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Accounting and the Financial Statements

After studying Chapter 1, you should be able to:

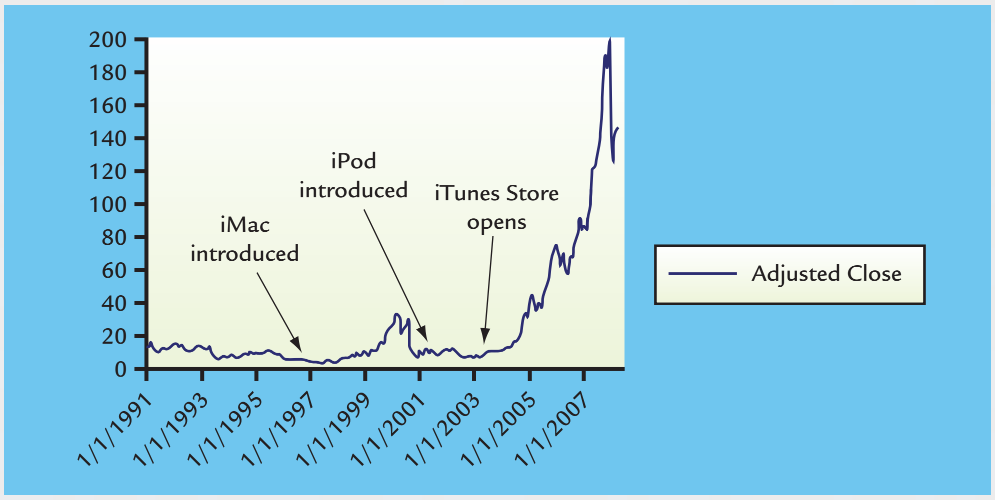
1. Explain the nature of accounting.
2. Identify the forms of business organizations and the types of business activities.
3. Describe the relationships shown by the fundamental accounting equation.
4. Prepare a classified balance sheet and understand the information it communicates.
5. Prepare an income statement and understand the information it communicates.
6. Prepare the statement of retained earnings and understand the information it communicates.
7. Understand the information communicated by the statement of cash flows.
8. Describe the relationships among the financial statements.
9. Describe other information contained in the annual report and the importance of ethics in accounting.

Experience Financial Accounting

with Apple

In 1976, Steve Jobs and Steve Wozniak, the founders of **Apple Computer, Inc.**[1] began building personal computers in the garage of Jobs' parents. By 1984, Apple had become a leader in the personal computing industry, and its Macintosh computer is regarded by many as a key contributor to the development of the desktop publishing market. Apple appeared invincible. However, the development of Microsoft's Windows operating system and several product failures led many to predict the end of one of the computer industry's most prominent companies. How could a company with such a bright future experience failure? And, perhaps more remarkable, how could a company on the verge of extinction, experience the kind of success that Apple has recently experienced? With the introduction of the iMac, the iPod, and the iTunes Store, Apple's stock price increased from approximately $7 per share in June 1998 to more than $120 in June 2007 as shown in the chart below.

What type of information can help someone predict the successes of a company like Apple? A good place to start is with the financial information contained in a company's annual report. This financial information is provided in the form of financial statements—a summary of the results of a company's operations. A study of a company's financial statements will give you insights into a company that will aid you in your investment decisions. It will help you determine how successful a company has been in the past as well as its prospects for the future. While this information is easily accessible and free of charge, your final judgment on a company's future prospects will be influenced by how well you understand the information contained in its financial statements.



[1] In February 2007, Apple Computer Inc. changed its name to Apple Inc. to reflect that the future of Apple lies beyond simply the personal computer.

OBJECTIVE 1
Explain the nature of accounting.

What Is Accounting?

Our economy is comprised of many different businesses. Some companies, such as Apple Inc., focus on providing goods, which for Apple take the form of Macintosh computers, iPod portable digital music players, iPhone cellular phones, or downloadable music. Other companies are primarily concerned with providing services. For example, **Walt Disney** offers a variety of entertainment services from theme parks to motion pictures. While most entities, like Apple and Disney, exist in order to earn a profit, some are organized to achieve some other benefit to society (e.g., school districts exist to meet the educational needs of a community). Regardless of their objective, all entities use accounting to plan future operations, make decisions, and evaluate performance.

Accounting is the process of identifying, measuring, recording, and communicating financial information about a company's activities so decision makers can make informed decisions. Accounting information is useful because it helps people answer questions and make better decisions.

The demand for accounting information comes from both inside and outside the business. Inside the business, managers use accounting information to help them plan and make decisions about the company. For example, they can use accounting information to predict the consequences of their future actions and to help decide which actions to take. They also use accounting information to control the operations of the company and evaluate the effectiveness of their past decisions. Employees use accounting information to help them judge the future prospects of their company, which should translate into future promotion opportunities. Outside the business, investors use accounting information to evaluate the future prospects of a company and decide where to invest their money. Creditors use accounting information to evaluate whether to loan money to a company. Even governments use accounting information to determine taxes owed by companies, to implement regulatory objectives, and to make policy decisions. This demand for accounting information is summarized by Exhibit 1-1.

Accounting is more than the process of recording information and maintaining accounting records—activities that are frequently called bookkeeping. Accounting is the "language of business". That is, accounting can be viewed as an information system that communicates the economic activities of a company to interested parties. The focus of this book is on providing information that satisfies the needs of external decision-makers (outside demand) and is termed **financial accounting**. The objectives of financial accounting involve providing decision-makers with information that assists them in assessing the amounts, timing, and uncertainties of a company's future

Exhibit 1-1

The Demand for Accounting Information and Typical Questions

cash flows. This information is provided through four basic financial statements: the balance sheet, the income statement, the statement of retained earnings, and the statement of cash flows.

In this chapter, we will discuss the basic functioning of the accounting system within a business. We will address the following questions:

- What forms do businesses take?
- What are the basic activities in which businesses engage?
- How does the accounting system report these activities?
- How can decision-makers use the information provided by the accounting system?

Regardless of your major or future plans, knowledge of accounting and the ability to use accounting information will be critical to your success in business.

CONCEPT Q&A

How will accounting affect my life?

Possible Answer:

The business that sells us goods or services uses accounting to keep track of how much money it received as well as the cost of operating the business. Calculating the amount of tax that is due to the government requires accounting. When we invest our money, we should use accounting to understand a company's business and its prospects for the future. Plans that we make for the future often involve accounting to determine how much money we will need. Accounting will impact many aspects of our daily lives.

Businesses: Forms and Activities

OBJECTIVE 2
Identify the forms of business organizations and the types of business activities.

Accounting identifies, measures, records, and communicates financial information about an accounting entity. An accounting entity is a company that has an identity separate from that of its owners and managers and for which accounting records are kept. This text emphasizes accounting for entities which take one of three different forms: sole proprietorship, partnership, or corporation.

Forms of Business Organization

A **sole proprietorship** is a business owned by one person. Sole proprietorships, which account for more than 70 percent of all businesses, are usually small, local businesses such as restaurants, photography studios, retail stores, or website providers. This organizational form is popular due to the simplicity and low cost of formation. While a sole proprietorship is an accounting entity separate from its owner, the owner is personally responsible for the debt of the business. Sole proprietorships can be formed or dissolved at the wishes of the owner.

A **partnership** is a business owned jointly by two or more individuals. Small businesses and many professional practices of physicians, lawyers, and accountants, are often organized as partnerships. Relative to sole proprietorships, partnerships provide increased access to financial resources as well as access to the individual skills of each of the partners. Similar to sole proprietorships, partnerships are accounting entities separate from the owner-partners; however, the owner-partners are jointly responsible for all the debt of the partnership.[2] Finally, the partnership is automatically dissolved when any partner leaves the partnership; of course, the remaining partners may form a new partnership and continue to operate.

A **corporation** is a business organized under the laws of a particular state. A corporation, such as Apple, is owned by one or more persons called *stockholders,* whose ownership interests are represented by shares of stock. A primary advantage of the corporate form is the ability to raise large amounts of money (capital) by issuing shares of stock. Unlike a sole proprietorship or a partnership, a corporation is an "artificial person" and the stockholders' legal responsibility for the debt of the business is limited to the amount they invested in the business. In addition, shares of stock can be easily transferred from one owner to another through capital markets without affecting the corporation that originally issued the stock. The ability to raise capital by selling new shares, the limited legal liability of owners, and the transferability of the shares give the corporation an advantage over other forms of business

[2] Many professional partnerships—including the largest public accounting firms—have been reorganized as *limited liability partnerships* (LLPs), which protect the personal assets of the partner from being used to pay partnership debts.

organization. However, corporate shareholders generally pay more taxes than owners of sole proprietorships or partnerships. Exhibit 1-2 illustrates the advantages and disadvantages of each form of organization.

