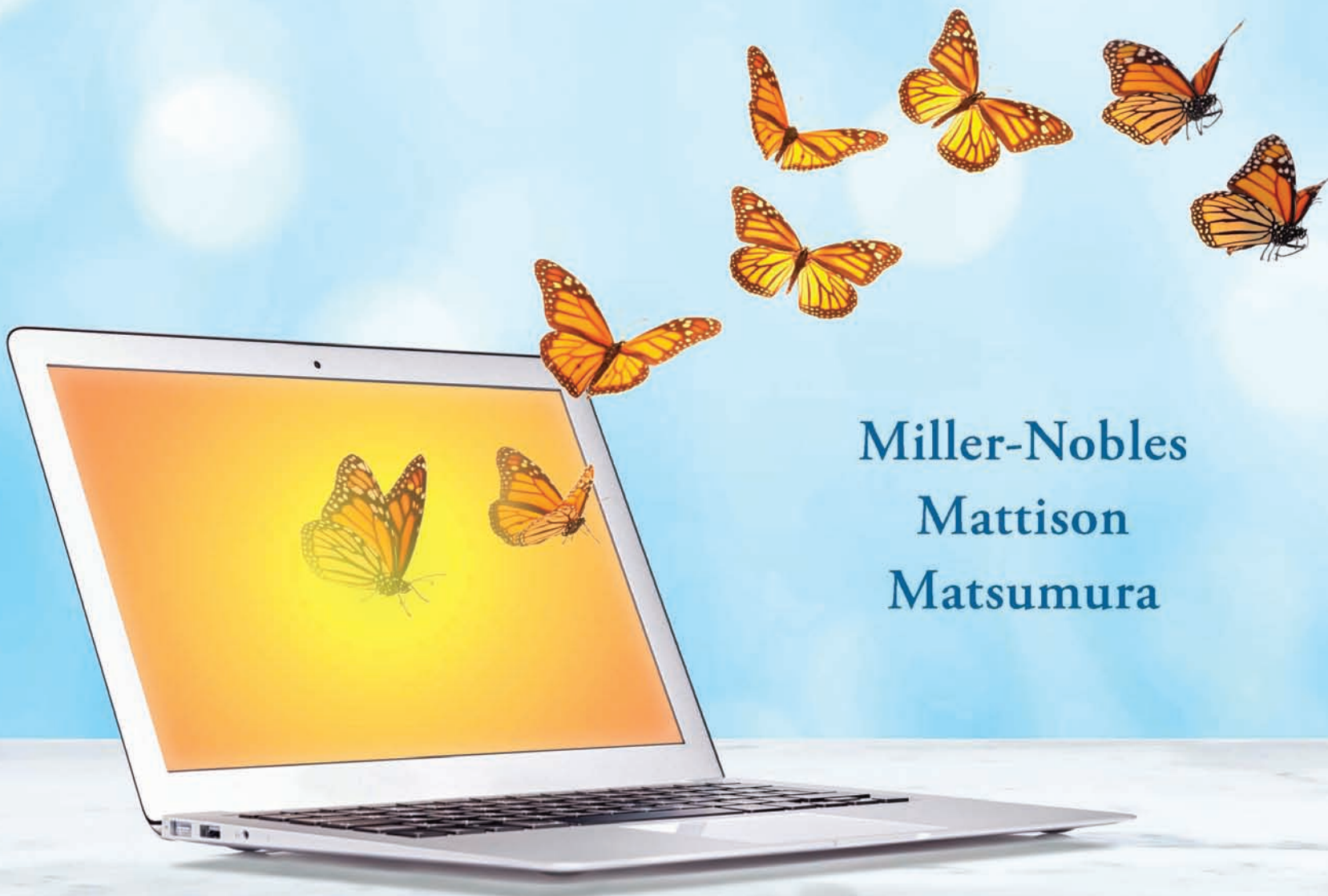


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Changes to This Edition

General

Revised end-of-chapter short exercises, exercises, problems, continuing problems, comprehensive problems, and critical thinking cases.

NEW! Using Excel. This end-of-chapter problem introduces students to Excel to solve common accounting problems as they would in the business environment.

