

*Horngren's*  
**ACCOUNTING**

**THE FINANCIAL CHAPTERS**

ELEVENTH EDITION

MILLER-NOBLES • MATTISON • MATSUMURA



HORNGREN'S  
**Accounting**  
THE FINANCIAL CHAPTERS

ELEVENTH EDITION

**Tracie Miller-Nobles**

*Austin Community College*

**Brenda Mattison**

*Tri-County Technical College*

**Ella Mae Matsumura**

*University of Wisconsin-Madison*

**PEARSON**

Boston Columbus Indianapolis New York San Francisco Hoboken  
Amsterdam Cape Town Dubai London Madrid Milan Munich Paris Montréal Toronto  
Delhi Mexico City São Paulo Sydney Hong Kong Seoul Singapore Taipei Tokyo

*Vice President, Business Publishing:* Donna Battista  
*Senior Acquisitions Editor:* Lacey Vitetta  
*Editorial Assistant:* Christine Donovan  
*Vice President, Product Marketing:* Maggie Moylan  
*Director of Marketing, Digital Services and Products:* Jeanette Koskinas  
*Senior Product Marketing Manager:* Alison Haskins  
*Executive Field Marketing Manager:* Lori DeShazo  
*Senior Strategic Marketing Manager:* Erin Gardner  
*Team Lead, Program Management:* Ashley Santora  
*Program Manager:* Mary Kate Murray  
*Team Lead, Project Management:* Jeff Holcomb  
*Project Manager:* Roberta Sherman  
*Supplements Project Manager:* Andra Skaalrud  
*Operations Specialist:* Carol Melville  
*Creative Director:* Blair Brown  
*Art Director:* Jon Boylan

*Vice President, Director of Digital Strategy and Assessment:* Paul Gentile  
*Manager of Learning Applications:* Paul Deluca  
*Digital Editor:* Sarah Peterson  
*Director, Digital Studio:* Sacha Laustsen  
*Digital Studio Manager:* Diane Lombardo  
*Product Manager:* James Bateman  
*Digital Content Team Lead:* Noel Lotz  
*Digital Content Project Lead:* Martha LaChance  
*Full-Service Project Management and Composition:*  
Integra Software Services Pvt. Ltd.  
*Interior Designer:* Jon Boylan  
*Cover Designer:* Jon Boylan  
*Cover Art:* Determined/Fotolia  
*Printer/Binder:* R. R. Donnelley  
*Cover Printer:* Lehigh Phoenix Color/Hagerstown  
*Typeface:* 11/13, Adobe Garamond Pro Regular

Microsoft and/or its respective suppliers make no representations about the suitability of the information contained in the documents and related graphics published as part of the services for any purpose. All such documents and related graphics are provided "as is" without warranty of any kind. Microsoft and/or its respective suppliers hereby disclaim all warranties and conditions with regard to this information, including all warranties and conditions of merchantability, whether express, implied or statutory, fitness for a particular purpose, title and non-infringement. In no event shall Microsoft and/or its respective suppliers be liable for any special, indirect or consequential damages or any damages whatsoever resulting from loss of use, data or profits, whether in an action of contract, negligence or other tortious action, arising out of or in connection with the use or performance of information available from the services.

The documents and related graphics contained herein could include technical inaccuracies or typographical errors. Changes are periodically added to the information herein. Microsoft and/or its respective suppliers may make improvements and/or changes in the product(s) and/or the program(s) described herein at any time. Partial screen shots may be viewed in full within the software version specified.

Microsoft® and Windows® are registered trademarks of the Microsoft Corporation in the U.S.A. and other countries. This book is not sponsored or endorsed by or affiliated with the Microsoft Corporation.

---

**Copyright © 2016, 2014, 2012, Pearson Education, Inc. or its affiliates.** All Rights Reserved. Manufactured in the United States of America. This publication is protected by copyright, and permission should be obtained from the publisher prior to any prohibited reproduction, storage in a retrieval system, or transmission in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise. For information regarding permissions, request forms, and the appropriate contacts within the Pearson Education Global Rights and Permissions department, please visit [www.pearsoned.com/permissions/](http://www.pearsoned.com/permissions/).

Acknowledgments of third-party content appear on the appropriate page within the text or on pages P-1 and P-2, which constitutes an extension of this copyright page.

PEARSON, ALWAYS LEARNING and MYACCOUNTINGLAB® are exclusive trademarks owned by Pearson Education, Inc. or its affiliates in the U.S. and/or other countries, Inc. or its affiliates.

Unless otherwise indicated herein, any third-party trademarks that may appear in this work are the property of their respective owners, and any references to third-party trademarks, logos, or other trade dress are for demonstrative or descriptive purposes only. Such references are not intended to imply any sponsorship, endorsement, authorization, or promotion of Pearson's products by the owners of such marks, or any relationship between the owner and Pearson Education, Inc. or its affiliates, authors, licensees, or distributors.

**Library of Congress Cataloging-in-Publication is on file with the Library of Congress**

10 9 8 7 6 5 4 3 2 1

**PEARSON**

ISBN-13: 978-0-13-386688-9  
ISBN-10: 0-13-386688-2

# About the Authors



**Tracie L. Miller-Nobles, CPA**, received her bachelor's and master's degrees in accounting from Texas A&M University and is currently pursuing her Ph.D. in adult learning also at Texas A&M University. She is an Associate Professor at Austin Community College, Austin, TX. Previously she served as a Senior Lecturer at Texas State University, San Marcos, TX, and has served as department chair of the Accounting, Business, Computer Information Systems, and Marketing/Management department at Aims Community College, Greeley, CO. In addition, Tracie has taught as an adjunct professor at University of Texas and has public accounting experience with Deloitte Tax LLP and Sample & Bailey, CPAs.

Tracie is a recipient of the Texas Society of CPAs Rising Star Award, TSCPAs Outstanding Accounting Educator Award, NISOD Teaching Excellence Award and the Aims Community College Excellence in Teaching Award. She is a member of the Teachers of Accounting at Two Year Colleges, the American Accounting Association, the American Institute of Certified Public Accountants, and the Texas State Society of Certified Public Accountants. She is currently serving on the Board of Directors as secretary/webmaster of Teachers of Accounting at Two Year Colleges, as a member of the American Institute of

Certified Public Accountants nominations committee, and as chair of the Texas Society of CPAs Relations with Education Institutions committee. In addition, Tracie served on the Commission on Accounting Higher Education: Pathways to a Profession.

Tracie has spoken on such topics as using technology in the classroom, motivating non-business majors to learn accounting, and incorporating active learning in the classroom at numerous conferences. In her spare time she enjoys spending time with her friends and family and camping, kayaking, and quilting.

**Brenda L. Mattison** has a bachelor's degree in education and a master's degree in accounting, both from Clemson University. She is currently an Accounting Instructor at Tri-County Technical College in Pendleton, South Carolina. Brenda previously served as Accounting Program Coordinator at TCTC and has prior experience teaching accounting at Robeson Community College, Lumberton, North Carolina; University of South Carolina Upstate, Spartanburg, South Carolina; and Rasmussen Business College, Eagan, Minnesota. She also has accounting work experience in retail and manufacturing businesses.

Brenda is a member of Teachers of Accounting at Two Year Colleges and the American Accounting Association. She is currently serving on the board of directors as Vice President of Conference Administration of Teachers of Accounting at Two Year Colleges.

Brenda previously served as Faculty Fellow at Tri-County Technical College. She has presented at several conferences on topics including active learning, course development, and student engagement.

In her spare time, Brenda enjoys reading and spending time with her family. She is also an active volunteer in the community, serving her church and other organizations.



**Ella Mae Matsumura, Ph.D.** is a professor in the Department of Accounting and Information Systems in the School of Business at the University of Wisconsin–Madison, and is affiliated with the university's Center for Quick Response Manufacturing. She received an A.B. in mathematics from the University of California, Berkeley, and M.Sc. and Ph.D. degrees from the University of British Columbia. Ella Mae has won two teaching excellence awards at the University of Wisconsin–Madison and was elected as a lifetime fellow of the university's Teaching Academy, formed to promote effective teaching. She is a member of the university team awarded an IBM Total Quality Management Partnership grant to develop curriculum for total quality management education.

Ella Mae was a co-winner of the 2010 Notable Contributions to Management Accounting Literature Award. She has served in numerous leadership positions in the American Accounting Association (AAA). She was coeditor of *Accounting Horizons* and has chaired and served on numerous AAA committees. She has been secretary-treasurer and president of the

AAA's Management Accounting Section. Her past and current research articles focus on decision making, performance evaluation, compensation, supply chain relationships, and sustainability. She coauthored a monograph on customer profitability analysis in credit unions.

# Brief Contents

---

CHAPTER 1	Accounting and the Business Environment	1
CHAPTER 2	Recording Business Transactions	53
CHAPTER 3	The Adjusting Process	115
CHAPTER 4	Completing the Accounting Cycle	181
CHAPTER 5	Merchandising Operations	244
CHAPTER 6	Merchandise Inventory	322
CHAPTER 7	Accounting Information Systems	372
CHAPTER 8	Internal Control and Cash	430
CHAPTER 9	Receivables	479
CHAPTER 10	Plant Assets, Natural Resources, and Intangibles	530
CHAPTER 11	Current Liabilities and Payroll	579
CHAPTER 12	Partnerships	620
CHAPTER 13	Corporations	673
CHAPTER 14	Long-Term Liabilities	728
CHAPTER 15	Investments	777
CHAPTER 16	The Statement of Cash Flows	809
CHAPTER 17	Financial Statement Analysis	874

---

<b>APPENDIX A</b> —2013 Green Mountain Coffee Roasters, Inc. Annual Report	A-1
<b>APPENDIX B</b> —Present Value Tables	B-1
<b>GLOSSARY</b>	G-1
<b>INDEX</b>	I-1
<b>PHOTO CREDITS</b>	P-1

# Contents

## CHAPTER 1

### Accounting and the Business Environment 1

#### Why Is Accounting Important? 2

- Decision Makers: The Users of Accounting Information 3
- The Accounting Profession 4

#### What Are the Organizations and Rules That Govern Accounting? 6

- Governing Organizations 6
- Generally Accepted Accounting Principles 6
- The Economic Entity Assumption 6
- The Cost Principle 7
- The Going Concern Assumption 7
- The Monetary Unit Assumption 7
- International Financial Reporting Standards 8
- Ethics in Accounting and Business 8

#### What Is the Accounting Equation? 9

- Assets 10
- Liabilities 10
- Equity 10

#### How Do You Analyze a Transaction? 11

- Transaction Analysis for Smart Touch Learning 11

#### How Do You Prepare Financial Statements? 17

- Income Statement 17
- Statement of Owner's Equity 18
- Balance Sheet 19
- Statement of Cash Flows 20

#### How Do You Use Financial Statements to Evaluate Business Performance? 22

- Green Mountain Coffee Roasters, Inc. 22
- Return on Assets (ROA) 22

■ Review 24

■ Assess Your Progress 29

■ Critical Thinking 51

## CHAPTER 2

### Recording Business Transactions 53

#### What Is an Account? 54

- Assets 54
- Liabilities 54
- Equity 56
- Chart of Accounts 56
- Ledger 57

#### What Is Double-Entry Accounting? 58

- The T-Account 58
- Increases and Decreases in the Accounts 58
- Expanding the Rules of Debit and Credit 59
- The Normal Balance of an Account 59
- Determining the Balance of a T-Account 60

