

FINANCIAL & MANAGERIAL ACCOUNTING

Warren / Reeve / Duchac 13e



Financial and Managerial Accounting

13e

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Warren/Reeve/Duchac Financial and Managerial Accounting & CengageNOWv2

*An Integrated Learning System
to Keep Students on Track and Progressing!*

Example Exercise 3-3 Adjustment for Prepaid Expense

The prepaid insurance account had a beginning balance of \$6,400 and was debited for \$3,600 of premiums paid during the year. Journalize the adjusting entry required at the end of the year, assuming the amount of unexpired insurance related to future periods is \$3,250.

Follow My Example 3-3

| | | |
|--|-------|-------|
| Insurance Expense | 6,750 | |
| Prepaid Insurance | | 6,750 |
| Insurance expired (\$6,400 + \$3,600 - \$3,250). | | |

Practice Exercises: PE 3-3A, PE 3-3B

Example Exercises (EE) throughout the chapter show students how to solve problems by reinforcing fundamental concepts. Students can follow these examples when completing Practice Exercises.

EE 3-3 p.112 PE 3-3A Adjustment for prepaid expense OBJ. 2

The supplies account had a beginning balance of \$3,375 and was debited for \$6,450 for supplies purchased during the year. Journalize the adjusting entry required at the end of the year, assuming the amount of supplies on hand is \$2,980.

Adjusting Entry for Prepaid Insurance

The balance in the prepaid insurance account, before adjustment at the end of the year, is \$21,700. Journalize the adjusting entry required under each of the following alternatives for determining the amount of the adjustment: (a) the amount of insurance expired during the year is \$16,450; (b) the amount of unexpired insurance applicable to future periods is \$5,250.

| Journal | | | | |
|---------|---|------------|--------|--------|
| Date | Description | Post. Ref. | Debit | Credit |
| Dec. 31 | Insurance Expense Prepaid Insurance Insurance expired | | 16,450 | 16,450 |

| Assets | | Liabilities | | Owner's Equity (Expense) | |
|-------------------|-------------------|-------------|--|--------------------------|--|
| Prepaid Insurance | Insurance Expense | | | | |
| Bal. 21,700 | Dec. 31 16,450 | | | Dec. 31 16,450 | |

Practice Exercises (PE) are homework problems that refer back to the Example Exercises (EE) in the chapter. These exercises encourage students to practice key concepts and procedures.

Show Me How problem demonstrations, linked to exercises in CengageNOWv2, mirror the structure of exercises and problems found in the textbook and include teaching tips and warnings to help students learn and avoid common mistakes.



Adjustment for Prepaid Expense

Instructions

The supplies account had a beginning balance of \$3,375 and was debited for \$6,450 for supplies purchased during the year. Journalize the adjusting entry required at the end of the year (December 31), assuming the amount of supplies on hand is \$2,980.

Journal

Journalize the adjusting entry on December 31.

| DATE | ACCOUNTS | POST. REF. | DEBIT | CREDIT |
|------|-----------------|------------|-------|--------|
| | Adjusting Entry | | | |

Practice Exercises are assignable in CengageNOWv2, which allows students to access helpful resources such as Check My Work and Show Me How problem demonstrations.

Set Course Expectations and Guide Students to Success!

Motivate students by reshaping their misconceptions about the introductory accounting course. Students are often surprised by both the approach to learning accounting and the necessary amount of time they need to spend outside of class working through homework assignments.

CengageNOWv2 Start-Up Center **NEW!**

The CengageNOWv2 **Start-Up Center** will help students identify what they need to do and where they need to focus in order to be successful with a variety of brand new resources.

NEW Success Strategies Module includes **Student Advice Videos** and a **Success Strategies Tip Sheet** to ensure that students understand course expectations (and how they may differ from other courses) and how to best plan and prepare so as to be successful in the introductory accounting course.



The **Student Advice Videos** feature real introductory accounting students giving guidance to students who are just starting the course about what it takes to be successful in introductory accounting.

NEW Math Review Module, designed to help students get up to speed with necessary math skills, includes **math review assignments** and **Show Me How** math review videos to ensure that students have an understanding of basic math skills, including:

- Whole number operations
- Decimal operations and rounding
- Percentage operations and conversion
- Fraction operations
- Converting numbers expressed in one form to a different form
- Positive and negative numbers
- Ratios and averages

NEW How to Use CengageNOWv2 Module allows students to focus on learning accounting, not on a particular software system. Quickly familiarize your students with CengageNOWv2 and direct them to all of its built-in student resources.

Expose Students to Concepts Before Class Begins!

With all the outside obligations accounting students have, finding time to read the textbook before class can be a struggle. Point students to the key concepts they need to know before they attend class.

Video: Animated Activities

Animated Activities are engaging animated scenarios that visually guide students through selected core topics in introductory accounting. Each activity uses a realistic company example to illustrate how the concepts relate to the everyday activities of a business. These activities include multiple-choice questions that gauge student understanding of the overarching chapter concepts.

| | February 26, 2016 | February 27, 2016 |
|----------------------------------|-------------------|-------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 1,183,967 | \$ 1,096,100 |
| Short-term investment securities | 605,608 | 431,476 |
| Merchandise inventories | 1,968,907 | 1,759,703 |
| Other current assets | 315,736 | 275,066 |
| Total current assets | 4,073,838 | 3,563,345 |
| Long-term investment securities | 121,446 | 132,860 |
| Property and equipment, net | 1,116,297 | 1,119,292 |
| Other assets | 334,812 | 318,631 |
| Total assets | \$ 5,646,193 | \$ 5,152,130 |

Animated Activities are assignable/gradable in CengageNOWv2 and available for self-study and review.

Prepaid Insurance

- The debit balance of \$2,400 in NetSolutions' prepaid insurance account represents the December 1 prepayment of insurance for 12 months.

| Dec. 31 | Insurance Expense | | 55 | 200 | 200 |
|---------|-----------------------------------|--|----|-----|-----|
| | Prepaid Insurance | | 15 | | |
| | Insurance expired (\$2,400 ÷ 12). | | | | |

Accounting Equation Impact

| Assets | | = | Liabilities | + | Owner's Equity (Expense) |
|-------------------|-------|---|-------------|---|--------------------------|
| Prepaid Insurance | 15 | | | | Insurance Expense |
| Bal. | 2,400 | | | | Dec. 31 |
| Adj. Bal. | 2,200 | | | | 200 |
| | | | | | 55 |

↓ decrease ↑ increase

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Tell Me More lecture activities for every Learning Objective are assignable/gradable in CengageNOWv2 and available for self-study and review.

Video: Tell Me More **NEW!**

Tell Me More lecture activities explain the core concepts of the chapter through an engaging auditory and visual presentation that is ideal for all class formats—flipped model, online, hybrid, face-to-face.

Expose Students to Concepts Before Class Begins!

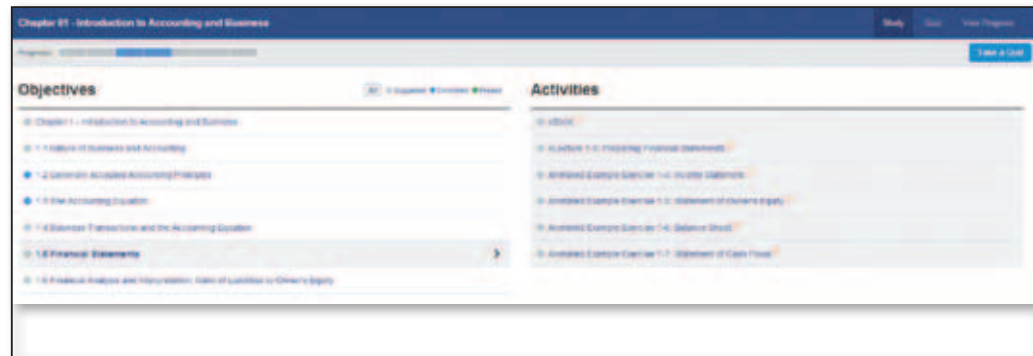
Students don't want to waste time going over concepts that they have already mastered. With the NEW Adaptive Study Plan, they can focus on learning new topics and fully understanding difficult concepts.



Adaptive Study Plan **NEW!**

The Adaptive Study Plan in CengageNOWv2 is an assignable/gradable study center that adapts to each student's unique needs and provides a remediation pathway to keep students progressing.

The Adaptive Study Plan is assignable/gradable in CengageNOWv2 and available for self-study and review.



How does it work?

Step 1: Students take a chapter-level quiz consisting of randomized questions that cover both conceptual and procedural aspects of the chapter.

Step 2: Feedback is provided for each answer option explaining why the answer is right or wrong.