While the combined number of sole proprietorships and partnerships greatly exceeds that of corporations, the majority of business in the United States is conducted by corporations. Therefore, this book emphasizes the corporate form of organization.

Exhibit 1-2

Forms of Business Organization

Sole Proprietorship

- ☺ Easily formed
- ☺ Tax advantages
- ☺ Controlled by owner
- ☹ Personal liability

Partnership

- ☺ Easily formed
- ☺ Tax advantages
- ☺ Shared control
- ☹ Personal liability
- ☹ Limited life

Corporation

- ☺ Easier to raise money
- ☺ Easier to transfer ownership
- ☺ Limited liability
- ☹ More complex to organize
- ☹ Higher taxes

DECISION-MAKING & ANALYSIS

Choice of Organizational Form

Joe Brooks, who is starting a campus-area bookstore, is in the process of choosing among three organizational forms—sole proprietorship, partnership, or corporation. Brooks has enough personal wealth to finance 40 percent of the business, but he must get the remaining 60 percent from other sources. The following are questions that Brooks must consider before deciding which form of entity to establish:

1. *How does organizational form impact Brooks' ability to obtain the needed funds?*

Whichever type of organizational form Brooks chooses, the additional 60 percent of the funds needed could be borrowed from a bank. However, if it proves difficult to get banks to support a new business, partnerships and corporations offer advantages over sole proprietorships. The advantage resides in the ability to obtain funds from a partner or through the issuance of stock.

2. *What is the impact of organizational form on control of the business?*

A sole proprietorship would offer Brooks the most control over the operations of the business. A partnership would transfer a 60 percent controlling interest to one or more partners who would join Brooks. Similarly, a corporation would transfer a 60 percent controlling interest to other stockholders. However, if the stock were widely dispersed among many investors, Brooks might retain effective control of operations with a 40 percent interest.

Business Activities

Regardless of the form of a business, all businesses engage in a multitude of activities that can be categorized as financing, investing, or operating activities. These activities are illustrated in Exhibit 1-3. Because a major function of accounting is to identify, measure, record, and communicate information about these activities to interested parties, we will take a closer look at these activities.

Financing Activities A company's financing activities include obtaining the funds necessary to begin and operate a business. These funds come from either issuing stock or borrowing money. Most companies use both types of financing to obtain funds.

When a corporation borrows money from another entity such as a bank, it must repay the amount borrowed. The person to whom the corporation owes money is called a **creditor**. This obligation to repay a creditor is termed a **liability** and can take many forms. A common way for a corporation to obtain cash is to borrow money with the promise to repay the amount borrowed plus interest at a future date. Such borrowings are commonly referred to as *notes payable*. A special form of note payable that is used by corporations to obtain large amounts of money is called a *bond payable*.

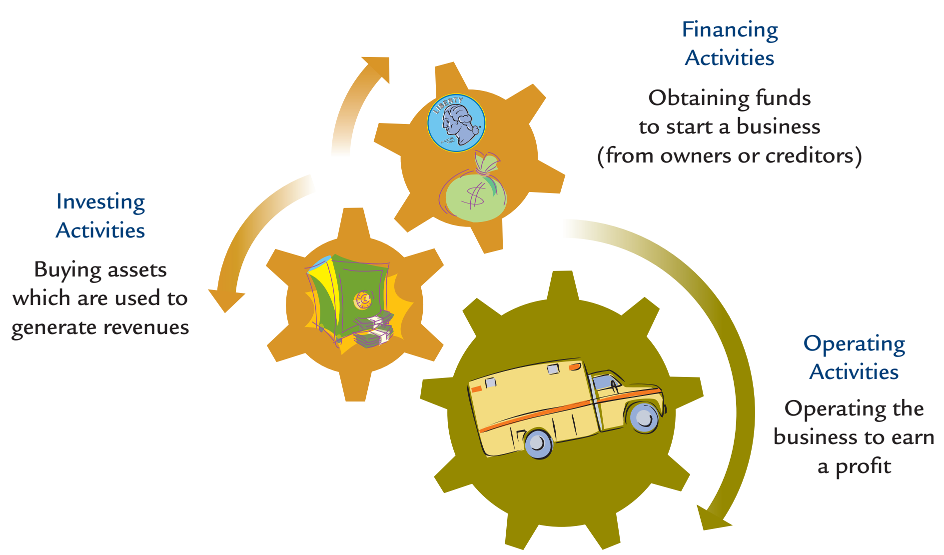
In addition to borrowing money from creditors, a corporation may issue shares of stock to investors in exchange for cash. The dollar amount paid to a corporation for these shares is termed *common stock* and represents the basic ownership interest in a corporation. As of September 29, 2007, Apple had issued 872,328,972 shares of common stock. The corporation is not obligated to repay the stockholder the amount invested; however, many corporations distribute a portion of their earnings to stockholders on a regular basis. These distributions are called *dividends*.

Creditors and stockholders have a claim on the **assets**, or economic resources, of a corporation. However, the claims on these resources differ. In the case of financial difficulty or distress, the claims of the creditors (called liabilities) must be paid prior to the claims of the stockholders (called **stockholders' equity**). The stockholders' claims are considered a residual interest in the assets of a corporation that remain after deducting its liabilities.

Investing Activities Once a corporation has obtained funds through its financing activities, it buys assets that enable a corporation to operate. For example, Apple has bought approximately $1.8 billion in land, buildings, machinery, and equipment

Exhibit 1-3

Business Activities



that it uses in its operations. The corporation may also obtain intangible assets that lack physical substance, such as copyrights and patents. Apple reported $337 million of intangible assets related to technology and trademarks that it uses in its operations. The purchase (and sale) of the assets that are used in operations (commonly referred to as property, plant, and equipment) are a corporation's investing activities.

Regardless of its form, assets are future economic benefits that a corporation controls. The assets purchased by a corporation vary depending on the type of business that the corporation engages in, and the composition of these assets is likely to vary across different companies and different industries. For example, in 2007, property, plant, and equipment made up approximately 7 percent of Apple's total assets. This is typical of many technology companies. In contrast, property, plant, and equipment made up 66 percent of the total assets of Southwest Airlines, a company that relies heavily on airplanes to produce revenue.

Operating Activities Once a corporation has acquired the assets that it needs, it can begin to operate. While different businesses have different purposes, they all want to generate revenue. **Revenue** is the increase in assets that results from the sale of products or services. For example, Apple reported revenue of approximately $24.6 billion in 2007. In addition to revenue, assets such as *cash*, *accounts receivable* (the right to collect an amount due from customers), *supplies,* and *inventory* (products held for resale) often result from operating activities.

To earn revenue, a corporation will incur various costs or expenses. **Expenses** are the cost of assets used, or the liabilities created, in the operation of the business. Apple reported expenses of $15.852 billion related to the cost of iPods and other products sold in 2007.

The liabilities that arise from operating activities can be of different types. For example, if a corporation purchases goods on credit from a supplier, the obligation to repay the supplier is called an *account payable*. As of September 29, 2007, Apple reported approximately $4.9 billion of accounts payable. Other examples of liabilities created by operating activities include *wages payable* (amounts owed to employees for work performed) and *income taxes payable* (taxes owed to the government).

The results of a company's operating activities can be determined by comparing revenues to expenses. If revenues are greater than expenses, a corporation has earned **net income**. If expenses are greater than revenues, a corporation has incurred a **net loss**.

OBJECTIVE 3
Describe the relationships shown by the fundamental accounting equation.

Communication of Accounting Information

The financing, investing, and operating activities of a company are recorded by accounting systems in the form of detailed transactions. To effectively communicate a company's activities to decision-makers, these detailed transactions are summarized and reported in a set of standardized reports called **financial statements**. The role of financial statements is to provide information that will help investors, creditors, and others make judgments and predictions that serve as the basis for the various decisions they make. Financial statements help to answer questions such as those shown in Exhibit 1-4.

