HORNGREN'S

FINANCIAL & MANAGERIAL ACCOUNTING

FOURTH EDITION

NOBLES • MATTISON • MATSUMURA

HORNGREN'S

FINANCIAL & MANAGERIAL ACCOUNTING

FOURTH EDITION

Tracie Nobles

Texas State University–San Marcos

Brenda Mattison

Tri-County Technical College

Ella Mae Matsumura

University of Wisconsin–Madison

PEARSON

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

Editor-in-Chief: Donna Battista
Acquisitions Editor: Lacey Vitetta
Director of Editorial Services: Ashley Santora
VP/Director of Development: Steve Deitmer
Development Editor: Linda Harrison, Harrison Ridge Services
Editorial Project Manager: Nicole Sam
Editorial Assistants: Jane Avery and Lauren Zanedis
Director of Marketing: Maggie Moylan Leen
Marketing Manager: Alison Haskins
Marketing Assistant: Kimberly Lovato
Managing Editor, Production: Jeff Holcomb
Senior Production Project Manager: Roberta Sherman
Permissions Project Manager: Jill Dougan
Manufacturing Buyer: Carol Melville
Senior Art Director: Anthony Gemmellaro
Interior Design: Anthony Gemmellaro/Studio Montage
Cover Design: Anthony Gemmellaro
Cover Photo: Sascha Burkard/Shutterstock.com; Le Do/Shutterstock.com
Editorial Media Project Manager: James Bateman
Production Media Project Manager: John Cassar
Full-Service Project Management and Composition: Integra
Printer/Binder: Courier Kendallville
Cover Printer: Lehigh Phoenix Color/Hagerstown
Typeface: 11/13, Adobe Garamond Pro Regular

Credits and acknowledgments borrowed from other sources and reproduced, with permission, in this textbook appear on appropriate page within text or on pages P-1 and P-2.

Library of Congress Cataloging-in-Publication Data on file.

10 9 8 7 6 5 4 3 2

PEARSON

ISBN-13: 978-0-13-325124-1
ISBN-10: 0-13-325124-1

In memory of *Charles T. Horngren* 1926–2011

Whose vast contributions to the teaching and learning of accounting impacted and will continue to impact generations of accounting students and professionals.

About the Authors

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

Professor Nobles is a recipient of the Texas Society of CPAs 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 chair of the American Institute of Certified Public Accountants Pre-certification Executive Education committee, and as program chair for the Teaching, Learning and Curriculum section of the American Accounting Association. In addition, Professor Nobles 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, fishing, 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 Registration of Teachers of Accounting at Two Year Colleges.

Brenda engages in the scholarship of teaching and learning (SOTL). While serving as Faculty Fellow at Tri-County Technical College, her research project was Using Applied Linguistics in Teaching Accounting, the Language of Business. Brenda has presented her research findings. Other presentations include using active learning and manipulatives, such as building blocks and poker chips, in teaching accounting concepts.

In her spare time, Brenda enjoys reading and spending time with her family, especially touring the United States in their motorhome. She is also an active volunteer in the community, serving her church, local Girl Scouts, and other organizations.

Ella Mae Matsumura 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. Matsumura 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.

Professor Matsumura 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

Contents

Changes to This Edition

General

Added chapter openers that identify how an individual uses the chapter's accounting concepts; this opener is then related to a real-world company.
Added margin notes that show the effect of each journal entry on the accounting equation.
Standardized key terms for terminology, accounting concepts, and accounting names that are used in multiple chapters.
Placed key terms in margin notes to further emphasize important accounting terminology.
Added a student question feature in the margin that poses questions our students have asked to address confusing accounting topics.
Added tips designed to help students remember key concepts.
Added a Decisions feature to emphasize how accounting information is used in decision making.
Added an Ethics feature to provide real-world examples of ethical decisions in the accounting and business world.
Added a Try It! feature at the end of each learning objective to provide students an opportunity to review each objective separately.
Added a financial ratio section in each financial chapter using Green Mountain Coffee Roasters, Inc.
Provided students the opportunity to apply financial ratios they have learned in each financial chapter through an end of chapter case using Starbucks Corporation.
Provided a review of each learning objective, presented in question and answer format, at the end of each chapter.
Revised end of chapter summary problems, quick checks, short exercises, exercises, problems, continuing problems, comprehensive problems, and application cases (now called Critical Thinking cases).
Added review questions covering each learning objective to the end of chapter material.
Added three new chapters to the textbook: Investments, Process Costing, and Variable Costing.
Added an appendix covering Accounting Information Systems.
Streamlined topics: Stockholders' Equity now presented in one chapter (Chapter 13); Responsibility Accounting and Performance Evaluation combined into one chapter (Chapter 24).