Step 3: Based on the quiz results, students are provided a remediation path that includes media assets and algorithmic practice problems to help them improve their understanding of the course material.

Instructors may use prerequisites that require students to achieve mastery in the Adaptive Study Plan before moving on to new material.

The new Adaptive Study Plan offers the benefit of customization coupled with remediation.

— Jennifer Schneider, professor at University of North Georgia

Make Content Relatable!

Show students how the material they are learning matters in real life and help them connect accounting concepts to the world around them.



Experience Managerial Accounting Videos are assignable/gradable in CengageNOWv2 and available for self-study and review.

Video: Experience Managerial Accounting

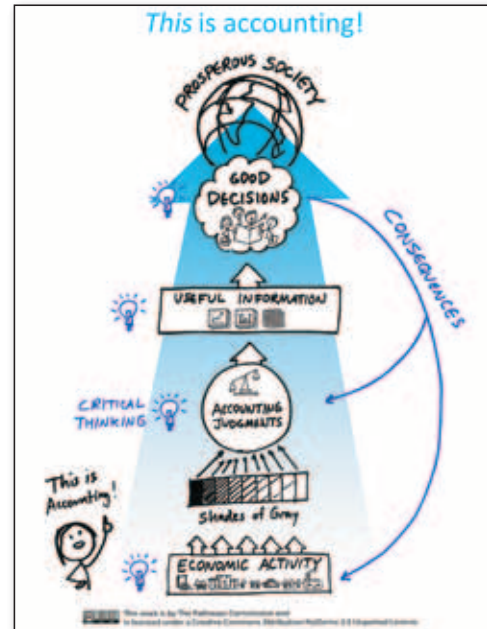
Experience Managerial Accounting Videos, available in CengageNOWv2, show students how progressive companies such as [Cold Stone Creamery](#), [Second City](#), and [Hard Rock Café](#) incorporate managerial accounting to fuel better business performance.

Pathways Commission “THIS is accounting!” **NEW!**

Pathways Commission “THIS is accounting!” illustrates what students should understand as a result of their first exposure to accounting. Incorporated into Chapter 1, this graphic gives students a big picture view of how accounting can lead to a prosperous society.

Service Focus **NEW!**

Service Focus features highlight the differences between manufacturing companies and service companies and illustrate how managerial accounting concepts apply to service companies such as [The Walt Disney Company](#) and [Sierra Nevada](#).



Source: *Charting a National Strategy for the Next Generation of Accountants*, The Pathways Commission, July 2012.

| Service | Focus |
|--|---|
| <p>PROFIT, LOSS, AND BREAK-EVEN IN MAJOR LEAGUE BASEBALL</p> <p>Major League Baseball is a tough game and a tough business. Ticket prices (unit selling price), player salaries (variable costs), stadium fees (fixed costs), and attendance (volume) converge to make it difficult for teams to make a profit, or at least break even. So, which major league baseball team was the most profitable in 2013? Well, it wasn't the World Champion Boston Red Sox. Nor was it the star-studded New York Yankees. Then, it had to be the recently turned around Los Angeles Angels, right? Not even close. It was actually the worst team in baseball—the Houston Astros.</p> <p>Just how profitable were the Astros? They earned \$99 million in 2013, which was more than the combined 2013 profits of the six most recent World Series champions. How could the team with the worst record in baseball since 2005</p> | <p>have one of the most profitable years in baseball history? By paying careful attention to costs and volume. Between 2011 and 2013, the Astros cut their player payroll from \$56 million to less than \$13 million. That's right, all of the players on the Houston Astros baseball team combined, made less in 2013 than Alex Rodriguez (New York Yankees), Cliff Lee (Philadelphia Phillies), Prince Fielder (Detroit Tigers), and Tim Lincecum (San Francisco Giants) made individually. While attendance at Astros games has dropped by around 20% since 2011, the cost reductions from reduced player salaries have far outpaced the drop in attendance, making the 2013 Astros the most profitable team in baseball history. While no one likes losing baseball games, the Houston Astros have shown that focusing on the relationship between cost and volume can yield a hefty profit, even when they aren't winning.</p> <p>Source: D. Alexander, "2013 Houston Astros: Baseball's Worst Team Is The Most Profitable in History," <i>Forbes</i>, August 26, 2013.</p> |

Close the Gap Between Homework and Exam Performance!



Good tool to make students understand concepts without overly relying on technology's help.

– Ramesh Narasimhan, professor
at Montclair State University

I like it because it appears to bridge the gap between the homework and my exam.

– Lawrence Chui, professor
at University of St. Thomas

This will minimize students' complaints about how the exam looks different from the homework format.

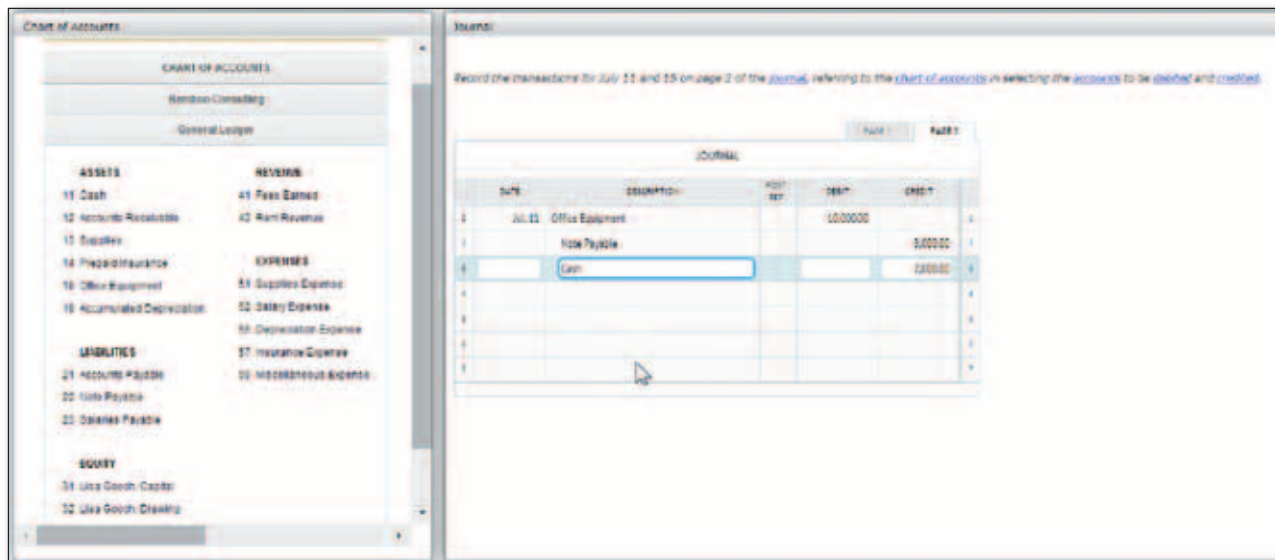
– Rama Ramamurthy, professor
at Georgetown University

Many students perform well on homework but struggle when it comes to exams. Now, with the new Blank Sheet of Paper Experience, students must problem-solve on their own, just as they would if taking a test on a blank sheet of paper.

Blank Sheet of Paper Experience **NEW!**

A less-leading Blank Sheet of Paper Experience discourages overreliance on the system.

