entries for each transaction. Be sure to use good referencing and categorize each account as an asset (A), liability (L), or stockholders' equity (SE). If a transaction does not require a journal entry, explain the reason.

E2-13 **LO2-4, 2-5** **Analyzing the Effects of Transactions Using T-Accounts and Interpreting the Current Ratio as a Manager of the Company**

Higgins Company has been operating for one year (2014). You are a member of the management team investigating expansion ideas that will require borrowing funds from banks. At the start of 2015, Higgins's T-account balances were as follows:

Assets:

Cash	
5,000	

Short-Term Investments	
2,500	

Property and Equipment	
3,000	

Liabilities:

Short-Term Notes Payable	
	2,200

Long-Term Notes Payable	
	800

Stockholders' Equity:

Common Stock	
	500

Additional Paid-in Capital	
	4,000

Retained Earnings	
	3,000

Required:
1. Using the data from these T-accounts, determine the amounts for the following on January 1, 2015:

   Assets $________ = Liabilities $________ + Stockholders' Equity $________

2. Enter the following 2015 transactions in the T-accounts:
   (a) Borrowed $4,000 from a local bank, signing a note due in three years.
   (b) Sold $1,500 of the investments for $1,500 cash.
   (c) Sold one-half of the property and equipment for $1,500 in cash.
   (d) Declared and paid $800 in cash dividends to stockholders.

3. Compute ending balances in the T-accounts to determine amounts for the following on December 31, 2015:

   Assets $________ = Liabilities $________ + Stockholders' Equity $________

4. Calculate the current ratio at December 31, 2015. If the industry average for the current ratio is 1.50, what does your computation suggest to you about Higgins Company? Would you suggest that Higgins Company increase its short-term liabilities? Why or why not?

Preparing a Balance Sheet

E2-14
LO2-5

Refer to E2-13.

Required:
From the ending balances in the T-accounts in E2-13, prepare a classified balance sheet at December 31, 2015, in good form.

Analyzing the Effects of Transactions Using T-Accounts, Preparing a Balance Sheet, and Evaluating the Current Ratio over Time as a Bank Loan Officer

E2-15
LO2-4, 2-5

Strauderman Delivery Company, Inc., was organized in 2014 in Wisconsin. The following transactions occurred during year 2014:

a. Received $40,000 cash from organizers in exchange for 10,000 shares of stock (par value of $1.00 per share) in the new company.
b. Purchased land in Wisconsin for $16,000, signing a one-year note (ignore interest).
c. Bought two used delivery trucks for operating purposes at the start of the year at a cost of $10,000 each; paid $4,000 cash and signed a note due in three years for the rest (ignore interest).
d. Paid $1,000 cash to a truck repair shop for a new motor for one of the trucks. (*Hint:* Increase the account you used to record the purchase of the trucks since the productive life of the truck has been improved.)
e. Sold one-fourth of the land for $4,000 to Pablo Development Corporation, which signed a six-month note.
f. Stockholder Melissa Strauderman paid $27,600 cash for a vacant lot (land) in Canada for her personal use.

Required:
1. Set up appropriate T-accounts with beginning balances of zero for Cash, Short-Term Notes Receivable, Land, Equipment, Short-Term Notes Payable, Long-Term Notes Payable, Common Stock, and Additional Paid-in Capital. Using the T-accounts, record the effects of transactions (*a*) through (*f*) by Strauderman Delivery Company.
2. Prepare a trial balance at December 31, 2014.
3. Prepare a classified balance sheet for Strauderman Delivery Company at December 31, 2014.
4. At the end of the next two years, Strauderman Delivery Company reported the following amounts on its balance sheets:

	December 31, 2015	December 31, 2016
Current Assets	$52,000	$ 47,000
Long-Term Assets	38,000	73,000
Total Assets	**90,000**	**120,000**
Short-Term Notes Payable	23,000	40,000
Long-Term Notes Payable	17,000	20,000
Total Liabilities	**40,000**	**60,000**
Stockholders' Equity	**50,000**	**60,000**

   Compute the company's current ratio for 2014, 2015, and 2016. What is the trend and what does this suggest about the company?
5. At the beginning of year 2017, Strauderman Delivery Company applied to your bank for a $50,000 short-term loan to expand the business. The vice president of the bank asked you to review the information and make a recommendation on lending the funds based solely on the results of the current ratio. What recommendation would you make to the bank's vice president about lending the money to Strauderman Delivery Company?

Explaining the Effects of Transactions on Balance Sheet Accounts Using T-Accounts

E2-16
LO2-4

Waltman Furniture Repair Service, a company with two stockholders, began operations on June 1, 2014. The following T-accounts indicate the activities for the month of June.

