chapter 2 Investing and Financing
Decisions and the Accounting
System

# Financial Accounting 11e

Libby • Libby • Hodge

#### **Recognition and Measurement Concepts**

#### **Assumptions**

- Separate entity assumption: each business's activities must be accounted for separately from the personal activities of the owners, all other persons, and other entities.
- Foing concern assumption (continuity assumption): it is assumed that the business will continue operating into the foreseeable future, long enough to meet its contractual commitments and plans.
- Monetary unit assumption: the financial statements are reported using the national monetary unit (e.g., dollars in the United States)

#### **Measurement Concept**

Historical cost: the balance sheet elements are initially recorded at their cost.

#### Elements of the Balance Sheet: Assets

Assets: resources that provide a future economic benefit.

- Listed on the balance sheet in order of liquidity.
- Assets are grouped as current or long-term assets.
  - Current assets are resources the company will use or turn into cash within one year.
    - Cash, Short-Term Investments, Accounts Receivable, Supplies, Inventories, and Prepaid Expenses
  - Long term (or noncurrent) assets are to be used or turned into cash after a year.
    - Property and equipment (Land, Buildings, and Equipment), Operating lease right-of-use assets (rented assets), Intangibles, and Stocks and bonds of other companies.

## Exhibit 2.1 Chipotle Mexican Grill, Inc., Balance Sheet

#### CHIPOTLE MEXICAN GRILL, INC. Consolidated Balance Sheet\* December 31, 2019 (in millions of dollars, except per share data) ASSETS Current Assets: Cash 481 Short-term investments 400 Current Accounts receivable 81 Assets 26 Supplies Rent, advertising, and insurance paid in advance 85 Prepaid expenses 1.073 Total current assets one year Property and Equipment: Land 13 Buildings owned 1.811 Buildings 836 Equipment Noncurrent Total cost 2,660 Assets (1,201)Accumulated depreciation 1,459 Net property and equipment Operating lease right-of-use assets 2,505 Intangible assets 69

Total assets

#### EXPLANATIONS

"Consolidated" means all subsidiaries are combined Point in time for which the balance sheet was prepared

Ownership of other companies' stocks and bonds Amounts due from customers and others

Food, beverage, and packaging supplies on hand

Summary of assets to be used or turned into cash within

Includes furniture and fixtures

Cost of property and equipment at date of acquisition Amount of cost used in past operations

Facilities rented under leases with right to use the assets Rights, such as patents, trademarks, and licenses

\$5,106

#### Elements of the Balance Sheet: Liabilities

**Liabilities**: obligations that require a future economic sacrifice.

- Listed in order of maturity (how soon an obligation is to be paid) and grouped by current and noncurrent (long-term).
  - Current liabilities will need to be paid or settled within one year.
    - Accounts Payable, Unearned Revenue, Accrued Expenses Payable, Current Lease Liabilities, and others.
  - Noncurrent liabilities have due dates beyond one year.
    - Notes Payable and Long-term Lease Liabilities.

## Exhibit 2.1 Chipotle Mexican Grill, Inc., Balance Sheet (2 of 2)

|               | LIABILITIES AND STOCKHOLDERS' E            | QUITY   |
|---------------|--|---------|
|               | Current Liabilities:                       |         |
| ſ             | Accounts payable                           | \$ 116  |
|               | Unearned revenue                           | 95      |
| Current       | Accrued expenses payable:                  |         |
| Liabilities   | Wages payable                              | 127     |
|               | Utilities payable                          | 156     |
| l l           | Current lease liabilities                  | 173     |
|               | Total current liabilities                  | 667     |
| Noncurrent [  | Notes payable                              | 77      |
| Liabilities   | Long-term lease liabilities                | 2,678   |
|               | Total liabilities                          | 3,422   |
|               | Stockholders' Equity:                      |         |
|               | Common stock (\$0.01 par value)            | 1       |
| Stockholders' | Additional paid-in capital                 | 1,466   |
| Equity        | Treasury stock                             | (2,699) |
|               | Retained earnings                          | 2,916   |
|               | Total stockholders' equity                 | 1,684   |
|               | Total liabilities and stockholders' equity | \$5,106 |

Amount due to suppliers Unredeemed gift cards

Amount due to employees

Amount due for electric, gas, and telephone utilities Amount due on rented facilities within the next year

Summary of liabilities to be settled within one year

Amount owed on loans from banks

Amount due on rented facilities after one year

Total par value of stock issued by company to investors Excess amount received from investors over par Amount paid to repurchase its own stock from investors Undistributed earnings reinvested in the company

<sup>\*</sup>The information has been adapted from actual statements and simplified for this chapter.