Chapter 1—Accounting and the Business Environment

Updated the coverage of the conceptual framework.
Streamlined the discussion of business entity.
Introduced the use of steps when analyzing transactions.
Reformatted the transaction analysis to clarify the concept to students.
Revised the discussion of financial statements for ease of understanding.

Chapter 2—Recording Business Transactions

Clarified the discussion of debits and credits to improve student understanding of this important concept.
Added a section on how to determine the balance in a T-account.
Enhanced the presentation of journal entries to incorporate the steps learned in Chapter 1.
Introduced unearned revenues and accrued liabilities in Chapter 2 instead of Chapter 3.
Changed the four-column format reference from Jrnl. Ref. to Post Ref for consistency with current practice.
Added a section after the trial balance coverage that reviews the financial statements presented in Chapter 1 to enhance students' understanding of the purpose of the trial balance.

Chapter 3—The Adjusting Process

Reworked the examples in the cash versus accrual basis section to better emphasize the concept of timing.
Changed the methodology of the chapter to use the unadjusted trial balance presented in Chapter 2, enabling students to better see the flow of transactions through the accounting cycle.
Made adjusting entries at year-end (Dec. 31) instead of at the end of the month, more accurately representing what is done in practice.
Added a section on how to record the future payment of accrued expense.
Added a section on how to record the future receipt of accrued revenues.
Added a section on using the worksheet to prepare adjustments and the adjusted trial balance.
Added a section on the impact of adjusting entries on the financial statements.

Chapter 4—Completing the Accounting Cycle

Moved coverage of the financial statements from Chapter 3 to the beginning of Chapter 4 to emphasize that financial statements must be prepared before closing entries.

Moved coverage of the classified balance sheet from the end of Chapter 4 and included it in the coverage of the financial statements.

Expanded the coverage of the classified balance sheet to include long-term investments and intangible assets.

Split worksheet coverage between Chapters 3 and 4 to better cover the process used in the accounting cycle.

Expanded coverage of closing entries by providing in-text examples of the closing entries.

Added Comprehensive Problem 2, which continues Comprehensive Problem 1, requiring students to continue business activities after one accounting cycle has been completed.

Chapter 5—Merchandising Operations

Reworked the section on merchandising options to include an expanded discussion on merchandisers.

Included calculation of Cost of Goods Sold in the chapter.

Added a subsection in Purchase Returns and Allowances showing journal entries for a return within the discount period with subsequent payment.

Added coverage of the adjusted trial balance for easier understanding of how closing entries are completed.

Provided a summary of all journal entries for the chapter.

Included a section in Appendix 5A on adjusting and closing entries when using the periodic system.

Chapter 6—Merchandise Inventory

Enhanced the discussion on FIFO, LIFO, and Weighted-Average to increase student understanding of these topics.

Updated Appendix 6A with better examples and examples that cause the LIFO method to be different under the periodic method.

Moved the gross profit method to Appendix 6B and added a section on the retail method.

Chapter 7—Internal Control and Cash

Added a section on changing the amount of the petty cash fund.

Streamlined the discussion of internal controls for e-commerce.

Chapter 8—Receivables

Added a section on factoring and pledging receivables.

Increased usage of T-accounts to further students' understanding of the different ways to estimate bad debts expense when using the allowance method.

Chapter 9—Plant Assets, Natural Resources, and Intangibles

Clarified calculation of depreciation methods.

Added a section on tax depreciation (MACRS).

Added discussion on how to report plant assets.

Completely reworked the disposal section to improve students' understanding of this difficult topic.

Clarified content on exchanging plant assets and moved it to Appendix 9A.

Chapter 10—Investments

NEW to the 4th edition

Included discussion on why companies invest and types of investments.

Discussed how investments in debt securities and equity securities are accounted for.

Included discussion on comprehensive income.

Chapter 11—Current Liabilities and Payroll

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

Added discussion on the use of a payroll register to journalize employee payroll.