NEW! Tying It All Together feature ties together key concepts from the chapter using the company highlighted in the chapter opener. The in-chapter box feature presents scenarios and questions that the company could face and focuses on the decision-making process. The end-of-chapter business case helps students synthesize the concepts of the chapter and reinforce critical thinking.

NEW! A Continuing Problem starts in Chapter 1 and runs through the financial chapters, exposing students to recording entries for a service company and then moving into recording transactions for a merchandiser later in the text. The managerial chapters' continuing problem has been revised for this edition and emphasizes the relevant topics for that chapter using a continuous company.

Chapter 1

NEW! Added discussion about why accounting is important to non-accounting majors.

Chapter 3

Updated discussion of the revenue recognition principle for the newly released standard.

Added a discussion on how to calculate interest for notes receivable and notes payable.

Changed interest calculations to use a 365-day year rather than a 360-day year to better reflect how actual lenders calculate interest.

Chapter 4

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

Changed the balance sheet presentation to reflect Property, Plant, and Equipment rather than Plant Assets.

Chapter 5

REVISED! Discussion on sales of merchandise revised to reflect the newly released revenue recognition standard, including reporting sales on account at the net amount and introduction of the Sales Discounts Forfeited account.

Changed income statement presentation to reflect Other Income and (Expenses) instead of Other Revenue and (Expenses) to better reflect how actual income statements are presented.

NEW! Added Appendix 5A that discusses multiple performance obligations.

Chapter 6

NEW! Added a comprehensive problem for Chapters 5 and 6 which includes the complete accounting cycle for a merchandising company with ratio analysis.

Chapter 8

NEW! Added coverage of credit card sales. In previous editions, this topic was covered in Chapter 9.

Chapter 9

Expanded coverage of estimating bad debts to help students understand why the Allowance for Bad Debts account may have either a debit or credit unadjusted balance due to previously overestimated or underestimated adjustments.

Chapter 10

NEW! Added comprehensive problem for Chapters 8–10 which includes transactions and analysis for cash, receivables, and long-term assets.

Chapter 11

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

Added a section to illustrate how companies record the payment of payroll liabilities.

Chapter 13

NEW! Moved the corporate income statement, including calculating earnings per share, from the Chapter 17 Appendix to Chapter 13. The discussion on the Extraordinary Items section has been removed to align with current standards.

Chapter 14

NEW! Added discussion on future value, including determining the future value of a lump sum and of an annuity.

NEW! Added comprehensive problem for Chapters 11, 13, and 14 which includes payroll, other current liabilities, long-term liabilities, and stockholders' equity transactions and analysis.

Chapter 15

REVISED! Discussion on debt and equity securities revised to reflect newly released financial instrument standard including the elimination of trading investments (equity) and available-for-sale investments (equity).

Chapter 16

Modified the wording in Changes to Current Assets and Current Liabilities section of preparing the statement of cash flows, indirect method, to emphasize adjustments are made to net income to convert from accrual basis to cash basis.

Chapter 17

Rearranged the liquidity ratios from most stringent to least stringent (cash ratio, acid-test ratio, current ratio).

NEW! Added problem (both A and B series) that has students complete a trend analysis and ratios to analyze a company for its investment potential.

Chapter 18

Expanded the discussion of managerial accounting to include manager's role in the organization and managerial accounting functions.

Clarified and expanded the discussion of how companies classify costs used in managerial accounting.

Revised the discussion on manufacturing cost flows, including better explanation of how cost of goods manufactured and cost of goods sold are calculated.

Expanded discussion on business trends that are affecting managerial accounting.

Chapter 19

Expanded the discussion on cost accounting systems, including why companies choose either process or job-order costing.

Clarified the discussion on the allocation and adjustment of manufacturing overhead.

Chapter 20

REVISED! For consistency throughout the chapter, all company examples now use the same company, Puzzle Me, to better understand how costs flow through a process costing system and are reflected on the production cost report.

Expanded and clarified discussion on equivalent units of production.

REVISED! The discussion on preparing a production cost report was split into two learning objectives (first department and subsequent departments) allowing faculty to omit the discussion on subsequent departments.