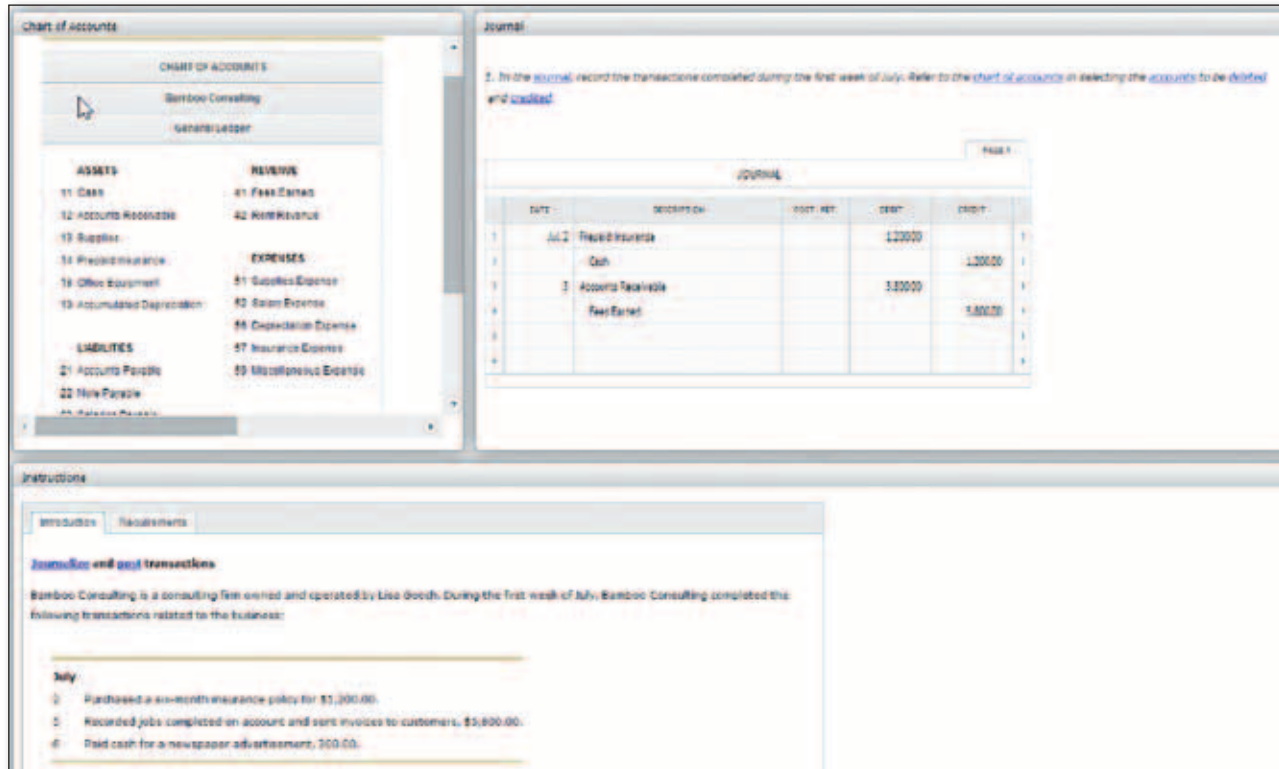
- The use of drop down menus and Smart Entry (type-ahead) has been eliminated.
- Students must refer to the Chart of Accounts and decide for themselves what account is impacted.
- The number of accounts in each transactions is not given away.
- Whether the account should be debited or credited is not given away.
- Transactions may be entered in any order (as long as the entries are correct).
- Check My Work feedback only reports on what students have actually attempted, which prevents students from “guessing” their way through the assignment.



Check it out! Visit cnovv2demo.cengage.com for an interactive demo.

Help Students Make Connections and See the Big Picture!

Homework software should not get in the way of learning. One of the biggest complaints students have about online homework is the scrolling, which prevents students from seeing the big picture and understanding the accounting system. The new Multi-Panel View addresses this issue and enhances student learning.



Multi-Panel View **NEW!**

The NEW Multi-Panel View in CengageNOWv2 enables students to see all the elements of a problem on one screen.

- Students make connections and see the tasks as connected components in the accounting process.
- Dramatically reduced scrolling eliminates student frustration.

With the ability to move and resize journals, ledgers, forms, and financial statements, it is easier to navigate the problem and understand the accounting system.

This is just a lot better and less confusing than scrolling up and down. . . . Having it like that would make it much easier —not so much scrolling and it wouldn't be so confusing.

— Tyler Mason, student at Northern Essex Community College

Multi-Panel View makes it much easier for students to see how each piece of the accounting cycle impacts the other pieces. Having it all in one view reduces student frustration and gives them a clearer picture of the complete accounting cycle.

— Kristen Quinn, professor at Northern Essex Community College

Close the Gap Between Homework and Exam Performance!

Students often complete homework at odd times. And when they use CengageNOWv2, they get help right when they need it.



Adaptive Feedback **NEW!**

Adaptive Feedback in CengageNOWv2 responds to students based upon their unique answers and alerts them to the type of error they have made without giving away the answer.

| PAGE 1 | | PAGE 2 | | | | | |
|---------|---------|------------------|------------|-----------|----------|---------------|--|
| JOURNAL | | | | | | Score: 33/138 | |
| | DATE | DESCRIPTION | POST. REF. | DEBIT | CREDIT | | |
| 1 | Jul. 11 | Office Equipment | ✓ | 10,000.00 | | 1 | |
| 2 | | Cash | ✓ | | 8,000.00 | 2 | |
| 3 | | Note Payaable | | | 2,000.00 | 3 | |
| 4 | | | | | | 4 | |
| 5 | | | | | | 5 | |
| 6 | | | | | | 6 | |
| 7 | | | | | | 7 | |
| 8 | | | | | | 8 | |
| 9 | | | | | | 9 | |
| 10 | | | | | | 10 | |
| 11 | | | | | | 11 | |

| PAGE 1 | | PAGE 2 | | | | | |
|---------|---------|------------------|------------|-----------|----------|---------------|--|
| JOURNAL | | | | | | Score: 33/138 | |
| | DATE | DESCRIPTION | POST. REF. | DEBIT | CREDIT | | |
| 1 | Jul. 11 | Office Equipment | ✓ | 10,000.00 | | 1 | |
| 2 | | Cash | ✓ | | 8,000.00 | 2 | |
| 3 | | Note Payaable | | | 2,000.00 | 3 | |
| 4 | | | | | | 4 | |
| 5 | | | | | | 5 | |
| 6 | | | | | | 6 | |
| 7 | | | | | | 7 | |
| 8 | | | | | | 8 | |
| 9 | | | | | | 9 | |

There is a minor spelling error in the account title. You will be graded as if you had entered "Note Payable."

Line _____

- The amount for this account is incorrect, although you've entered the amount in the correct column. [-2]

Points: 0.24 / 1

Feedback

▼ Check My Work

Identify which accounts are affected in each transaction. Keep in mind that every transaction involves at least two accounts. Determine whether the account increases or decreases and record each increase or decrease following the rules of debit and credit. Use the Posting Reference column to enter the corresponding account number from the general ledger account. Remember total debits should equal total credits in your entries.

[Learning Objective 1](#)
[Learning Objective 2](#)
[Learning Objective 3](#)

I like the adaptive feedback. It will reduce a number of errors that cause students to give up.

— Kevin Jones, professor at Drexel University

Excellent! Often learning from feedback is more powerful than learning from the instructor, text, etc.

— Lisa Brown, professor at Indiana Institute of Technology

In addition to groundbreaking, adaptive feedback, CengageNOWv2 continues to provide multiple layers of guidance to keep students on track and progressing.

- **Check My Work Feedback** provides general guidance and hints as students work through homework assignments.
- **NEW Check My Work Feedback** in CengageNOWv2 now only reports on what students have actually attempted, which prevents them from "guessing" their way through assignments.
- **Explanations** are available after the assignment has been submitted and provide a detailed description of how to arrive at the solution.

Check it out! Visit cnovv2demo.cengage.com for an interactive demo.

Help Students Make Connections and See the Big Picture!

The best way to learn accounting is through practice, but students often get stuck when attempting homework assignments on their own.

Adjusting Entry for Prepaid Insurance

The balance in the prepaid insurance account, before adjustment at the end of the year, is \$21,700. Journalize the adjusting entry required under each of the following alternatives for determining the amount of the adjustment: (a) the amount of insurance expired during the year is \$16,450; (b) the amount of unexpired insurance applicable to future periods is \$5,250.

| Journal | | | | |
|---------|---|------------|--------|--------|
| Date | Description | Post. Ref. | Debit | Credit |
| Dec. 31 | Insurance Expense Prepaid Insurance Insurance expired | | 16,450 | 16,450 |

| Assets | | = | Liabilities | + | Owner's Equity (Expense) |
|-------------------|---------|---|-------------|---|--------------------------|
| Prepaid Insurance | | | | | Insurance Expense |
| Bal. | 21,700 | | | | Dec. 31 |
| | Dec. 31 | | | | 16,450 |
| | | | | | |

Video: Show Me How NEW!

Created for the most frequently assigned end-of-chapter items, hundreds of NEW Show Me How problem demonstration videos provide a step-by-step model of a similar problem. Embedded tips and warnings help students avoid common mistakes and pitfalls.

Identified by an icon in the text margins, Show Me How videos are linked to assignments in CengageNOWv2 and available for self-study and review.

Blueprint Problems

Blueprint Problems are teaching problems that walk students through a single accounting topic. These problems cover the primary learning objectives and are designed to help students understand foundational content and the associated building blocks versus memorizing the formulas or journal entries.

Adjusting entries—Deferred

Under actual basis accounting, adjustments are often necessary at the end of the period to ensure that revenues and expenses are recorded in the correct accounting period. These adjustments are made after the first trial balance is taken. There are two types of adjusting entries: **accruals** and **deferrals**. Whether the adjusting entry is an accrual or a deferral, the following is always true: The income statement account is always affected, the balance sheet account is always affected, and Cash is never affected. Let's focus on deferrals.

