

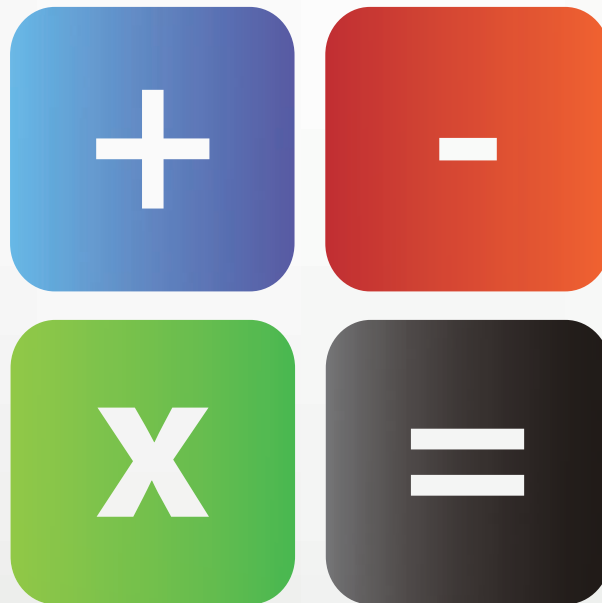
GLOBAL  
EDITION



# Horngren's Accounting

TENTH EDITION

Nobles • Mattison • Matsumura



# HORNGREN'S ACCOUNTING

TENTH EDITION

Global Edition

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

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## Accounting for Manufacture Overhead

Manufacturing Overhead We  
Actual Overhead Costs Overhead Allocation Direct Materials



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# Changes to This Edition

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## 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 four new chapters to the textbook: Accounting Information Systems, Partnerships, Investments, and Process Costing.
- Streamlined topics: Corporations now presented in one chapter (Chapter 13); Cost Allocation and Responsibility Accounting 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, that 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 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—Accounting Information Systems

### NEW to the 10th 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.

## Chapter 8—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 9—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 10—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 10A.



## 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—Partnerships

### **NEW to the 10th edition**

Moved coverage of accounting of partnerships from an end-of-textbook appendix to a stand-alone chapter.

Expanded coverage of partnership financial statements to include statement of partners' equity.

Added a section on death of a partner.

Expanded the section on liquidation to include sale of assets at a loss with capital deficiency.

## Chapter 13—Corporations

Combined the contents of two chapters to provide more complete coverage of corporations.

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—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 15—Investments

### **NEW to the 10th 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 16—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 17—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 18—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 19—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 18, emphasizing cost flows and their tie to end reports.

## Chapter 20—Process Costing

### NEW to the 10th 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 20A.

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 21—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.

Updated variable costing content and moved it into Appendix 21A in the text from an online appendix.

## 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—Cost Allocation and Responsibility Accounting

Streamlined concepts to emphasize material that students need to know at this level of accounting.

Expanded coverage of cost allocation to include single allocation rates, multiple allocation rates, and activity-based costing.

Expanded coverage of responsibility reports.

Added content on transfer pricing in Appendix 24A.

## 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.

# Horngren's 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 successfully closed several

...er 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.

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

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

## 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.

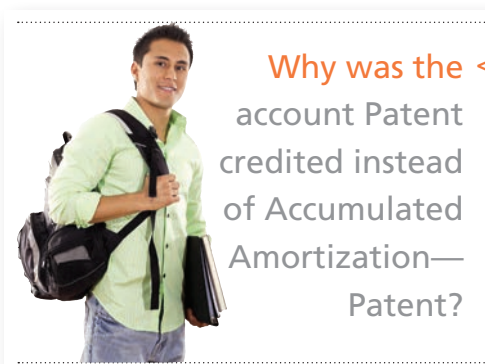
$$\begin{array}{r} \text{A} \downarrow \\ \text{Accumulated} \\ \text{Depreciation—} \\ \text{Building} \uparrow \end{array} \left. \vphantom{\begin{array}{r} \text{A} \downarrow \\ \text{Accumulated} \\ \text{Depreciation—} \\ \text{Building} \uparrow \end{array}} \right\} = \left\{ \begin{array}{r}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

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

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

## 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.



## 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				Service Revenue			
Nov. 10	3,000	2,000	Nov. 22		5,500	Nov. 8	
Dec. 31	800				3,000	Nov. 10	
Bal.	1,800				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.