REVISED! Discussion on preparing a production cost report for the first department now realistically reflects beginning inventory.

Updated the discussion on how the weighted-average method is different than the FIFO method when preparing the production cost report.

Chapter 21

Moved discussion of breakeven point before coverage of target profit for better student understanding.

Clarified the high-low method when determining a company's variable and fixed costs.

NEW! Discussion on how sensitivity analysis could be used and the differences between predicted cost behavior versus actual management behavior.

Expanded discussion on the differences between absorption and variable costing and the impact on operating income.

Chapter 22

Expanded discussion benefits of budgets, including benchmarking.

NEW! Added discussion on types of budgets, including participative, zero-based, and continuous budgets.

Moved the coverage of merchandising budgets from the appendix into the chapter. This allows faculty to choose to cover both manufacturing and merchandising budgets or either. Each section is developed on a stand-alone basis.

Clarified the steps involved in the different budgets for better student understanding.

Chapter 23

Expanded the discussion on performance reports using static budgets, including advantages and disadvantages.

Chapter 26

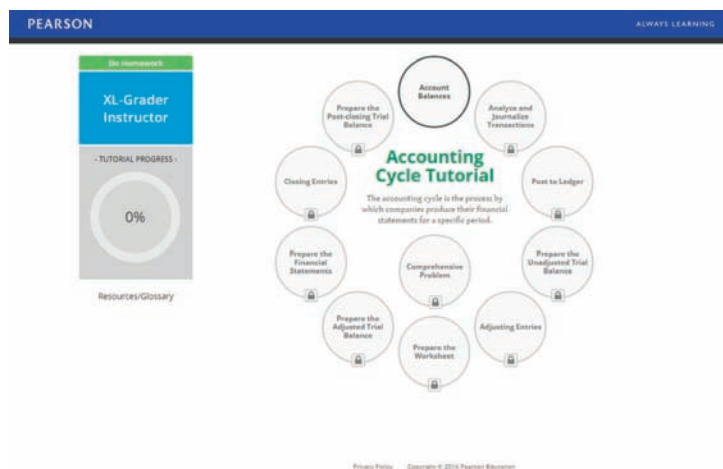
NEW! Added discussion on future value, including determining the future value of a lump sum and of an annuity.

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

Horngren's Accounting . . . Expanding on Proven Success

Accounting Cycle Tutorial

MyAccountingLab's interactive tutorial helps students master the Accounting Cycle for early and continued success in the Introduction to Accounting course. The tutorial, accessed by computer, smartphone, or tablet, provides students with brief explanations of each concept of the Accounting Cycle through engaging, interactive activities. Students are immediately assessed on their understanding and their performance is recorded in the MyAccountingLab Gradebook. Whether the Accounting Cycle Tutorial is used as a remediation self-study tool or course assignment, students have yet another resource within MyAccountingLab to help them be successful with the accounting cycle.



NEW! ACT Comprehensive Problem

The Accounting Cycle Tutorial now includes a comprehensive problem that allows students to work with the same set of transactions throughout the accounting cycle. The comprehensive problem, which can be assigned at the beginning or the end of the full cycle, reinforces the lessons learned in the accounting cycle tutorial activities by emphasizing the connections between the accounting cycle concepts.

Study Plan

The Study Plan acts as a tutor, providing personalized recommendations for each of your students based on his or her ability to master the learning objectives in your course. This allows students to focus their study time by pinpointing the precise areas they need to review, and allowing them to use customized practice and learning aids—such as videos, eText, tutorials, and more—to get them back on track. Using the report available in the Gradebook, you can then tailor course lectures to prioritize the content where students need the most support—offering you better insight into classroom and individual performance.

Dynamic Study Modules

Help students study effectively on their own by continuously assessing their activity and performance in real time. Here's how it works: students complete a set of questions with a unique answer format that also asks them to indicate their confidence level. Questions repeat until the student can answer them all correctly and confidently. Once completed, Dynamic Study Modules explain the concept using materials from the text. These are available as graded assignments prior to class, and accessible on smartphones, tablets, and computers. **NEW!** Instructors can now remove questions from Dynamic Study Modules to better fit their course. Available for select titles.