Expanded discussion on current liabilities that must be estimated to include coverage of bonus plans and vacation, health, and pension benefits.

Chapter 12—Long-Term Liabilities

Increased use of amortization schedules throughout the chapter to enhance students' understanding of long-term liabilities.
Added discussion on bond financing versus issuing stock.
Moved discussion of retirement of bonds payable, including retirement at maturity and retirement before maturity, from an appendix to the chapter.
Expanded discussion of the time value of money to include the concepts of time value and simple interest versus compound interest.
Clarified the calculations for the effective-interest amortization method.

Chapter 13—Stockholders' Equity

Combined the contents of two chapters to provide more complete coverage of stockholders' equity.
Streamlined coverage of the concepts of corporations to emphasize material that students need to know at this level of accounting.
Expanded discussion of characteristics of a corporation.
Clarified the discussion of dividends paid on cumulative and noncumulative preferred stock.

Chapter 14—The Statement of Cash Flows

Expanded discussion on the purpose of the statement of cash flows.
Added an exhibit that summarizes the sections of the statement of cash flows.
Increased the use of T-accounts and summary journal entries throughout the chapter to enhance students' understanding of computing cash inflows and outflows.

Chapter 15—Financial Statement Analysis

Added discussion on how financial statements are used to analyze a business.
Included an overview of corporate financial reports summarizing the different reporting requirements.
Added discussion of cash ratio when evaluating a company's ability to pay current liabilities.
Included a discussion on the complete corporate income statement introducing continued operations, discontinued operations, extraordinary items, earnings per share, and changes in accounting principles.

Chapter 16—Introduction to Managerial Accounting

Streamlined the discussion of financial versus managerial accounting and service and merchandising companies.
Updated the manufacturing example from DVDs to touch screen tablet computers.
Added an exhibit with a side-by-side comparison of service, merchandising, and manufacturing company income statements and balance sheets.
Added an exhibit with examples of product and period costs.

Chapter 17—Job Order Costing

Added an exhibit with examples of companies that need costing systems.
Emphasized the process of accumulating, assigning, allocating, and adjusting to explain costing systems.
Updated an exhibit to show cost flows of individual jobs.
Updated all exhibits with sample source documents.
Added a summary of all journal entries.
Added the schedule of cost of goods manufactured and income statement from Chapter 16, emphasizing cost flows and their tie to end reports.

Chapter 18—Process Costing

NEW to the 4th edition
Moved process costing from the job costing chapter appendix to its own chapter—with FIFO method in chapter and weighted-average method in Appendix 18A.
Clarified the completion of a production cost report, with exhibits showing the completion of each step.
Provided production costs reports for two departments, enabling illustration of transferred in costs.
Expanded journal entry section to include all journal entries associated with a process costing system: accumulate, assign, allocate, and adjust.

Chapter 19—Cost Management Systems: Activity-Based, Just-In-Time, and Quality Management Systems

Reviewed traditional overhead allocation before introducing activity-based costing.
Expanded coverage of traditional allocation systems to include both single plantwide rates and departmental rates.

Added a section on using activity-based management for service companies.
Continued emphasis on accumulating, assigning, allocating, and adjusting in both ABC and JIT systems.

Chapter 20—Cost-Volume-Profit Analysis

Added the concept of relativity when determining whether costs are fixed or variable.
Expanded coverage of contribution margin: in total, per unit, and ratio.
Emphasized the use of the contribution margin statement and compared it to traditional income statement.
Introduced CVP by illustrating how to calculate required sales for target profit using three methods and advantages of each.
Illustrated breakeven calculation as a variation of target profit calculation.
Added coverage of operating leverage.

Chapter 21—Variable Costing

NEW to 4th edition
Expanded an online appendix into a full chapter.
Added a section on using variable costing for management decisions.
Added a section on using variable costing in service companies.

Chapter 22—Master Budgets

Expanded coverage of different types of budgets: strategic versus operational and static versus flexible.
Expanded coverage of budgeting and human behavior.
Expanded coverage of the master budget by providing an example of a manufacturing company in the chapter and a merchandising company in Appendix 22A.
Added Comprehensive Budgeting Problems, A and B series, for a manufacturing company.
Moved coverage of responsibility accounting to its own chapter, Chapter 24.

Chapter 23—Flexible Budgets and Standard Cost Systems

Expanded coverage of performance reports.
Added coverage of variance relationships and responsibilities.