#### Elements of the Balance Sheet: Stockholders' Equity

**Stockholders' Equity:** Represents the residual interest in the assets of the entity after subtracting liabilities.

# Financing Provided by Owners is referred to as contributed capital.

- Use the accounts Common Stock and Additional Paid-in Capital to represent the amount investors paid when they purchased the stock from the company.
- The Treasury Stock account represents the amount the company paid to its investors to repurchase common stock. Treasury Stock **reduces** stockholders' equity.

# Financing Provided by Operations is referred to as earned capital or retained earnings.

- The portion of profits reinvested in the business is called Retained Earnings.
- Losses and dividends decrease the Retained No reproduction or distribution without the prior written consent of McGraw Hill LLC.

#### Accounts

# Accounts are used by companies to accumulate the dollar effect of transactions.

- A list of all account titles and their unique numbers is called a chart of accounts.
- Each company has its own chart of accounts. **Do not**try to memorize a typical chart of accounts;
  instead focus on understanding the nature of each
  typical account and where it is located in the financial
  statements.

#### Examples of accounts include:

- Cash
- Inventories
- Accounts payable
- Retained earnings

## Exhibit 2.2 Typical Account Titles

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.

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.

| Assets   | Liabilities                                | Liabilities Stockholder's Equity              |   | Expenses |
|--|--|---|---|----------|
| Cash Short-Term Investments Accounts Receivable Notes Receivable Inventory (to be sold) Supplies Prepaid Expenses Long-Term Investments Equipment Buildings Land Intangibles | title are <b>always</b><br>representing am | pany by others who<br>bods or services<br>ny. | Sales Revenue Fee Revenue Interest Revenue Rent Revenue Service Revenue | · ·      |

#### **Principles of Transaction Analysis**

Every transaction has at least two effects (dual effects) on the basic accounting equation. Most transactions with external parties involve an exchange where the business entity both receives something and gives up something in return.

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

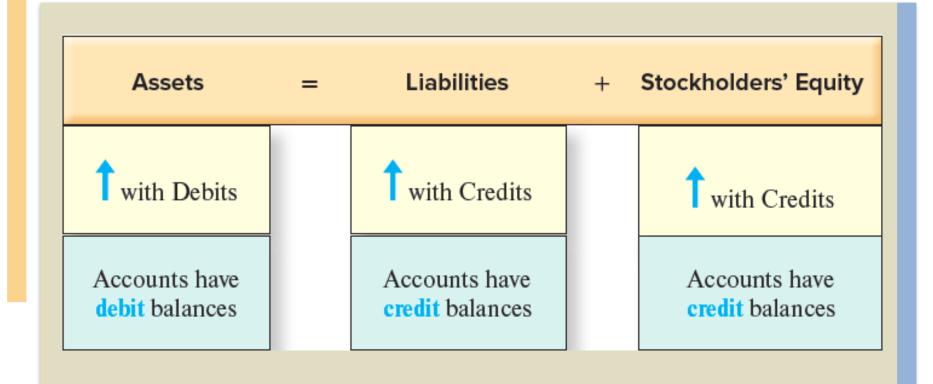
The accounting equation must remain in balance after each transaction.