The Four Basic Financial Statements

Companies prepare four basic financial statements:

- The **balance sheet** reports the resources (assets) owned by a company and the claims against those resources (liabilities and stockholders' equity) at a specific point in time.
- The **income statement** reports how well a company has performed its operations (revenues, expenses, and income) over a period of time.
- The **statement of retained earnings** reports how much of the company's income was retained in the business and how much was distributed to owners for a period of time.[3]
- The **statement of cash flows** reports the sources of a company's cash inflow and the uses of a company's cash over a period of time.

[3] Information contained in the statement of retained earnings is often included in a more comprehensive statement of changes in stockholders' equity, which describes changes in all components of stockholders' equity.

Exhibit 1-4

Questions Answered by Financial Statements

How much better off is the company at the end of the year than it was at the beginning of the year?

What are the economic resources of the company and the claims against those resources?

From what sources did a company's cash come and for what did the company use cash during the year?

While financial statements can be prepared for any point or period of time (e.g., monthly, quarterly, or annually), most companies prepare financial statements at the end of each month, quarter, and year. Note that the balance sheet is a point-in-time description, whereas the other financial statements are period-of-time descriptions that explain the business activities between balance sheet dates as shown in Exhibit 1-5.

These four statements are prepared and issued at the end of the year, and frequently companies issue statements monthly or quarterly to satisfy the users' needs for timely information. The annual statements usually are accompanied by supporting information and explanatory material called the notes to the financial statements.

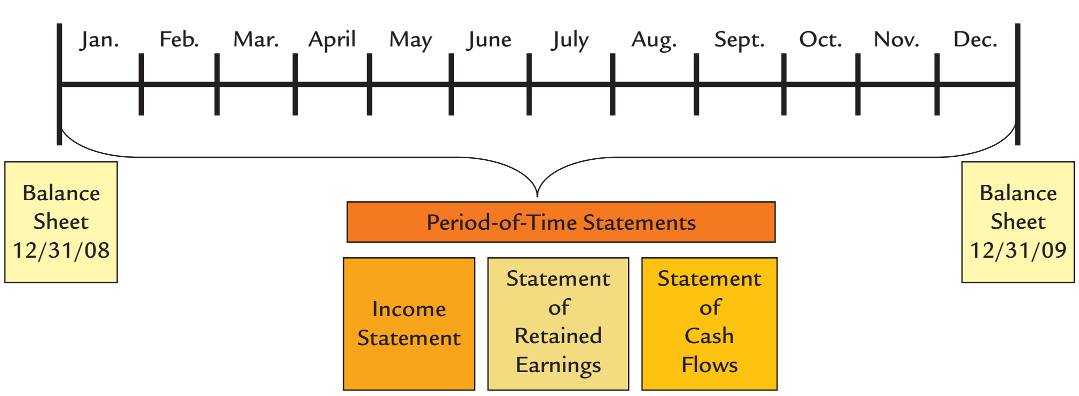
While these financial statements provide the kind of information users want and need, the financial statements do not interpret this information. The financial statement user must use his or her general knowledge of business and accounting to interpret the financial statements as a basis for decision-making. One of the main objectives of this text is help you develop an ability to interpret and analyze real financial statements.

The Fundamental Accounting Equation

To understand financial statements, it is necessary that you understand how the accounting system records, classifies, and reports information about business activities. The **fundamental accounting equation** illustrates the foundation of the accounting system.

Exhibit 1-5

Financial Statement Time Periods



$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

The fundamental accounting equation captures two basic features of any company. The left side of the accounting equation shows the assets, or economic resources of a company. The right side of the accounting equation indicates who has a claim on the company's assets. These claims may be the claims of creditors (liabilities) or they may be the claims of owners (stockholders' equity).

The implication of the fundamental accounting equation is that what a company owns (its assets) must always be equal to what it owes (its liabilities and stockholders' equity). Cornerstone 1-1 illustrates this key relationship implied by the fundamental accounting equation.

CORNERSTONE 1-1

HOW TO Use the Fundamental Accounting Equation

Concept:
A company's resources (its assets) must always equal the claims on those resources (its liabilities and stockholders' equity).

Information:
On January 1, 2009, Gundrum Company reported assets of $125,000 and liabilities of $75,000. During 2009, assets increased by $44,000 and stockholders' equity increased by $15,000.

Required:
1. What is the amount reported for stockholders' equity on January 1, 2009?
2. What is the amount reported for liabilities on December 31, 2009?

Solution:
1. Stockholders' equity on January 1, 2009, is $50,000. This amount is calculated by rearranging the fundamental accounting equation as follows:

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Stockholders' Equity} \\ \$125{,}000 &= \$75{,}000 + \text{Stockholders' Equity} \\ \text{Stockholders equity} &= \$125{,}000 - \$75{,}000 = \underline{\underline{\mathbf{\$50{,}000}}} \end{aligned}$$

2. At December 31, 2009, liabilities are $104,000. This amount is computed by adding the change to the appropriate balance sheet elements and then rearranging the fundamental accounting equation as follows:

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Stockholders' Equity} \\ (\$125{,}000 + \$44{,}000) &= \text{Liabilities} + (\$50{,}000 + 15{,}000) \\ \text{Liabilities} &= (\$125{,}000 + \$44{,}000) - (\$50{,}000 + 15{,}000) \\ &= \$169{,}000 - \$65{,}000 = \underline{\underline{\mathbf{\$104{,}000}}} \end{aligned}$$

The fundamental accounting equation will be used to capture all of the economic activities recorded by an accounting system. In Chapter 2, this equation will be expanded and used to analyze specific transactions and events.

OBJECTIVE 4
Prepare a classified balance sheet and understand the information it communicates.

The Classified Balance Sheet

The purpose of the balance sheet is to report the financial position of a company (its assets, liabilities, and stockholders' equity) at a specific point in time. The relationship between the elements of the balance sheet is given by the fundamental accounting equation (Assets = Liabilities + Stockholders' Equity). Note that the balance sheet gets its name because the economic resources of a company (assets) must always equal, or be in balance with, the claims against those resources (liabilities and stockholders' equity).

The balance sheet is organized, or classified, to help users identify the fundamental economic similarities and differences between the various items within the balance sheet. These classifications help users answer questions such as (1) how a company obtained its resources and (2) whether a company will be able to pay its obligations when they become due. While companies often use different classifications and different levels of detail on their balance sheets, some common classifications are shown in Exhibit 1-6.

Let's examine the balance sheet classifications in more detail by looking at Apple's balance sheet shown in Exhibit 1-7. With regard to the heading of the financial statement, several items are of interest. First, the company for which the accounting information is collected and reported is clearly defined. Second, the title of the financial statement follows the name of the company. Third, the specific date of the statement is listed. Apple operates on a fiscal year that ends in September. A **fiscal year** is an accounting period that runs for one year. While many companies adopt a fiscal year that corresponds to the calendar year, others adopt a fiscal year that more closely corresponds with their business cycle. Finally, Apple reports its financial results rounded to the nearest millions of dollars. Large companies often round the amounts presented to make for a more clear presentation. For Apple, the reported cash amount of $9,352 is actually $9,352,000,000.

Current Assets

The basic classification of a company's assets is between current and noncurrent items. In a typical company, it is reasonable to designate one year as the dividing line between current and noncurrent items. However, if the operating cycle of a company is longer than one year, it may be necessary to extend this dividing line beyond one year so that it corresponds to the length of the operating cycle. The **operating cycle** of a company is the average time that it takes a company to purchase goods, resell the goods, and collect the cash from customers. In other words, **current assets** consist of cash and other assets that are reasonably expected to be converted into cash within one year or one operating cycle, whichever is longer. Because most companies