Learning Catalytics

Learning Catalytics helps you generate class discussion, customize your lecture, and promote peer-to-peer learning with real-time analytics. As a student response tool, Learning Catalytics uses students' smartphones, tablets, or laptops to engage them in more interactive tasks and thinking.

- **NEW!** Upload a full PowerPoint® deck for easy creation of slide questions.
- Help your students develop critical thinking skills.
- Monitor responses to find out where your students are struggling.
- Rely on real-time data to adjust your teaching strategy.
- Automatically group students for discussion, teamwork, and peer-to-peer learning.

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Session 26148360

Multiple choice question

Furniture Company allocates overhead based on machine hours. Selected data for the most recent year follow:

- Estimated manufacturing overhead cost \$240,000
- Actual manufacturing overhead cost \$215,000
- Estimated machine hours 40,000
- Actual machine hours 41,000

The estimates were made as of the beginning of the year, while the actual results were for the entire year. The amount of manufacturing overhead allocated for the year based on machine hours would have been:

A. \$215,000

B. \$227,500

C. \$240,000

D. \$144,000

Submit response / Change response

Refresh Send a message to the instructor Join another session

Depreciation

Related Account: Furniture (Normal DR balance)

Contra Account: Accumulated Depreciation—Furniture (Normal CR balance)

A business may have a separate Accumulated Depreciation account for each depreciable asset

- Accumulated Depreciation – Furniture
- Accumulated Depreciation - Building

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Animated Lectures

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

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.

NEW! Tying It All Together

This feature ties together key concepts from the chapter using the company highlighted in the chapter opener. The in-chapter box feature presents scenarios and questions that the company could face and focuses on the decision-making process. The end of chapter business case helps students synthesize the concepts of the chapter and reinforce critical thinking.

TYING IT ALL TOGETHER

Hyatt Hotels Corporation was founded in 1957 when Jay Pritzker purchased the first Hyatt hotel next to the Los Angeles International Airport. Today, Hyatt Hotels owns and operates hotels in 52 countries around the world. For the year ended December 31, 2015, the company reported revenues totaling \$4.3 billion with net income of \$124 million. (You can find Hyatt Hotels Corporation's annual report at <https://www.sec.gov/Archives/edgar/data/1468174/000146817416000152/h10-k123115.htm>)

Would Hyatt Hotels Corporation record closing entries and why?

Hyatt Hotels would record closing entries in order to get the accounts ready for next year. All companies record closing entries in order to zero out all revenue and expense accounts. In addition, the closing process updates the equity account balance for net income or loss during the period and any payments made to owners (stockholders).

Why are temporary accounts important in the closing process? What type of temporary accounts would Hyatt Hotels Corporation have?

Temporary accounts are important in the closing process because these accounts relate to a particular accounting period and are

closed at the end of the period. Revenues, expenses, and withdrawals (called dividends for corporations) are all temporary accounts. Some examples of temporary accounts that Hyatt Hotels might have include Owned and Leased Hotels Revenue; Selling, General, and Administrative Expense; and Interest Expense.

When would Hyatt Hotels Corporation prepare its post-closing trial balance? What type of accounts would be reported on this trial balance?

A post-closing trial balance is a list of all permanent accounts and their balances at the end of the accounting period and is prepared after the closing process. Hyatt Hotels would report only permanent accounts on its post-closing trial balance. Some examples of permanent accounts that Hyatt Hotels might have include assets, such as Cash and Property; liabilities, such as Accounts Payable; and equity.

> Tying It All Together 4-1

Before you begin this assignment, review the Tying It All Together feature in the chapter. It will also be helpful if you review Hyatt Hotels Corporation's 2015 annual report (<https://www.sec.gov/Archives/edgar/data/1468174/000146817416000152/h10-k123115.htm>).

Hyatt Hotels Corporation is headquartered in Chicago and is a leading global hospitality company. The company develops, owns, and operates hotels, resorts, and vacation ownership properties in 52 different countries.