When revenue is received in advance, it is said to be deferred. At that time, Cash is increased (increased Revenue, a liability, is also increased). An adjusting entry is recorded at the end of the period in which the service or product is provided to recognize that the revenue (or part of it) has been earned. In the adjusting entry, the debit is to account and the credit is to account.

In the table at below, indicate how the adjusting entry affects the accounting equation and on what financial statement the account is reported.

| DEFERRED REVENUES | | | | |
|---------------------|---|-------------|---|--------|
| Assets | = | Liabilities | + | Equity |
| Account appears on: | | | | |
| DEBIT | | CREDIT | | CREDIT |
| Credit | | Debit | | Debit |

When an expense is paid in advance, it is said to be deferred because the recognition of the expense is deferred until a later date. At that time, an asset is increased (rather than an expense) and Cash is **decreased**. An adjusting entry is recorded at the end of the period in which the asset or part of the asset is consumed. The debit is to account and the credit is to account. In the table at below, indicate how the adjusting entry affects the accounting equation and on what financial statement the account is reported.

| DEFERRED EXPENSES | | | | |
|---------------------|---|-------------|---|--------|
| Assets | = | Liabilities | + | Equity |
| Account appears on: | | | | |
| DEBIT | | CREDIT | | CREDIT |
| Credit | | Debit | | Debit |

Blueprint Problems are assignable/gradable in CengageNOWv2.

NetSolutions Continuing Case Study

Students follow a fictitious company, **NetSolutions**, which demonstrates a rich variety of transactions. The continuity of presentation helps students master difficult concepts such as the accounting cycle.

Help Students Go Beyond Memorization to True Understanding!

Students often struggle to understand how concepts relate to one another. For most students, an introductory accounting course is their first exposure to both *business transactions* and the *accounting system*. While these concepts are already difficult to master individually, their combination and interdependency in the introductory accounting course often pose a challenge for students.



Dynamic Exhibits **NEW!**

To overcome this gap, the authors have created a series of interactive Dynamic Exhibits that allow students to change the variables in a scenario and see how a change ripples through the accounting system. Dynamic Exhibits allow students to see connections and relationships like never before!

Identified by an icon in the text, Dynamic Exhibits are embedded within the MindTap eReader in CengageNOWv2. They are assignable/gradable in CengageNOWv2 and available for self-study and review.

Blueprint Connections

Blueprint Connections are scenario-based teaching problems that solidify concepts and demonstrate their interrelationships, as well as promote critical thinking. Blueprint Connections combine multiple topics, allowing students to explore a larger concept more fully, and strengthen analytical skills.



Blueprint Connections are assignable/gradable in CengageNOWv2.

Help Students Build Critical Thinking Skills!

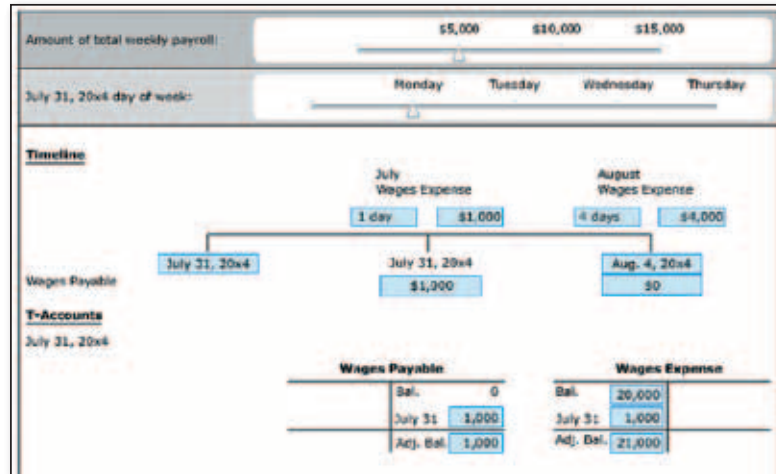
Students often resort to memorization as a way to pass the course, but such surface learning does little to develop the critical thinking skills and deep understanding that are necessary for success in future business courses.

Activation Exercises

To overcome these challenges, the authors have created Activation Exercises to provide a learning system that focuses on developing a better understanding of:

- Key terms and definitions
- Economics of business transactions
- How transactions are recorded in the accounting system
- How transactions are ultimately reflected in the financial statements

These “what if” exercises help students understand relationships using interactive tools.



The Activation Exercises are assignable/gradable in CengageNOWv2.

These exercises are interactive and actually allow students to experiment with the data, visually viewing the impact when data is altered. The exercises show not only how a transaction looks in the journal and ledger accounts, but also the impact it ultimately has on financial statements. Finally, students are challenged to analyze the overall impact of a transaction by answering questions related to the topic. This is an excellent learning tool.

– Rita Mintz, professor at Calhoun Community College

The Activation Exercises structure builds the critical thinking skills that are necessary for students to succeed in both introductory accounting and future accounting courses. Reviewers have enthusiastically praised the authors’ online activities and indicated that they would be both ideal for pre-class activities and after-class assignments.



Financial Statement Analysis and Interpretation

The Financial Statement Analysis and Interpretation sections, at the end of financial accounting chapters, help students understand key ratios and how stakeholders interpret financial reports. These sections encourage students to go deeper into the material to analyze accounting information and improve critical thinking skills.

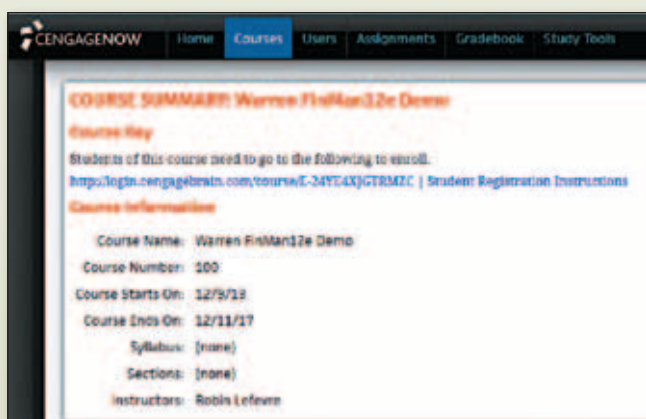
Online Solutions



CengageNOWv2 is a powerful course management and online homework resource that provides control and customization to optimize the student learning experience. Included are many proven resources including algorithmic activities, test bank, course management tools, reporting and assessment options, and much more.

Recent CengageNOW Enhancements **NEW!**

- **Refreshed Design:** This refreshed look will help you and your students focus easily and quickly on what is important, while maintaining the same functionality that CengageNOW users know and love.
- **Integration with Popular Learning Management Systems:** Single login, deep linking, and grade return! (Check with your local Learning Consultant for more details!)
- **Upload Files Capability:** You can now upload files in CengageNOW for student use—including videos, Excel files, Word files, and more.
- **Email Instructor Feature:** Students can now send you a screenshot of the question they are working on directly through CengageNOW and ask specific questions about where they are stuck.
- **Better Date Management:** When modifying assignment due dates for a whole course, the system will now automatically adjust due dates based on a new start date, making it easier to reuse a course from one term to the next and adjust for snow days.
- **Streamlined Assignment Creation Process:** A simplified and streamlined Assignment Creation process allows instructors to quickly set up and manage assignments from a single page!
- **New Report Options:** New reporting options allow you to get better reports on your students' progress.
- **New Student Registration Process:** When you create a course, a URL will be generated that will automatically take students right into the instructor's course without them having to enter the course key!

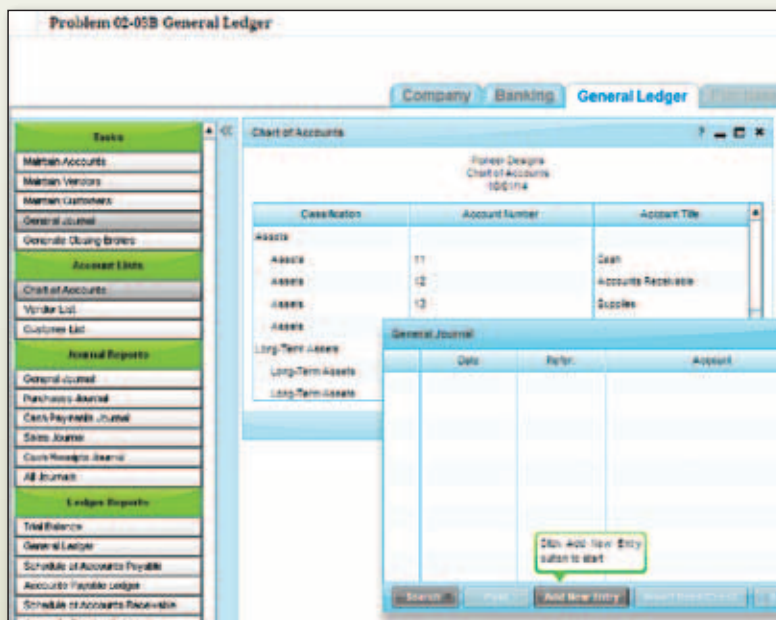


MindTap eReader

The MindTap eReader for Warren/Reeve/Duchac's *Financial and Managerial Accounting* is the most robust digital reading experience available. Hallmark features include:

- Fully optimized for the iPad.
- Note taking, highlighting, and more.
- Embedded digital media such as Dynamic Exhibits.