Exhibit 1-6

Common Balance Sheet Classifications

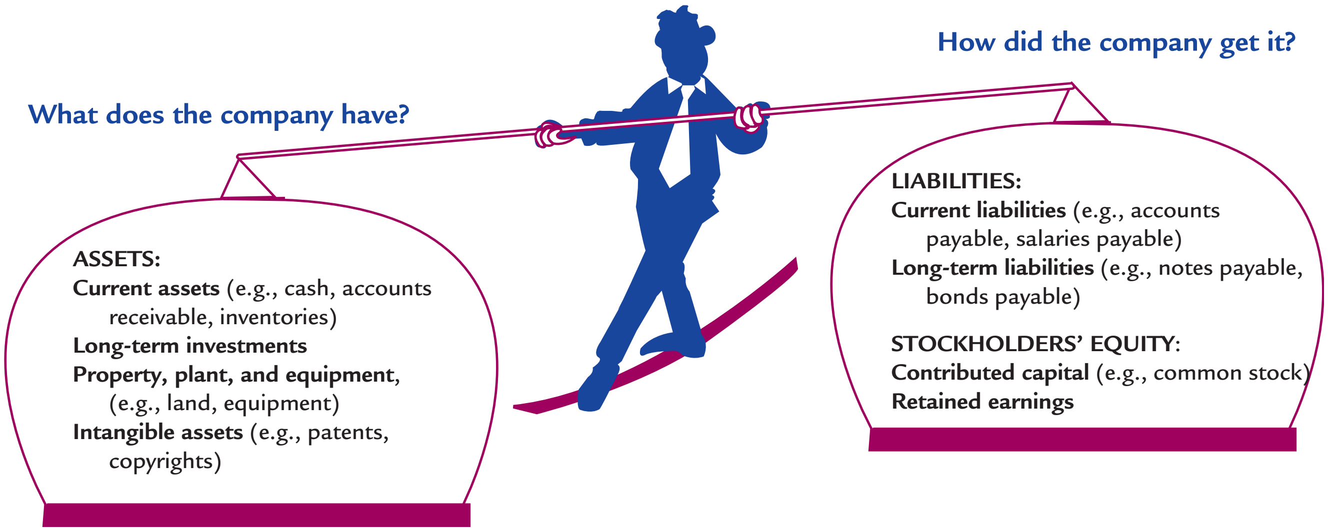


Exhibit 1-7

Classified Balance Sheet of Apple Inc.

Apple Inc.
Balance Sheet*
September 29, 2007
(in millions of dollars)

ASSETS		
Current assets:		
Cash	$ 9,352	
Short-term investments	6,034	
Accounts receivable	1,637	
Inventories	346	
Other current assets	4,587	
Total current assets		$21,956
Property, plant, and equipment:		
Land and buildings	$ 762	
Machinery and equipment	2,079	
Less: accumulated depreciation	(1,009)	
Total property, plant, and equipment		1,832
Intangible assets		337
Other assets		1,222
Total assets		$25,347
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$4,970	
Salaries payable	254	
Unearned revenue	1,410	
Other current liabilities	2,665	
Total current liabilities		$ 9,299
Long-term liabilities:		1,516
Total liabilities		$10,815
Stockholders' equity:		
Contributed capital	$5,368	
Retained earnings	9,101	
Other equity**	63	
Total stockholders' equity		14,532
Total liabilities and stockholders' equity		$25,347

*The balance sheet information was taken from the annual report of Apple Inc. and has been summarized and reformatted by the authors.
**The $63 million of other equity reported by Apple represents accumulated other comprehensive income. The accounting for accumulated other comprehensive income is beyond the scope of this text and is not discussed.

have operating cycles less than one year, we will use the one-year dividing line to distinguish between current and noncurrent items. Common types of current assets are:

- Cash
- Short-term investments or marketable securities—investments in the stocks and bonds of other companies as well as government securities
- Accounts receivable—the right to collect an amount due from customers
- Inventories—goods or products held for resale to customers
- Other current assets—a "catch-all" category that includes items such as prepaid expenses (advance payments for rent, insurance, and other services) and supplies

Current assets are listed on the balance sheet in order of liquidity or nearness to cash. That is, the items are reported in the order in which the company expects to convert them into cash.

Noncurrent Assets

Assets that are not classified as current are classified as long-term or noncurrent assets. These include (1) long-term investments, (2) property, plant, and equipment, (3) intangible assets, and (4) other noncurrent assets.

Long-term investments are similar to short-term investments, except that the company expects to hold the investment for longer than one year. This category also includes land or buildings that a company is not currently using in operations. Apple does not currently report any long-term investments, but if it did, they would be reported immediately before property, plant, and equipment.

Property, plant, and equipment represents the tangible, long-lived, productive assets used by a company in its operations to produce revenue. This category includes land, buildings, machinery, manufacturing equipment, office equipment, and furniture. Apple reported property, plant, and equipment of \$1,832 million, representing 7.2 percent (\$1,832 ÷ \$25,347) of its total assets. Because property, plant, and equipment helps to produce revenue over a number of years, companies assign, or allocate, a portion of the asset's cost as an expense in each period in which the asset is used. This process is called *depreciation*. The *accumulated depreciation* shown on Apple's balance sheet represents the total amount of depreciation that the company has expensed over the life of its assets. Because accumulated depreciation is subtracted from the cost of an asset, it is called a *contra-asset*.

Intangible assets are similar to property, plant, and equipment in that they provide a benefit to a company over a number of years; however, these assets lack physical substance. Examples of intangible assets include patents, copyrights, trademarks, and goodwill. *Other noncurrent assets* is a catch-all category that includes items such as deferred charges (long-term prepaid expenses) and other miscellaneous noncurrent assets.

CONCEPT Q&A

There are many classifications on the balance sheet that are essentially subtotals. Is it really important to place accounts within the right category or is it enough to simply understand if they are assets, liabilities, or stockholders' equity?

Possible Answer:

It is critical that you be able to identify accounts as assets, liabilities, or stockholders' equity accounts. However, the classifications are also important. Financial accounting is concerned with communicating useful information to decision-makers. These classifications provide decision-makers with critical information about the structure of assets, liabilities, and stockholders' equity that assists them in understanding a company's financial position.

Current Liabilities

Current liabilities are closely related to current assets. **Current liabilities** consist of obligations that will be satisfied within one year or the operating cycle, whichever is longer. These liabilities can be satisfied through the payment of cash or by providing goods or services. **Current liabilities are typically listed in the order in which they will be paid** and include:

- Accounts payable—an obligation to repay a vendor or supplier for merchandise supplied to the company
- Salaries payable—an obligation to pay an employee for services performed
- Unearned revenue—an obligation to deliver goods or perform a service for which a company has already been paid
- Interest payable—an obligation to pay interest on money that a company has borrowed
- Taxes payable—an obligation to pay taxes on a company's income

Long-Term Liabilities and Stockholders' Equity

Long-term liabilities are the obligations of the company that will require payment beyond one year or the operating cycle, whichever is longer. Common examples are:

- Notes payable—an obligation to repay cash borrowed at a future date
- Bonds payable—a form of an interest-bearing note payable issued by corporations in an effort to attract a large amount of investors

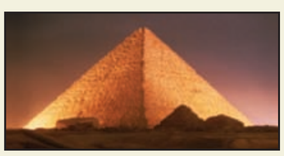
Stockholders' equity is the final major classification on a company's balance sheet. Stockholder's equity arises from two sources:

- Contributed capital—the owners' contributions of cash and other assets to the company (includes the common stock of a company)
- Retained earnings—the accumulated net income of a company that has not been distributed to owners in the form of dividends

If a firm has been profitable for many years, and if its stockholders have been willing to forgo large dividends, retained earnings may be a large segment of equity. Apple reported approximately $9.1 billion of retained earnings at September 29, 2007 which represents over 62 percent of its total stockholders' equity.

Together, a company's liabilities and equity make up the **capital** of a business. Apple has debt capital, capital raised from creditors, of approximately $10.8 billion (total liabilities). Of this, approximately $9.3 billion comes from current creditors, while approximately $1.5 billion comes from long-term creditors. Apple's equity capital, which is the capital raised from stockholders, is approximately $14.5 billion (total stockholders' equity).

Using the fundamental accounting equation and the common classifications of balance sheet items, a company will prepare its balance sheet. Cornerstone 1-2 illustrates the steps in the preparation of a classified balance sheet.



CORNERSTONE 1-2

HOW TO Prepare a Classified Balance Sheet

Concept:
The balance sheet reports the financial position of a company (its assets, liabilities, and stockholders' equity) at a specific point in time.

Information:
Hightower Inc. reported the following account balances at December 31, 2009:

Inventories	$ 2,300	Accounts receivable	$ 4,200	Accounts payable	$ 3,750
Land	12,100	Cash	2,500	Common stock	14,450
Salaries payable	1,200	Equipment	21,000	Patents	2,500
Retained earnings	11,300	Accumulated depreciation	5,800	Notes payable	8,100

Required:
Prepare Hightower Inc.'s balance sheet at December 31, 2009.