Cash (A)

6/1/14	0		
a.	20,000	*c.*	10,000
d.	900	*b.*	1,800

Notes Receivable (A)

6/1/14	0		
b.	1,800		

Tools and Equipment (A)

6/1/14	0		
a.	5,000	*d.*	900

Building (A)

6/1/14	0		
c.	40,000		

Notes Payable (L)

		6/1/14	0
		c.	30,000

Common Stock (100,000 shares) (SE)

		6/1/14	0
		a.	2,000

Additional Paid-in Capital (SE)

		6/1/14	0
		a.	23,000

Required:

Explain events *(a)* through *(d)* that resulted in the entries in the T-accounts. That is, for each account, what transactions made it increase and/or decrease?

E2-17 LO2-4 Inferring Typical Investing and Financing Activities in Accounts

The following T-accounts indicate the effects of normal business transactions:

Equipment

1/1	500	
	250	?
12/31	100	

Notes Receivable

1/1	150	
	?	225
12/31	170	

Notes Payable

	100	1/1
?	170	
	160	12/31

Required:

1. Describe the typical investing and financing transactions that affect each T-account. That is, what economic events occur to make each of these accounts increase and decrease?
2. For each T-account, compute the missing amounts.

E2-18 LO2-6 Identifying Investing and Financing Activities Affecting Cash Flows

Foot Locker, Inc.

Foot Locker, Inc., is a large global retailer of athletic footwear and apparel selling directly to customers and through the Internet. It includes the Foot Locker family of stores, Champs Sports, Footaction, CCS, and Eastbay. The following are several of Foot Locker's investing and financing activities as reflected in a recent annual statement of cash flows.

a. Reduction of long-term debt.
b. Sale of short-term investments.
c. Issuance of common stock.
d. Capital expenditures (for property, plant, and equipment).
e. Dividends paid on common stock.

Required:

For each of these, indicate whether the activity is investing (I) or financing (F) and the direction of the effect on cash flows (+ for increases cash; − for decreases cash).

E2-19 LO2-6 Identifying the Investing and Financing Activities Affecting Cash Flows

Starwood Hotels & Resorts Worldwide, Inc.

Starwood Hotels & Resorts Worldwide, Inc., is one of the world's largest hotel and leisure companies. It conducts business both directly and through its subsidiaries, including the following hotel brands: Sheraton, Four Points, W, Aloft, The Luxury Collection, Le Meridien, Element, Westin, and St. Regis.* Information adapted from the company's recent annual statement of cash flows indicates the following investing and financing activities during that year (simplified, in millions of dollars):

*Sheraton, Four Points, W, Aloft, The Luxury Collection, Le Meridien, Element, Westin, St. Regis and their respective logos are the trademarks of Starwood Hotels & Resorts Worldwide, Inc., or its affiliates.

a.	Additional borrowing from banks	$ 47
b.	Purchase of investments	8
c.	Sale of assets and investments (assume sold at cost)	294
d.	Issuance of stock	70
e.	Purchase and renovation of properties	385
f.	Payment of debt principal	650
g.	Receipt of principal payment on a note receivable	5

Required:
For each of these indicate whether the activity is investing (I) or financing (F) and the direction of the effects on cash flows (+ for increases cash; − for decreases cash).

Finding Financial Information as a Potential Investor

E2-20
LO2-2, 2-5, 2-6

You are considering investing the cash you inherited from your grandfather in various stocks. You have received the annual reports of several major companies.

Required:
For each of the following, indicate where you would locate the information in an annual report. The information may be in more than one location.

1. Total current assets.
2. Amount of debt principal repaid during the year.
3. Summary of significant accounting policies.
4. Cash received from sales of noncurrent assets.
5. Amount of dividends paid during the year.
6. Short-term obligations.
7. Date of the statement of financial position.

To practice with more exercises, go to the text website at **www.mhhe.com/libby8e**.

connect ACCOUNTING

PROBLEMS

Identifying Accounts on a Classified Balance Sheet and Their Normal Debit or Credit Balances (AP2-1)

P2-1
LO2-1, 2-2, 2-4

ExxonMobil

Exxon Mobil Corporation explores, produces, refines, markets, and supplies crude oil, natural gas, and petroleum products in the United States and around the world. The following are accounts from a recent balance sheet of Exxon Mobil Corporation:

	Balance Sheet Classification	Debit or Credit Balance
(1) Notes and Loans Payable (short-term)	________	________
(2) Materials and Supplies	________	________
(3) Common Stock	________	________
(4) Patents (an intangible asset)	________	________
(5) Income Taxes Payable	________	________
(6) Long-Term Debt	________	________
(7) Marketable Securities (short-term investments)	________	________
(8) Property, Plant, and Equipment	________	________
(9) Retained Earnings	________	________
(10) Notes and Accounts Receivable (short-term)	________	________
(11) Investments (long-term)	________	________
(12) Cash and Cash Equivalents	________	________
(13) Accounts Payable	________	________
(14) Crude Oil Products and Merchandise	________	________
(15) Additional Paid-in Capital	________	________

Required:
For each account, indicate how it normally should be categorized on a classified balance sheet. Use CA for current asset, NCA for noncurrent asset, CL for current liability, NCL for noncurrent liability, and SE for stockholders' equity. Also indicate whether the account normally has a debit or credit balance.