# In-Class Example – Effect on the Accounting Equation

#### The Journal Entry

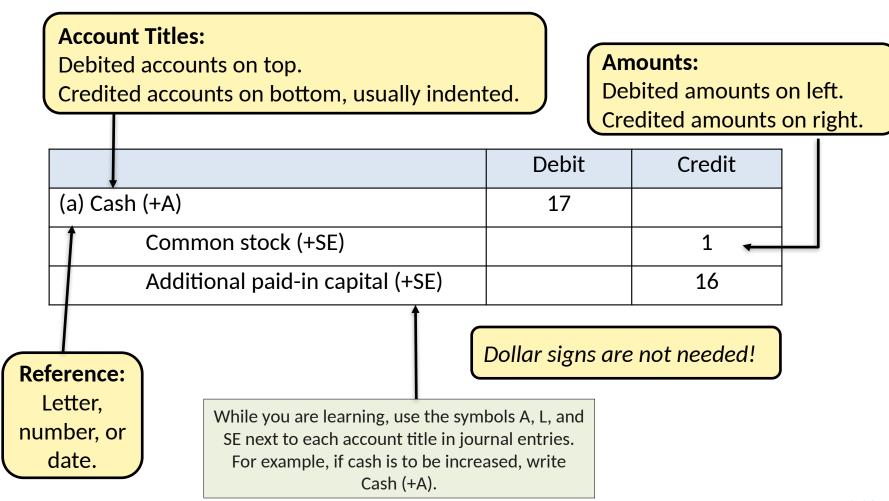
- In an accounting system, transactions are recorded in chronological order in a **general journal** (or, simply, journal).
- After analyzing the business documents (such as purchase invoices, receipts, and cash register tapes) that describe a transaction, the effects on the accounts are recorded in the journal using **debits** and **credits**.
- The journal entry is an accounting method for expressing the effects of a transaction on accounts.
- It is written in a debits-equal-credits format.

## **Debits and Credits**



#### The Journal Entry

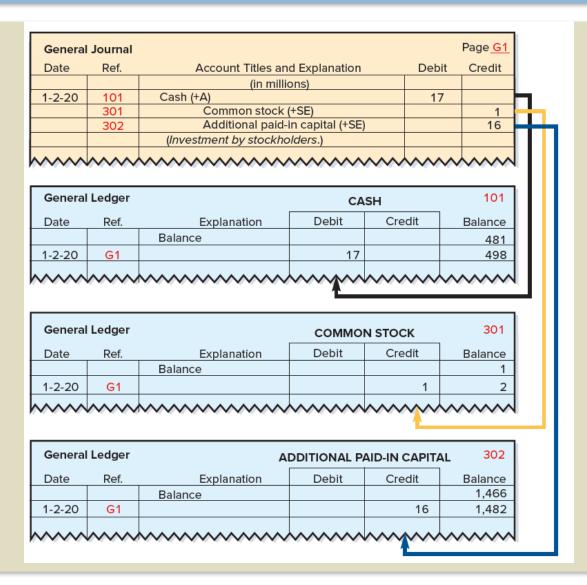
(a) Assume Chipotle issued (sold) 100 additional shares of common stock with a par value of \$0.01 per share at a market value of \$0.17 per share, receiving \$17 in cash from investors.



# In-Class Example – Journal Entries

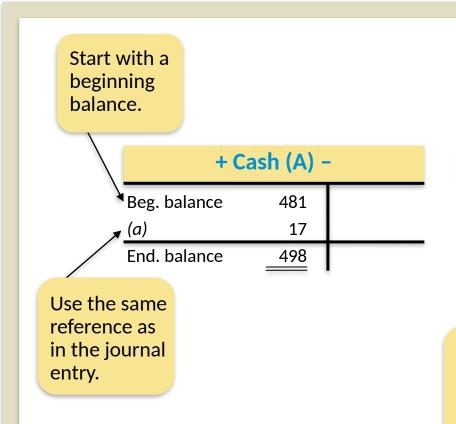
## Exhibit 2.6

### Posting Transaction Effects from the Journal to the Ledger

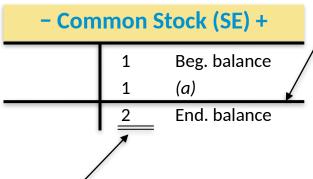


# Exhibit 2.7

### T-Accounts Illustrated



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).