Solution:
The preparation of a classified balance sheet involves five steps:

1. Prepare a heading that includes the name of the company, the title of the financial statement, and the time period covered.
2. List the assets of the company in order of their liquidity or nearness to cash. Use appropriate classifications. Add the assets and double underline the total.
3. List the liabilities of the company in order of their time to maturity. Use appropriate classifications.
4. List the stockholders' equity balances with appropriate classifications.
5. Add the liabilities and stockholders' equity and double underline the total.

In general, only the first items in a column as well as any subtotals or totals have dollar signs. Also when multiple items exist within a classification, these items are grouped together in a separate column (to the left of the main column) and their total is placed in the main column.

CORNERSTONE 1-2 (continued)

Hightower Inc. Balance Sheet December 31, 2009			
			Step 1
ASSETS			
Current assets:			Step 2
Cash	$ 2,500		
Accounts receivable	4,200		
Inventories	2,300		
Total current assets		$ 9,000	
Property, plant, and equipment:			
Land	$12,100		
Equipment	21,000		
Less: accumulated depreciation	(5,800)		
Total property, plant, and equipment		27,300	
Intangible assets:			
Patents		2,500	
Total assets		$38,800	
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current liabilities:			Step 3
Accounts payable	$ 3,750		
Salaries payable	1,200		
Total current liabilities		$ 4,950	
Long-term liabilities:			
Notes payable		8,100	
Total liabilities		$13,050	
Stockholders' equity:			Step 4
Common stock	$14,450		
Retained earnings	11,300		
Total stockholders' equity		25,750	
Total liabilities and stockholders' equity		$38,800	Step 5

Using Balance Sheet Information

The balance sheet conveys important information about the structure of assets, liabilities, and stockholders' equity to users of financial statements. For example, the relationship between current assets and current liabilities gives users insights into a company's **liquidity**—a company's ability to pay obligations as they become due. Two useful measures of liquidity are **working capital** (current assets − current liabilities) and the **current ratio** (current assets ÷ current liabilities). Working capital and current ratios for a company are helpful to an investor when these numbers are compared to those of other companies in the same industry. It is even more helpful to look at the trend of these measures over several years.

Because current liabilities will be settled with current assets, Apple's working capital of $12,657 million ($21,956 million − $9,299 million) signals that it has adequate funds with which to pay its current obligations. Because working capital is expressed in a dollar amount, the information it can convey is limited. For example, comparing Apple's working capital of $12,657 million to **Dell**'s working capital of $2,148 million would be misleading since Apple is more than three times as large (in

DECISION-MAKING & ANALYSIS

Assessing the Creditworthiness of a Prospective Customer

Thin Inc., a newly organized health club in Des Moines, Iowa, has approached the regional office of NordicTrack to purchase $50,000 worth of exercise equipment. Thin Inc. offers to pay the full amount in six months plus 9 percent interest. John Peterson, the regional credit manager for NordicTrack has asked you, a member of his staff, to evaluate the creditworthiness of Thin Inc. and make a recommendation. At your request, Thin Inc. provides the following figures from its balance sheet:

Current Assets		Current Liabilities	
Cash	$10,000	Accounts payable	$25,000
Accounts receivable	50,000	Notes payable	30,000
Supplies	4,000	Current portion of mortgage payable	18,000
Total	$64,000	Total	$73,000

Allowing a company to purchase assets on credit requires evaluating the debtor's ability to repay the loan out of current assets. You raise the following questions to determine Thin's ability to repay the short-term loan:

1. *What is the present relationship between Thin's current assets and current liabilities?*

Thin's current liabilities exceed current assets by $9,000 ($64,000 − $73,000) resulting in negative working capital. In addition, its current ratio is 0.88 ($64,000 ÷ $73,000).

2. *Is there likely to be any change in the relationship between current assets and current liabilities during the period of the loan?*

There is no evidence that Thin's liquidity problem will improve. Actually, it appears that Thin will have difficulty in paying its current liabilities as they come due. Thus it seems unrealistic for Thin to take on additional current liabilities at this time.

3. *Would you allow Thin Inc. to purchase the exercise equipment on credit?*

You recommend that, unless Thin can demonstrate how it will pay its current short-term obligations as well as the additional funds that would be owed to NordicTrack, short-term credit should not be extended.

terms of net assets). The current ratio is an alternative measure of liquidity that allows comparisons to be made between different companies. For example, Apple's current ratio of 2.36 ($21,956 million ÷ $9,299 million) can be compared with its competitors (e.g., Dell's current ratio is 1.12).[4] Apple's current ratio tells us that for every dollar of current liabilities, Apple has $2.36 of current assets. When compared to Dell, Apple is much more liquid.

OBJECTIVE 5
Prepare an income statement and understand the information it communicates.

The Income Statement

The income statement reports the results of a company's operations—the sale of goods and services and the associated cost of operating the company—for a given period. The long-term survival of a company depends on its ability to produce net income by earning revenues in excess of expenses. Income enables a company to pay for the capital it uses (dividends to stockholders and interest to creditors) and attract new capital necessary for continued existence and growth. Investors buy and sell stock and creditors loan money based on their beliefs about a company's future performance. The past income reported on a company's income statement provides investors with information about a company's ability to earn future income.

[4] Information for Dell was obtained from Dell's fiscal year 2007 annual report that ended on February 2, 2007.

Elements of the Income Statement

The income statement consists of two major items: revenues and expenses. An income statement for Apple is presented in Exhibit 1-8.

Examining the heading of the income statement, you should notice that it follows the same general format as the balance sheet—it indicates the name of the company, the title of the financial statement, and the time period covered by the statement. However, the income statement differs from the balance sheet in that it covers a period of time instead of a specific date.

Revenues are the increase in assets that result from the sale of products or services. Revenues can arise from different sources and have different names depending on the source of the revenue. *Sales revenue* arises from the principal activity of the business. For Apple, its sales revenue comes from sales of hardware (e.g., iPod, Macintosh computers, iPhone), software (operating systems), peripheral products and accessories, digital content (e.g., iTunes store sales) and service and support. Apple, like most other companies, generally recognizes sales revenue in the period that a sale occurs. Revenues also can be generated from activities other than the company's principal operations (e.g., nonoperating activities). For example, in addition to sales of its products, Apple also earns *interest income* from investments.

Expenses are the cost of resources used to earn revenues during a period. Expenses have different names depending on their function. Apple's income statement in Exhibit 1-8 reports five different expenses. *Cost of sales* (often called *cost of goods sold*) is the cost to the seller of all goods sold during the accounting period.[5] *Selling, general, and administrative expenses* are the expenses that a company incurs in selling goods, providing services, or managing the company that are not directly related to production. These expenses include advertising expenses, salaries paid to salespersons or managers, depreciation on administrative buildings and expenses related to insurance, utilities, property taxes, and repairs. *Research and development expense* represents the cost of developing new products. *Other expense* is a catch-all category used to capture other miscellaneous expenses incurred by the company. *Income tax expense* represents the income taxes paid on the company's pretax income.

Net income, or net earnings, is the difference between total revenues and expenses. Apple reported net income of \$3,496 million (\$24,653 million – \$21,157 million). If total expenses are greater than total revenues, the company would report a net loss. Cornerstone 1-3 shows how to prepare an income statement.

Exhibit 1-8

Income Statement

Apple Inc.
Income Statement*
For the fiscal year ended September 29, 2007
(in millions of dollars)

Revenues:		
Net sales	$24,006	
Interest income	647	$24,653
Expenses:		
Cost of sales	$15,852	
Selling, general, and administrative expenses	2,963	
Research and development expense	782	
Other expenses	48	
Income tax expense	1,512	21,157
Net income		$ 3,496

*The income statement information was taken from the annual report of Apple Inc. and has been summarized and reformatted by the authors.

[5] We will discuss procedures for calculating cost of sales in a later chapter.

CORNERSTONE 1-3

HOW TO Prepare an Income Statement

Concept:
The income statement reports the results of a company's operations (revenues less expenses) for a given period of time.

Information:
Hightower Inc. reported the following account balances for the year ending December 31, 2009:

Cost of sales	$31,300	Interest expense	$ 540
Salaries expense	8,800	Sales revenue	50,600
Insurance expense	700	Depreciation expense	1,500
Interest revenue	1,200	Rent expense	2,100
Income tax expense	2,000		

Required:
Prepare Hightower Inc.'s income statement for the year ending December 31, 2009.