#### How Do You Record Transactions? 61

- Source Documents—The Origin of the Transactions 61
- Journalizing and Posting Transactions 62
- The Ledger Accounts After Posting 73
- The Four-Column Account: An Alternative to the T-Account 75

#### What Is the Trial Balance? 77

- Preparing Financial Statements from the Trial Balance 77
- Correcting Trial Balance Errors 78

#### How Do You Use the Debt Ratio to Evaluate Business Performance? 79

■ Review 81

■ Assess Your Progress 88

■ Critical Thinking 113

## CHAPTER 3

### The Adjusting Process 115

#### What Is the Difference Between Cash Basis Accounting and Accrual Basis Accounting? 116

#### What Concepts and Principles Apply to Accrual Basis Accounting? 118

- The Time Period Concept 118
- The Revenue Recognition Principle 118
- The Matching Principle 119

#### What Are Adjusting Entries, and How Do We Record Them? 120

- Deferred Expenses 121
- Deferred Revenues 127
- Accrued Expenses 128
- Accrued Revenues 131

#### What Is the Purpose of the Adjusted Trial Balance, and How Do We Prepare It? 136

#### What Is the Impact of Adjusting Entries on the Financial Statements? 138

#### How Could a Worksheet Help in Preparing Adjusting Entries and the Adjusted Trial Balance? 139

#### APPENDIX 3A: Alternative Treatment of Recording Deferred Expenses and Deferred Revenues 141

#### What Is an Alternative Treatment of Recording Deferred Expenses and Deferred Revenues? 141

- Deferred Expenses 141
- Deferred Revenues 143

■ Review 144

■ Assess Your Progress 152

■ Critical Thinking 178

## CHAPTER 4

### Completing the Accounting Cycle 181

#### How Do We Prepare Financial Statements? 182

- Relationships Among the Financial Statements 183

#### How Could a Worksheet Help in Preparing Financial Statements? 187

- Section 5—Income Statement 187
- Section 6—Balance Sheet 187
- Section 7—Determine Net Income or Net Loss 187

#### What Is the Closing Process, and How Do We Close the Accounts? 189

- Closing Temporary Accounts—Net Income for the Period 191
- Closing Temporary Accounts—Net Loss for the Period 193

**How Do We Prepare a Post-Closing Trial Balance?** 195

**What Is the Accounting Cycle?** 197

**How Do We Use the Current Ratio to Evaluate Business Performance?** 198

**APPENDIX 4A: Reversing Entries: An Optional Step** 200

**What Are Reversing Entries?** 200

Accounting for Accrued Expenses 200

Accounting Without a Reversing Entry 201

Accounting With a Reversing Entry 202

■ **Review** 204

■ **Assess Your Progress** 212

■ **Comprehensive Problem 1 for Chapters 1–4** 239

■ **Comprehensive Problem 2 for Chapters 1–4** 240

■ **Critical Thinking** 241

## CHAPTER 5

### Merchandising Operations 244

**What Are Merchandising Operations?** 245

The Operating Cycle of a Merchandising Business 245

Merchandise Inventory Systems: Perpetual and Periodic Inventory Systems 247

**How Are Purchases of Merchandise Inventory Recorded in a Perpetual Inventory System?** 248

Purchase of Merchandise Inventory 249

Purchase Discounts 250

Purchase Returns and Allowances 251

Transportation Costs 252

Cost of Inventory Purchased 254

**How Are Sales of Merchandise Inventory Recorded in a Perpetual Inventory System?** 255

Sale of Merchandise Inventory 255

Sales Discounts 257

Sales Returns and Allowances 257

Transportation Costs—Freight Out 259

Net Sales Revenue and Gross Profit 259

**What Are the Adjusting and Closing Entries for a Merchandiser?** 260

Adjusting Merchandise Inventory Based on a Physical Count 260

Closing the Accounts of a Merchandiser 261

Worksheet for a Merchandising Business—Perpetual Inventory System 263

**How Are a Merchandiser's Financial Statements Prepared?** 264

Income Statement 264

Statement of Owner's Equity and the Balance Sheet 267

**How Do We Use the Gross Profit Percentage to Evaluate Business Performance?** 267

**APPENDIX 5A: Accounting for Merchandise Inventory in a Periodic Inventory System** 269

**How Are Merchandise Inventory Transactions Recorded in a Periodic Inventory System?** 269

Purchases of Merchandise Inventory 269

Sale of Merchandise Inventory 271

Adjusting and Closing Entries 271

Preparing Financial Statements 274

■ **Review** 279

■ **Assess Your Progress** 290

■ **Comprehensive Problem for Chapters 1–5** 318

■ **Critical Thinking** 319

## CHAPTER 6

### Merchandise Inventory 322

**What Are the Accounting Principles and Controls That Relate to Merchandise Inventory?** 323

Accounting Principles 323

Control Over Merchandise Inventory 324

**How Are Merchandise Inventory Costs Determined Under a Perpetual Inventory System?** 325

Specific Identification Method 327

First-In, First-Out (FIFO) Method 328

Last-In, First-Out (LIFO) Method 329

Weighted-Average Method 331

**How Are Financial Statements Affected by Using Different Inventory Costing Methods?** 334

Income Statement 334

Balance Sheet 335

**How Is Merchandise Inventory Valued When Using the Lower-of-Cost-or-Market Rule?** 337

Computing the Lower-of-Cost-or-Market 337

Recording the Adjusting Journal Entry to Adjust Merchandise Inventory 337

**What Are the Effects of Merchandise Inventory Errors on the Financial Statements?** 339

**How Do We Use Inventory Turnover and Days' Sales in Inventory to Evaluate Business Performance?** 341

Inventory Turnover 342

Days' Sales in Inventory 342

**APPENDIX 6A: Merchandise Inventory Costs Under a Periodic Inventory System** 343

**How Are Merchandise Inventory Costs Determined Under a Periodic Inventory System?** 343

First-In, First-Out (FIFO) Method 344

Last-In, First-Out (LIFO) Method 345

Weighted-Average Method 345

■ **Review** 346

■ **Assess Your Progress** 353

■ **Critical Thinking** 370

## CHAPTER 7

### Accounting Information Systems 372

**What Is an Accounting Information System?** 373

Effective Accounting Information Systems 373

Components of an Accounting Information System 374

**How Are Sales and Cash Receipts Recorded In a Manual Accounting Information System?** 376

Special Journals 376

Subsidiary Ledgers 377

The Sales Journal 378

The Cash Receipts Journal 381

**How Are Purchases, Cash Payments, And Other Transactions Recorded In a Manual Accounting Information System?** 385

- The Purchases Journal 385
- The Cash Payments Journal 387
- The General Journal 390

**How Are Transactions Recorded In a Computerized Accounting Information System?** 392

- Entry-Level Software 392
- Enterprise Resource Planning (ERP) Systems 392
- QuickBooks 393

■ **Review** 397

■ **Assess Your Progress** 402

■ **Comprehensive Problems for Chapter 7** 425

■ **Critical Thinking** 427

## CHAPTER 8

### Internal Control and Cash 430

**What Is Internal Control, and How Can It Be Used to Protect a Company's Assets?** 431

- Internal Control and the Sarbanes-Oxley Act 431
- The Components of Internal Control 432
- Internal Control Procedures 433
- The Limitations of Internal Control—Costs and Benefits 435

**What Are the Internal Control Procedures With Respect to Cash Receipts?** 436

- Cash Receipts Over the Counter 436
- Cash Receipts by Mail 437

**What Are the Internal Control Procedures With Respect to Cash Payments?** 438

- Controls Over Payment by Check 438

**How Can a Petty Cash Fund Be Used for Internal Control Purposes?** 440

- Setting Up the Petty Cash Fund 441
- Replenishing the Petty Cash Fund 441
- Changing the Amount of the Petty Cash Fund 443

**How Can the Bank Account Be Used as a Control Device?** 443

- Signature Card 444
- Deposit Ticket 444
- Check 444
- Bank Statement 445
- Electronic Funds Transfers 445
- Bank Reconciliation 446
- Examining a Bank Reconciliation 449
- Journalizing Transactions from the Bank Reconciliation 450

**How Can the Cash Ratio Be Used to Evaluate Business Performance?** 451

■ **Review** 452

■ **Assess Your Progress** 460

■ **Critical Thinking** 477

## CHAPTER 9

### Receivables 479

**What Are Common Types of Receivables, and How Are Credit Sales Recorded?** 480

- Types of Receivables 480

- Exercising Internal Control Over Receivables 481
- Recording Sales on Credit 481
- Recording Credit Card and Debit Card Sales 482
- Factoring and Pledging Receivables 484

**How Are Uncollectibles Accounted for When Using the Direct Write-Off Method?** 485

- Recording and Writing Off Uncollectible Accounts—Direct Write-Off Method 485
- Recovery of Accounts Previously Written Off—Direct Write-Off Method 485
- Limitations of the Direct Write-Off Method 486

**How Are Uncollectibles Accounted for When Using the Allowance Method?** 487

- Recording Bad Debts Expense—Allowance Method 487
- Writing Off Uncollectible Accounts—Allowance Method 488
- Recovery of Accounts Previously Written Off—Allowance Method 489
- Estimating and Recording Bad Debts Expense—Allowance Method 489
- Comparison of Accounting for Uncollectibles 494

**How Are Notes Receivable Accounted For?** 496

- Identifying Maturity Date 497
- Computing Interest on a Note 498
- Accruing Interest Revenue and Recording Honored Notes Receivable 498
- Recording Dishonored Notes Receivable 500

**How Do We Use the Acid-Test Ratio, Accounts Receivable Turnover Ratio, and Days' Sales in Receivables to Evaluate Business Performance?** 501

- Acid-Test (or Quick) Ratio 502
- Accounts Receivable Turnover Ratio 502
- Days' Sales in Receivables 503

■ **Review** 504

■ **Assess Your Progress** 510

■ **Critical Thinking** 528

## CHAPTER 10

### Plant Assets, Natural Resources, and Intangibles 530

**How Does a Business Measure the Cost of a Plant Asset?** 531

- Land and Land Improvements 532
- Buildings 533
- Machinery and Equipment 533
- Furniture and Fixtures 533
- Lump-Sum Purchases 534
- Capital and Revenue Expenditures 535

**What Is Depreciation, and How Is It Computed?** 536

- Factors in Computing Depreciation 537
- Depreciation Methods 537
- Partial-Year Depreciation 543
- Changing Estimates of Depreciable Asset 544
- Reporting Plant Assets 545

**How Are Disposals of Plant Assets Recorded?** 546

- Discarding Plant Assets 546
- Selling Plant Assets 548

**How Are Natural Resources Accounted For?** 552

**How Are Intangible Assets Accounted For?** 553

- Accounting for Intangibles 553
- Specific Intangibles 553
- Reporting of Intangible Assets 556