Chapter 24—Responsibility Accounting and Performance Evaluation

Rearranged content so responsibility accounting and performance evaluation are in the same chapter.
Expanded coverage of responsibility reports.
Added content on transfer pricing, including objectives and setting prices.

Chapter 25—Short-Term Business Decisions

Rearranged coverage to illustrate regular pricing before special pricing.
Added coverage of sales mix decisions.

Chapter 26—Capital Investment Decisions

Expanded coverage of sensitivity analysis, adding Excel formulas and screen shots.
Expanded coverage of capital rationing, including decision trees.

Appendix C—Accounting Information Systems

NEW to the 4th edition
Provided coverage of accounting information systems.
Added discussion on the use of special journals and subsidiary ledgers in a manual accounting information system.
Explained how transactions are recorded using a computerized accounting information system including screen shots from QuickBooks.
Included a brief discussion of technology and software used in accounting information systems including QuickBooks, Sage 50 Accounting (formerly Peachtree), and Enterprise Resource Planning Systems.

Financial & Managerial Accounting… Redefining Tradition

NEW! 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.


3

The Adjusting Process

Where's My Bonus?

Liam 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 up to 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.

chapter outline

- What is the difference between cash basis accounting and accrual basis accounting?
- What concepts and principles apply to accrual basis accounting?
- What are adjusting entries and how do we record them?
- What is the purpose of the adjusted trial balance and how do we prepare it?
- What is the impact of adjusting entries on the financial statements?
- How could a worksheet help in preparing adjusting entries and the adjusted trial balance?
- What is an alternative treatment of recording prepaid expenses and unearned revenues? (Appendix 3A)

NEW! Effect on the Accounting Equation

Next to every journal entry, these illustrations help reinforce the connections between recording a transaction 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.

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

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

NEW! 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.

A↓		L	+	E↓
Accumulated Depreciation—Building↑	=			Depreciation Expense—Building↑

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

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.

NEW! 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.

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

NEW! 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 2014. 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 2014 for expenses incurred during the next year.

1. Determine the amount of service revenue and expenses for 2014 using a cash basis accounting system.
2. Determine the amount of service revenue and expenses for 2014 using an accrual basis accounting system.

Check your answers at the end of the chapter.

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.

Accounts Receivable

Nov. 10	3,000	2,000	Nov. 22
Dec. 31	800		
Bal.	1,800		

Service Revenue

		5,500	Nov. 8
		3,000	Nov. 10
		8,000	Dec. 28
		200	Dec. 31
		800	Dec. 31
		17,500	Bal.

IFRS

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

IFRS

NEW! 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

What would be the most appropriate fiscal year?

Molly Kielman opened Summertime Day Camp. She is deciding between using a calendar year or a noncalendar year for her financial statements. Because the majority of her business will be during the months of June and July, she is thinking about using a fiscal year-end of August 31. What fiscal year-end should Molly use for her new business?

Solution

From an accounting perspective, Molly should align her year-end date with the lowest point of activity in her business, August 31. Typically, businesses that are highly seasonal, such as Molly's, will not use a calendar year-end. This allows the business to more accurately reflect the revenue and expenses of the business because there are fewer transactions and complications.

Alternative Solution

Molly's tax advisor might suggest an alternative answer of December 31. If Molly is operating her business as a sole proprietorship, the business and the owner must both file a tax return using the same year-end. Most individuals do not file a tax return using a year-end other than December 31. Choosing a fiscal year-end, such as August 31, might unnecessarily complicate her individual tax return. However, if the business is organized as a corporation, it is a separate legal entity. The business year end would have no effect on the stockholders' individual income tax returns.

NEW! End-of-Chapter Review and Summary Problems

All end-of-chapter problems were reviewed and either updated or rewritten by the authors to ensure accuracy and consistency with text.

REVIEW

> Things You Should Know

1. **What is the difference between cash basis accounting and accrual basis accounting?**
   - Cash basis accounting: Revenue is recorded only when cash is received, and expenses are recorded only when cash is paid.
     - Not GAAP
     - Often used by small businesses
   - Accrual basis accounting: Revenue is recorded when earned, and expenses are recorded when incurred.