Solution:
The preparation of an income statement involves four steps:

1. Prepare a heading that includes the name of the company, the title of the financial statement, and the time period covered.
2. List the revenues of the company, starting with sales revenue (or service revenue) and then listing other revenue items. Add the revenues to get total revenue.
3. List the expenses of the company, usually starting with cost of sales (if it exists). Add the expenses to get total expenses.
4. Subtract the expenses from the revenues to get net income (or net loss if expenses exceed revenues). Double-underline net income.

In general, only the first items in a column as well as any subtotals or totals have dollar signs. Also when multiple items exist within a classification, these items are grouped together in a separate column (to the left of the main column) and their total is placed in the main column.

Hightower Inc.
Income Statement
For the Year Ended December 31, 2009 — Step 1

Revenues:			
Sales revenue	$50,600		Step 2
Interest revenue	1,200		
Total revenues		$51,800	
Expenses:			
Cost of sales	$31,300		
Salaries expense	8,800		
Rent expense	2,100		
Depreciation expense	1,500		Step 3
Insurance expense	700		
Interest expense	540		
Income tax expense	2,000		
Total expenses		46,940	
Net income		$ 4,860	Step 4

Income Statement Formats

Companies prepare their income statements in one of two different formats. The format that we illustrated in Cornerstone 1-3 is called a *single-step income statement*. In a single-step income statement, there are only two categories: total revenues and total expenses. Total expenses are subtracted from total revenues in a *single step* to arrive at net income. The advantage of a single-step income statement is its simplicity.

A second income statement format is the *multiple-step income statement*. The multiple-step income statement provides classifications of revenues and expenses that financial statement users find useful. A multiple-step income statement contains three important subtotals:

1. **Gross margin (gross profit)**—the difference between net sales and cost of sales (or cost of goods sold)
2. **Income from operations**—the difference between gross margin and operating expenses
3. **Net income**—the difference between income from operations and any nonoperating revenues and expenses

A multiple-step income statement for Apple is shown in Exhibit 1-9.

Let's examine these three classifications, First, the difference between net sales and cost of goods sold is reported as a company's *gross margin* or *gross profit*. Gross margin represents the initial profit made from selling a product, but it is *not* a measure of total profit because other operating expenses have not yet been subtracted. However, gross margin is closely watched by managers and other financial statement users. A change in a company's gross margin can give insights into a company's current pricing and purchasing policies, thereby providing insight into the company's future performance.

Second, *income from operations* is computed by subtracting operating expenses from gross margin. Operating expenses are the expenses the business incurs in selling goods or providing services and managing the company. Operating expenses typically include research and development expenses, selling expenses, and general and administrative expenses. Income from operations indicates the level of profit produced by the principle activities of the company. Apple can increase its income from operations by either increasing its gross margin or decreasing its operating expenses.

Exhibit 1-9

Multiple-Step Income Statement

Apple Inc.
Income Statement*
For the fiscal year ended September 29, 2007
(in millions of dollars)

Net sales	$24,006	
Cost of sales	15,852	
Gross margin		$8,154
Operating expenses:		
Research and development expense	$ 782	
Selling, general, and administrative expenses	2,963	
Total operating expenses		3,745
Income from operations		$4,409
Other income and expense:		
Interest income	$ 647	
Other expenses	(48)	599
Income before income taxes		$5,008
Income tax expense		1,512
Net income		$3,496

*The income statement information was taken from the annual report of Apple Inc. and has been summarized and reformatted by the authors.

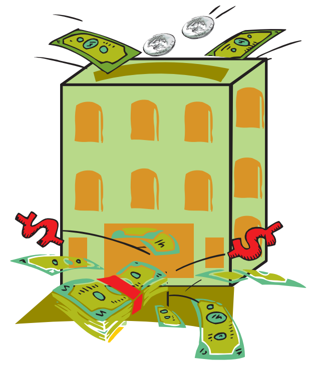
Exhibit 1-10

Typical Nonoperating Items

Other Revenues and Gains

Interest revenue on investments
Dividend revenue from investments in stock of other companies
Rent revenue
Gains on sale of property, plant, and equipment

Other Expenses and Losses



Interest expense from loans
Losses from sale of property, plant, and equipment
Losses from accidents or vandalism
Losses from employee strikes
Income tax expense

Finally, a multiple-step income statement reports nonoperating activities in a section which is frequently called *other income and expenses. Nonoperating activities* are revenues and expenses from activities other than the company's principle operations. They include gains and losses from the sale of equipment and other items that were not acquired for resale. For many companies, the most important nonoperating item is interest. Exhibit 1-10 lists some common nonoperating items.

These nonoperating items are subtracted from income from operations to obtain income before taxes. Income tax expense is then subtracted to obtain net income.

Regardless of the format used, notice that there is no difference in the amount of the revenue or expense items reported. That is, net income is the same under either the single-step or the multiple-step format. The only difference is how the revenues and expenses are classified.

Using Income Statement Information

The income statement provides information about the future profitability and growth of a company. **Earnings per share**, which measures the net income earned for each share of common stock is probably one of the most frequently cited ratios in financial analysis.[6] Examining earnings per share ratios (and other financial information) for a company over time, investors can gain insight into the earnings performance and profitability of a company.

For example, assume that you want to invest in one of two companies, either Growth, Inc., or Stagnation Company. Your first step is to examine some key elements from the current income statements of each company:

Growth, Inc.		Stagnation Company	
Sales revenue	$1,000,000	Sales revenue	$1,000,000
Gross margin	$400,000	Gross margin	$400,000
Net income	$50,000	Net income	$50,000
Number of shares	20,000 shares	Number of shares	10,000 shares
Earnings per share	$2.50	Earnings per share	$5.00

Next, examine a five–year summary of sales revenue and net income for the two firms in order to detect trends for each company over time.

Growth, Inc.

	2006	2007	2008	2009	2010
Sales revenue	$625,000	$700,000	$750,000	$875,000	$1,000,000
Net income	$30,000	$36,000	$40,000	$42,000	$50,000
Earnings per share	$1.50	$1.80	$2.00	$2.10	$2.50

[6] Earnings per share will be discussed in more depth in Chapter 10.

Stagnation Company

	2006	2007	2008	2009	2010
Sales revenue	$1,025,000	$975,000	$997,000	$950,000	$1,000,000
Net income	$51,000	$48,000	$46,000	$49,000	$50,000
Earnings per share	$5.10	$4.80	$4.60	$4.90	$5.00

As an investor, you seek those investments that will provide the largest return at the lowest risk. One factor considered to be associated with large returns is growth, and accounting information can help you judge a company's growth potential. In assessing the growth potential for our two hypothetical companies, you note that, over the last five years, Growth's sales and net income have steadily increased while Stagnation's sales and net income have remained, on average, stable. Additionally, Growth exhibits a clear upward trend in its earnings per share ratio while Stagnation's earnings per share ratio has, on average, declined. Therefore, while the future never can be predicted with certainty, the past five years' data suggest that, if Growth continues to grow more rapidly than Stagnation, an investment in Growth would probably yield the larger return.

Statement of Retained Earnings

OBJECTIVE 6
Prepare the statement of retained earnings and understand the information it communicates.

The owners of a company contribute capital in one of two ways:

1. directly, though purchases of common stock from the company, and
2. indirectly, by the company retaining some or all of the net income earned each year rather than paying it out in dividends.

As noted earlier, the income earned by the company but not paid out in the form of dividends is called retained earnings. A company may choose to retain a portion of its earnings in order to provide profit to be used for future growth. The statement of retained earnings summarizes and explains the changes in retained earnings during the accounting period.[7] Exhibit 1-11 shows the statement of retained earnings for Apple.

Exhibit 1-11

Statement of Retained Earnings

Apple Inc.
Statement of Retained Earnings*
For the fiscal year ended September 29, 2007
(in millions of dollars)

Retained earnings, Sept. 30, 2006	$5,607
Add: Net income	3,496
	$9,103
Less: Dividends	0
Other**	(2)
Retained earnings, Sept. 29, 2007	$9,101

*The statement of retained earnings was created by the authors from information contained in Apple Inc.'s 2007 annual report.
**The other item deducted in Apple's statement of retained earnings is related to common stock issued under Apple's stock plans. This is an unusual item and beyond the scope of this text and is not discussed.

[7] Some companies may choose to report a statement of changes in stockholders' equity, which explains the changes in all of the stockholders' equity accounts, rather than a statement of retained earnings.