**How Do We Use the Asset Turnover Ratio to Evaluate Business Performance?** 557

**APPENDIX 10A: Exchanging Plant Assets** 558

**How Are Exchanges of Plant Assets Accounted For?** 558

Exchange of Plant Assets—Gain Situation 558

Exchange of Plant Assets—Loss Situation 559

■ Review 560

■ Assess Your Progress 565

■ Critical Thinking 577

## CHAPTER 11

### Current Liabilities and Payroll 579

**How Are Current Liabilities of Known Amounts Accounted For?** 580

Accounts Payable 580

Sales Tax Payable 581

Unearned Revenues 581

Short-Term Notes Payable 582

Current Portion of Long-Term Notes Payable 583

**How Do Companies Account for and Record Payroll?** 584

Gross Pay and Net (Take-Home) Pay 585

Employee Payroll Withholding Deductions 585

Payroll Register 588

Journalizing Employee Payroll 589

Employer Payroll Taxes 589

Internal Control Over Payroll 591

**How Are Current Liabilities That Must Be Estimated Accounted For?** 592

Bonus Plans 592

Vacation, Health, and Pension Benefits 593

Warranties 593

**How Are Contingent Liabilities Accounted For?** 595

Remote Contingent Liability 595

Reasonably Possible Contingent Liability 595

Probable Contingent Liability 595

**How Do We Use the Times-Interest-Earned Ratio to Evaluate Business Performance?** 597

■ Review 598

■ Assess Your Progress 604

■ Critical Thinking 618

## CHAPTER 12

### Partnerships 620

**What are the Characteristics and Types of Partnerships?** 621

Partnership Characteristics 621

Types of Partnerships 623

Other Forms of Business 624

**How are Partnerships Organized?** 625

The Start-up of a Partnership 626

Partnership Financial Statements 626

**How are Partnerships Profits and Losses Allocated?** 627

Allocation Based on a Stated Ratio 628

Allocation Based on Capital Balances 629

Allocation Based on Services, Capital Balances, and Stated Ratios 629

Partner Withdrawal of Cash and Other Assets 632

Statement of Partners' Equity 633

**How Is the Admission of a Partner Accounted For?** 634

Admission by Purchasing an Existing Partner's Interest 634

Admission by Contributing to the Partnership 635

**How Is the Withdrawal of a Partner Accounted For?** 638

**How Is the Liquidation of a Partnership Accounted For?** 640

Sale of Assets at a Gain 640

Sale of Assets at a Loss with Capital Deficiency 643

■ Review 646

■ Assess Your Progress 653

■ Critical Thinking 670

## CHAPTER 13

### Corporations 673

**What Is a Corporation?** 674

Characteristics of Corporations 674

Stockholders' Equity Basics 675

**How Is the Issuance of Stock Accounted For?** 678

Issuing Common Stock at Par Value 678

Issuing Common Stock at a Premium 678

Issuing No-Par Common Stock 679

Issuing Stated Value Common Stock 680

Issuing Common Stock for Assets Other Than Cash 681

Issuing Preferred Stock 682

**How Is Treasury Stock Accounted For?** 683

Treasury Stock Basics 683

Purchase of Treasury Stock 683

Sale of Treasury Stock 683

Retirement of Stock 686

**How Are Dividends and Stock Splits Accounted For?** 687

Cash Dividends 687

Stock Dividends 690

Stock Splits 694

Cash Dividends, Stock Dividends, and Stock Splits Compared 694

**How Are Net Income and Equity Reported for a Corporation?** 695

Income Statement 695

Statement of Retained Earnings 696

Statement of Stockholders' Equity 698

**How Do We Use Stockholders' Equity Ratios to Evaluate Business Performance?** 699

Earnings per Share 699

Price/Earnings Ratio 700

Rate of Return on Common Stock 700

■ Review 701

■ Assess Your Progress 709

■ Critical Thinking 726

## CHAPTER 14

### Long-Term Liabilities 728

**How Are Long-Term Notes Payable and Mortgages Payable Accounted For?** 729

Long-Term Notes Payable 729

Mortgages Payable 730

## What Are Bonds? 732

- Types of Bonds 734
- Bond Prices 734
- Present Value 735
- Bond Interest Rates 735
- Issuing Bonds Versus Issuing Stock 736

## How Are Bonds Payable Accounted for Using the Straight-Line Amortization Method? 737

- Issuing Bonds Payable at Face Value 738
- Issuing Bonds Payable at a Discount 738
- Issuing Bonds Payable at a Premium 741

## How Is the Retirement of Bonds Payable Accounted For? 743

- Retirement of Bonds at Maturity 743
- Retirement of Bonds Before Maturity 744

## How Are Liabilities Reported on the Balance Sheet? 746

## How Do We Use the Debt to Equity Ratio to Evaluate Business Performance? 747

## APPENDIX 14A: The Time Value of Money 748

## What Is the Time Value of Money, and How Is the Present Value of a Future Amount Calculated? 748

- Time Value of Money Concepts 749
- Present Value of a Lump Sum 751
- Present Value of an Annuity 751
- Present Value of Bonds Payable 752

## APPENDIX 14B: Effective-Interest Method of Amortization 754

## How Are Bonds Payable Accounted for Using the Effective-Interest Amortization Method? 754

- Effective-Interest Amortization for a Bond Discount 754
- Effective-Interest Amortization of a Bond Premium 755

■ Review 757

■ Assess Your Progress 762

■ Critical Thinking 775

## CHAPTER 15

### Investments 777

## Why Do Companies Invest? 778

- Debt Securities Versus Equity Securities 778
- Reasons to Invest 778
- Classification and Reporting of Investments 779

## How Are Investments in Debt Securities Accounted For? 781

- Purchase of Debt Securities 781
- Interest Revenue 781
- Disposition at Maturity 781

## How Are Investments in Equity Securities Accounted For? 782

- Equity Securities with Less Than 20% Ownership (Cost Method) 782
- Equity Securities with 20% to 50% Ownership (Equity Method) 783
- Equity Securities with More Than 50% Ownership (Consolidations) 786

## How Are Debt and Equity Securities Reported? 786

- Trading Investments 786
- Available-for-Sale Investments 788
- Held-to-Maturity Investments 790

## How Do We Use the Rate of Return on Total Assets to Evaluate Business Performance? 791

■ Review 792

■ Assess Your Progress 798

■ Critical Thinking 806

## CHAPTER 16

### The Statement of Cash Flows 809

## What Is the Statement of Cash Flows? 810

- Purpose of the Statement of Cash Flows 810
- Classification of Cash Flows 811
- Two Formats for Operating Activities 813

## How Is the Statement of Cash Flows Prepared Using the Indirect Method? 813

- Cash Flows from Operating Activities 816
- Cash Flows from Investing Activities 820
- Cash Flows from Financing Activities 822
- Net Change in Cash and Cash Balances 825
- Non-cash Investing and Financing Activities 826

## How Do We Use Free Cash Flow to Evaluate Business Performance? 828

## APPENDIX 16A: Preparing the Statement of Cash Flows by the Direct Method 829

## How Is the Statement of Cash Flows Prepared Using the Direct Method? 829

- Cash Flows from Operating Activities 829

## APPENDIX 16B: Preparing the Indirect Statement of Cash Flows Using a Spreadsheet 835

## How Is the Statement of Cash Flows Prepared Using the Indirect Method and a Spreadsheet? 835

■ Review 839

■ Assess Your Progress 845

■ Critical Thinking 872

## CHAPTER 17

### Financial Statement Analysis 874

## How Are Financial Statements Used to Analyze a Business? 875

- Purpose of Analysis 875
- Tools of Analysis 875
- Corporate Financial Reports 875

## How Do We Use Horizontal Analysis to Analyze a Business? 877

- Horizontal Analysis of the Income Statement 878
- Horizontal Analysis of the Balance Sheet 879
- Trend Analysis 880

## How Do We Use Vertical Analysis to Analyze a Business? 881

- Vertical Analysis of the Income Statement 882
- Vertical Analysis of the Balance Sheet 882
- Common-Size Statements 884
- Benchmarking 885

## How Do We Use Ratios to Analyze a Business? 886

- Evaluating the Ability to Pay Current Liabilities 887
- Evaluating the Ability to Sell Merchandise Inventory and Collect Receivables 889
- Evaluating the Ability to Pay Long-Term Debt 892
- Evaluating Profitability 894

Evaluating Stock as an Investment 897  
Red Flags in Financial Statement Analyses 899

**APPENDIX 17A: *The Corporate Income Statement*** 902

**How Is the Complete Corporate Income Statement Prepared?** 902

Continuing Operations 903  
Discontinued Operations 904  
Extraordinary Items 904  
Earnings per Share 905

■ **Review** 905

■ **Assess Your Progress** 913

■ **Comprehensive Problem for Chapter 17** 934

■ **Critical Thinking** 935

---

**APPENDIX A—**2013 Green Mountain Coffee Roasters, Inc. Annual Report A-1

**APPENDIX B—**Present Value Tables B-1

**GLOSSARY** G-1

**INDEX** I-1

**PHOTO CREDITS** P-1

# Changes to This Edition

---

## General

Revised end-of-chapter short exercises, exercises, problems, continuing problems, comprehensive problems, and critical thinking cases.  
**NEW!** Added three comprehensive problems in managerial chapters.

## Chapter 1

**NEW!** Added discussion of the Pathways Commission and incorporated the Pathways' Vision Model.  
Clarified and simplified the financial statement presentation.

## Chapter 3

**NEW!** Added discussion of the new revenue recognition principle.  
Replaced the word *prepaids* with *deferrals* to better align with the presentation of the other types of adjusting entries.

## Chapter 4

Increased the usage of the classified balance sheet as a requirement for end-of-chapter problems.

## Chapter 10

Expanded the discussion on partial-year depreciation.

## Chapter 11

Updated the payroll section for consistency with current payroll laws at the time of printing.

## Chapter 13

Moved coverage of treasury stock before dividends to increase students' understanding of dividend transactions.  
**NEW!** Added section on income tax expense and updated income statement presentation.

# Horngren's Accounting...

## Expanding on Proven Success

### New to the Enhanced eText

The Enhanced eText keeps students engaged in learning on their own time, while helping them achieve greater conceptual understanding of course material. The worked examples bring learning to life, and algorithmic practice allows students to apply the very concepts they are reading about. Combining resources that illuminate content with accessible self-assessment, MyAccountingLab with Enhanced eText provides students with a complete digital learning experience—all in one place.

**NEW!**

### Try It! Solution Videos—

Author recorded solution videos accompany Try Its! Just click on the Try It! box and watch the author will walk students through the problem and the solution.

Startech Surveillance Services had the following adjustments as of the end of the year:

- Equipment depreciation was \$1,500. **D**
- \$700 of advertising expense was incurred but not paid. (Use Advertising Payable.) **A**
- Office Supplies on hand at the end of the year totaled \$250. The beginning balance of Office Supplies was \$600. **D**
- \$1,200 of rent revenue was earned but not recorded or received. **A**
- Unearned revenue of \$3,000 had been earned. **D**

6. For each situation, indicate which category of adjustment (deferral or accrual) is described.  
7. Journalize the adjusting entry needed.