The MindTap eReader also features ReadSpeaker®, an online text-to-speech application that vocalizes, or “speech-enables,” online educational content. This feature is ideally suited for both instructors and learners who would like to listen to content instead of (or in addition to) reading it.



Cengage Learning General Ledger Software (CLGL)

CLGL exposes students to computerized accounting software without teaching the specifics of a certain software system—preparing students for *any* software program they might encounter in the real world.

- Now available in CengageNOWv2, CLGL allows students to work through end-of-chapter assignments and practice sets in a format that emulates commercial general ledger software, but in a manner that is more forgiving of errors.
- Assignments are automatically graded online.
- Selected problems that can be solved using CLGL are designated by an icon in the textbook and are listed in the assignment preparation grid in the Instructor's Manual.

New to This Edition

In addition to the many new digital assets created for this edition of *Financial and Managerial Accounting*, the textbook content itself has also been revised. The most significant changes for this edition involve the inclusion of the new revenue recognition standard and a greater emphasis on service companies in the managerial accounting chapters.

In all chapters, the following improvements have been made:

- Updated dates and real company information for currency
- Added headers and sub-headers to help students navigate through the chapter and easily reference sections when completing homework assignments
- Set unlabeled graphics as numbered exhibits for easier student reference
- Used more bulleted lists to call students' attention to specific information
- Refreshed end-of-chapter assignments with different numerical values and updated information

The new revenue recognition standard required the following changes:

- Revised the definitions of revenue and revenue recognition in Chapters 1–3, including the glossary. These revisions are consistent with the new revenue recognition standard, **Revenue from Contracts with Customers (Topic 606)**, FASB, May 2014.
- Revised Chapter 5, *Accounting for Merchandising Businesses*, to be consistent with the preceding standard. These revisions include using the net method for all purchase and sales discounts. In addition, the accounting for customer returns and allowances, including cash refunds, has been updated. As a result, sales discounts and sales return and allowances accounts are no longer used.
- Added new Appendix D, *Revenue Recognition*, which describes and illustrates the new Five-Step process for recognizing revenue. The illustration includes the accounting for a bundled product with different performance obligations.

Chapter 1

- New Business Connection includes The Pathways Commission definition of *accounting*

Chapter 2

- New Business Connection on Microsoft's unearned revenue

Chapter 3

- New chapter opener on Pandora
- Revised introduction to revenue recognition
- New Business Connection on Microsoft dealing with unearned revenue for support services

Chapter 4

- New chapter opener on Zynga
- Updated exposition of Appendix 1 showing end-of-period spreadsheet usage

Chapter 5

- Updated the Sales Discounts and Sales Returns and Allowances discussion for accuracy with the new revenue recognition standard

Chapter 9

- New chapter opener on McDonald's

Chapter 10

- New chapter opener on Starbucks
- Updated Exhibit 3 to reflect current wage withholding rates

Chapter 12

- Updated learning objective 1 to more clearly explain alternatives in financing corporations

Chapter 13

- New chapter opener on The Coca-Cola Company
- Significantly streamlined learning objective 5
- New Business Connection on cash and investments in the pharmaceutical industry

Chapter 14

- New chapter opener on National Beverage Co.
- Updated Exhibit 1 to more clearly detail specific examples of sources and uses of cash

Chapter 16

- New exhibit with income statements for merchandising and manufacturing businesses

Chapter 17

- New Service Focus on job order costing in a law firm

Chapter 19

- New chapter opener on Ford Motor Company

Chapter 20

- New exhibit explaining the difference between absorption costing and variable costing

Chapter 21

- New chapter opener on Hendrick Motorsport
- New Service Focus on film budgeting
- Updated two learning objectives to reflect the differences between operating and financial budgets
- New Exhibit 7 on the master budget for a manufacturing company

Chapter 22

- New Business Connection on standard costing for breweries
- New Service Focus on standard costing in the restaurant industry

Chapter 23

- New Service Focus on Charles Schwab

Chapter 25

- New chapter opener on Vail Resorts, Inc.
- New Service Focus on network business models

Chapter 26

- New exhibit explaining allocation of factory overhead costs

Chapter 27

- New exhibit explaining costs of controlling quality
- Updated "just-in-time inventory" description to reflect more current "lean inventory" description

Instructor Resources

Solutions Manual

Author-written and carefully verified multiple times to ensure accuracy and consistency with the text, the Solutions Manual contains answers to the Discussion Questions, Practice Exercises, Exercises, Problems (Series A and Series B), Cases, and Continuing Problems that appear in the text. These solutions help you easily plan, assign, and efficiently grade assignments.

Test Bank **NEW!**

NEW for this edition, Test Bank content is now delivered in an online platform. Cengage Learning Testing Powered by Cognero is a flexible, online system that allows you to:

- Author, edit, and manage test bank content from multiple Cengage Learning solutions
- Create multiple test versions in an instant
- Deliver tests from your LMS, your classroom, or wherever you want

Also **NEW** for this edition, 100 new Test Bank questions have been added (in addition to revising numeric values for approximately 20% of the existing questions).

Companion Web Site

This robust companion Web site provides immediate access to a rich array of teaching and learning resources—including the Instructor’s Manual, PowerPoint slides, and Excel Template Solutions. Easily download the instructor resources you need from the password-protected, instructor-only section of the site.

Instructor’s Manual Discover new ways to engage your students by utilizing the Instructor’s Manual ideas for class discussion, group learning activities, writing exercises, and Internet activities. Moreover, simplify class preparation by reviewing a brief summary of each chapter, a detailed chapter synopsis (**NEW** for this edition), teaching tips regarding a suggested approach to the material, questions students frequently ask in the classroom, lecture aids, and demonstration problems in the Instructor’s Manual. Transparency Masters and

Handouts (with solutions) are also included. Quickly identify the assignments that best align with your course with the assignment preparation grid that includes information about learning objective coverage, difficulty level and Bloom’s taxonomy categorization, time estimates, and accrediting standard alignment for business programs, AICPA, ACBSP, and IMA.

PowerPoint Slides Bring your lectures to life with slides designed to clarify difficult concepts for your students. The lecture PowerPoints include key terms and definitions, equations, examples, exhibits, and all Example Exercises (with solutions) from the textbook.

- **NEW** for this edition, descriptions for all graphics in the PowerPoints have been added to enhance PowerPoint usability for students with disabilities.
- Two separate PowerPoint decks that include just the Example Exercises (and solutions) and just the Exhibits from the textbook are ideal for instructors that create their own PowerPoint decks and just want to refresh them.

Excel Template Solutions Excel Templates are provided for selected long or complicated end-of-chapter exercises and problems to assist the student as they set up and work the problem. Certain cells are coded to display a red asterisk when an incorrect answer is entered, which helps students stay on track. Selected problems that can be solved using these templates are designated by an icon in the textbook and are listed in the assignment preparation grid in the Instructor’s Manual. The Excel Template Solutions provide answers to these templates. **NEW** for this edition, 10 more Excel Templates have been added.



Practice Set Solutions Establish a fundamental understanding of the accounting cycle for your students with Practice Sets, which require students to complete one month of transactions for a fictional company. Brief descriptions of each practice set are provided in the table of contents. The Practice Set Solutions provide answers to these practice sets.

Student Resources

Study Guide

Now available free in CengageNOWv2, the Study Guide allows students to easily assess what they know with a “Do You Know” checklist covering the key points in each chapter. To further test their comprehension, students can work through Practice Exercises, which include a “strategy” hint and solution so they can continue to practice applying key accounting concepts.

Working Papers

Now available free in CengageNOWv2, students will find the tools they need to help work through end-of-chapter assignments with these working papers. The preformatted templates provide a starting point by giving students a basic structure for problems and journal entries. Working Papers are also available in a printed format as a bundle option.

Practice Sets

For more in-depth application of accounting practices, instructors may choose from among six different Practice Sets for long-term assignments. Each Practice Set requires students to complete one month of transactions for a fictional company. Practice Sets can be solved manually or with the Cengage Learning General Ledger software.

Web Site

Designed specifically for your students’ accounting needs, this Web site features student PowerPoint slides, Excel Templates, learning games, and flashcards.