Requirements

1. Review Hyatt Hotels Corporation's income statement for year ended December 31, 2015. What does the income statement report? What was the amount of net income or loss for the year ending December 31, 2015.
2. What are some accounts that are listed on Hyatt Hotels Corporation's income statement?
3. Review the Hyatt Hotels Corporation's balance sheet. What does the balance sheet tell an investor? Did Hyatt Hotels Corporation present a unclassified or classified balance sheet? Explain.

Effect on the Accounting Equation

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

On November 8, Smart Touch Learning collected cash of \$5,500 for service revenue that the business earned by providing e-learning services for clients.

The asset Cash increased, so we debit Cash. Revenue increased, so we credit Service Revenue.

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

Date	Accounts and Explanation	Debit	Credit
Nov. 8	Cash	5,500	
	Service Revenue		5,500
	<i>Performed services and received cash.</i>		

Instructor Tips & Tricks

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

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

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

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

Common Questions, Answered

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

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

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

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



Try It! Boxes

Found after each learning objective, Try Its! give students opportunities to apply the concept they've just learned by completing an accounting problem. Links to these exercises appear throughout the eText, allowing students to practice in MyAccountingLab without interruption.

Try It!

Total Pool Services earned \$130,000 of service revenue during 2018. 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 2018 for expenses incurred during the next year.

1. Determine the amount of service revenue and expenses for 2018 using a cash basis accounting system.
2. Determine the amount of service revenue and expenses for 2018 using an accrual basis accounting system.

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

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

Try It! Solution Videos

Author-recorded and accompanying Try It! Exercises, these videos walk students through the problem and the solution.

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

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

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

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

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

IFRS

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



Decision Boxes

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

DECISIONS

Which depreciation method should be selected?

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

Solution

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

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

> Things You Should Know

1. How do we prepare financial statements?

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

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

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

Things You Should Know

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

NEW! Using Excel Problems

This end of chapter problem introduces students to Excel to solve common accounting problems as they would in the business environment. Students will work from a template that will aid them in solving the problem related to accounting concepts taught in the chapter. Each chapter focuses on different Excel skills.

> Using Excel

P4-41 Using Excel to prepare financial statements, closing entries, and the post-closing trial balance

Download an Excel template for this problem online in MyAccountingLab or at <http://www.pearsonhighered.com/Horngren>. Cedar River Company started operations on July 1, 2018. On July 31, a trial balance was prepared, adjusting entries were journalized and posted, and an adjusted trial balance was completed. A worksheet is to be used to help prepare the financial statements and the post-closing trial balance.

Requirements

1. Use Excel to complete the Income Statement and Balance Sheet columns of the worksheet. Carry numbers from the adjusted trial balance columns of the worksheet to the income statement and balance sheet columns using Excel formulas.
 - a. Use formulas to total the columns.
 - b. Use a formula to determine the amount of the net income or net loss.
 - c. Format the cells requiring dollar signs.
 - d. Boldface the totals.
2. Prepare the income statement, the statement of owner's equity, and a classified balance sheet.
 - a. Use the Increase Indent button on the Home tab to indent items.
 - b. Use formulas to sum items.
 - c. Format the cells requiring dollar signs.
 - d. Format the cells requiring double underlines.
3. Journalize the closing entries. The account titles are available when you click on the down-arrow. Indent the account to be credited.
4. Post the closing entries to the T-accounts. Use cell references from the closing entries.
5. Complete the post-closing trial balance using formulas referencing the T-accounts. The account titles are available when you click the down-arrow.
 - a. Format the cells requiring dollar signs.
 - b. Boldface the totals.
 - c. Format the cells requiring double underlines.

End-of-Chapter Continuing and Comprehensive Problems

> Continuing Problem

P1-55 is the first problem in a continuing problem that will be used throughout the chapters to reinforce the concepts learned.

P1-55 Using the accounting equation for transaction analysis, preparing financial statements, and calculating return on assets (ROA)

Canyon Canoe Company is a service-based company that rents canoes for use on local lakes and rivers. Amber Wilson graduated from college about 10 years ago. She worked for one of the "Big Four" accounting firms and became a CPA. Because she loves the outdoors, she decided to begin a new business that will combine her love of outdoor activities with her business knowledge. Amber decides that she will create a new sole proprietorship, Canyon Canoe Company, or CCC for short. The business began operations on November 1, 2018.