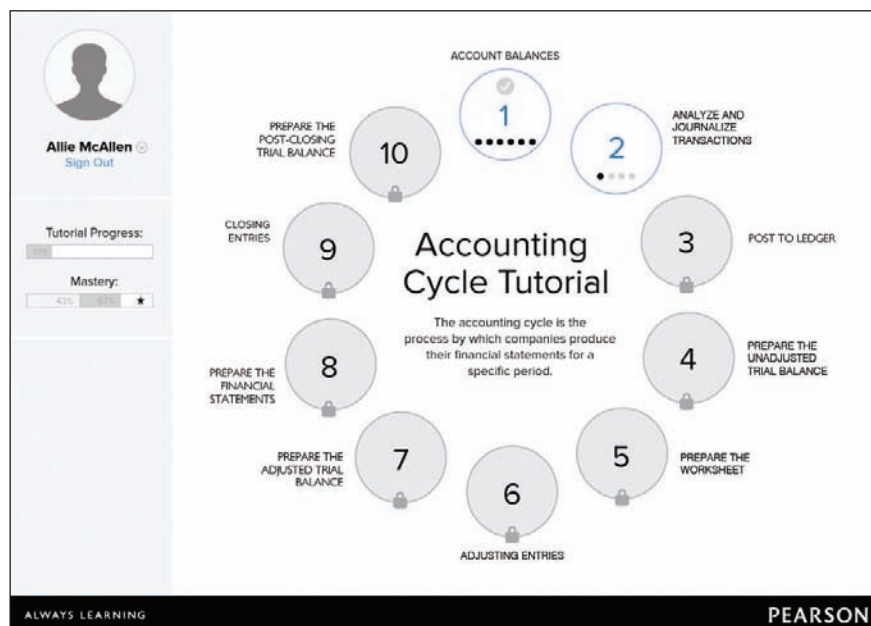
*Deferral: Cash occurs before revenue or expense*  
*Accrual: Cash occurs after revenue or expense*

a. Dep. Exp.	1500	b. Adv. Exp.	700
Acc. Dep.	1500	Adv. Pay.	700

**NEW!**

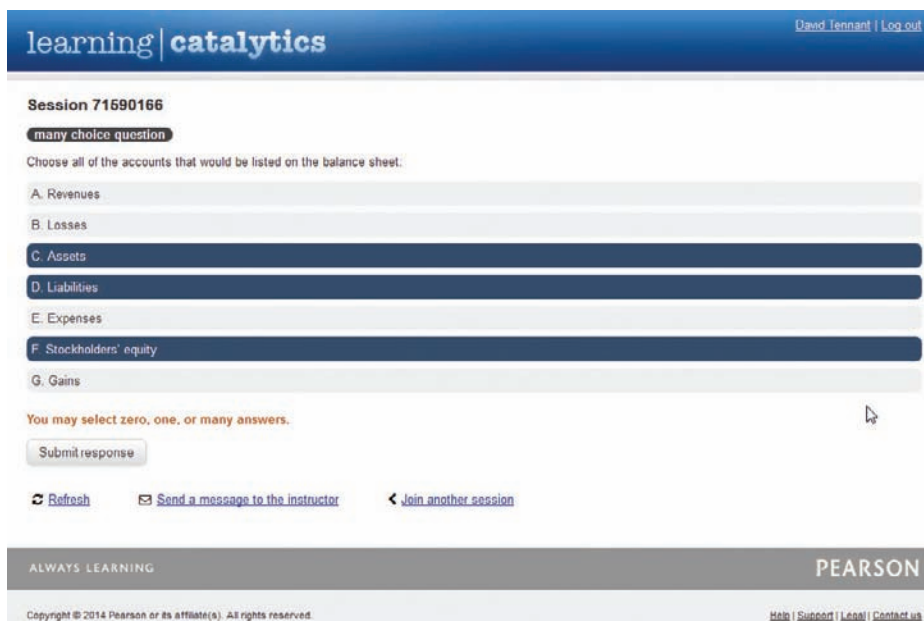
### Accounting Cycle Tutorial—MyAccountingLab's new interactive tutorial helps students master the Accounting Cycle for early and continued success in the introduction to Accounting course.

The tutorial, accessed by computer, Smartphone, or tablet, provides students with brief explanations of each concept of the Accounting Cycle through engaging videos and/or animations. Students are immediately assessed on their understanding and their performance is recorded in the MyAccountingLab grade book. Whether the Accounting Cycle Tutorial is used as a remediation self-study tool or course assignment, students have yet another resource within MyAccountingLab to help them be successful with the accounting cycle.



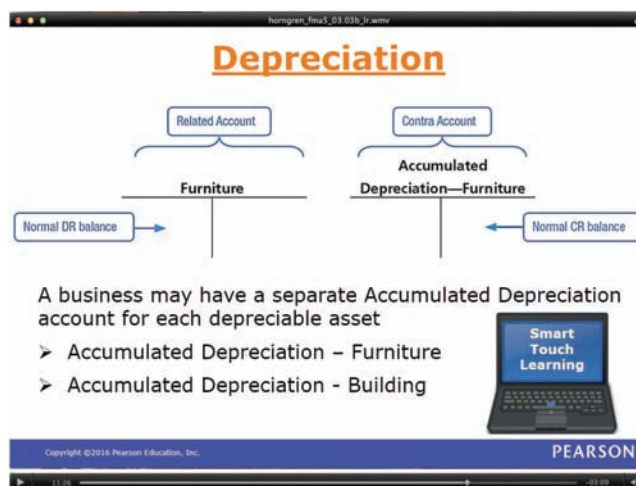
**NEW!**

**Learning Catalytics**—A “bring your own device” assessment and classroom activity system that expands the possibilities for student engagement. Using Learning Catalytics, you can deliver a wide range of auto-gradable or open-ended questions that test content knowledge and build critical thinking skills. Eighteen different answer types provide great flexibility, including graphical, numerical, textual input, and more.



**NEW!**

**Animated Lectures**—These pre-class learning aids are available for every learning objective and are professor-narrated PowerPoint summaries that will help students prepare for class. These can be used in an online or flipped classroom experience or simply to get students ready for lecture.



## End-of-Chapter Continuing and Comprehensive Problems

### > Continuing Problem

Problem P1-54 is the first problem in a sequence that begins an accounting cycle. The cycle is continued in Chapter 2 and completed in Chapter 5.

#### **P1-54 Using the accounting equation for transaction analysis, preparing financial statements, and calculating return on assets (ROA)**

Daniels Consulting began operations and completed the following transactions during December 2016:

Dec. 2	Daniels contributed \$20,000 cash in exchange for capital.
2	Paid monthly office rent, \$2,000.
3	Paid cash for a computer, \$3,600. This equipment is expected to remain in service for five years.
4	Purchased office furniture on account, \$3,000. The furniture should last for five years.
5	Purchased office supplies on account, \$800.
9	Performed consulting service for a client on account, \$2,500.
12	Paid utilities expenses, \$150.
18	Performed service for a client and received cash of \$2,100.
21	Received \$2,400 in advance for client service to be performed in the future. (This increases the Unearned Revenue account, which is a liability. This account will be explained in more detail in Chapter 2.)
21	Hired an administrative assistant to be paid \$2,055 on the 20th day of each month. The secretary begins work immediately.

**Continuing Problem**—Starts in Chapter 1 and runs through the entire book exposing students to recording entries for a service company and then moving into recording transactions for a merchandiser later in the text. The managerial chapters emphasize the relevant topics for that chapter using a continuous company.

**Practice Set**—Starts in Chapter 2 and goes through the financial chapters and provides another opportunity for students to practice the entire accounting cycle. The practice set uses the same company in each chapter but is often not as extensive as the continuing problem.

**Comprehensive Problem 1 for Chapters 1–4**—Covers the entire accounting cycle for a service company.

**Comprehensive Problem 2 for Chapters 1–4**—A continuation of Comprehensive Problem 1. It requires the student to record transactions for the month after the closing process.

**Comprehensive Problem for Chapters 1–5**—Covers the entire accounting cycle for a merchandise company.

**Comprehensive Problem for Chapter 7**—Uses special journals and subsidiary ledgers and covers the entire accounting cycle for a merchandise company. Students can complete this comprehensive problem using the MyAccountingLab General Ledger or Quickbooks™ software.

**Comprehensive Problem for Chapter 17**—Students use trend analysis and ratios to analyze a company for its investment potential.

### > Comprehensive Problem 1 for Chapters 1–4

Magness Delivery Service completed the following transactions during December 2016:

Dec. 1	Magness Delivery Service began operations by receiving \$10,000 cash and a truck with a fair value of \$20,000 from Robert Magness. The business gave Magness capital in exchange for this contribution.
1	Paid \$1,000 cash for a four-month insurance policy. The policy begins December 1.
4	Paid \$500 cash for office supplies.
12	Performed delivery services for a customer and received \$2,000 cash.
15	Completed a large delivery job, billed the customer, \$2,500, and received a promise to collect the \$2,500 within one week.
18	Paid employee salary, \$1,000.
20	Received \$15,000 cash for performing delivery services.
22	Collected \$800 in advance for delivery service to be performed later.
25	Collected \$2,500 cash from customer on account.
27	Purchased fuel for the truck, paying \$300 on account. (Credit Accounts Payable)
28	Performed delivery services on account, \$700.
29	Paid office rent, \$1,600, for the month of December.
30	Paid \$300 on account.
31	Magness withdrew cash of \$3,000.

#### **Requirements**

1. Record each transaction in the journal using the following chart of accounts. Explanations are not required.

## Chapter Openers

Chapter openers set up the concepts to be covered in the chapter using stories students can relate to. The implications of those concepts on a company's reporting and decision making processes are then discussed.

# The Adjusting Process

# 3

Where's My Bonus?

**L**iam Mills was surprised when he opened his mail. He had just received his most recent quarterly bonus check from his employer, Custom Marketing, and the check was smaller than he expected. Liam worked as a sales manager and was responsible for product marketing and implementation in the southwest region of the United States. He was paid a monthly salary but also received a 3% bonus for all revenue generated from advertising services provided to customers in his geographical area. He was counting on his fourth quarter (October–December) bonus check to be large enough to pay off the credit card debt he had accumulated over the holiday break. It had been a great year-end for Liam. He had closed several open accounts, successfully signing several annual advertising contracts. In addition, because of his negotiating skills, he was

able to collect half of the payments for services up front instead of waiting for his customers to pay every month. Liam expected that his bonus check would be huge because of this new business, but it wasn't.

The next day, Liam stopped by the accounting office to discuss his bonus check. He was surprised to learn that his bonus was calculated by the revenue earned by his company through December 31. Although Liam had negotiated to receive half of the payments up front, the business had not yet earned the revenue from those payments. Custom Marketing will not record revenue earned until the advertising services have been performed. Eventually Liam will see the new business reflected in his bonus check, but he'll have to wait until the revenue has been earned.

