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chapter **2**

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Investing and Financing Decisions and the Accounting System

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

How did Chipotle grow so fast? It did so in two stages. First, in 1999, McDonald's Corporation became the majority stockholder by investing about \$360 million in Chipotle. This provided funding for its tremendous early growth from 19 stores to nearly 490 restaurants by the end of 2005. Then, in January 2006, Chipotle “went public.” In its IPO or initial public offering, it issued stock to the public for the first time. That stock is listed on the New York Stock Exchange as CMG. McDonald's also sold its ownership in Chipotle for nearly \$1.4 billion—a handsome profit of over \$1 billion. Comparing its balance sheet from 2005 to 2011 highlights the company's amazing 264 percent growth since becoming a public company:

Learning Objectives

After studying this chapter, you should be able to:

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

2-2

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

- 2-3** Apply transaction analysis to simple business transactions in terms of the accounting model: $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$. p. 49
- 2-4** Determine the impact of business transactions on the balance sheet using two basic tools: Journal entries and T-accounts. p. 54
- 2-5** Prepare a trial balance and simple classified balance sheet, and analyze the company using the current ratio. p. 64
- 2-6** Identify investing and financing transactions and demonstrate how they impact cash flows. p. 68

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FOCUS COMPANY:

Chipotle Mexican Grill

EXPANDING ONE OF THE HOTTEST
CHAINS BUILT ON
SUSTAINABILITY

www.chipotle.com

(in millions of dollars)

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

This growth was stimulated in part by Ells's evolving vision that “fresh is not enough anymore.” He has committed Chipotle to serving naturally raised pork, chicken, and beef; using no-trans-fat cooking oil; serving cheese and sour cream products that are free of synthetic bovine growth hormones; using certified organic beans and locally grown organic produce when in season; and serving preservative-free corn and flour tortillas. In an even more dramatic show of commitment to sustainability, in 2009, Chipotle built the first-ever free-standing

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restaurant to receive the highest rating (LEED Platinum) from the U.S. Green Building Council,¹ a start toward other sustainable renovations and projects. In 2011, the company created the Chipotle Cultivate Foundation to expand philanthropic work surrounding sustainable agriculture. Page 42

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

UNDERSTANDING THE BUSINESS

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

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

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

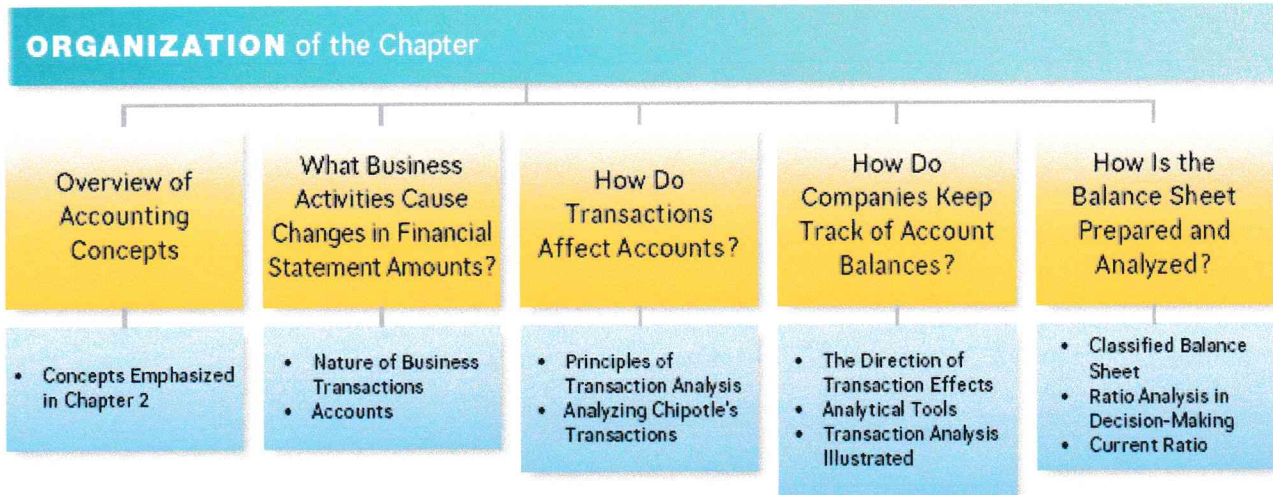
- What business activities cause changes in the balance sheet amounts from one period to the next?
- How do specific business activities affect each of the balance sheet amounts?
- How do companies keep track of the balance sheet amounts?

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

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OVERVIEW OF ACCOUNTING CONCEPTS

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

Concepts Emphasized in Chapter 2

LEARNING OBJECTIVE 2-1

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

Objective of Financial Reporting

PRIMARY OBJECTIVE OF FINANCIAL REPORTING TO EXTERNAL USERS is to provide financial information about the

reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.

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

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

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EXHIBIT 2.1

Financial Accounting and Reporting Conceptual Framework

Objective of Financial Reporting to External Users: (in Ch. 2)

To provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity

> **Pervasive Cost-Benefit Constraint:** Benefits of providing information should outweigh its costs.

Fundamental Qualitative Characteristics of Useful Information: (in Ch. 2)

Relevance (including materiality) and Faithful Representation

Attributes that Enhance Qualitative Characteristics:

Comparability (including consistency), Verifiability, Timeliness, and Understandability

Elements to Be Measured and Reported:

Assets, Liabilities, Stockholders' Equity, Investments by Owners, and Distributions to Owners (in Ch. 2)

Revenues, Expenses, Gains, and Losses (in Ch. 3)

Comprehensive Income (in Ch. 5)

Recognition, Measurement, and Disclosure Concepts:

Assumptions: Separate Entity, Continuity (Going Concern), and Stable Monetary Unit (in Ch. 2)
Time Period (in Ch. 3)

Principles: Mixed-Attribute Measurement (in Ch. 2)
Revenue Realization and Expense Matching (in Ch. 3)
Full Disclosure (in Ch. 5)

Qualitative Characteristics of Useful Information

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

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

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

Recognition and Measurement Concepts

SEPARATE-ENTITY

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

CONTINUITY (GOING-

CONCERN) ASSUMPTION states that businesses are assumed to continue into the foreseeable future.

STABLE MONETARY UNIT

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

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

MIXED-ATTRIBUTE

MEASUREMENT MODEL is applied to measuring different assets and liabilities.

Finally, accountants measure the elements of the balance sheet using what is called a **mixed-attribute measurement model**. Most balance sheet elements are recorded at their

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

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Elements of the Balance Sheet

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

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

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



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

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

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

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

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

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

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

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

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



PAUSE FOR FEEDBACK



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

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HOW IS THE BALANCE SHEET PREPARED AND ANALYZED?

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LEARNING OBJECTIVE 2-5

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

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

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

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

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

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

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

EXHIBIT 2.8

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

Classified Balance Sheet

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

- The assets and liabilities are **classified** into two categories: **current** and **noncurrent**. Current assets are those to be used or turned into cash within the upcoming year, whereas noncurrent assets are those that will last longer than one year. Current liabilities are those obligations to be paid or settled within the next 12 months with current assets.
- Dollar signs are indicated at the top and bottom of the asset section and top and bottom of the liabilities and shareholders' equity section. More than that tends to look messy.

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INTERNATIONAL PERSPECTIVE



Understanding Foreign Financial Statements

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

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

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

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

Ratio Analysis in Decision-Making

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

KEY RATIO ANALYSIS



Current Ratio

? ANALYTICAL QUESTION

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

% RATIO AND COMPARISONS

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

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

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