P2-2
LO2-2, 2-3, 2-5

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Determining Financial Statement Effects of Various Transactions (AP2–2)

East Hill Home Healthcare Services was organized on January 1, 2014, by four friends. Each organizer invested $10,000 in the company and, in turn, was issued 8,000 shares of $1.00 par value stock. To date, they are the only stockholders. At the end of 2015, the accounting records reflected total assets of $700,000 ($50,000 cash; $500,000 land; $50,000 equipment; and $100,000 buildings), total liabilities of $200,000 (short-term notes payable $100,000 and long-term notes payable $100,000), and stockholders' equity of $500,000 ($20,000 common stock, $80,000 additional paid-in capital, and $400,000 retained earnings). During the current year, 2016, the following summarized events occurred:

a. Sold 9,000 additional shares of stock to the original organizers for a total of $90,000 cash.
b. Purchased a building for $60,000, equipment for $15,000, and four acres of land for $14,000; paid $9,000 in cash and signed a note for the balance (due in 15 years). (*Hint:* Five different accounts are affected.)
c. Sold one acre of land acquired in (*b*) for $3,500 cash to another company.
d. Purchased short-term investments for $18,000 cash.
e. One stockholder reported to the company that 300 shares of his East Hill stock had been sold and transferred to another stockholder for $3,000 cash.
f. Lent one of the shareholders $5,000 for moving costs, receiving a signed six-month note from the shareholder.

Required:

1. Was East Hill Home Healthcare Services organized as a sole proprietorship, a partnership, or a corporation? Explain the basis for your answer.
2. During 2016, the records of the company were inadequate. You were asked to prepare the summary of the preceding transactions. To develop a quick assessment of their economic effects on East Hill Home Healthcare Services, you have decided to complete the tabulation that follows and to use plus (+) for increases and minus (−) for decreases for each account. The first event is used as an example.

	ASSETS						=	LIABILITIES		+	STOCKHOLDERS' EQUITY		
	Cash	Short-Term Investments	Notes Receivable	Land	Buildings	Equipment		Short-Term Notes Payable	Long-Term Notes Payable		Common Stock	Additional Paid-in Capital	Retained Earnings
Beg.	50,000			500,000	100,000	50,000	=	100,000	100,000		20,000	80,000	400,000
(*a*)	+90,000						=				+9,000	+81,000	

3. Did you include the transaction between the two stockholders—event (*e*)—in the tabulation? Why?
4. Based only on the completed tabulation, provide the following amounts (show computations):
   a. Total assets at the end of the year.
   b. Total liabilities at the end of the year.
   c. Total stockholders' equity at the end of the year.
   d. Cash balance at the end of the year.
   e. Total current assets at the end of the year.
5. Compute the current ratio for 2016. What does this suggest about the company?

P2-3
LO2-2, 2-4, 2-5

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Recording Transactions in T-Accounts, Preparing the Balance Sheet from a Trial Balance, and Evaluating the Current Ratio (AP2-3)

Cougar Plastics Company has been operating for three years. At December 31, 2014, the accounting records reflected the following:

Cash	$22,000	Accounts payable	$15,000
Investments (short-term)	3,000	Accrued liabilities payable	4,000
Accounts receivable	3,000	Notes payable (short-term)	7,000
Inventory	20,000	Long-term notes payable	47,000
Notes receivable (long-term)	1,000	Common stock	10,000
Equipment	50,000	Additional paid-in capital	80,000
Factory building	90,000	Retained earnings	31,000
Intangibles	5,000		

During the year 2015, the company had the following summarized activities:

a. Purchased short-term investments for $10,000 cash.
b. Lent $5,000 to a supplier who signed a two-year note.
c. Purchased equipment that cost $18,000; paid $5,000 cash and signed a one-year note for the balance.
d. Hired a new president at the end of the year. The contract was for $85,000 per year plus options to purchase company stock at a set price based on company performance.

e. Issued an additional 2,000 shares of $0.50 par value common stock for $11,000 cash.
f. Borrowed $9,000 cash from a local bank, payable in three months.
g. Purchased a patent (an intangible asset) for $3,000 cash.
h. Built an addition to the factory for $24,000; paid $8,000 in cash and signed a three-year note for the balance.
i. Returned defective equipment to the manufacturer, receiving a cash refund of $1,000.