**How Was Revenue Earned Calculated?**

At the end of a time period (often December 31), companies are required to accurately report revenues earned and expenses incurred during that time period. In order to do this, the company reviews the account balances as of the end of the time period and determines whether any adjustments are needed. For example, CC Media Holdings, Inc., the parent company of radio giant Clear Channel Communications and Clear Channel Outdoor Holdings, an outdoor advertising agency, must determine the amount of revenue earned from open advertising contracts. These contracts can cover only a few weeks or as long as several years. Only the amount earned in the current time period is reported as revenue on the income statement. Adjusting the books is the process of reviewing and adjusting the account balances so that amounts on the financial statements are reported accurately. This is what we will learn in this chapter.

## Effect on the Accounting Equation

Next to every journal entry, these illustrations help reinforce the connections between recording transactions and the effect those transactions have on the accounting equation.

On November 10, Smart Touch Learning performed services for clients, for which the clients will pay the company later. The business earned \$3,000 of service revenue on account.

This transaction increased Accounts Receivable, so we debit this asset. Service Revenue is increased with a credit.

$$\left. \begin{array}{l} \text{A}\uparrow \\ \text{Accounts} \\ \text{Receivable}\uparrow \end{array} \right\} = \left\{ \begin{array}{l} \text{L} + \text{E}\uparrow \\ \text{Service} \\ \text{Revenue}\uparrow \end{array} \right.$$

Date	Accounts and Explanation	Debit	Credit
Nov. 10	Accounts Receivable	3,000	
	Service Revenue		3,000
	<i>Performed services on account.</i>		

## Instructor Tips & Tricks

Found throughout the text, these handwritten notes mimic the experience of having an experienced teacher walk a student through concepts on the “board.” Many include mnemonic devices or examples to help students remember the rules of accounting.

$$\left. \begin{array}{l} \text{A}\downarrow \\ \text{Accumulated} \\ \text{Depreciation} \\ \text{Building}\uparrow \end{array} \right\} = \left\{ \begin{array}{l} \text{L} + \text{E}\downarrow \\ \text{Depreciation} \\ \text{Expense—} \\ \text{Building}\uparrow \end{array} \right.$$

Date	Accounts and Explanation	Debit	Credit
Dec. 31	Depreciation Expense—Building	250	
	Accumulated Depreciation—Building		250
	<i>To record depreciation on building.</i>		

Remember, an increase in a contra asset, such as Accumulated Depreciation, decreases total assets. This is because a contra asset has a credit balance and credits decrease assets.



## Common Questions, Answered

Our authors have spent years in the classroom answering students' questions and have found patterns in the concepts or rules that consistently confuse students. These commonly asked questions are located in the margin of the text next to where the answer or clarification can be found highlighted in orange text.



Why was the account Patent credited instead of Accumulated Amortization—Patent?

Notice that Smart Touch Learning credited the amortization directly to the intangible asset, Patent, instead of using an Accumulated Amortization account. A company may credit an intangible asset directly when recording amortization expense, or it may use the account Accumulated Amortization. **Companies frequently choose to credit the asset account directly because the residual value is generally zero and there is no physical asset to dispose of at the end of its useful life, so the asset essentially removes itself from the books through the process of amortization.**

At the end of the first year, Smart Touch Learning will report this patent at \$160,000 (\$200,000 cost minus first-year amortization of \$40,000), the next year at \$120,000, and so forth. Each year for five years the value of the patent will be reduced until the end of its five-year life, at which point its book value will be \$0.

## Try It! Boxes

Found after each learning objective, Try Its! give students the opportunity to apply the concept they just learned to an accounting problem. Deep linking in the eText will allow students to practice in MyAccountingLab without interrupting their interaction with the eText.

### Try It!

Total Pool Services earned \$130,000 of service revenue during 2016. Of the \$130,000 earned, the business received \$105,000 in cash. The remaining amount, \$25,000, was still owed by customers as of December 31. In addition, Total Pool Services incurred \$85,000 of expenses during the year. As of December 31, \$10,000 of the expenses still needed to be paid. In addition, Total Pool Services prepaid \$5,000 cash in December 2016 for expenses incurred during the next year.

1. Determine the amount of service revenue and expenses for 2016 using a cash basis accounting system.
2. Determine the amount of service revenue and expenses for 2016 using an accrual basis accounting system.

Check your answers online in MyAccountingLab or at <http://www.pearsonhighered.com/Horngren>.

For more practice, see Short Exercises S3-1 and S3-2. [MyAccountingLab](#)

## Redesigned

The redesign includes clean and consistent art for T-accounts, journal entries, financial statements, and the accounting equation. New art types include clear explanations and connection arrows to help students follow the transaction process.

$$\text{ASSETS} = \left\{ \begin{array}{l} \text{LIABILITIES} + \\ \text{EQUITY} \end{array} \right.$$

Owner, - Owner, + Revenues - Expenses  
Capital      Withdrawals

## IFRS

Information on IFRS provides guidance on how IFRS differs from U.S. GAAP throughout the financial chapters.



## Decision Boxes

This feature provides common questions and potential solutions business owners face. Students are asked to determine the course of action they would take based on concepts covered in the chapter and are then given potential solutions.

### DECISIONS

#### Which depreciation method should be selected?

Three Junes Weaving has just purchased an automated weaving machine and is trying to figure out which depreciation method to use: straight-line, units-of-production, or double-declining-balance. Ira Glasier, the controller, is interested in using a depreciation method that approximates the usage of the weaving machine. He also expects that the weaving machine will have increasing repairs and maintenance as the asset ages. Which method should Ira choose?

#### Solution

If Ira is interested in using a depreciation method that approximates the usage of the weaving machine, he should use the units-of-production method to depreciate the asset. He could use number of machine hours as the unit of output. This method

would best match the usage of the machine to the amount of expense recorded. Ira should be aware, though, that this method could produce varying amounts of depreciation expense each year. For example, if Three Junes Weaving does not use the weaving machine in one year, no depreciation expense would be recorded. This could cause net income to vary significantly from year to year. Because Ira expects the weaving machine to need more repairs as the asset ages, Ira might consider using the double-declining-balance method instead. The double-declining-balance method records a higher amount of depreciation in the early years and less later. This method works well for assets that are expected to have increasing repairs and maintenance in their later years because the total expense (depreciation and repairs and maintenance) can be spread out equally over the life of the asset.

### > Things You Should Know

#### 1. How do we prepare financial statements?

- Financial statements are prepared from the adjusted trial balance in the following order:
  1. Income statement—reports revenues and expenses and calculates net income or net loss during the period
  2. Statement of owner's equity—shows how capital changed during the period due to owner contributions, net income or net loss, and owner withdrawals
  3. Balance sheet—reports assets, liabilities, and owner's equity as of the last day of the period
- A classified balance sheet classifies each asset and each liability into specific categories.

#### 2. How could a worksheet help in preparing financial statements?

- The columns of a worksheet can be extended to help in preparing the financial statements.
- The income statement section will include only revenue and expense accounts.
- The balance sheet section will include asset and liability accounts and all equity accounts except revenues and expenses.

### Things You Should Know

Provides students with a brief review of each learning objective presented in a question and answer format.

*This page intentionally left blank*

Dear Colleague,

Thank you for taking time, out of what we know is a busy schedule, to review the newest edition of *Horngren's Accounting*. We are excited to share our innovations with you as we expand on the proven success of our significant revision to the Horngren franchise. Using what we have learned from focus groups, market feedback, and our colleagues, we've designed this edition to focus on several goals.

First, we made certain that our content was clear, consistent, and above all, accurate. As authors, we reviewed each chapter to ensure that students understand what they are reading and that there is consistency from chapter to chapter. In addition, our textbook goes through a multi-level accuracy check which includes the author team working every single accounting problem and having a team of accounting professors from across the nation review for accuracy. Next, through ongoing conversations with our colleagues and our time engaged at professional conferences, we confirmed that our pedagogy and content represents the leading methods used in the classroom and provides your students with the foundation they need to be successful in their future academic and professional careers. Lastly, we concentrated on student success and providing resources for professors to create an active and engaging classroom.

**Student success.** Using our experience as educators, our team carefully considered how students learn, what they learn, and where they struggle the most. We understand that sometimes there is a gap in students' understanding between the textbook content and what is done in the classroom or in an online environment, so we have included in the textbook and enhanced eText several great learning aids for students. *Instructor Tips and Tricks* and *Common Questions Answered* address areas that are typically challenging for students. These aids provide handy memory tools or address common student misconceptions or confusion. We also realized that students use our enhanced eText to study on their own time and we have built in many new features to bring learning to life and to allow students to apply the concepts they are reading about outside of the classroom. Available through MyAccountingLab, students have the opportunity to watch author recorded solution videos, practice the accounting cycle using an interactive tutorial, and watch in-depth author-driven animated lectures that cover every learning objective.

**Professor expectations.** As professors, we know it's critical to have excellent end-of-chapter material and instructor resources. With these expectations, all end-of-chapter problems have been revised and our author team, along with our trusted accuracy checkers, have checked every problem for accuracy and consistency. In addition to financial comprehensive problems, three NEW comprehensive problems have been added to the managerial content. These problems cover multiple chapters and encourage students to think reflectively about prior material learned and the connections between accounting concepts. We have also reviewed and updated ALL instructor resources to accompany this edition of the book. In addition, the PowerPoint presentations and Test Bank have had significant revisions based upon your feedback and needs.

**Expanding on the proven success** of our last edition, we believe that our enhancements to *Horngren's Accounting*, along with MyAccountingLab, will help your students achieve success in accounting. We welcome your feedback, suggestions, and comments. Please don't hesitate to contact us at [HorngrensAccounting@pearson.com](mailto:HorngrensAccounting@pearson.com).

Tracie L. Miller-Nobles, CPA    Brenda Mattison    Ella Mae Matsumura, PhD

*This page intentionally left blank*

# Instructor and Student Resources

---

Each supplement, including the resources in MyAccountingLab, has been reviewed by the author team to ensure accuracy and consistency with the text. Given their personal involvement, you can be assured of the high quality and accuracy of all supplements.

## For Instructors

MyAccountingLab

**Online Homework and Assessment Manager:** <http://www.myaccountinglab.com>

**Instructor Resource Center:** <http://www.pearsonhighered.com/Horngren>

For the instructor's convenience, the instructor resources can be downloaded from the textbook's catalog page (<http://www.pearsonhighered.com/Horngren>) and MyAccountingLab. Available resources include the following:

### Online Instructor's Resource Manual:

#### *Course Content:*

- Tips for Taking Your Course from Traditional to Hybrid, Blended, or Online
- Standard Syllabi for Financial Accounting (10-week & 16-week)
- Standard Syllabi for Managerial Accounting (10-week & 16-week)
- Sample Syllabi for 10- and 16-week courses
- "First Day of Class" student handouts include:
  - Student Walk-Through to Set-up MyAccountingLab
  - Tips on How to Get an A in This Class

#### *Chapter Content:*

- Chapter Overview
  - Contains a brief synopsis and overview of each chapter.
- Learning Objectives
- Teaching Outline with Lecture Notes
  - Revised to combine the Teaching Outline and the Lecture Outline Topics, so instructors only have one document to review.
  - Walks instructors through what material to cover and what examples to use when addressing certain items within the chapter.
- Handout for Student Notes
  - An outline to assist students in taking notes on the chapter.
- Student Chapter Summary
  - Aids students in their comprehension of the chapter.
- Assignment Grid
  - Indicates the corresponding Learning Objective for each exercise and problem.
- Answer Key to Chapter Quiz
- Ten-Minute Quiz
  - To quickly assess students' understanding of the chapter material.
- Extra Critical Thinking Problems and Solutions
  - Critical Thinking Problems removed from this edition of the text were moved to the IRM so instructors can continue to use their favorite problems.
- NEW Guide to Classroom Engagement Questions
  - Author-created element will offer tips and tricks to instructors in order to help them use the Learning Catalytic questions in class.