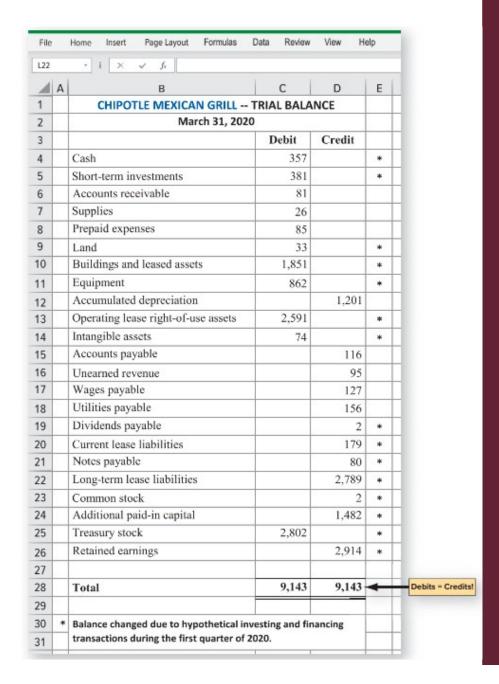
# Exhibit 2.8 T-Accounts

After analyzing the transactions from (a)–(h), the T-accounts balances are:

|   | + Cash (A) -  1/1/20   | + Short-Term Investments (A) —  1/1/20   | + Land (A) -  1/1/20 13 (d) 20  33                              |
|---|--|--|---|
| + Buildings (A) —  1/1/20 1,811 (d) 40  1,851 | + Equipment (A) —  1/1/20  | + Operating Lease ROU Assets (A) —  1/1/20 2,505 (d) 86  2,591  - Current Lease Liabilities (L) +  173 1/1/20 6 (d)  179 | + Intangible Assets (A) —  1/1/20 69 (c) 5                      |
|   | - Long-Term Lease Liabilities (L) +  2,678 1/1/20 111 (d) 2,789  + Treasury Stock (SE) -  1/1/20 2,699 (g) 103 2,802 |  | - Additional Paid-in Capital (SE) +  1,466 1/1/20 16 (a)  1,482 |

#### **Trial Balance**

- List the names of the T-accounts in financial statement order (assets, liabilities, stockholders' equity, revenues, and expenses).
- The purpose of the trial balance is to check the equality of the debits and credits.
- Errors may still exist if the wrong accounts or amounts were used in the journal entries!



#### **Current Ratio**



Current Ratio =

<u>Current Assets</u> Current Liabilities

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

The 2019 ratio for Chipotle is (dollars in millions):

$$\frac{\$1,073}{\$667} = 1.609$$

| COMPARISONS OVER TIME |                              |  |  |  |  |  |  |  |  |
|-----------------------|------------------------------|--|--|--|--|--|--|--|--|
| Chipotle              | Chipotle Mexican Grill, Inc. |  |  |  |  |  |  |  |  |
| 2017                  | 2017 2018 2019               |  |  |  |  |  |  |  |  |
| 1.944                 | 1.944 1.811 1.609            |  |  |  |  |  |  |  |  |

| COMPARISONS WITH COMPETITORS                   |       |  |  |  |  |  |  |
|--|-------|--|--|--|--|--|--|
| El Pollo Loco Holdings, Inc. Shake Shack, Inc. |       |  |  |  |  |  |  |
| 2019   | 2019  |  |  |  |  |  |  |
| 0.334  | 0.882 |  |  |  |  |  |  |

Offers Mexicaninspired grilled chicken and entrees Offers a classic

American menu of
premium burgers, hot
dogs, crispy chicken,
crinkle cut fries, shakes,
and more

The Slides below are Transaction Analysis and Journal Entry Textbook Slides – Left in slide show for reference.

(a) Chipotle issued (sold) 100 additional shares of common stock with a par value of \$0.01 per share at a market value of \$0.17 per share, receiving \$17 in cash from investors – a financing activity.

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

Received: Cash (+A) 17

Step 2: What was given?

```
Given: Additional stock shares → Common Stock (+SE) 1 (100 shares × $0.01 per share)

Additional Paid-in Capital (+SE) 16 (100 shares × $0.16 per share)
```

Step 3: Verify that the accounting equation balances: A 17 = L 0 + SE 17

(b) Chipotle borrowed \$4 from its local bank, signing a note to be paid in three years (a noncurrent liability) – a financing activity.

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

Received: Cash (+A) 4

Step 2: What was given?