Required:

1. Create T-accounts for each of the accounts on the balance sheet and enter the balances at the end of 2014 as beginning balances for 2015.
2. Record each of the events for 2015 in T-accounts (including referencing) and determine the ending balances.
3. Explain your response to event (*d*).
4. Prepare a trial balance at December 31, 2015.
5. Prepare a classified balance sheet at December 31, 2015.
6. Compute the current ratio for 2015. What does this suggest about Cougar Plastics?

Identifying Effects of Transactions on the Statement of Cash Flows (AP2-4)

P2-4
LO2-6

Refer to P2-3.

Required:
Using the events (*a*) through (*i*) in P2-3, indicate whether each is an investing (I) or financing (F) activity for the year and the direction of the effect on cash flows (+ for increase and − for decrease). If there is no effect on cash flows, write NE.

Recording Transactions, Preparing Journal Entries, Posting to T-Accounts, Preparing the Balance Sheet, and Evaluating the Current Ratio

P2-5
LO2-2, 2-4, 2-5
Dell

Dell Inc., headquartered in Austin, Texas, is the global leader in selling computer products and services. The following is Dell's (simplified) balance sheet from a recent year (fiscal year ending on Friday nearest January 31).

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DELL INC.
Balance Sheet
at February 3, 2012
(dollars in millions)

ASSETS	
Current assets:	
Cash	$13,852
Short-term investments	966
Receivables and other assets	9,803
Inventories	1,404
Other	3,423
Total current assets	**29,448**
Property, plant, and equipment	2,124
Long-term investments	3,404
Other noncurrent assets	9,557
Total assets	**$44,533**
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current Liabilities:	
Accounts payable	$11,656
Other short-term obligations	10,345
Total current liabilities	**22,001**
Long-term liabilities	13,615
Total liabilities	**35,616**
Stockholders' equity:	
Common stock ($0.01 par value)	34
Additional paid-in capital	12,153
Retained earnings	28,236
Other stockholders' equity items	(31,506)
Total stockholders' equity	**8,917**
Total stockholders' equity and liabilities	**$44,533**

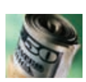
Assume that the following transactions (in millions) occurred during the remainder of 2012 (ending on February 1, 2013):

a. Borrowed $50 from banks due in two years.
b. Lent $300 to affiliates, who signed a six-month note.
c. Purchased additional investments for $13,000 cash; one-fifth were long term and the rest were short term.
d. Purchased property, plant, and equipment; paid $875 in cash and $1,410 with additional long-term bank loans.
e. Issued 1,000 additional shares of stock for $400 in cash.
f. Sold short-term investments costing $11,000 for $11,000 cash.
g. Dell does not actually pay dividends; it reinvests its earnings into the company for growth purposes. Assume instead for this problem that Dell declared and paid $60 in dividends during 2012.

Required:

1. Prepare a journal entry for each transaction. Use the account titles in the Dell balance sheet.
2. Create T-accounts for each balance sheet account and include the February 3, 2012, balances. Post each journal entry to the appropriate T-accounts.
3. Prepare a balance sheet from the T-account ending balances for Dell at February 1, 2013, based on these transactions.
4. Compute Dell's current ratio for 2012 (year ending on February 1, 2013). What does this suggest about the company?

P2-6
LO2-6
Dell



Identifying the Investing and Financing Activities Affecting the Statement of Cash Flows

Refer to P2-5.

Required:

For each of the activities (*a*)–(*g*), indicate whether the activity is investing (I) or financing (F) and the direction and amount of the effect on cash flows (+ for increases; − for decreases).

ALTERNATE **PROBLEMS**

AP2-1
LO2-1, 2-2, 2-4

Identifying Accounts on a Classified Balance Sheet and Their Normal Debit or Credit Balances (P2-1)

According to a recent Form 10-K report of Mattel, Inc., the company "designs, manufactures, and markets a broad variety of toy products worldwide." Mattel's brands include Barbie, Hot Wheels, Fisher-Price toys, and American Girl brand dolls and accessories. The following are several of the accounts from a recent balance sheet:

	Balance Sheet Classification	Debit or Credit Balance
(1) Prepaid Expenses	________	________
(2) Inventories	________	________
(3) Accounts Receivable	________	________
(4) Long-Term Debt	________	________
(5) Cash and Equivalents	________	________
(6) Goodwill (an intangible asset)	________	________
(7) Accounts Payable	________	________
(8) Income Taxes Payable	________	________
(9) Property, Plant, and Equipment	________	________
(10) Retained Earnings	________	________
(11) Additional Paid-in Capital	________	________
(12) Short-Term Borrowings	________	________
(13) Accrued Liabilities	________	________
(14) Common Stock	________	________

Required:
Indicate how each account normally should be categorized on a classified balance sheet. Use CA for current asset, NCA for noncurrent asset, CL for current liability, NCL for noncurrent liability, and SE for stockholders' equity. Also indicate whether the account normally has a debit or credit balance.