### Online Instructor's Solutions Manual:

- Contains solutions to all end-of-chapter questions, short exercises, exercises, and problems.
- The Try It! Solutions, previously found at the end of each chapter, are now available for download with the ISM.
- All solutions were thoroughly reviewed by the author team and other professors.

**Online Test Bank:**

- Includes more than 3,900 questions.
- Both conceptual and computational problems are available in true/false, multiple choice, and open-ended formats.
- Algorithmic test bank is available in MyAccountingLab.

**PowerPoint Presentations:***Instructor PowerPoint Presentations:*

- Complete with lecture notes.
- Mirrors the organization of the text and includes key exhibits.

*Student PowerPoint Presentations:*

- Abridged versions of the Instructor PowerPoint Presentations.
- Can be used as a study tool or note-taking tool for students.

*Demonstration Problem PowerPoint Presentations:*

- Offers instructors the opportunity to review in class the exercises and problems from the chapter using different companies and numbers.

*Clicker Response System (CRS) PowerPoint Presentations:*

- 10 multiple-choice questions to use with a Clicker Response System.

*Image Library:*

- All image files from the text to assist instructors in modifying our supplied PowerPoint presentations or in creating their own PowerPoint presentations.

**Working Papers and Solutions:**

- Available in Excel format.
- Templates for students to use to complete exercises and problems in the text.

**Data and Solutions Files:**

- Select end-of-chapter problems have been set up in different software applications, including QuickBooks and General Ledger.
- Corresponding solution files are provided for QuickBooks.

## For Students

MyAccountingLab

**Online Homework and Assessment Manager:** <http://www.myaccountinglab.com>

- Pearson Enhanced eText
- Data Files
- Animated Lectures
- Demo Docs
- Working Papers
- Student PowerPoint® Presentations
- Accounting Cycle Tutorial
- Flash Cards

**Student Resource Web site:** <http://www.pearsonhighered.com/Horngren>

The book's Web site contains the following:

- Data Files: Select end-of-chapter problems have been set up in QuickBooks software and the related files are available for download.
- Working Papers
- Try It! Solutions: The solutions to all in-chapter Try Its! are available for download.

<http://www.pearsonhighered.com/Horngren>

# Acknowledgments

---

## Acknowledgments for This Edition:

*Tracie Miller–Nobles would like to thank her parents and sister: Kipp and Sylvia Miller and Michelle Miller. She would also like to express her gratitude to her many colleagues and friends who encourage and support her. In addition, she would like to thank Kevin Morris for always making her laugh and for being the best camping buddy she could ever ask for. Here's to many more trails.*

*Brenda Mattison has always had the loving support of her family and wishes to express her gratitude to them, especially her husband, Grant Mattison, who has been a constant and stable influence and inspiration for more than 25 years. Her family's faith in her, along with her faith in God, provided the solid foundation that allowed her to develop her gift of teaching and achieve her dreams while helping others to achieve theirs.*

*Ella Mae Matsumura thanks her family for their longstanding love and support in her endeavors: husband, Kam-Wah Tsui; son, David Tsui; sister and late parents, Linda, Lester, and Eda Matsumura. She would also like to express her appreciation to: the numerous colleagues and friends who have encouraged her and helped her grow as a scholar and a person; the many students who have provided constructive feedback that has shaped her teaching; and her faith community for its enduring love and affirmation.*

*The authors would like to sincerely thank Lacey Vitetta, Roberta Sherman, Mary Kate Murray, Andra Skaalrud, Alison Haskins, and Donna Battista for their unwavering support of this edition. They express their extreme pleasure in working with each of them and are appreciative of their guidance, patience, and belief in the success of this project.*

## Contributor:

Lori Hatchell, *Aims Community College*

## Advisory Panels, Focus Group Participants, and Reviewers:

Samad Adams, *Bristol Community College*

Sharon Agee, *Rollins College*

Markus Ahrens, *St. Louis Community College*

Janice Akao, *Butler County Community College*

Anna Alexander, *Caldwell Community College and Technical Institute*

Sheila Ammons, *Austin Community College*

Sidney Askew, *Borough of Manhattan Community College*

Michael Barendse, *Grossmont College*

Vikki Bentz, *Yavapai College*

Jennifer Cainas, *University of South Florida*

Anne Cardozo, *Broward College*

Elizabeth Carlson, *University of South Florida Sarasota-Manatee*

Martha Cavalaris, *Miami Dade College*

Donna Chadwick, *Sinclair Community College*

Colleen Chung, *Miami Dade College*

Tom Clement, *University of North Dakota*

Geoffrey Danzig, *Miami Dade College–North*

Judy Daulton, *Piedmont Technical College*

Michelle Davidowitz, *Kingsborough Community College*

Annette Fisher Davis, *Glendale Community College*

Anthony Dellarte, *Luzerne County Community College*

Crystal Drum, *Guilford Technical Community College*

Mary Ewanekchko, *Monroe Community College*

Elisa Fernandez, *Miami Dade College*

Lori Grady, *Bucks County Community College*

Marina Grau, *Houston Community College*

Gloria Grayless, *Sam Houston State University*

Dawn D. Hart, *Darton State College*

Lori Hatchell, *Aims Community College*

Shauna Hatfield, *Salt Lake Community College*

Patricia Holmes, *Des Moines Area Community College*

Cynthia Johnson, *University of Arkansas, Little Rock*

Jeffrey Jones, *The College of Southern Nevada*

Thomas K. Y. Kam, *Hawaii Pacific University*

Anne Kenner, *Brevard Community College*

Stephanie (Sam) King, *Edison State College*

Paul Koulakov, *Nashville State Community College*

Christy Land, *Catawba Valley Community College*

Wayne Lewis, *Hudson Valley Community College*

Mabel Machin, *Valencia College*

Mostafa Maksy, *Kutztown University*

Richard Mandau, *Piedmont Technical College*

Maria C. Mari, *Miami Dade College*

Cynthia J. Miller, *University of Kentucky*

Joanne Orabone, *Community College of Rhode Island*

Kimberly Perkins, *Austin Community College*

William Quilliam, *Florida Southern College*

Marcela Raphael, *Chippewa Valley Technical College*

Ryan Rees, *Salt Lake Community College*

Cecile Robert, *Community College of Rhode Island*

Shani Nicole Robinson, *Sam Houston State University*

Carol Rowey, *Community College of Rhode Island*

Amanda J. Salinas, *Palo Alto College*



Dennis Shea, *Southern New Hampshire University*  
Jaye Simpson, *Tarrant County*  
John Stancil, *Florida Southern*  
Diana Sullivan, *Portland Community College*  
Annette Taggart, *Texas A&M University–Commerce*  
Linda Tarrago, *Hillsborough Community College*  
Teresa Thompson, *Chaffey College*  
Judy Toland, *Bucks County Community College*

Robin D. Turner, *Rowan-Cabarrus Community College*  
William Van Glabek, *Edison State College*  
Stanley Walker, *Georgia Northwestern Tech*  
Deb Weber, *Hawkeye Community College*  
Denise A. White, *Austin Community College*  
Donald R. Wilke, *Northwest Florida State College*  
Wanda Wong, *Chabot College*  
Judy Zander, *Grossmont College*

### Accuracy Checkers:

James L. Baker, *Harford Community College*  
Nancy Emerson, *North Dakota State University*  
Richard Mandau, *Piedmont Technical College*

Carolyn Streuly  
Carol Hughes, *Asheville-Buncombe Technical Community College*

### Supplements Authors and Reviewers:

David Dearman, *Piedmont Technical College*  
Kelly Damron, *Glendale Community College*  
Helen Brubeck, *Saint Mary-of-the-Woods College*  
Brett Killion, *Lakeland College*  
Sheila Ammons, *Austin Community College*

Dave Alldredge, *Salt Lake Community College*  
Michelle Suminski, *Marygrove College*  
Connie Belden, *Butler Community College*  
Kate Demarest, *Carroll Community College*

The authors would like to express their gratitude for the diligent and exemplary work of all of our contributors, reviewers, accuracy checkers, and supplement authors. Each of you played a part in making this book successful! Thank you!

# Accounting and the Business Environment

1



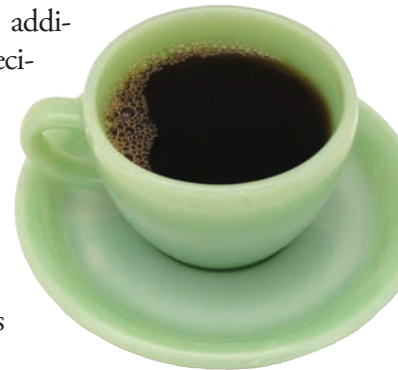
## Coffee, Anyone?

Aiden Jackson stared at the list the banker had given him during their meeting. *Business plan, cash flow projections, financial statements, tax returns.* Aiden had visited with the banker because he had a dream of opening a coffee shop near campus. He knew there was a need; students were always looking for a place to study and visit with their friends. He also had the experience. He had worked for the past three years as a manager of a coffee shop in a neighboring town. Aiden needed one thing, though—money. He had saved a small amount of money from his job and received several contributions from family and friends, but he still didn't have enough to open the business. He had decided the best option was to get a loan from

his bank. After the meeting, Aiden felt overwhelmed and unsure of the future of his business.

You might think that Aiden was facing an impossible situation, but you'd be wrong. Almost every new business faces a similar situation. The owner starts with an inspiration, and then he or she needs to provide enough continuous cash flow to build the business. In addition, the owner has to make decisions such as: *Should we expand to another location? Do we have enough money to purchase a new coffee roaster? How do I know if the business made a profit?*

So how does Aiden get started? Keep reading. That's what accounting teaches you.



## Why Study Accounting?

The situation that Aiden faced is similar to the situations faced in the founding of most businesses. **Starbucks Corporation**, for example, first opened its doors in Seattle, Washington, in 1971. Three partners, Jerry Baldwin, Zev Siegl, and Gordon Bowker, were inspired by a dream of selling high-quality coffee. We know their dream was successful because Starbucks currently has more than 19,000 stores in 60 countries. How did Starbucks grow from a small one-store shop to what it is today? The partners understood accounting—the language of business. They understood how to measure the activities of the business, process that information into reports (financial statements), and then use those reports to make business decisions. Your knowledge of accounting will help you better understand businesses. It will make you a better business owner, employee, or investor.