Given: Written promises to pay the bank: Notes Payable (+L) 4 (noncurrent)

Step 3: Verify that the accounting equation balances: A 4 = L 4 + SE 0

(c) Chipotle purchased for cash \$26 in new equipment and \$5 in additional intangible assets – an investing activity.

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

| Received: Equipment (+A) | 26 |  |
|--------------------------|----|--|
| Intangible Assets (+A)   | 5  |  |

Step 2: What was given?

**Step 3:** Verify that the accounting equation balances: A 0 = L 0 + SE 0

(d) Chipotle acquired \$20 in additional land and \$40 in new buildings, signed leases for \$86 for right-of-use (ROU) assets, paid \$29 in cash, and signed \$6 in current leases and \$111 in long-term leases to rent

facilities — an investing activity, what was received: (account name, type of account, amount, and direction of effect)

| Received: Land (+A)                      | 20 |
|--|----|
| Buildings (+A)                           | 40 |
| Operating Lease Right-of-Use Assets (+A) | 86 |

Step 2: What was given?

| Given: Cash (-A)                 | 29  |  |
|----------------------------------|-----|--|
| Current Lease Liabilities (+L)   | 6   |  |
| Long-Term Lease Liabilities (+L) | 111 |  |

Step 3: Verify that the accounting equation balances: A 117 = L 117 + SE 0

|     |             | Assets   |               | Assets = Liabilities            |  |                              |                                  | + | Stockholders' Equity |
|-----|-------------|----------|---------------|---------------------------------|--|------------------------------|----------------------------------|---|----------------------|
| (d) | Cash<br>-29 | Land +20 | Buildings +40 | Operating Lease ROU  Assets +86 |  | Current Lease Liabilities +6 | Long-Term Lease Liabilities +111 |   |                      |

# (e) Chipotle sold \$19 in its short-term investments for \$19 cash—an investing activity.

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

Received: Cash (+A) 19

Step 2: What was given?

Given: Short-Term Investments (-A) 19

Step 3: Verify that the accounting equation balances: A 0 = L 0 + SE 0

(f) Within the quarter, assume Chipotle paid \$1 on the note payable in (b) above (ignore any interest on the loan in this chapter)—a financing activity.

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

Received: Reduction in the amount owed: Notes Payable (-L) 1

**Step 2:** What was **given**?

Given: Cash (-A) 1

Step 3: Verify that the accounting equation balances: A (1) = L (1) + SE 0

# (g) Chipotle repurchased a portion of its issued common stock from investors for \$103 cash—a financing activity.

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

Received: Reduction in stockholders' equity (the owners' claims to the company's assets:)

Treasury Stock (—SE) 103

Step 2: What was given?

Given: Cash (-A) 103

Step 3: Verify that the accounting equation balances: A (103) = L 0 + SE (103)

(h) For illustration purposes, assume Chipotle's board of directors declared that the Company will pay a total of \$2 in cash as dividends to shareholders next quarter.

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

Received: Reduction in owners' claims to the company's assets: Retained Earnings (-SE) 2

Step 2: What was given?

Given: A promise to pay: Dividends Payable (+L) 2

**Step 3:** Verify that the accounting equation balances: A 0 = L 2 + SE (2)

Assets = Liabilities + Stockholders' Equity

(h) Dividends Payable + Retained Earnings -2

(a) Assume Chipotle issued (sold) 100 additional shares of common stock with a par value of \$0.01 per share at a market value of \$0.17 per share, receiving \$17 in cash from investors—an financing activity. Common stock is recorded at par (100 shares × \$0.01 par value per share) and Additional Paid-in Capital is recorded for the excess over par value (100 shares × \$0.16 per share).