- Nov. 1 Received \$16,000 cash to begin the company and gave capital to Amber.
- 2 Signed a lease for a building and paid \$1,200 for the first month's rent.
- 3 Purchased canoes for \$4,800 on account.
- 4 Purchased office supplies on account, \$750.
- 7 Earned \$1,400 cash for rental of canoes.
- 13 Paid \$1,500 cash for wages.
- 15 Wilson withdrew \$50 cash from the business.
- 16 Received a bill for \$150 for utilities. (Use separate payable account.)

NEW! **Continuing Problem**—Starts in Chapter 1 and runs through the financial chapters, exposing students to recording entries for a service company and then moving into recording transactions for a merchandiser later in the text. The managerial chapters' continuing problem has been revised for this edition and emphasizes the relevant topics for that chapter using a continuous company.

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

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

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

NEW! **Comprehensive Problem for Chapters 5 and 6**—Covers the entire accounting cycle for a merchandising company, including analysis.

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

NEW! **Comprehensive Problem for Chapters 8–10**—Covers cash, receivables, and long-term assets transactions and analysis.

NEW! **Comprehensive Problem for Chapters 11, 13, and 14**—Covers payroll, other current liabilities, long-term liabilities, and stockholders' equity transactions and analysis.

Comprehensive Problem for Chapters 18–21—Covers fundamental managerial accounting concepts: job order costing, process costing, cost management systems, and cost-volume-profit analysis.

Comprehensive Problem for Chapters 22–24—Covers planning and control decisions for a manufacturing company, including a master budget, flexible budget, variance analysis, and performance evaluation.

Comprehensive Problem for Chapters 25–26—Covers decision making, both short-term business decisions and capital budgeting decisions.

> Comprehensive Problem for Chapters 18–21

The Jacksonville Shirt Company makes two types of T-shirts: basic and custom. Basic shirts are plain shirts without any screen printing on them. Custom shirts are created using the basic shirts and then adding a custom screen printing design.

The company buys cloth in various colors and then makes the basic shirts in two departments, Cutting and Sewing. The company uses a process costing system (weighted-average method) to determine the production cost of the basic shirts. In the Cutting Department, direct materials (cloth) are added at the beginning of the process and conversion costs are added evenly through the process. In the Sewing Department, no direct materials are added. The only additional material, thread, is considered an indirect material because it cannot be easily traced to the finished product. Conversion costs are added evenly throughout the process in the Sewing Department. The finished basic shirts are sold to retail stores or are sent to the Custom Design Department for custom screen printing.

The Custom Design Department creates custom shirts by adding screen printing to the basic shirt. The department creates a design based on the customer's request and then prints the design using up to four colors. Because these shirts have the custom printing added, which is unique for each order, the additional cost incurred is determined using job order costing, with each custom order considered a separate job.

Enhanced eText

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

And with the **Pearson eText 2.0** mobile app (available for select titles) students can now access the Enhanced eText and all of its functionality from their computer, tablet, or mobile phone. Because students' progress is synced across all of their devices, they can stop what they're doing on one device and pick up again later on another one—without breaking their stride.

Dear Colleague,

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

First, we again made certain that the textbook, student resources, and instructor supplements are clear, consistent, and accurate. As authors, we reviewed each and every component to ensure a student experience free of hurdles. Next, through our ongoing conversations with our colleagues and our time engaged at professional conferences, we confirmed that our pedagogy and content represents the leading methods used in teaching our students these critical foundational topics. Lastly, we concentrated on student success and providing resources for professors to create an active and engaging classroom.

We are excited to share with you some new features and changes in this latest edition. First, we have added a new Tying It All Together feature that highlights an actual company and addresses how the concepts of the chapter apply to the business environment. A Using Excel problem has also been added to every chapter to introduce students to using Excel to solve common accounting problems as they would in the business environment. Chapter 5 (Merchandising Operations) has been updated for the newly released revenue recognition standard. The managerial chapters went through a significant review with a focus of clarifying current coverage and expanding on content areas that needed more explanation.