# Chapter 1 Learning Objectives



- 1 Explain why accounting is important and list the users of accounting information
- 2 Describe the organizations and rules that govern accounting
- 3 Describe the accounting equation and define assets, liabilities, and equity
- 4 Use the accounting equation to analyze transactions
- 5 Prepare financial statements
- 6 Use financial statements and return on assets (ROA) to evaluate business performance

## WHY IS ACCOUNTING IMPORTANT?

### Learning Objective 1

Explain why accounting is important and list the users of accounting information

### Accounting

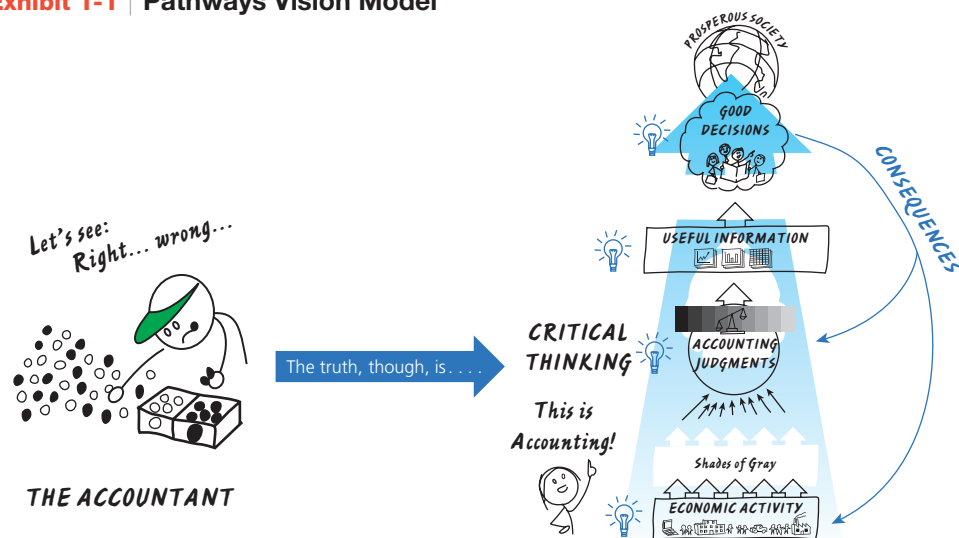
The information system that measures business activities, processes the information into reports, and communicates the results to decision makers.

You've heard the term *accounting*, but what exactly is it? **Accounting** is the information system that measures business activities, processes the information into reports, and communicates the results to decision makers. Accounting is the language of business. The better you understand the language of business, the better you can manage your own business, be a valuable employee, or make wise investments.

We tend to think of accountants as boring and dry. However, accounting is much more than simple recordkeeping or bookkeeping. Today's accountants participate in a broad range of activities such as the investigation of financial evidence, the development of computer programs to process accounting information, and the communication of financial results to interested parties. The knowledge of accounting is used every day to help make business decisions.

Recently, leaders from across the accounting community, called the Pathways Commission, came together to create a vision model (see Exhibit 1-1) to help students and

**Exhibit 1-1** Pathways Vision Model



We tend to think of accountants as boring and dry.

Accountants are instrumental in helping to create a prosperous society.




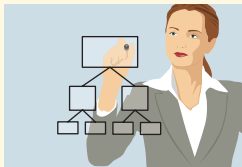
the public understand what accounting is. The model is intended to explain in a visual way what accountants really do. Accounting starts with economic activities that accountants review and evaluate using critical thinking and judgment to create useful information that helps individuals make good decisions. The model emphasizes that good decisions have an impact on accounting judgments and economic activity, thus creating a circular flow of cause and effect. Accountants are more than boring, tedious number crunchers. Instead, accountants play a critical role in supporting a prosperous society.

## Decision Makers: The Users of Accounting Information

We can divide accounting into two major fields: financial accounting and managerial accounting. **Financial accounting** provides information for external decision makers, such as outside investors, lenders, customers, and the federal government. **Managerial accounting** focuses on information for internal decision makers, such as the company's managers and employees.

Exhibit 1-2 illustrates the difference between financial accounting and managerial accounting. Regardless of whether they are external or internal to the company, all decision makers need information to make the best choices. The bigger the decision, the more information decision makers need. Let's look at some ways in which various people use accounting information to make important decisions.

### Exhibit 1-2 | Decision Making: Financial Versus Managerial Accounting

Financial Accounting	Managerial Accounting
	
<p><b>External Decision Makers:</b></p> <p>Should I invest in the business? Is the business profitable? Should we lend money to the business? Can the business pay us back?</p>	<p><b>Internal Decision Makers:</b></p> <p>How much money should the business budget for production? Should the business expand to a new location? How do actual costs compare to budgeted costs?</p>

### Individuals

How much cash do you have? How much do you need to save each month to retire at a certain age or pay for your children's college education? Accounting can help you answer questions like these. By using accounting information, you can manage your money, evaluate a new job, and better decide whether you can afford to buy a new computer. Businesses need accounting information to make similar decisions.

### Businesses

Business owners use accounting information to set goals, measure progress toward those goals, and make adjustments when needed. The financial statements give owners the information they need to help make those decisions. Financial statements are helpful when, for example, a business owner wants to know whether his or her business has enough cash to purchase another computer.

### Financial Accounting

The field of accounting that focuses on providing information for external decision makers.

### Managerial Accounting

The field of accounting that focuses on providing information for internal decision makers.



Accounting is alive! As businesses evolve and the type of business transactions change, so must the language of business. The most significant changes in the business world in the last decade have been the huge increases in international commerce. Because more business is conducted internationally, decision makers are looking for an international accounting language.

Look for more information about International Financial Reporting Standards (IFRS) anywhere that you see this image.



### Investors

Outside investors who have some ownership interest often provide the money to get a business going. Suppose you're considering investing in a business. How would you decide whether it is a good investment? In making this decision, you might try to predict the amount of income you would earn on the investment. Also, after making an investment, investors can use a company's financial statements to analyze how their investment is performing.

You might have the opportunity to invest in the stock market through your company's retirement plan. Which investments should you pick? Understanding a company's financial statements will help you decide. You can view the financial statements of large companies that report to the SEC by logging on to <http://www.finance.yahoo.com>, <http://www.google.com/finance>, or the Security and Exchange Commission's EDGAR database (<http://www.sec.gov/edgar.shtml>).

### Creditors

Any person or business to whom a business owes money is a **creditor**. Before extending credit to a business, a creditor evaluates the company's ability to make the payments by reviewing its financial statements. Creditors follow the same process when you need to borrow money for a new car or a house. The creditor reviews accounting data to determine your ability to make the loan payments. What does your financial position tell the creditor about your ability to pay the loan? Are you a good risk for the bank?

### Taxing Authorities

Local, state, and federal governments levy taxes. Income tax is calculated using accounting information. Good accounting records can help individuals and businesses take advantage of lawful deductions. Without good records, the IRS can disallow tax deductions, resulting in a higher tax bill plus interest and penalties.

### The Accounting Profession

What do businesses such as Amazon.com, Walmart, or even your local sandwich shop across from campus have in common? They all need accountants! That is why a degree in accounting opens so many doors upon graduation.

You've probably heard of a CPA before. **Certified Public Accountants**, or **CPAs**, are licensed professional accountants who serve the general public. CPAs work for public accounting firms, businesses, government entities, or educational institutions. What does it take to be a CPA? Although requirements vary between states, to be certified in a profession, one must meet the educational and/or experience requirements *and* pass a qualifying exam. **The American Institute of Certified Public Accountants (AICPA) Web site (<http://www.thiswaytocpa.com>) contains a wealth of information about becoming a CPA, career opportunities, and exam requirements.**

**Certified Management Accountants**, or **CMAs**, are certified professionals who specialize in accounting and financial management knowledge. Generally, CMAs work for a single company. **You can find information about becoming a CMA, how a CMA differs from a CPA, and why employers are recognizing the CMA certification on the Institute of Management Accountants (IMA) Web site (<http://www.imanet.org>).** It's worth spending the time and energy for accountants to get certified—certified accountants generally make 10–15% more than their noncertified colleagues when they enter the workforce.

Studying accounting and becoming certified professionally can lead to a financially secure job. According to Robert Half's *2014 Salary Guide*, the top positions in demand that rely on accounting skills are controllers, financial analysts, tax accountants, auditors, cost accountants, and business systems analysts. How much do these types of accountants make? Exhibit 1-3 provides a snapshot of the earning potential for key positions.

#### Creditor

Any person or business to whom a business owes money.

#### Certified Public Accountants (CPAs)

Licensed professional accountants who serve the general public.

What if I want more information about becoming a CPA or CMA?

#### Certified Management Accountants (CMAs)

Certified professionals who specialize in accounting and financial management knowledge. They typically work for a single company.




**Exhibit 1-3 | Comparison of Accounting Positions**

Position	Job Description	Salary Range
<b>Controllers</b>	Compile financial statements, interact with auditors, and oversee regulatory reporting.	\$89,000–\$216,000
<b>Financial analysts</b>	Review financial data and help to explain the story behind the numbers.	\$41,250–\$125,000
<b>Business systems analysts</b>	Use accounting knowledge to create computer systems.	\$44,250–\$107,250
<b>Tax accountants</b>	Help companies navigate tax laws.	\$44,000–\$190,750
<b>Auditors</b>	Perform reviews of companies to ensure compliance to rules and regulations.	\$44,500–\$184,750
<b>Cost accountants</b>	Typically work in a manufacturing business. Help analyze accounting data.	\$43,000–\$113,000
<b>Paraprofessional/Bookkeeper</b>	Record financial transactions and help prepare financial records.	\$39,750–\$59,250

Accountants generally work either in public, private, or governmental accounting. Public accounting involves services such as auditing and tax preparation. Well-known public accounting firms include Ernst & Young, Deloitte, PwC, and KPMG. Private accounting involves working for a single company such as Amazon.com, Walmart, or Dell. Other accountants work for the federal or state governments. Wherever accountants work, demand for their services is high. According to the U.S. Bureau of Labor Statistics, employment of accountants and auditors is expected to grow 13% from 2012–2022.



Recently, the AICPA added a certification program in international accounting for those CPAs who want to specialize in global commerce.

## Try It!

Match the accounting terminology to the definitions.

- |                                     |   |
|-------------------------------------|---|
| 1. Certified management accountants | a. the information system that measures business activities, processes that information into reports, and communicates the results to decision makers |
| 2. Accounting                       | b. licensed professional accountants who serve the general public   |
| 3. Managerial accounting            | c. any person or business to whom a business owes money   |
| 4. Certified public accountants     | d. the field of accounting that focuses on providing information for internal decision makers   |
| 5. Financial accounting             | e. certified professionals who work for a single company  |
| 6. Creditor                         | f. the field of accounting that focuses on providing information for external decision makers   |

Check your answers online in MyAccountingLab or at <http://www.pearsonhighered.com/Horngren>.



## WHAT ARE THE ORGANIZATIONS AND RULES THAT GOVERN ACCOUNTING?

### Learning Objective 2

Describe the organizations and rules that govern accounting

#### Financial Accounting Standards Board (FASB)

The private organization that oversees the creation and governance of accounting standards in the United States.

#### Securities and Exchange Commission (SEC)

U.S. governmental agency that oversees the U.S. financial markets.

#### Generally Accepted Accounting Principles (GAAP)

Accounting guidelines, currently formulated by the *Financial Accounting Standards Board (FASB)*; the main U.S. accounting rule book.