|                                  | Debit | Credit |
|----------------------------------|-------|--------|
| (a) Cash (+A)                    | 17    |        |
| Common stock (+SE)               |       | 1      |
| Additional paid-in capital (+SE) |       | 16     |

|       | Assets | 5       | = | Liabiliti | es          | +          | Stockhold |                  | ers' Equi | ty          |
|-------|--------|---------|---|-----------|-------------|------------|-----------|------------------|-----------|-------------|
| Cash  |        | +17     |   |           |             |            | Co        | mmon stock       |           | +1          |
|       |        |         |   |           |             |            | Ad        | ditional paid-in | capital   | +16         |
|       | + Cas  | h (A) — |   | – Commo   | n Stock (Sl | E) +       |           | – Additional Pa  | id-in Cap | ital (SE) + |
| 1/1/2 | 0 481  |         |   |           | 1           | 1/1/20     | •         |                  | 1,466     | 1/1/20      |
| (4    | ı) 17  |         |   |           | 1           | <i>(a)</i> |           |                  | 16        | (a)         |

(b) Chipotle borrowed \$4 from its local bank, signing a note to be paid in three years (a noncurrent liability)—an financing activity.

|                    | Debit | Credit |
|--------------------|-------|--------|
| (b) Cash (+A)      | 4     |        |
| Notes payable (+L) |       | 4      |

|            | + Cas | h (A) — | - Notes I | Payable | e (L) +    |
|------------|-------|---------|-----------|---------|------------|
| 1/1/20     | 481   |         |           | 77      | 1/1/20     |
| (a)        | 17    |         |           | 4       | <i>(b)</i> |
| <i>(b)</i> | 4     |         |           |         |            |

(c) Chipotle purchased for cash \$26 in new equipment and \$5 in additional intangible assets—an investing activity.

|                        | Debit | Credit |
|------------------------|-------|--------|
| (c) Equipment (+A)     | 26    |        |
| Intangible assets (+A) | 5     |        |
| Cash (- A)             |       | 31     |

Assets = Liabilities + Stockholders' Equity

Equipment +26

Intangible assets +5

Cash -31

|            | + Cash (A) - |    |            | +      | Equipn | nent (A) — | + Intangible Assets (A) - |    |  |  |
|------------|--------------|----|------------|--------|--------|------------|---------------------------|----|--|--|
| 1/1/20     | 481          |    | _          | 1/1/20 | 836    |            | 1/1/20                    | 69 |  |  |
| (a)        | 17           | 31 | <i>(c)</i> | (c)    | 26     |            | (c)                       | 5  |  |  |
| <i>(b)</i> | 4            |    |            |        |        |            |                           |    |  |  |

(d) Chipotle acquired \$20 in additional land and \$40 in new buildings, signed leases for \$86 for right-of-use (ROU) assets, paid \$29 in cash, and signed \$6 in current leases and \$111 in long-term leases to rent facilities—an financing activity.

|  | Debit | Credit |
|--|-------|--------|
| (d) Land (+A)                            | 20    |        |
| Buildings (+A)                           | 40    |        |
| Operating lease right-of-use assets (+A) | 86    |        |
| Cash (-A)                                |       | 29     |
| Current lease liabilities (+L)           |       | 6      |
| Long-term lease liabilities (+L)         |       | 111    |

|  | Ass      | sets      |                          | =       |            | Liabili   | ties       |      | +          | Stoc     | kholders  | s' Equity   |
|--|----------|-----------|--------------------------|---------|------------|-----------|------------|------|------------|----------|-----------|-------------|
| Land<br>Buildings<br>Operating<br>Cash | lease R  | OU assets | +20<br>+40<br>+86<br>-29 |         | arrent lea |           |            | +111 |            |          |           |             |
|  | + Cas    | h (A) —   |                          |         | + Lan      | d (A) –   |            |      |            | + Buildi | ngs (A) – | -           |
| 1/1/20                                 | 481      |           |                          | 1/1/20  | 13         |           |            |      | 1/1/20     | 1,811    |           |             |
| (a)                                    | 17       | 31        | (c)                      | (d)     | 20         |           |            |      | <i>(d)</i> | 40       |           |             |
| (b)                                    | 4        | 29        | <i>(d)</i>               |         |            |           |            |      |            |          |           |             |
| + Operati                              | ng Lease | ROU Asset | s (A) —                  | – Curre | ent Leas   | e Liabili | ties (L) + | _    | - Long-T   | erm Lea  | se Liabil | ities (L) + |
| 1/1/20                                 | 2,505    |           |                          |         |            | 173       | 1/1/20     |      |            |          | 2,678     | 1/1/20      |
| (d)                                    | 86       |           |                          |         |            | 6         | (d)        |      |            |          | 111       | (d)         |