Notice the heading is similar to the heading for the income statement in that it covers a period of time (the fiscal year ended September 29, 2007). In addition, Apple declared no dividends for 2007 but chose to keep the net income earned within the company. The preparation of a statement of retained earnings is detailed in Cornerstone 1-4.

CORNERSTONE 1-4

HOW TO Prepare a Statement of Retained Earnings

Concept:
The statement of retained earnings summarizes and explains the changes in retained earnings during an accounting period.

Information:
Hightower Inc. reported the following account balances for the year ending December 31, 2009:

Net Income	$4,860	Retained earnings, 1/1/2009	$10,590
Dividends	3,000	Retained earnings, 12/31/2009	11,300

Required:
Prepare Hightower Inc.'s statement of retained earnings for the year ending December 31, 2009.

Solution:
The preparation of the statement of retained earnings involves four steps:

1. Prepare a heading that includes the name of the company, the title of the financial statement, and the time period covered.
2. List the retained earnings balance at the beginning of the period obtained from the balance sheet dated December 31, 2008.
3. Add net income obtained from the income statement.
4. Subtract any dividends declared during the period. Double-underline the total which should equal retained earnings at the end of the period as reported on the balance sheet dated December 31, 2009.

Hightower Inc.
Statement of Retained Earnings
For the Year Ended December 31, 2009 } Step 1

Retained earnings, January 1, 2009	$ 9,440	Step 2
Add: Net income	4,860	Step 3
Deduct: Dividends	(3,000)	Step 4
Retained earnings, December 31, 2009	**$11,300**	

Use of the Statement of Retained Earnings

The statement of retained earnings is used to monitor a company's dividend payouts to its shareholders. For example, some older investors seek out companies with high dividend payouts so that they will receive cash during the year. Also, creditors are interested in a company's dividend payouts. If a company pays out too much in dividends, the company may not have enough cash on hand to repay its debt when it becomes due.

Statement of Cash Flows

OBJECTIVE 7
Understand the information communicated by the statement of cash flows.

The last of the major financial statements, the statement of cash flows, describes the company's cash receipts (cash inflows) and cash payments (cash outflows) for a period of time. The statement of cash flows for Apple is shown in Exhibit 1-12.
Cash flows are classified into one of three categories:

- **Cash flows from operating activities**—any cash flows directly related to earning income. This category includes cash sales and collections of accounts receivable as well as cash payments for goods, services, salaries, and interest.
- **Cash flows from investing activities**—any cash flow related to the acquisition or sale of investments and long-term assets such as property, plant, and equipment.
- **Cash flows from financing activities**—any cash flow related to obtaining capital of the company. This category includes the issuance and repayment of debt, common stock transactions, and the payment of dividends.

The preparation of the statement of cash flows will be discussed in Chapter 11.

Use of the Statement of Cash Flows

The statement of cash flows is used by creditors who wish to assess the creditworthiness of a company. A company with healthy cash flow—particularly if it comes from operating activities—is in a good position to repay debts as they come due and is usually a low-risk borrower. Stockholders are also interested in the adequacy of cash flows as an indicator of the company's ability to pay dividends and to expand its business. The statement of cash flows is covered in more detail in Chapter 11.

Relationships Among the Statements

OBJECTIVE 8
Describe the relationships among the financial statements.

At this point, it is important to notice the natural relationships of the four basic financial statements and the natural progression from one financial statement to another. Normally, we begin an accounting period with a balance sheet. During the year, the company earns net income from operating its business. Net income from the income statement increases retained earnings on the statement of retained earnings. Ending retained earnings from the statement of retained earnings is reported in the stockholders' equity section of the balance sheet at the end of the accounting period. Finally, the statement of cash flow explains the change in cash on the balance sheets at the beginning and end of the accounting period. These relationships are shown in Exhibit 1-13.

Exhibit 1-12

Statement of Cash Flows

Apple Inc.
Statement of Cash Flows*
For the fiscal year ended September 29, 2007
(in millions of dollars)

Net cash provided from operating activities	$ 5,470
Net cash used by investing activities	(3,249)
Net cash provided from financing activities	739
Net change in cash	$ 2,960
Cash at the beginning of the year	6,392
Cash at the end of the year	$ 9,352

*The statement of cash flow information was taken from the annual report of Apple Inc. and has been summarized and reformatted by the authors.

Exhibit 1-13

Relationships Among the Financial Statements

Beginning of the Period → **End of the Period**

Hightower Inc.
Balance Sheet
Dec. 31, 2008

Assets:	
Cash	$ 2,030
Other assets	32,360
Total assets	$ 34,390
Total Liabilities:	$ 10,500
Stockholders' Equity:	
Common stock	14,450
Retained Earnings	9,440
Total Liabilities & Stockholders' Equity	$ 34,390

Hightower Inc.
Income Statement
For the Year Ended Dec. 31, 2009

Revenues	$51,800
Expenses	46,940
Net Income	$ 4,860

Hightower Inc.
Statement of Retained Earnings
For the Year Ended Dec. 31, 2009

Retained Earnings, 1/1	$ 9,440
Add: Net income	4,860
Less: Dividends	(3,000)
Retained Earnings, 12/31	$11,300

Hightower Inc.
Statement of Cash Flows
For the Year Ended Dec. 31, 2009

Net cash provided from operating activities	$3,470
Net cash used by investing activities	(4,800)
Net cash provided from financing activities	1,800
Net change in cash	$ 470
Cash, 1/1/2009	2,030
Cash 12/31/2009	$2,500

Hightower Inc.
Balance Sheet
Dec. 31, 2009

Assets:	
Cash	$ 2,500
Other assets	36,300
Total assets	$38,800
Total Liabilities:	$13,050
Stockholders' Equity:	
Common stock	14,450
Retained Earnings	11,300
Total Liabilities & Stockholders' Equity	$38,800

Other Items in the Annual Report and Professional Ethics

OBJECTIVE 9
Describe other information contained in the annual report and the importance of ethics in accounting.

The financial statements discussed in the previous section were reported to users in an *annual report*. The annual report includes the financial statements of a company and other important information such as the notes to the financial statements, management's discussion and analysis of the condition of the company, and the auditor's report. For publicly-traded companies that are required to file reports with the Securities and Exchange Commission, the annual report is contained within the company's 10-K filing.

CONCEPT Q&A

Is there a single equation or financial statement which captures the business activities (operating, investing, and financing) that all companies engage in?

Possible Answer:

The fundamental accounting equation captures the business activities of companies and encompasses all of the major financial statements. While certain statements provide more information on certain business activities (e.g., the income statement provides information about a company's operating activities), information is also contained in other statements as well (e.g., current assets and current liabilities provide insight into a company's operations). Therefore, all financial statements and the notes to the financial statements must be examined as an integrated whole.

Notes to the Financial Statements

The **notes to the financial statements (or footnotes)** clarify and expand upon the information presented in the financial statements. The notes are an integral part of the financial statements and help to fulfill the accountant's responsibility for full disclosure of all relevant information. Without the information contained in the notes, the financial statements are incomplete and could not be adequately understood by users. The information contained in the notes can be either quantitative (numerical) or qualitative (nonnumerical).

Generally, the first note contains a summary of significant accounting policies. For example, the following is an excerpt from Apple's notes to the financial statements concerning its accounting for revenues:

Revenue Recognition

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collection is probable. Product is considered delivered to the customer once it has been shipped and title and risk of loss have been transferred. For most of the Company's product sales, these criteria are met at the time the product is shipped.

Other footnotes provide additional detail on line items presented in the financial statements. For example, while Apple only reports a single number on the balance sheet for property, plant, and equipment, the company provides a detailed breakdown of the components of property, plant, and equipment (land, building, machinery, equipment, and furniture) in the notes. Other notes provide disclosures about items not reported in the financial statements. For instance, Apple provides detailed explanations of its stock option activity over the last three years—an activity not directly reported on the financial statements yet of significant interest to users.

Management's Discussion and Analysis

The annual report also includes a section entitled "**Management's Discussion and Analysis**." In this section, management provides a discussion and explanation of various items reported in the financial statements. Additionally, management uses this opportunity to highlight favorable and unfavorable trends and significant risks facing the company. For example, in explaining the increase in sales from the previous years, Apple disclosed the following:

Net sales of iPods increased $629 million or 8% during 2007 compared to 2006. Unit sales of iPods increased 31% compared to 2006. The iPod growth was primarily driven by increased sales of the iPod shuffle and iPod nano particularly in international markets. iPod unit sales growth was significantly greater than iPod net sales due to a shift in overall iPod product mix, as well as due to lower selling prices for the iPod classic, iPod nano and iPod shuffle in 2007 compared to 2006.