> Summary Problem 7-1

Misler Corporation established a $300 petty cash fund on January 12, 2015. Karen Misler (KM) is the fund custodian. At the end of the month, the petty cash fund contains the following:

a. Cash: $163

b. Petty cash tickets, as follows:

No.	Amount	Issued to	Signed by	Account Debited
44	$14	B. Jarvis	B. Jarvis and KM	Office Supplies
45	39	S. Bell	S. Bell	Delivery Expense
47	43	R. Tate	R. Tate and KM	—
48	33	L. Blair	L. Blair and KM	Travel Expense

Dear Colleagues,

We are very excited about the changes to the newest edition of *Horngren's Financial & Managerial Accounting*. As you and your students use this book, we hope you'll notice that this edition looks much different than previous editions. The birth of this edition began quite some time ago, when a group of accounting educators sat around a table and discussed what they wanted to see in a textbook. We asked them, "If you could design a textbook that helped students learn accounting, what would it look like?" Their response suggested that we build on the Horngren tradition, while redefining the design, chapter features, and accounting content to be more student friendly. Using these suggestions and the feedback we received from other in-depth focus groups and surveys, we are Redefining Tradition with the 4th edition of *Horngren's Financial & Managerial Accounting*. We focused on student success and professor expectations.

Student success. Using our experience as educators, we considered how students learn, what they learn, and what they struggle with. We wanted a way to bridge the gap between the textbook content and the teaching that we do in the classroom, so we've added several great new learning aids for students. One of these is specific callouts for students that address areas that are always challenging. These are tips that we always mention in class, such as a handy memory tool to help students remember the rules of debits and credits. We've also added student questions. As professors, we know that we often get the same question every semester about a key accounting concept. We've put many of those questions in the book and addressed common student misconceptions or confusion. And, we'd be remiss if we didn't mention MyAccountingLab and all of the wonderful supplemental materials such as the DemoDocs, resource videos, and audio PowerPoints.

Professor expectations. As professors, we know that you want a book that contains the content that you need, has excellent end-of-chapter material, and is error-free. With these expectations in mind, we have significantly changed the table of contents of the book, adding important accounting topics, such as investments, accounting information systems, variable costing, and budgeting for manufacturing companies. We reviewed and created the end-of-chapter questions, exercises, problems, and cases taking into account the types of assignments we would want to use in class and assign as homework. The textbook and solutions manual have been put through a rigorous accuracy check to ensure that they are complete and error-free.

What started with a single question has now developed into the new and redefined *Horngren's Financial & Managerial Accounting*. We welcome your feedback, suggestions, and comments. Please don't hesitate to contact us at HorngrensAccounting@pearson.com.

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

Student and Instructor Resources

For Students

MyAccountingLab

myaccountinglab.com Online Homework and Assessment Manager

- Pearson eText
- Data Files
- Videos
- Demo Docs
- Working Papers
- Audio and Student PowerPoint® Presentations
- Accounting Cycle Tutorial
- MP3 Files with Chapter Objectives and Summaries
- Flash Cards

Student Resource Web site: pearsonhighered.com/horngren

The book's Web site contains the following:

- Data Files: Select end-of-chapter problems have been set up in different software applications, including QuickBooks 2012 and General Ledger
- Working Papers

For Instructors

MyAccountingLab

myaccountinglab.com Online Homework and Assessment Manager

Instructor Resource Center: pearsonhighered.com/accounting

For the instructor's convenience, the instructor resources are available on CD or can be downloaded from the textbook's catalog page (pearsonhighered.com/horngren) and MyAccountingLab. Available resources include the following:

- **Online Instructor's Manual:** Includes chapter summaries, teaching tips provided by reviewers, pitfalls for new students, and "best of" practices from instructors across the country. Additional resources offered in the instructor's manual include the following:
  - Introduction to the Instructor's Manual with a list of resources and a roadmap to help navigate what's available in MyAccountingLab.
  - Instructor tips for teaching courses in multiple formats—traditional, hybrid, or online.
  - "First Day of Class" student handout that includes tips for success in the course, as well as an additional document that shows students how to register and log on to MyAccountingLab.
  - Sample syllabi for 10- and 16-week courses.
  - Chapter overview and teaching outline that includes a brief synopsis and overview of each chapter.
  - Key topics that walk instructors through what material to cover and what examples to use when addressing certain items within the chapter.
  - Student chapter summary handout.
  - Assignment grid that outlines all end-of-chapter exercises and problems, the topic being covered in that particular exercise or problem, estimated completion time, level of difficulty, and availability in Excel templates.
  - Ten-minute quizzes that quickly assess students' understanding of the chapter material.
  - Demonstration Problems for use in class.
- **Instructor's Solutions Manual:** Contains solutions to all end-of-chapter questions, including short exercises, exercises, and problems.