Determining Financial Statement Effects of Various Transactions (P2-2)

AP2-2
LO2-2, 2-3, 2-5

Adamson Incorporated is a small manufacturing company that makes model trains to sell to toy stores. It has a small service department that repairs customers' trains for a fee. The company has been in business for five years. At December 31, 2014 (the company's fiscal year-end), the accounting records reflected total assets of $500,000 (cash, $120,000; equipment, $70,000; buildings, $310,000), total liabilities of $200,000 (short-term notes payable, $140,000; long-term notes payable, $60,000), and total stockholders' equity of $300,000 [common stock (par value $1.00 per share), $20,000: additional paid-in capital, $200,000; retained earnings, $80,000]. During the current year, 2015, the following summarized events occurred:

a. Borrowed $110,000 cash from the bank and signed a 10-year note.
b. Purchased equipment for $30,000, paying $3,000 in cash and signing a note due in six months for the balance.
c. Issued an additional 10,000 shares of capital stock for $100,000 cash.
d. Purchased a delivery truck (equipment) for $10,000; paid $5,000 cash and signed a short-term note payable for the remainder.
e. Lent $2,000 cash to the company president, Clark Adamson, who signed a note with terms showing the principal plus interest due in one year.
f. Built an addition on the factory for $200,000 and paid cash to the contractor.
g. Purchased $85,000 in long-term investments.
h. Returned a $3,000 piece of equipment purchased in (*b*) because it proved to be defective; received a reduction of its short-term note payable.
i. A stockholder sold $5,000 of his capital stock in Adamson Incorporated to his neighbor.

Required:
1. Was Adamson Incorporated organized as a sole proprietorship, a partnership, or a corporation? Explain the basis for your answer.
2. During 2015, the records of the company were inadequate. You were asked to prepare the summary of the preceding transactions. To develop a quick assessment of their economic effects on Adamson Incorporated, you have decided to complete the tabulation that follows and to use plus (+) for increases and minus (−) for decreases for each account. The first transaction is used as an example.

	ASSETS					=	LIABILITIES		+	STOCKHOLDERS' EQUITY		
	Cash	Notes Receivable	Long-Term Investments	Equipment	Buildings		Short-Term Notes Payable	Long-Term Notes Payable		Common Stock	Additional Paid-in Capital	Retained Earnings
Beg.	120,000			70,000	310,000	=	140,000	60,000		20,000	200,000	80,000
(*a*)	+110,000					=		+110,000				

3. Did you include event (*i*) in the tabulation? Why?
4. Based on beginning balances plus the completed tabulation, provide the following amounts (show computations):
   a. Total assets at the end of the year.
   b. Total liabilities at the end of the year.
   c. Total stockholders' equity at the end of the year.
   d. Cash balance at the end of the year.
   e. Total current assets at the end of the year.
5. Compute the current ratio for 2015. What does this suggest about the company?

Recording Transactions in T-Accounts, Preparing the Balance Sheet, and Evaluating the Current Ratio (P2-3)

AP2-3
LO2-2, 2-4, 2-5

ETHAN ALLEN

Ethan Allen Interiors, Inc., is a leading manufacturer and retailer of home furnishings in the United States and abroad. The following is adapted from Ethan Allen's June 30, 2011, annual financial report. Amounts are in thousands.

Cash and cash equivalents	$ 78,519	Accounts payable	$ 26,958
Short-term investments	12,909	Accrued expenses payable	127,639
Accounts receivable	15,036	Long-term debt (includes the	
Inventories	141,692	current portion of $19)	165,032
Prepaid expenses and		Other long-term liabilities	27,009
other current assets	20,372	Common stock ($0.01 par value)	484
Property, plant, and equipment	294,853	Additional paid-in capital	359,728
Intangibles	45,128	Retained earnings	501,908
Other assets	19,816	Other stockholders' equity items	(580,433)

Assume that the following events occurred in the first quarter ended September 30, 2011:

a. Issued 1,600 additional shares of stock for $1,020 in cash.
b. Purchased $3,400 in additional intangibles for cash.
c. Ordered $43,500 in wood and other raw materials for the manufacturing plants.
d. Sold equipment at its cost for $4,020 cash.
e. Purchased $2,980 in short-term investments for cash.
f. Purchased property, plant, and equipment; paid $1,830 in cash and signed additional long-term notes for $9,400.
g. Sold at cost other assets for $310 cash.
h. Declared and paid $300 in dividends.