(e) Chipotle sold \$19 in its short-term investments for \$19 cash—an investing activity.

|                             | Debit | Credit |
|-----------------------------|-------|--------|
| (e) Cash (+A)               | 19    |        |
| Short-term investments (-A) |       | 19     |

Assets = Liabilities + Stockholders' Equity

Cash +19

Short-term investments -19

|                      | + Cas |    |     | + Short- | + Short-Term Investments (A) — |    |     |  |  |  |
|----------------------|-------|----|-----|----------|--------------------------------|----|-----|--|--|--|
| 1/1/20<br>(a)<br>(b) | 481   |    | _   | 1/1/20   | 400                            |    |     |  |  |  |
| (a)                  | 17    | 31 | (c) |          |                                | 19 | (e) |  |  |  |
| (b)                  | 4     | 29 | (d) |          |                                |    |     |  |  |  |
| (e)                  | 19    |    |     |          |                                |    |     |  |  |  |

(f) Within the quarter, assume Chipotle paid \$1 on the note payable in (b) above (ignore any interest on the loan in this chapter)—a financing activity.

|                        | Debit | Credit |
|------------------------|-------|--------|
| (f) Notes payable (-L) | 1     |        |
| Cash (-A)              |       | 1      |

|      | Assets |        | =     |         | Liabilit  | ies        | +         |        | Stockhol | ders' Equity |  |
|------|--------|--------|-------|---------|-----------|------------|-----------|--------|----------|--------------|--|
| Cash |        | -      | -1    | Note    | s payable |            | -1        |        |          |              |  |
|      |        |        | + Cas | n (A) — |           |            | - Notes P | ayable | (L) +    |              |  |
|      |        | 1/1/20 | 481   |         |           |            |           | 77     | 1/1/20   | •            |  |
|      |        | (a)    | 17    | 31      | (c)       | <i>(f)</i> | 1         | 4      | (b)      |              |  |
|      |        | (b)    | 4     | 29      | (d)       |            |           | •      |          |              |  |
|      |        | (e)    | 19    | 1       | (f)       |            |           |        |          |              |  |

(g) Chipotle repurchased a portion of its issued common stock from investors for \$103 cash—a financing activity. When a company buys back its stock, it is accounted for in a new type of account called a contra-account. A contra-account reduces an account or section of a financial statement it is related to. In this case, the account is called Treasury Stock and it reduces total stockholders' equity. Treasury Stock accounting and reporting are discussed in more depth in Chapter 11.

|                          | Debit | Credit |
|--------------------------|-------|--------|
| (g) Treasury stock (-SE) | 103   |        |
| Cash (-A)                |       | 103    |

|      | Assets | s      | =     | = <u> </u> | Liab       | ilities | _ +       | Stockho       | olders' Equity |
|------|--------|--------|-------|------------|------------|---------|-----------|---------------|----------------|
| Cash |        | -:     | 103   |            |            |         |           | Treasury Stoc | ek −103        |
|      |        |        | + Cas | h (A) —    |            | + T     | reasury S | tock (SE) —   |                |
|      | ·      | 1/1/20 | 481   |            |            | 1/1/20  | 2,699     |               | •              |
|      |        | (a)    | 17    | 31         | (c)        | (g)     | 103       |               |                |
|      |        | (b)    | 4     | 29         | (d)        |         | ·         |               |                |
|      |        | (e)    | 19    | 1          | <i>(f)</i> |         |           |               |                |
|      |        |        |       | 103        | (g)        |         |           |               |                |

(h) 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 a total of \$2 in cash as dividends to shareholders next quarter. Dividends are a distribution of profits (from Retained Earnings) to shareholders. When cash dividends are declared, a liability is created until the cash is distributed to shareholders. Because Dividends Payable was not listed on the December 31, 2019, balance sheet (see Exhibit 2.1), it has a \$0 balance on January 1, 2020.

|                             | Debit | Credit |
|-----------------------------|-------|--------|
| (h) Retained earnings (-SE) | 2     |        |
| Dividends payable (+L)      |       | 2      |