- **TestBank:** Includes more than 3,000 questions. Both objective-based questions and computational problems are available.
- **PowerPoint Presentations:** These presentations help facilitate classroom discussion by demonstrating where the numbers come from and what they mean to the concept at hand. Includes NEW Demonstration Problem slides
  – Instructor PowerPoint Presentations—complete with lecture notes
  – Student PowerPoint Presentations
  – Audio Narrated PowerPoint Presentations
  – Clicker Response System (CRS) PowerPoint Presentations
- **Working Papers and Solutions in Excel and PDF Format**
- **Image Library**
- **Data and Solution Files:** Select end-of-chapter problems have been set up in different software applications, including QuickBooks 2012 and General Ledger. Corresponding solution files are also provided.

Acknowledgments

Acknowledgments for This Edition:

Tracie Nobles would like to thank her parents, sister, and friends: Kipp and Sylvia Miller, Michelle Miller, and Cathy, Denise, Chris, Colleen, Kibby, Lori, and Cindy. Each of you supported me, cried with me, comforted me, loved me, and encouraged me. You are all a testament to the quote by Helen Keller, "I would rather walk with a friend in the dark, than alone in the light." Your lights brightened my night and for that I am eternally grateful.

Brenda Mattison has always had the loving support of her family and wishes to express her gratitude to them: mother, Omie Sturgill; husband, Grant Mattison; and sons, Christopher and Dillon Mattison. She would also like to remember her late father, Golden Sturgill, for his inspiration and the confidence that he instilled in her. 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, Linda Harrison, Nicole Sam, Alison Haskins, and Stephanie Wall 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.

Contributors:

Lori Hatchell, *Aims Community College*
Denise A. White, *Austin Community College*

Advisory Panels, Focus Group Participants and Reviewers:

Sharon Agee, *Rollins College*
Markus Ahrens, *St. Louis Community College*
Janice Akao, *Butler County Community College*
Michael Barendse, *Grossmont College*
Anne Cardozo, *Broward College*
Martha Cavalaris, *Miami Dade College*
Donna Chadwick, *Sinclair Community College*
Colleen Chung, *Miami Dade College*
Geoffrey Danzig, *Miami Dade College – North*
Judy Daulton, *Piedmont Technical College*
Annette Fisher Davis, *Glendale Community College*
Mary Ewanechko, *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*
Lori Hatchell, *Aims Community College*
Shauna Hatfield, *Salt Lake Community College*
Patricia Holmes, *Des Moines Area Community College*
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*
Mabel Machin, *Valencia College*
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*
Cecile Robert, *Community College of Rhode Island*
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:

Carl Essig, *Montgomery County Community College*
Marc Giullian, *Montana State University*
Florence McGovern, *Bergen Community College*
Carolyn Streuly

Supplements Authors and Reviewers:

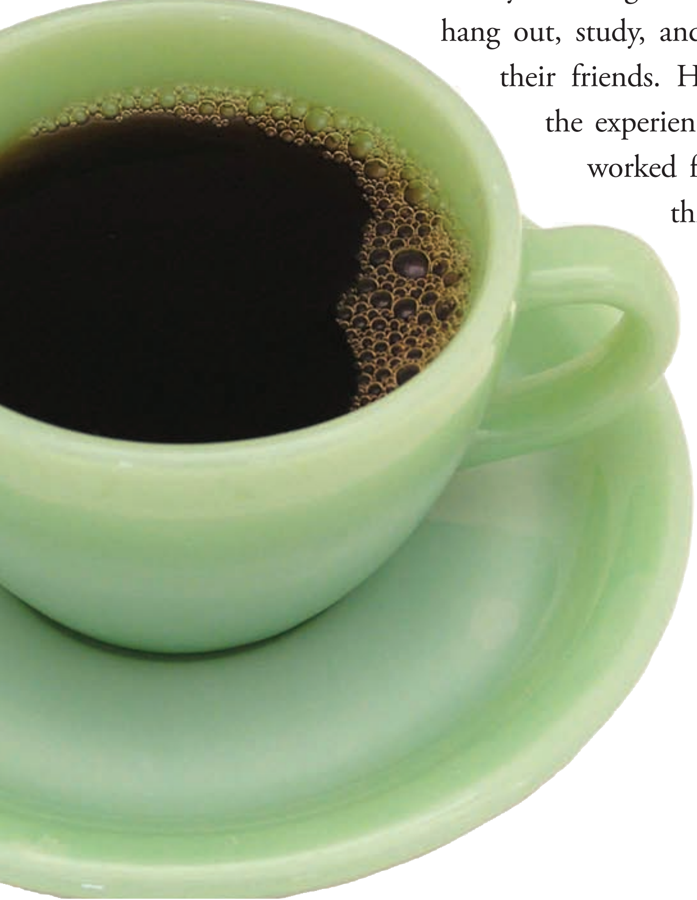
Judy Daulton, *Piedmont Technical College*
Annette Fisher Davis, *Glendale Community College*
Jamie McCracken, *Saint Mary-of-the-Woods College*
Cynthia J. Miller, *University of Kentucky*
Kimberly Perkins, *Austin Community College*
Richard Rand, *Tennessee Technical University*
Michelle Suminski, *Marygrove College*

1

Accounting and the Business Environment

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 across the street from campus. He knew there was a need; students were always looking for a place to hang out, 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 15,000 stores in 50 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 outline

- Why is accounting important?
- What are the organizations and rules that govern accounting?
- What is the accounting equation?
- How do you analyze a transaction?
- How do you prepare financial statements?
- How do you use financial statements to evaluate business performance?

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.

Decision Makers: The Users of Accounting Information

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.

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.

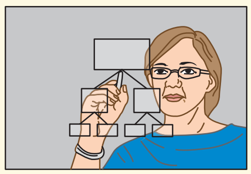
Exhibit 1-1 illustrates the difference between financial accounting and managerial accounting. Regardless of whether they are external or internal to the company, all decision

Exhibit 1-1 | **Decision Making: Financial versus Managerial Accounting**

Financial Accounting

External Decision Makers:
Should I invest in the business?
Is the business profitable?
Should we lend money to the business?
Can the business pay us back?

Managerial Accounting



Internal Decision Makers:
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?

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.

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) in these elements.

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.

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://finance.yahoo.com**, **www.google.com/finance**, or the Security and Exchange Commission's EDGAR database (**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?

Creditor
Any person or business to whom a business owes money.

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

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.

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

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) website (**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) website (**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 non-certified colleagues when they enter the work force.

Studying accounting and becoming certified professionally can lead to a financially secure job. According to Robert Half's *2012 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 1-2 provides a snapshot of the earning potential for key positions.

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. Department of Labor's *Occupational Outlook Handbook 2010–2011*, the federal government expects faster than average employment growth for accountants and auditors from 2008–2018.

Exhibit 1-2 | Comparison of Accounting Positions

Position	Job Description	Salary Range
Controllers	Compile financial statements, interact with auditors, and oversee regulatory reporting.	$82,750–$199,000
Financial analysts	Review financial data and help to explain the story behind the numbers.	$38,000–$114,500
Business systems analysts	Use accounting knowledge to create computer systems.	$44,250–$107,250
Tax accountants	Help companies navigate tax laws.	$41,500–$114,750
Auditors	Perform reviews of companies to ensure compliance to rules and regulations.	$42,500–$171,750
Cost accountants	Typically work in a manufacturing business. Help analyze accounting data.	$40,000–$103,750

> 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 at the end of the chapter.

For more practice, see Short Exercise S1-1. MyAccountingLab

WHAT ARE THE ORGANIZATIONS AND RULES THAT GOVERN ACCOUNTING?

Learning Objective 2
Describe the organizations and rules that govern accounting.

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).

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

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.[1] Relevant information allows users of the information to make a decision. Information that is faithfully representative is

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

[1] This wording was changed from relevant and reliable by the *Statement of Financial Accounting Concepts No. 8*.

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

Economic Entity Assumption
An organization that stands apart as a separate economic unit.

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 1-3 summarizes the similarities and differences among the four types of business organizations.

Distinguishing Characteristics and Organization of a Corporation

Stockholder
A person who owns stock in a corporation.

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.