Required:

1. Create T-accounts for each of the accounts on the balance sheet; enter the balances at June 30, 2011.
2. Record each of the transactions for the first quarter ended September 30, 2011, in the T-accounts (including referencing) and determine the ending balances.
3. Explain your response to event (*c*).
4. Prepare a trial balance at September 30, 2011.
5. Prepare a classified balance sheet at September 30, 2011.
6. Compute the current ratio for the quarter ended September 30, 2011. What does this suggest about Ethan Allen Interiors, Inc.?

AP2-4
LO2-6

ETHAN ALLEN

Identifying Effects of Transactions on the Statement of Cash Flows (P2-4)

Refer to AP2-3.

Required:
Using the events (*a*) through (*h*) in AP2-3, indicate whether each transaction is an investing (I) or financing (F) activity for the quarter and the direction and amount of the effect on cash flows (+ for increase and − for decrease). If there is no effect on cash flows, write NE.

CASES AND PROJECTS

Annual Report Cases

CP2-1
LO2-1, 2-2, 2-5, 2-6

AMERICAN EAGLE OUTFITTERS, INC.

Finding Financial Information

Refer to the financial statements of American Eagle Outfitters in Appendix B at the end of this book.

Required:

1. Is the company a corporation, a partnership, or a sole proprietorship? How do you know?
2. The company shows on the balance sheet that inventories are worth $378,426,000. Does this amount represent the expected selling price? Why or why not?

3. List the types of current obligations this company has. You need not provide the amounts.
4. Compute the company's current ratio and explain its meaning.
5. How much cash did the company spend on purchasing property and equipment each year (capital expenditures)? Where did you find the information?

CP2-2
LO2-1, 2-2, 2-5, 2-6

Finding Financial Information

Refer to the financial statements of Urban Outfitters in Appendix C at the end of this book.

Required:
1. Use the company's balance sheet to determine the amounts in the accounting equation (A = L + SE) as of January 31, 2012.
2. If the company were liquidated at the end of the current year (January 31, 2012), are the shareholders guaranteed to receive $1,066,268,000?
3. What are the company's noncurrent liabilities?
4. What is the company's current ratio?
5. Did the company have a cash inflow or outflow from investing activities? Of how much?

CP2-3
LO2-2, 2-5, 2-6

Comparing Companies within an Industry

Refer to the financial statements of American Eagle Outfitters in Appendix B, Urban Outfitters in Appendix C, and the Industry Ratio Report in Appendix D at the end of this book.

Required:
1. Compute the current ratio for both companies. Compared to the industry average (from the Industry Ratio Report), are these two companies more or less able to satisfy short-term obligations with current assets? How is the current ratio influenced by these companies' choice to rent space instead of buying it?
2. In the most recent year, how much cash, if any, was spent buying back (repurchasing) each company's own common stock?
3. How much, if any, did each company pay in dividends for the most recent year?
4. What account title or titles does each company use to report any land, buildings, and equipment it may have?

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Financial Reporting and Analysis Cases

CP2-4
LO2-2, 2-5, 2-6

Broadening Financial Research Skills: Locating Financial Information on the SEC's Database

The Securities and Exchange Commission (SEC) regulates companies that issue stock on the stock market. It receives financial reports from public companies electronically under a system called EDGAR (Electronic Data Gathering and Retrieval Service). Using the Internet, anyone may search the database for the reports that have been filed.

Using your Web browser, access the EDGAR database at www.sec.gov. To search the database, type in "chipotle" for the company name in the search window at the top of the page, and press enter.

Required:
To look at SEC filings, type in "10-Q" in the space indicating "Filing Type" and press enter. Skim down the left side until you locate the Form 10-Q (quarterly report) filed July 20, 2012. Click on the "Documents" for that report, click on the 10-Q document (first item), and skim to the Table of Contents.
1. Click on "Financial Statements" and skim to the "Condensed Consolidated Balance Sheets."
   a. What was the amount of Chipotle's total assets for the most recent quarter reported?
   b. Did current liabilities increase or decrease since December 31, 2011?
   c. Compute the current ratio. How does it compare to the ratio indicated for Chipotle Mexican Grill in the chapter? What does this suggest about the company?

2. Skim to the Chipotle "Consolidated Statements of Cash Flow."
   a. What amount did Chipotle spend on property and equipment for the quarter ended June 30, 2012?
   b. What was the total amount of cash flows from financing activities?