#### Economic Entity Assumption

An organization that stands apart as a separate economic unit.

#### Sole Proprietorship

A business with a single owner.

#### Partnership

A business with two or more owners and not organized as a corporation.

#### Corporation

A business organized under state law that is a separate legal entity.

#### Limited-Liability Company (LLC)

A company in which each member is only liable for his or her own actions.

All professions have regulations. Let's look at the organizations and rules that govern the accounting profession.

### Governing Organizations

In the United States, the **Financial Accounting Standards Board (FASB)**, a privately funded organization, oversees the creation and governance of accounting standards. The FASB works with governmental regulatory agencies like the **Securities and Exchange Commission (SEC)**. The SEC is the U.S. governmental agency that oversees the U.S. financial markets. It also oversees those organizations that set standards (like the FASB). The FASB also works with congressionally created groups like the Public Company Accounting Oversight Board (PCAOB) and private groups like the AICPA, IMA, and International Accounting Standards Board (IASB).

### Generally Accepted Accounting Principles

The guidelines for accounting information are called **Generally Accepted Accounting Principles (GAAP)**. GAAP is the main U.S. accounting rule book and is currently created and governed by the FASB. In order to use and prepare financial statements, it's important that we understand GAAP. GAAP rests on a conceptual framework that identifies the objectives, characteristics, elements, and implementation of financial statements and creates the acceptable accounting practices. The primary objective of financial reporting is to provide information useful for making investment and lending decisions. To be useful, information must be relevant and have faithful representation.<sup>1</sup> Relevant information allows users of the information to make a decision. Information that is faithfully representative is complete, neutral, and free from error. These basic accounting assumptions and principles are part of the foundation for the financial reports that companies present.

### The Economic Entity Assumption

The most basic concept in accounting is that of the **economic entity assumption**. An economic (business) entity is an organization that stands apart as a separate economic unit. We draw boundaries around each entity to keep its affairs distinct from those of other entities. An entity refers to one business, separate from its owners.

A business can be organized as a **sole proprietorship**, **partnership**, **corporation**, or **limited-liability company (LLC)**. Exhibit 1-4 summarizes the similarities and differences among the four types of business organizations.

In order to demonstrate the economic entity assumption and several other concepts in this chapter, we will use a fictitious company—Smart Touch Learning—an e-learning business that specializes in providing online courses in accounting, economics, marketing, and management. This fictitious business will be used often throughout the book.

Assume Sheena Bright started the business by contributing cash of \$30,000. Following the economic entity assumption, the \$30,000 is recorded separately from Sheena's personal assets, such as her clothing and car. To mix the \$30,000 of business cash with Sheena's personal assets would make it difficult to measure the success or failure of Smart Touch Learning. The economic entity assumption requires that each organization be separate from other businesses and from the owners.

<sup>1</sup> This wording was changed from relevant and reliable by the *Statement of Financial Accounting Concepts No. 8*.


**Exhibit 1-4 Business Organizations**

	Sole Proprietorship	Partnership	Corporation	Limited-Liability Company (LLC)
<b>Definition</b>	A business with a single owner	A business with two or more owners and not organized as a corporation	A business organized under state law that is a separate legal entity	A company in which each member is only liable for his or her own actions
<b>Number of owners</b>	One (called the proprietor)	Two or more (called partners)	One or more (called stockholders)	One or more (called members or partners)
<b>Life of the organization</b>	Terminates at owner's choice or death	Terminates at a partner's choice or death	Indefinite	Indefinite
<b>Personal liability of the owner(s) for the business's debts</b>	Owner is personally liable	Partners are personally liable	Stockholders are not personally liable	Members are not personally liable
<b>Taxation</b>	Not separate taxable entities. The owner pays tax on the proprietorship's earnings.	Partnership is not taxed. Instead partners pay tax on their share of the earnings.	Separate taxable entity. Corporation pays tax.	LLC is not taxed. Instead members pay tax on their share of earnings.
<b>Type of business</b>	Small businesses	Professional organizations of physicians, attorneys, and accountants	Large multinational businesses	An alternative to the partnership

## The Cost Principle

The **cost principle** states that acquired assets and services should be recorded at their actual cost (also called *historical cost*). The cost principle means we record a transaction at the amount shown on the receipt—the actual amount paid. Even though the purchaser may believe the price is a bargain, the item is recorded at the price actually paid and not at the “expected” cost. For example, assume our fictitious company Smart Touch Learning purchased land for \$20,000. The business might believe the land is instead worth \$25,000. The cost principle requires that Smart Touch Learning record the land at \$20,000, not \$25,000.

The cost principle also holds that the accounting records should continue reporting the historical cost of an asset over its useful life. Why? Because cost is a reliable measure. Suppose Smart Touch Learning holds the land for six months. During that time land prices rise, and the land could be sold for \$30,000. Should its accounting value—the figure on the books—be the actual cost of \$20,000 or the current market value of \$30,000? According to the cost principle, the accounting value of the land would remain at the actual cost of \$20,000.

## The Going Concern Assumption

Another reason for measuring assets at historical cost is the **going concern assumption**. This assumes that the entity will remain in operation for the foreseeable future. Under the going concern assumption, accountants assume that the business will remain in operation long enough to use existing resources for their intended purpose.

## The Monetary Unit Assumption

In the United States, we record transactions in dollars because the dollar is the medium of exchange. The value of a dollar changes over time, and a rise in the price level is called *inflation*. During periods of inflation, a dollar will purchase less. But accountants

### Cost Principle

A principle that states that acquired assets and services should be recorded at their actual cost.



Under international reporting standards, the company would be allowed to restate and report the land at \$30,000. The ability to report some assets and liabilities at their current fair value each year under international standards is a significant difference from U.S. rules.

### Going Concern Assumption

Assumes that the entity will remain in operation for the foreseeable future.





### Monetary Unit Assumption

The assumption that requires the items on the financial statements to be measured in terms of a monetary unit.

### International Financial Reporting Standards (IFRS)

A set of global accounting guidelines, formulated by the *International Accounting Standards Board (IASB)*.

### International Accounting Standards Board (IASB)

The private organization that oversees the creation and governance of *International Financial Reporting Standards (IFRS)*.

assume that the dollar's purchasing power is stable. This is the basis of the **monetary unit assumption**, which requires that the items on the financial statements be measured in terms of a monetary unit.

## International Financial Reporting Standards

The concepts and principles that we have discussed so far apply to businesses that follow U.S. GAAP and are traded on a U.S. stock exchange, such as the New York Stock Exchange. The SEC requires that U.S. businesses follow U.S. GAAP. Companies who are incorporated in or do significant business in another country might be required to publish financial statements using **International Financial Reporting Standards (IFRS)**, which are published by the **International Accounting Standards Board (IASB)**. IFRS is a set of global accounting standards that are used or required by more than 120 nations. They are generally less specific and based more on principle than U.S. GAAP. IFRS leaves more room for professional judgment. For example, unlike U.S. GAAP, IFRS allows periodic revaluation of certain assets and liabilities to restate them to market value, rather than keeping them at historical cost. At one point in time it was thought that the SEC would endorse IFRS. However, the SEC has backed away from this strategy and is currently considering whether a single set of global accounting standards is achievable.

## Ethics in Accounting and Business

Ethical considerations affect accounting. Investors and creditors need relevant and faithfully representative information about a company that they are investing in or lending money to. Companies want to be profitable and financially strong to attract investors and attempt to present their financial statements in a manner that portrays the business in the best possible way. Sometimes these two opposing viewpoints can cause conflicts of interest. For example, imagine a company that is facing a potential million-dollar lawsuit due to a defective product. The company might not want to share this information with investors because it would potentially hurt the business's profitability. On the other hand, investors would want to know about the pending lawsuit so that they could make an informed decision about investing in the business. To handle these conflicts of interest and to provide reliable information, the SEC requires publicly held companies to have their financial statements audited by independent accountants. An **audit** is an examination of a company's financial statements and records. The independent accountants then issue an opinion that states whether the financial statements give a fair picture of the company's financial situation.

The vast majority of accountants do their jobs professionally and ethically, but we often don't hear about them. Unfortunately, only those who cheat make the headlines. In recent years, we have seen many accounting scandals.

In response to the Enron and WorldCom reporting scandals, the U.S. government took swift action. It passed the **Sarbanes-Oxley Act (SOX)**, intended to curb financial scandals. SOX requires companies to review internal control and take responsibility for the accuracy and completeness of their financial reports. In addition, SOX made it a criminal offense to falsify financial statements. The Sarbanes-Oxley Act also created a new watchdog agency, the Public Company Accounting Oversight Board (PCAOB), to monitor the work of independent accountants who audit public companies. More recent scandals, such as the Bernie Madoff scandal in which Mr. Madoff pleaded guilty to defrauding thousands of investors by filing falsified trading reports, have further undermined the public's faith in financial reporting. This may result in more legislation for future reporting.

### Audit

An examination of a company's financial statements and records.

### Sarbanes-Oxley Act (SOX)

Requires companies to review internal control and take responsibility for the accuracy and completeness of their financial reports.



## Try It!

Match the accounting terminology to the definitions.

- |                                |  |
|--------------------------------|--|
| 7. Cost principle              | a. oversees the creation and governance of accounting standards in the United States |
| 8. GAAP                        | b. requires an organization to be a separate economic unit                           |
| 9. Faithful representation     | c. oversees U.S. financial markets   |
| 10. SEC                        | d. states that acquired assets and services should be recorded at their actual cost  |
| 11. FASB                       | e. creates International Financial Reporting Standards                               |
| 12. Monetary unit assumption   | f. the main U.S. accounting rule book  |
| 13. Economic entity assumption | g. assumes that an entity will remain in operation for the foreseeable future        |
| 14. Going concern assumption   | h. assumes that items on the financial statements are recorded in a monetary unit    |
| 15. IASB                       | i. requires information to be complete, neutral, and free from material error        |

Check your answers online in MyAccountingLab or at <http://www.pearsonhighered.com/Horngren>.

For more practice, see Short Exercises S1-2 through S1-5. [MyAccountingLab](#)

## WHAT IS THE ACCOUNTING EQUATION?

The basic tool of accounting is the **accounting equation**. It measures the resources of a business (what the business owns or has control of) and the claims to those resources (what the business owes to creditors and to the owners). The accounting equation is made up of three parts—assets, liabilities, and equity—and shows how these three parts are related. Assets appear on the left side of the equation, and the liabilities and equity appear on the right side.

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

*Remember, the accounting equation is an equation—so the left side of the equation always equals the right side of the equation.*

### Learning Objective 3

Describe the accounting equation and define assets, liabilities, and equity

### Accounting Equation

The basic tool of accounting, measuring the resources of the business (what the business owns or has control of) and the claims to those resources (what the business owes to creditors and to the owners).  
Assets = Liabilities + Equity.

**Example:** If a business has assets of \$230,000 and liabilities of \$120,000, its equity must be \$110,000 (\$230,000 – \$120,000).

<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Equity</b>
\$230,000	=	\$120,000	+	?
\$230,000	=	\$120,000	+	\$110,000