- **PowerPoint Slides:** Students can easily take notes or review difficult concepts with the student version of this edition’s PowerPoint slides.
- **Excel Templates:** These Excel Templates help students stay on track. If students enter an incorrect answer in certain cells, a red asterisk will appear to let them know something is wrong. Problems that can be solved using these templates are designated by an icon.
- **Crossword Puzzles:** Students can focus on learning the key terms and definitions for each chapter in a different way by completing these crossword puzzles.
- **Flashcards:** Students can prepare with these flashcards, which cover the key terms and definitions they need to know for each chapter.



GeneralLEDGER

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The many enhancements to this edition of *Financial and Managerial Accounting* are the direct result of one-on-one interviews, surveys, reviews, WebExes, and focus groups with over 300 instructors and students at institutions across the country over the past two years. We would like to take this opportunity to thank those who helped us better understand the challenges of the principles of accounting course and provided valuable feedback on our content and digital assets.

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- Visit the companion Web site at www.cengagebrain.com

Appendix F: Special Journals and Subsidiary Ledgers (online)

- Visit the companion Web site at www.cengagebrain.com

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Introduction to Accounting and Business

Twitter

When two teams pair up for a game of football, there is often a lot of noise. The band plays, the fans cheer, and fireworks light up the scoreboard. Obviously, the fans are committed and care about the outcome of the game. Just like fans at a football game, the owners of a business want their business to “win” against their competitors in the marketplace. While having your football team win can be a source of pride, winning in the marketplace goes beyond pride and has many tangible benefits. Companies that are winners are better able to serve customers, provide good jobs for employees, and make money for their owners.

Twitter is one of the most visible companies on the Internet. It provides a real-time information network where members can post messages, called Tweets, of up to 140 characters for free. Millions post Tweets every day throughout the world.

Do you think Twitter is a successful company? Does it make money? How would you know? Accounting helps to answer these questions.

This textbook introduces you to accounting, the language of business. Chapter 1 begins by discussing what a business is, how it operates, and the role that accounting plays.

Learning Objectives

After studying this chapter, you should be able to:

Example Exercises

OBJ
1

Describe the nature of a business and the role of accounting and ethics in business.

Nature of Business and Accounting
Types of Businesses
Role of Accounting in Business
Role of Ethics in Accounting and Business
Opportunities for Accountants

OBJ
2

Summarize the development of accounting principles and relate them to practice.

Generally Accepted Accounting Principles
Business Entity Concept
Cost Concept

EE 1-1

OBJ
3

State the accounting equation and define each element of the equation.

The Accounting Equation

EE 1-2

OBJ
4

Describe and illustrate how business transactions can be recorded in terms of the resulting change in the elements of the accounting equation.

Business Transactions and the Accounting Equation

EE 1-3

OBJ
5

Describe the financial statements of a corporation and explain how they interrelate.

Financial Statements
Income Statement
Retained Earnings Statement
Balance Sheet
Statement of Cash Flows
Interrelationships Among Financial Statements

EE 1-4

EE 1-5

EE 1-6

EE 1-7

OBJ
6

Describe and illustrate the use of the ratio of liabilities to stockholders' equity in evaluating a company's financial condition.

Financial Analysis and Interpretation: Ratio of Liabilities to Stockholders' Equity

EE 1-8

At a Glance 1

Page 23

OBJ
1

Describe the nature of business and the role of accounting and ethics in business.

Nature of Business and Accounting

A **business**¹ is an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers. Businesses come in all sizes, from a local coffee house to **Starbucks**, which sells over \$10 billion of coffee and related products each year.

The objective of most businesses is to earn a **profit**. Profit is the difference between the amounts received from customers for goods or services and the amounts paid for the inputs used to provide the goods or services. This text focuses on businesses operating to earn a profit. However, many of the same concepts and principles also apply to not-for-profit organizations such as hospitals, churches, and government agencies.

Types of Businesses

Three types of businesses operating for profit include service, merchandising, and manufacturing businesses. Some examples of each type of business follow:

- **Service businesses** provide services rather than products to customers.
 - Delta Air Lines** (transportation services)
 - The Walt Disney Company** (entertainment services)
- **Merchandising businesses** sell products they purchase from other businesses to customers.
 - Walmart** (general merchandise)
 - Amazon.com** (Internet books, music, videos)

¹ A complete glossary of terms appears at the end of the text.

- **Manufacturing businesses** change basic inputs into products that are sold to customers.
 - Ford Motor Co.** (cars, trucks, vans)
 - Dell Inc.** (personal computers)

Role of Accounting in Business

The role of accounting in business is to provide information for managers to use in operating the business. In addition, accounting provides information to other users in assessing the economic performance and condition of the business.

Thus, **accounting** can be defined as an information system that provides reports to users about the economic activities and condition of a business. You could think of accounting as the “language of business.” This is because accounting is the means by which businesses’ financial information is communicated to users.

The process by which accounting provides information to users is as follows:

1. Identify users.
2. Assess users’ information needs.
3. Design the accounting information system to meet users’ needs.
4. Record economic data about business activities and events.
5. Prepare accounting reports for users.

As illustrated in Exhibit 1, users of accounting information can be divided into two groups: internal users and external users.

Note:
Accounting is an information system that provides reports to users about the economic activities and condition of a business.

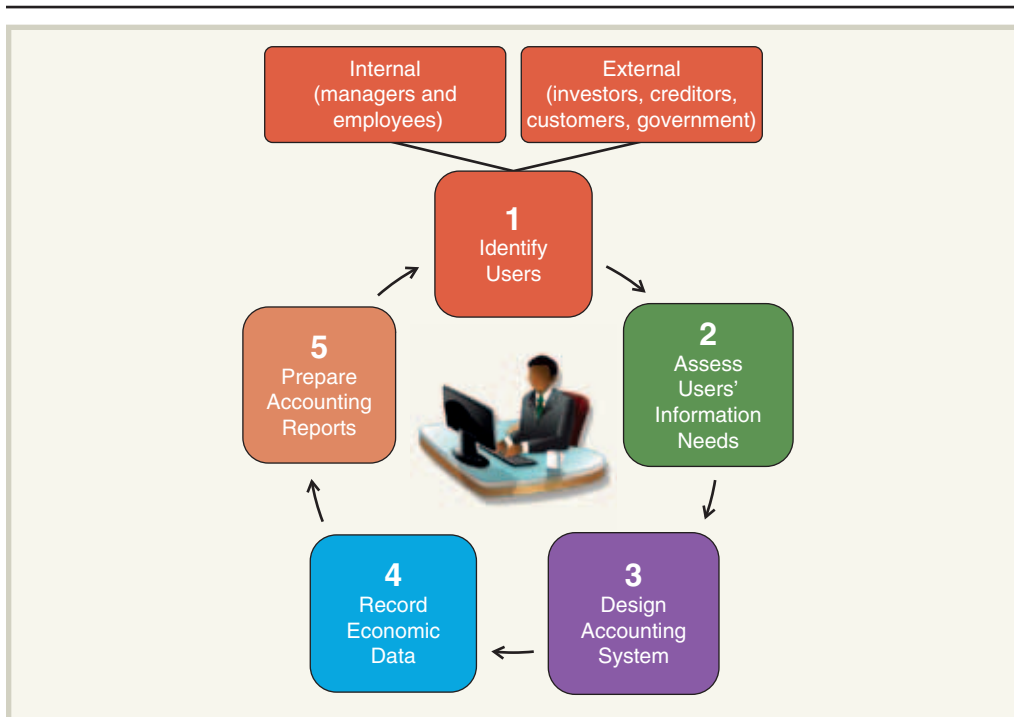


EXHIBIT 1

Accounting as an Information System

Managerial Accounting Internal users of accounting information include managers and employees. These users are directly involved in managing and operating the business. The area of accounting that provides internal users with information is called **managerial accounting**, or **management accounting**.

The objective of managerial accounting is to provide relevant and timely information for managers’ and employees’ decision-making needs. Oftentimes, such information is sensitive and is not distributed outside the business. Examples of sensitive information might include information about customers, prices, and plans to expand the business. Managerial accountants employed by a business are employed in **private accounting**.

Financial Accounting External users of accounting information include investors, creditors, customers, and the government. These users are not directly involved in managing and operating the business. The area of accounting that provides external users with information is called **financial accounting**.

The objective of financial accounting is to provide relevant and timely information for the decision-making needs of users outside of the business. For example, financial reports on the operations and condition of the business are useful for banks and other creditors in deciding whether to lend money to the business. **General-purpose financial statements** are one type of financial accounting report that is distributed to external users. The term *general-purpose* refers to the wide range of decision-making needs that these reports are designed to serve. Later in this chapter, general-purpose financial statements are described and illustrated.