## 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 is the owner of Summertime Day Camp. She has just started her business and 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.

## 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 8-1

Misler Company 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 *Hornngren's 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 Hornngren 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 10th edition of *Hornngren's 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 partnerships, investments, accounting information systems, 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 *Hornngren's Accounting*. We welcome your feedback, suggestions, and comments. Please don't hesitate to contact us at [HornngrensAccounting@pearson.com](mailto:HornngrensAccounting@pearson.com).

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

# Student and Instructor Resources

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## For Students

MyAccountingLab

### MyAccountingLab 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: [www.pearsonglobaleditions.com/Horngren](http://www.pearsonglobaleditions.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 Online Homework and Assessment Manager

### Instructor Resource Center: [www.pearsonglobaleditions.com/Horngren](http://www.pearsonglobaleditions.com/Horngren)

For the instructor's convenience, the instructor resources can be downloaded from the textbook's catalog page ([www.pearsonglobaleditions.com/Horngren](http://www.pearsonglobaleditions.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
- **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.



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# 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

neigh-

bor-

ing

town.

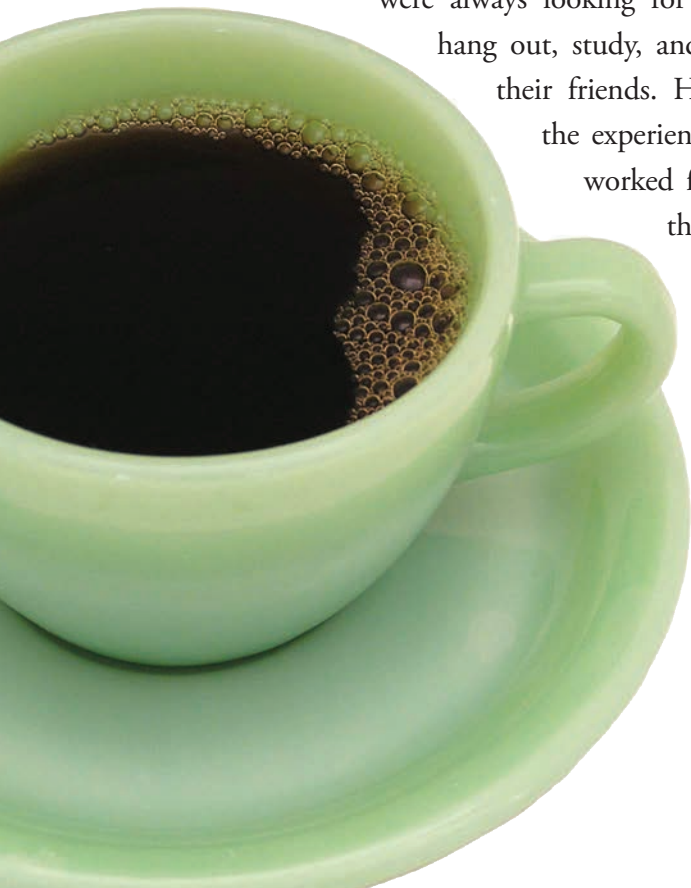
Aiden

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.

#### 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.

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

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

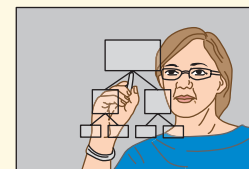
#### Financial Accounting



#### 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.

### 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](http://www.google.com/finance), or the Security and Exchange Commission's EDGAR database ([www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml)).

### Creditors

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

### Taxing Authorities

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

### The Accounting Profession

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

You've probably heard of a CPA before. **Certified public accountants**, or **CPAs**, are licensed professional accountants who serve the general public. CPAs work for public



Accounting 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.

#### Creditor

Any person or business to whom a business owes money.

#### Certified Public Accountants (CPAs)

Licensed professional accountants who serve the general public.



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

#### **Certified Management Accountants (CMAs)**

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



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](http://www.thiswaytocpa.com)) contains a wealth of information about becoming a CPA, career opportunities, and exam requirements.

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

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