CP2-5
LO2-1, 2-5

Using Financial Reports: Evaluating the Reliability of a Balance Sheet

Frances Sabatier asked a local bank for a $50,000 loan to expand her small company. The bank asked Frances to submit a financial statement of the business to supplement the loan application. Frances prepared the following balance sheet.

FS COMPUTING
Balance Sheet
June 30, 2015

Assets	
Cash and investments	$ 9,000
Inventory	30,000
Equipment	46,000
Personal residence (monthly payments, $2,800)	300,000
Remaining assets	20,000
Total assets	$405,000
Liabilities	
Short-term debt to suppliers	$ 62,000
Long-term debt on equipment	38,000
Total debt	100,000
Stockholders' Equity	305,000
Total liabilities and stockholders' equity	$405,000

Required:
The balance sheet has several flaws. However, there is at least one major deficiency. Identify it and explain its significance.

CP2-6
LO2-2, 2-4, 2-5
Dell

Using Financial Reports: Analyzing the Balance Sheet

Recent balance sheets are provided for Dell, Inc., a leading producer and marketer of a broad range of personal computers, mobility products, software, and related tools and services.

Required:
1. Is Dell a corporation, sole proprietorship, or partnership? Explain the basis of your answer.
2. Use the company's balance sheet (consolidated statement of financial position) to determine the amounts in the accounting equation (A = L + SE) at the end of the most recent year.
3. Calculate the company's current ratio on February 3, 2012. Interpret the ratio that you calculated. What other information would make your interpretation more useful?
4. Prepare the journal entry the company will make in 2012 when it pays its fiscal year 2011 accounts payable (fiscal year 2011 ends on February 3, 2012).
5. Does the company appear to have been profitable over its years in business? On what account are you basing your answer? Assuming no dividends were paid, how much was net income (or net loss) in the most recent year? If it is impossible to determine without an income statement, state so.

DELL INC.
Consolidated Statements of Financial Position
(dollars in millions)

	February 3, 2012	January 28, 2011
ASSETS		
Current assets		
Cash and cash equivalents	$ 13,852	$ 13,913
Short-term investments	966	452
Accounts receivable	9,803	10,136
Inventories	1,404	1,301
Other	3,423	3,219
Total current assets	29,448	29,021
Property, plant and equipment, net	2,124	1,953
Investments	3,404	704
Intangibles	7,695	5,860
Other noncurrent assets	1,862	1,061
	$ 44,533	$ 38,599
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Short-term debt	$ 2,867	$ 851
Accounts payable	11,656	11,293
Accrued and other liabilities	3,934	4,181
Deferred service revenue	3,544	3,158
Total current liabilities	22,001	19,483
Long-term debt	6,387	5,146
Long-term deferred service revenue	3,836	3,518
Other noncurrent liabilities	3,392	2,686
Total liabilities	35,616	30,833
Stockholders' equity		
Contributed capital	12,187	11,797
Retained earnings	28,236	24,744
Other	(31,506)	(28,775)
Total stockholders' equity	8,917	7,766
	$ 44,533	$ 38,599

Critical Thinking Cases

Making a Decision as a Financial Analyst: Preparing and Analyzing a Balance Sheet

CP2-7
LO2-1, 2-5

Your best friend from home writes you a letter about an investment opportunity that has come her way. A company is raising money by issuing shares of stock and wants her to invest $20,000 (her recent inheritance from her great-aunt's estate). Your friend has never invested in a company before and, knowing that you are a financial analyst, asks that you look over the balance sheet and send her some advice. An **unaudited** balance sheet, in only moderately good form, is enclosed with the letter.

DEWEY, CHEETUM, AND HOWE, INC. Balance Sheet For the Year Ending December 31, 2015	
Accounts receivable	$ 8,000
Cash	1,000
Inventory	8,000
Furniture and fixtures	52,000
Delivery truck	12,000
Buildings (estimated market value)	98,000
Total assets	**$179,000**
Accounts payable	$ 16,000
Payroll taxes payable	13,000
Notes payable (due in three years)	15,000
Mortgage payable	50,000
Total liabilities	**$ 94,000**
Contributed capital	$ 80,000
Retained earnings	5,000
Total stockholders' equity	**$ 85,000**

There is only one disclosure note, and it states that the building was purchased for $65,000, has been depreciated by $5,000 on the books, and still carries a mortgage (shown in the liability section). The note also states that, in the opinion of the company president, the building is "easily worth $98,000."

Required:

1. Draft a new balance sheet for your friend, correcting any errors you note. (If any of the account balances need to be corrected, you may need to adjust the retained earnings balance correspondingly.) If there are no errors or omissions, so state.
2. Write a letter to your friend explaining the changes you made to the balance sheet, if any, and offer your comments on the company's apparent financial condition based only on this information. Suggest other information your friend might want to review before coming to a final decision on whether to invest.