Role of Ethics in Accounting and Business

The objective of accounting is to provide relevant, timely information for user decision making. Accountants must behave in an ethical manner so that the information they provide users will be trustworthy and, thus, useful for decision making. Managers and employees must also behave in an ethical manner in managing and operating a business. Otherwise, no one will be willing to invest in or loan money to the business.

Ethics are moral principles that guide the conduct of individuals. Unfortunately, business managers and accountants sometimes behave in an unethical manner. Many of the managers of the companies listed in Exhibit 2 engaged in accounting or business fraud. These ethical violations led to fines, firings, and lawsuits. In some cases, managers were criminally prosecuted, convicted, and sent to prison.

EXHIBIT 2

Accounting and Business Frauds

| Company | Nature of Accounting or Business Fraud | Result |
|--|---|---|
| Computer Associates International, Inc. | Fraudulently inflated its financial results. | CEO and senior executives indicted. Five executives pled guilty. \$225 million fine. |
| Enron | Fraudulently inflated its financial results. | Bankruptcy. Senior executives criminally convicted. More than \$60 billion in stock market losses. |
| HealthSouth | Overstated performance by \$4 billion in false entries. | Senior executives criminally convicted. |
| Qwest Communications International, Inc. | Improperly recognized \$3 billion in false receipts. | CEO and six other executives criminally convicted of "massive financial fraud." \$250 million SEC fine. |
| Xerox Corporation | Recognized \$3 billion in revenue prior to when it should have been recorded. | \$10 million fine to SEC. Six executives forced to pay \$22 million. |

What went wrong for the managers and companies listed in Exhibit 2? The answer normally involved one or both of the following two factors:

- **Failure of Individual Character.** Ethical managers and accountants are honest and fair. However, managers and accountants often face pressures from supervisors to meet company and investor expectations. In many of the cases in Exhibit 2, managers and accountants justified small ethical violations to avoid such pressures. However, these small violations became big violations as the company's financial problems became worse.

- **Culture of Greed and Ethical Indifference.** By their behavior and attitude, senior managers set the company culture. In most of the companies listed in Exhibit 2, the senior managers created a culture of greed and indifference to the truth.

As a result of the accounting and business frauds shown in Exhibit 2, Congress passed laws to monitor the behavior of accounting and business. For example, the **Sarbanes-Oxley Act (SOX)** was enacted. SOX established a new oversight body for the accounting profession called the **Public Company Accounting Oversight Board (PCAOB)**. In addition, SOX established standards for independence, corporate responsibility, and disclosure.

How does one behave ethically when faced with financial or other types of pressure? Guidelines for behaving ethically follow:²

1. Identify an ethical decision by using your personal ethical standards of honesty and fairness.
2. Identify the consequences of the decision and its effect on others.
3. Consider your obligations and responsibilities to those who will be affected by your decision.
4. Make a decision that is ethical and fair to those affected by it.

Integrity, Objectivity, and Ethics in Business



BERNIE MADOFF

In June 2009, Bernard L. “Bernie” Madoff was sentenced to 150 years in prison for defrauding thousands of investors in one of the biggest frauds in American history. Madoff’s fraud started several decades earlier when he began a “Ponzi scheme” in his investment management firm, Bernard L. Madoff Investment Securities LLC.

In a Ponzi scheme, the investment manager uses funds received from new investors to pay a return to existing investors, rather than basing investment returns

on the fund’s actual performance. As long as the investment manager is able to attract new investors, he or she will have new funds to pay existing investors and continue the fraud. While most Ponzi schemes collapse quickly when the investment manager runs out of new investors, Madoff’s reputation, popularity, and personal contacts provided a steady stream of investors, which allowed the fraud to survive for decades.

Opportunities for Accountants

Numerous career opportunities are available for students majoring in accounting. Currently, the demand for accountants exceeds the number of new graduates entering the job market. This is partly due to the increased regulation of business caused by the accounting and business frauds shown in Exhibit 2. Also, more and more businesses have come to recognize the importance and value of accounting information.

As indicated earlier, accountants employed by a business are employed in private accounting. Private accountants have a variety of possible career options within a company. Some of these career options are shown in Exhibit 3 along with their starting salaries. Accountants who provide audit services, called *auditors*, verify the accuracy of financial records, accounts, and systems. As shown in Exhibit 3, several private accounting careers have certification options.

Accountants and their staff who provide services on a fee basis are said to be employed in **public accounting**. In public accounting, an accountant may practice as an individual or as a member of a public accounting firm. Public accountants who have met a state’s education, experience, and examination requirements may become **Certified Public Accountants (CPAs)**. CPAs typically perform general accounting,

² Many companies have ethical standards of conduct for managers and employees. In addition, the Institute of Management Accountants and the American Institute of Certified Public Accountants have professional codes of conduct, which can be obtained from their Web sites at www.imanet.org and www.aicpa.org, respectively.

EXHIBIT 3 Accounting Career Paths and Salaries

| Accounting Career Track | Description | Career Options | Annual Starting Salaries* | Certification |
|-------------------------|--|--------------------------------|---------------------------|---|
| Private Accounting | Accountants employed by companies, government, and not-for-profit entities. | Bookkeeper | \$39,750 | Certified Payroll Professional (CPP) Certified Management Accountant (CMA) Certified Internal Auditor (CIA) Certified Information Systems Auditor (CISA) |
| | | Payroll clerk | \$38,250 | |
| | | General accountant | \$46,375 | |
| | | Budget analyst | \$49,375 | |
| | | Cost accountant | \$48,375 | |
| | | Internal auditor | \$53,875 | |
| | | Information technology auditor | \$62,875 | |
| Public Accounting | Accountants employed individually or within a public accounting firm in tax or audit services. | Local firms | \$48,500 | Certified Public Accountant (CPA) Certified Public Accountant (CPA) |
| | | National firms | \$58,625 | |

*Mean salaries of a reported range. Private accounting salaries are reported for large companies. Salaries may vary by region.
 Source: Robert Half 2013 U.S. Salary Guide (Finance and Accounting), Robert Half International, Inc. (<http://www.rhi.com/salaryguides>)

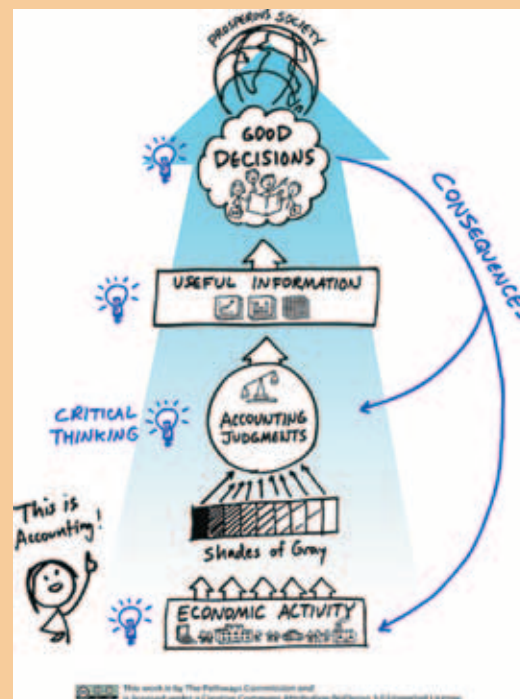
audit, or tax services. As can be seen in Exhibit 3, CPAs have slightly better starting salaries than private accountants. Career statistics indicate, however, that these salary differences tend to disappear over time.

Because all functions within a business use accounting information, experience in private or public accounting provides a solid foundation for a career. Many positions in industry and in government agencies are held by individuals with accounting backgrounds.

Business Connection

PATHWAYS COMMISSION

The Pathway Commission recently issued its study titled *Charting a National Strategy for the Next Generation of Accountants*. The Commission was made up of diverse members and was jointly sponsored by the American Institute of Certified Public Accountants (AICPA) and the American Accounting Association (AAA). The Commission emphasized the importance of accounting for a prosperous society and good decision making. The Commission also emphasized that accountants must be critical thinkers who are comfortable addressing the shades of grey required by accounting judgments.



Sources: *Charting a National Strategy for the Next Generation of Accountants*, The Pathways Commission, July 2012.

Generally Accepted Accounting Principles

If a company's management could record and report financial data as it saw fit, comparisons among companies would be difficult, if not impossible. Thus, financial accountants follow **generally accepted accounting principles (GAAP)** in preparing reports. These reports allow investors and other users to compare one company to another.