Report of Independent Accountants

An independent accountant (or auditor) is an accounting professional who conducts an examination of a company's financial statements. The objective of this examination is to gather evidence that will enable the auditor to form an opinion as to whether the financial statements fairly present the financial position and result of operations of the company. The auditor's opinion of the financial statements is presented in the form of an **audit report**. Exhibit 1-14 shows an excerpt from the audit report for Apple.

Because financial statement users cannot directly observe the company's accounting practices, companies hire auditors to give the users of the financial statements assurance or confidence that the financial statements are a fair presentation of the company's financial health. In performing an audit, it is impractical for an auditor to retrace every transaction of the company for the entire accounting period. Instead, the auditor performs procedures (e.g., sampling of transactions) that enable an opinion to be expressed on the financial statement as a whole.

Exhibit 1-14

Auditor's Report

Report of Independent Registered Public Accounting Firm (partial)

The Board of Directors and Shareholders
Apple, Inc.:

We have audited the accompanying consolidated balance sheets of Apple Inc. and subsidiaries (the Company) as of September 29, 2007 and September 30, 2006, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the years in the three-year period ended September 29, 2007. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Apple Inc. and subsidiaries as of September 29, 2007 and September 30, 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended September 29, 2007, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Apple Inc.'s internal control over financial reporting as of September 29, 2007, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated November 15, 2007 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP
Mountain View, California
November 15, 2007

DECISION-MAKING & ANALYSIS

Career Analysis

Virtually every organization must have an accounting system; thus, accountants are employed in a wide range of businesses. Accounting knowledge and experience can also open doors to other areas of business.

1. *What skills and character traits are required for accountants?*

Accountants must have well-developed analytical skills and must be effective communicators, both verbally and in writing. Most accounting assignments—whether in business, government, or public accounting—are team assignments in which team members must be able to communicate effectively and work quickly and cooperatively to a solution. As a profession, accounting is subject to professional competence requirements and requires a high level of academic study. In addition, accountants must have personal integrity and behave ethically.

2. *What credentials are useful for a career in accounting?*

Most members of public accounting firms, and many management accountants and consultants, are (or are in the process of becoming) Certified Public Accountants (CPAs). The CPA designation is awarded under state law in each of the 50 states to ensure that accountants who offer their services to the public are properly qualified. The CPA is earned by meeting education and experience requirements and by passing a professional examination. The examination is administered nationally by the American Institute of Certified Public Accountants (AICPA). Other valuable professional certifications are the Certified Management Accountant (CMA) designation, which is awarded by the Institute of Management Accountants, and the Certified Internal Auditor (CIA) designation, which is awarded by the Institute of Internal Auditors. Some accountants have obtained the Certified Fraud Examiner (CFE) designation awarded by the Association of Certified Fraud Examiners.

3. *What are the career paths of accountants?*

Accountants work for many types of organizations, including private companies, public accounting firms, governments, and banks. An accounting graduate who begins in public accounting enters as a staff accountant and from there progresses to senior accountant, to manager, and finally to partner. Public accountants perform financial statement audits, provide tax services to their clients, and/or offer management consulting services (e.g., the design and installation of accounting systems). Some accounting graduates choose to begin employment with either profit or nonprofit organizations. In such organizations, an accountant may perform duties that include general accounting, internal auditing, budgeting, and cost accounting. With the knowledge and experience gained through accounting, many accountants have the opportunity to advance within the organization to the corporate executive level. As you can see, the career opportunities for accountants are virtually boundless.

Professional Ethics

Confidence that standards of ethical behavior will be maintained—even when individuals have incentives to violate those standards—is essential to the conduct of any business activity. Owners of businesses must trust their managers, managers must trust each other and their employees, and the investing public must trust its auditors to behave according to accepted ethical standards, which may or may not be reflected in formal written codes. The violation of ethical standards may bring clear and direct penalties but more often bring subtle and long-lasting negative consequences for individuals and companies.

For the economy to function effectively and efficiently, users must have faith that the information reported in financial statements is accurate and dependable. This can only be accomplished through ethical behavior. The American Institute of Certified Public Accountants (AICPA), recognizing that its members have an obligation of self-discipline above and beyond the requirements of generally accepted accounting principles, has adopted a code of professional conduct which provides ethical guidelines for accountants in the performance of their duties. These ethical principles require accountants to serve the public interest with integrity. For example, auditors should fulfill their duties with objectivity, independence, and due professional care. In no situation should an auditor yield to pressure from management to report positively on financial statements that overstate the company's performance or prospects. Violation of these ethical standards can result in severe penalties, including revocation of an accountant's license to practice as a certified public accountant.

In recent years, there have been an increasing number of news reports about unethical behavior involving accounting practices. Acting ethically is not always easy. However, because of the important role of accounting in society, accountants are expected to maintain the highest level of ethical behavior. Throughout this book, you will be exposed to ethical dilemmas that we urge you to consider.

Summary of Learning Objectives

LO1. Explain the nature of accounting.

- Accounting is the process of identifying, measuring, recording and communicating financial information.
- This information is used both inside and outside of the business to make better decisions.
- Accounting is also called the language of business.
- Financial accounting focuses on the needs of external decision-makers.

LO2. Identify the forms of business organizations and the types of business activities.

- The three forms of business organizations are a sole proprietorship (owned by one person), a partnership (jointly owned by two or more individuals), and a corporation (separate legal entity organized under the laws of a particular state).
- Regardless of the form of business, all businesses are involved in three activities. Financing activities include obtaining funds necessary to begin and operate a business. Investing activities involve buying the assets that enable a business to operate. Operating activities are the activities of a business that generate a profit.

LO3. Describe the relationships shown by the fundamental accounting equation.

- The fundamental accounting equation captures all of the economic activities recorded by an accounting system.
- The left side of the accounting equation shows the assets, or economic resources of a company.
- The right side of the accounting equation shows the claims on the company's assets (liabilities or stockholders' equity).

LO4. Prepare a classified balance sheet and understand the information it communicates.

- A balance sheet reports the resources (assets) owned by a company and the claims against those resources (liabilities and stockholders' equity) at a specific point in time.
- These elements are related by the fundamental accounting equation: Assets = Liabilities + Stockholders Equity.
- In order to help users identify the fundamental economic similarities and differences between the various items on the balance sheet, assets and liabilities are classified as either current or noncurrent (long-term). Stockholders' equity is classified as either contributed capital or retained earnings.

LO5. Prepare an income statement and understand the information it communicates.

- The income statement reports how well a company has performed its operations over a period of time and provides information about the future profitability and growth of a company.

- The income statement includes the revenues and expenses of a company which can be reported in either a single-step or multiple-step format.

LO6. Prepare the statement of retained earnings and understand the information it communicates.

- The statement of retained earnings reports how much of a company's income was retained in the business and how much was distributed to owners for a period of time.
- The statement of retained earnings provides users with insights into a company's dividend payouts.

LO7. Understand the information communicated by the statement of cash flows.

- The statement of cash flows reports the sources of a company's cash inflow and the uses of a company's cash over time.
- The statement of cash flows can be used to assess the creditworthiness of a company.

LO8. Describe the relationships among the financial statements.

- There is a natural relationship among the four basic financial statements so that financial statements are prepared in a particular order.
- Starting with the balance sheet at the beginning of the accounting period, financial statements are generally prepared in the following order: income statement, the statement of retained earnings, and the balance sheet at the end of the accounting period.
- The statement of cash flow explains the change in cash on the balance sheets at the beginning and end of the accounting period.

LO9. Describe other information contained in the annual report and the importance of ethics in accounting.

- The notes to the financial statements clarify and expand upon the information presented in the financial statements, and are considered an integral part of a company's financial statements.
- Management's discussion and analysis provides a discussion and explanation of various items reported in the financial statements.
- The auditor's report gives the auditor's opinion as to whether the financial statements fairly present the financial condition and results of operations of the company.
- Maintenance of standards of ethical behavior is essential to the conduct of any business activity. Violation of these standards often brings significant short- and long-term negative consequences for individuals and companies.
- The maintenance of a high ethical standard is necessary for users to have faith in the accuracy of the financial statements, which is a key factor in the effective and efficient functioning of the economy.

CORNERSTONES FOR CHAPTER 1