In this book, we spend most of our time studying accounting for corporations. There are several features that distinguish a corporation from other types of business organizations. Let's look at them now.

Separate Legal Entity A corporation is a business entity formed under state law. The state grants a charter (also called *articles of incorporation*), which is the document that gives the state's permission to form a corporation. This is called authorization because the state "authorizes" or approves the establishment of the corporate entity.

A corporation is a distinct entity from a legal perspective. It is an entity that exists apart from its owners, who are called the **stockholders** or *shareholders*. However, the corporation has many of the rights that a person has. For example, a corporation may buy, own, and sell property; enter into contracts; sue; and be sued. Items that the business owns (its assets) and those items that the business has to pay later (its liabilities) belong to the corporation and not to the individual stockholders.

The ownership interest of a corporation is divided into shares of stock. A person becomes a stockholder by purchasing the stock of the corporation. The corporate

Exhibit 1-3 | **Business Organizations**

	Sole Proprietorship	Partnership	Corporation	Limited-Liability Company (LLC)
Definition	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
Number of owners	One (called the proprietor)	Two or more (called partners)	One or more (called stockholders)	One or more (called members or partners)
Life of the organization	Terminates at owner's choice or death	Terminates at a partner's choice or death	Indefinite	Indefinite
Personal liability of the owner(s) for the business's debts	Owner is personally liable	Partners are personally liable	Stockholders are not personally liable	Members are not personally liable
Taxation	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.
Type of business	Small businesses	Professional organizations of physicians, attorneys, and accountants	Large multinational businesses	An alternative to the partnership

charter specifies how much stock the corporation is authorized to issue (sell) to the public. Due to this fact, it is usually easier for corporations to raise capital.

Continuous Life and Transferability of Ownership Stockholders may transfer stock as they wish—by selling or trading the stock to another person, giving the stock away, bequeathing it in a will, or disposing of the stock in any other way. Because corporations have continuous lives regardless of changes in the ownership of their stock, the transfer of the stock has no effect on the continuity of the corporation. Sole proprietorships and partnerships, in contrast, end when their ownership changes for any reason. A corporation's life is not dependent on a specific individual's ownership.

No Mutual Agency No mutual agency means that the stockholder of a corporation cannot commit the corporation to a contract unless that stockholder is acting in a different role, such as an officer in the business. Mutual agency of the owners is not present in a corporation as it is in a partnership.

Limited Liability of Stockholders A stockholder has limited liability for the corporation's debts. The most that stockholders can lose is the amount they originally paid for the stock. (Depending on state law, this limited liability would also apply to a Limited-Liability Company member; however, conversely, sole proprietors and partners are personally liable for the debts of their businesses.)

The combination of limited liability and no mutual agency means that persons can invest unlimited amounts in a corporation with only the fear of losing whatever amount the individual has invested if the business fails. This attractive feature enables a corporation to raise more money than proprietorships and partnerships.

Separation of Ownership and Management Stockholders own the business, but a board of directors—elected by the stockholders—appoints corporate officers to manage the business. Thus, stockholders do not have to disrupt their personal affairs to manage the business.

This separation between stockholders (owners of the corporation) and management may create problems. Corporate officers may decide to run the business for their own benefit rather than for the benefit of the company. Stockholders may find it difficult to lodge an effective protest against management because of the distance between them and the top managers.

Corporate Taxation Corporations are separate taxable entities. They pay a variety of taxes not paid by sole proprietorships or partnerships. Depending on the state in which the organization incorporated and the state(s) in which the corporation operates, the taxes could include some or all of the following:

- Annual franchise tax levied by the state. The franchise tax is paid to keep the corporation charter in force and enables the corporation to continue in business.
- Federal and state income taxes. Corporate earnings are subject to double taxation. First, corporations pay their own income tax on corporate income. Then the stockholders pay personal income tax on the dividends that they receive from corporations. This is different from sole proprietorships and partnerships, which pay no business income tax. Instead, the tax falls solely on the individual owners.

Government Regulation To protect persons who loan money to a corporation or who invest in its stock, states monitor the actions of corporations. Corporations are subjected to more governmental regulation than other forms of business, which is a disadvantage for corporations and can be expensive.

Organization of a Corporation As noted earlier, creation of a corporation begins when its organizers, called the incorporators, obtain a charter from the state. The charter includes the authorization for the corporation to issue a certain number of shares of stock, which represent