Accounting principles and concepts develop from research, accepted accounting practices, and pronouncements of regulators. Within the United States, the **Financial Accounting Standards Board (FASB)** has the primary responsibility for developing accounting principles. The FASB publishes *Statements of Financial Accounting Standards* as well as *Interpretations* of these Standards. In addition, the **Securities and Exchange Commission (SEC)**, an agency of the U.S. government, has authority over the accounting and financial disclosures for companies whose shares of ownership (stock) are traded and sold to the public. The SEC normally accepts the accounting principles set forth by the FASB. However, the SEC may issue *Staff Accounting Bulletins* on accounting matters that may not have been addressed by the FASB.

Many countries outside the United States use generally accepted accounting principles adopted by the **International Accounting Standards Board (IASB)**. The IASB issues *International Financial Reporting Standards (IFRSs)*. Differences currently exist between FASB and IASB accounting principles. However, the FASB and IASB are working together to reduce and eliminate these differences into a single set of accounting principles. Such a set of worldwide accounting principles would help facilitate investment and business in an increasingly global economy.

In this chapter and text, accounting principles and concepts are emphasized. It is through this emphasis on the “why” as well as the “how” that you will gain an understanding of accounting.

OBJ 2 Summarize the development of accounting principles and relate them to practice.

IFRS
See Appendix C for more information.

International Connection

IFRS INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

IFRS are considered to be more “principles-based” than U.S. GAAP, which is considered to be more “rules-based.” For example, U.S. GAAP consists of approximately

17,000 pages, which include numerous industry-specific accounting rules. In contrast, IFRS allow more judgment in deciding how business transactions are recorded. Many believe that the strong regulatory and litigation environment in the United States is the cause for the more rules-based GAAP approach. Regardless, IFRS and GAAP share many common principles.*

*Differences between U.S. GAAP and IFRS are further discussed and illustrated in Appendix C.

Business Entity Concept





The **business entity concept** limits the economic data in an accounting system to data related directly to the activities of the business. In other words, the business is viewed as an entity separate from its owners, creditors, or other businesses. For example, the accountant for a business with one owner would record the activities of the business only and would not record the personal activities, property, or debts of the owner.

A business entity may take the form of a proprietorship, partnership, corporation, or limited liability company (LLC). Each of these forms and their major characteristics are listed in Exhibit 4.

The three types of businesses discussed earlier—service, merchandising, and manufacturing—may be organized as proprietorships, partnerships, corporations, or limited liability companies. Because of the large amount of resources required to operate a manufacturing business, most manufacturers such as **Ford Motor Company** are corporations. Most large retailers such as **Walmart** and **Home Depot** are also corporations.

Note:
Under the business entity concept, the activities of a business are recorded separately from the activities of its owners, creditors, or other businesses.

EXHIBIT 4 Forms of Business Entities

| Form of Business Entity | Characteristics | Examples |
|--|--|--|
|  <p>Proprietorship is owned by one individual.</p> | <ul style="list-style-type: none"> • 70% of business entities in the United States. • Easy and inexpensive to organize. • Resources are limited to those of the owner. • Used by small businesses. | <ul style="list-style-type: none"> • A & B Painting |
|  <p>Partnership is owned by two or more individuals.</p> | <ul style="list-style-type: none"> • 10% of business organizations in the United States (combined with limited liability companies). • Combines the skills and resources of more than one person. | <ul style="list-style-type: none"> • Jones & Smith, Architects |
|  <p>Corporation is organized under state or federal statutes as a separate legal taxable entity.</p> | <ul style="list-style-type: none"> • Generates 90% of business revenues. • 20% of the business organizations in the United States. • Ownership is divided into shares called stock. • Can obtain large amounts of resources by issuing stock. • Used by large businesses. | <ul style="list-style-type: none"> • Apple • Google • Ford Motor Company |
|  <p>Limited liability company (LLC) combines the attributes of a partnership and a corporation.</p> | <ul style="list-style-type: none"> • 10% of business organizations in the United States (combined with partnerships). • Often used as an alternative to a partnership. • Has tax and legal liability advantages for owners. | <ul style="list-style-type: none"> • Mosel & Farmer, CPAs, LLC |

Companies organized as corporations often include Inc. as part of their name to indicate that they are incorporated. For example, Apple's legal name is **Apple Inc.**

Cost Concept

Under the **cost concept**, amounts are initially recorded in the accounting records at their cost or purchase price. To illustrate, assume that Aaron Publishers purchased the following building on February 20, 2014, for \$150,000:

| | |
|--|-----------|
| Price listed by seller on January 1, 2014 | \$160,000 |
| Aaron Publishers' initial offer to buy on January 31, 2014 | 140,000 |
| Purchase price on February 20, 2014 | 150,000 |
| Estimated selling price on December 31, 2016 | 220,000 |
| Assessed value for property taxes, December 31, 2016 | 190,000 |

Under the cost concept, Aaron Publishers records the purchase of the building on February 20, 2014, at the purchase price of \$150,000. The other amounts listed have no effect on the accounting records.

The fact that the building has an estimated selling price of \$220,000 on December 31, 2016, indicates that the building has increased in value. However, to use the \$220,000 in the accounting records would be to record an illusory or unrealized profit. If Aaron Publishers sells the building on January 9, 2018, for \$240,000, a profit of \$90,000 (\$240,000 – \$150,000) is then realized and recorded. The new owner would record \$240,000 as its cost of the building.

The cost concept also involves the objectivity and unit of measure concepts. The **objectivity concept** requires that the amounts recorded in the accounting records be based on objective evidence. In exchanges between a buyer and a seller, both try to get the best price. Only the final agreed-upon amount is objective enough to be recorded in the accounting records. If amounts in the accounting records were constantly being revised upward or downward based on offers, appraisals, and opinions, accounting reports could become unstable and unreliable.

The **unit of measure concept** requires that economic data be recorded in dollars. Money is a common unit of measurement for reporting financial data and reports.

Example Exercise 1-1 Cost Concept



On August 25, Gallatin Repair Service extended an offer of \$125,000 for land that had been priced for sale at \$150,000. On September 3, Gallatin Repair Service accepted the seller's counteroffer of \$137,000. On October 20, the land was assessed at a value of \$98,000 for property tax purposes. On December 4, Gallatin Repair Service was offered \$160,000 for the land by a national retail chain. At what value should the land be recorded in Gallatin Repair Service's records?

Follow My Example 1-1

\$137,000. Under the cost concept, the land should be recorded at the cost to Gallatin Repair Service.

Practice Exercises: PE 1-1A, PE 1-1B

The Accounting Equation

OBJ 3 State the accounting equation and define each element of the equation.

The resources owned by a business are its **assets**. Examples of assets include cash, land, buildings, and equipment. The rights or claims to the assets are divided into two types: (1) the rights of creditors and (2) the rights of owners. The rights of creditors are the debts of the business and are called **liabilities**. The rights of the owners are called **stockholders' equity** for a corporation and **owner's equity** for a proprietorship, partnership, or limited liability company. Throughout this text, we use the corporate form of business. However, most of the concepts and principles described and illustrated also apply to proprietorships, partnerships, and limited liability companies.

The following equation shows the relationship among assets, liabilities, and stockholders' equity:

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

This equation is called the **accounting equation**. Liabilities usually are shown before stockholders' equity in the accounting equation because creditors have first rights to the assets.

Given any two amounts, the accounting equation may be solved for the third unknown amount. To illustrate, if the assets owned by a business amount to \$100,000 and the liabilities amount to \$30,000, the stockholders' equity is equal to \$70,000, computed as follows:

$$\begin{array}{r r r r r} \text{Assets} & - & \text{Liabilities} & = & \text{Stockholders' Equity} \\ \$100,000 & - & \$30,000 & = & \$70,000 \end{array}$$

Business Connection

THE ACCOUNTING EQUATION

The accounting equation serves as the basic foundation for the accounting systems of all companies. From the smallest business, such as the local convenience store, to

the largest business, such as **The Coca-Cola Company**, companies use the accounting equation. Some examples taken from recent financial reports of well-known companies follow:

| Company | Assets* | = | Liabilities | + | Stockholders' Equity |
|-----------------------|-----------|---|-------------|---|----------------------|
| The Coca-Cola Company | \$79,974 | = | \$48,339 | + | \$31,635 |
| DuPont | \$49,736 | = | \$39,648 | + | \$10,088 |
| eBay | \$37,074 | = | \$16,209 | + | \$20,865 |
| Google | \$93,798 | = | \$22,083 | + | \$71,715 |
| McDonald's | \$32,990 | = | \$18,600 | + | \$14,390 |
| Microsoft Corporation | \$121,271 | = | \$54,908 | + | \$66,363 |
| Southwest Airlines | \$18,596 | = | \$11,604 | + | \$6,992 |
| Walmart | \$193,406 | = | \$122,091 | + | \$71,315 |

*Amounts are shown in millions of dollars.