CP2-8 **Evaluating an Ethical Dilemma: Analyzing Management Incentives**

U.S. Foodservice, Inc.

In July 2004, the U.S. government filed civil and criminal charges against four former executives of Netherlands-based Ahold's subsidiary U.S. Foodservice, Inc., an operator of supermarkets such as Bi-Lo and Giant Food Stores. Two of the four executives have pleaded guilty, and the other two were indicted. The alleged widespread fraud included recording completely fictitious revenues for false promotions and persuading vendors to confirm to auditors the false promotional payments. U.S. Attorney David Kelley suggested the fraud was motivated by the greed of the executives to reap fat bonuses if the company met certain financial goals. The auditors did not uncover the fraud.

Required:

1. Describe the parties who were harmed or helped by this fraud.
2. Explain how greed may have contributed to the fraud.
3. Why do you think the independent auditors failed to catch the fraud?

Financial Reporting and Analysis Team Project

CP2-9 **Team Project: Analysis of Balance Sheets and Ratios**

LO2-2, 2-5, 2-6

As a team, select an industry to analyze. *Yahoo!Finance* provides lists of industries at biz.yahoo.com/p/industries.html. Click on an industry for a list of companies in that industry. Alternatively, go to Google Finance at www.google.com/finance, search for a company you are interested in, and you will be presented with a list including that company and its competitors. Each team member should acquire the annual report or 10-K for one publicly traded company in the industry, with each member selecting a different company (the SEC EDGAR service at www.sec.gov or the company's investor relations website itself are good sources).

Required:

On an individual basis, each team member should write a short report answering the following questions about the selected company. Discuss any patterns across the companies that you as a team observe. Then, as a team, write a short report comparing and contrasting your companies.

1. For the most recent year, what are the top three asset accounts by size? What percentage is each of total assets? (Calculated as Asset A ÷ Total Assets)
2. What are the major investing and financing activities (by dollar size) for the most recent year? (Look at the Statement of Cash Flows.)
3. Ratio Analysis:
   a. What does the current ratio measure in general?
   b. Compute the current ratio for each of the last three years. (You may find prior years' information in the section of the annual report or 10-K called "Selected Financial Information," or you may search for prior years' annual reports.)
   c. What do your results suggest about the company?
   d. If available, find the industry ratio for the most recent year, compare it to your results, and discuss why you believe your company differs or is similar to the industry ratio.

CONTINUING **CASE**

Accounting for the Establishment of a New Business (the Accounting Cycle)

CC2-1
LO2-4, 2-5, 2-6

Penny Cassidy has decided to start her business, Penny's Pool Service & Supply, Inc. (PPSS). There is much to do when starting a new business. Here are some transactions that have occurred in the business in March 2013.

a. Received $25,000 cash and a large delivery van with a value of $36,000 from Penny, who was given 4,000 shares of $0.05 par value common stock in exchange.
b. Purchased land with a small office and warehouse by paying $10,000 cash and signing a 10-year mortgage note payable to the local bank for $80,000. The land has a value of $18,000 and the building's value is $72,000. Use separate accounts for land and buildings.
c. Purchased a new computer from Dell for $2,500 cash and office furniture for $4,000, signing a short-term note payable in six months.
d. Hired a receptionist for the office at a salary of $1,500 per month, starting in April 2013.
e. Paid $1,000 on the note payable to the bank at the end of March 2013 (ignore interest).
f. Purchased short-term investments in the stock of other companies for $5,000 cash.
g. Ordered $10,000 in inventory from Pool Corporation, Inc., a pool supply wholesaler, to be received in April 2013.

Required:

1. For each of the events, prepare journal entries if a transaction of the business exists, checking that debits equal credits. If a transaction does not exist, explain why there is no transaction for the business.
2. Create T-accounts, and post each of the transactions to determine balances at March 31, 2013. Because this is a new business, beginning balances are $0.
3. Prepare a trial balance on March 31, 2013, to check that debits equal credits after the transactions are posted to the T-accounts.
4. From the trial balance, prepare a classified balance sheet (with current assets and current liabilities sections) at March 31, 2013 (before the beginning of operations in April).
5. For each of the events, indicate if it is an investing activity (I) or financing activity (F), and the direction (+ for increases; − for decreases) and amount of the effect on cash flows using the following structure. Write NE if there is no effect on cash flows.

	Type of Activity (I, F, or NE)	Effect on Cash Flows (+ or − and amount)
(*a*)	______	______
(*b*) etc.	______	______

6. Calculate the current ratio at March 31, 2013. What does this ratio indicate about the ability of PPSS to pay its current liabilities?