We trust you will find evidence of these goals throughout our text, MyAccountingLab, enhanced eText, and in our many new media enhanced resources such as the Accounting Cycle Tutorial with a new comprehensive problem and animated lectures. We welcome your feedback and comments. Please do not hesitate to contact us at HorngrensAccounting@pearson.com or through our editor, Lacey Vitetta, LaceyVitetta@pearson.com.

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Instructor and Student Resources

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

For Instructors

MyAccountingLab

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

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

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

Online Instructor's Resource Manual:

Course Content:

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

Chapter Content:

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

Online Instructor's Solutions Manual:

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

Online Test Bank:

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

PowerPoint Presentations:

Instructor PowerPoint Presentations:

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

Student PowerPoint Presentations:

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

Demonstration Problem PowerPoint Presentations:

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

Clicker Response System (CRS) PowerPoint Presentations:

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

Image Library:

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

Working Papers and Solutions:

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

Data and Solutions Files:

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

For Students

MyAccountingLab

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

- Pearson eText
- Using Excel templates
- Animated Lectures
- Demo Docs
- Interactive Figures
- Working Papers
- Accounting Videos
- Student PowerPoint® Presentations
- Accounting Cycle Tutorial
- Flash Cards

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

The book's Web site contains the following:

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

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

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Accounting and the Business Environment

1



Coffee, Anyone?

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

was to get a loan from his bank. After the meeting, Aiden felt overwhelmed and unsure of the future of his business.

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

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



Why Study Accounting?

The situation that Aiden faced is similar to the situations faced in the founding of most businesses. **Starbucks Corporation**, for example, first opened its doors in Seattle, Washington, in 1971. Three partners, Jerry Baldwin, Zev Siegl, and Gordon Bowker, were inspired by a dream of selling high-quality coffee. We know their dream was successful because Starbucks currently has more than 22,000 stores in 67 countries. How did Starbucks grow from a small one-store shop to what it is today? The partners understood accounting—the language of business. They understood how to measure the activities of the business, process that information into reports (financial statements), and then use those reports to make business decisions. Your knowledge of accounting will help you better understand businesses. It will make you a better business owner, employee, or investor.





Chapter 1 Learning Objectives



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

WHY IS ACCOUNTING IMPORTANT?

Learning Objective 1

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

Accounting

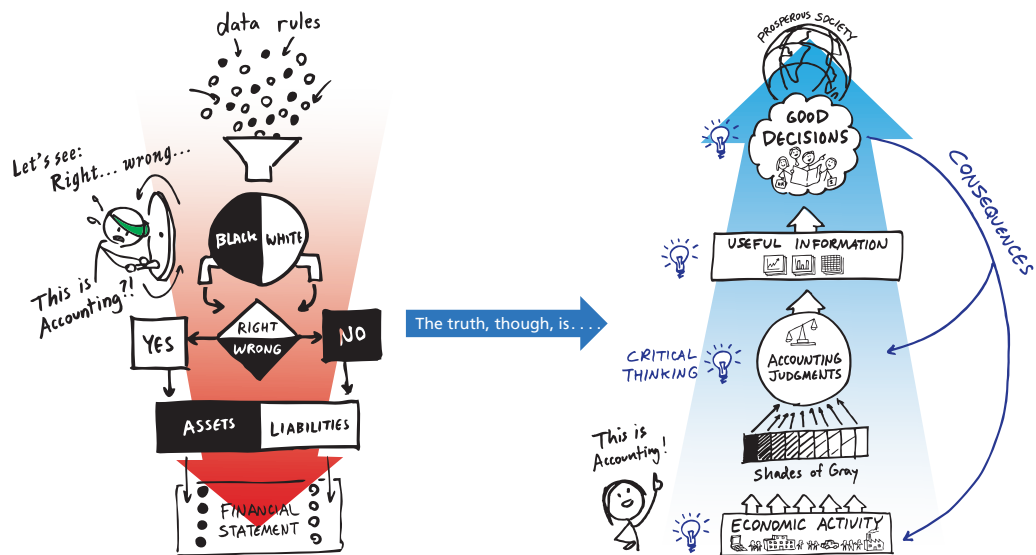
The information system that measures business activities, processes the information into reports, and communicates the results to decision makers.

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

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

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

Exhibit 1-1 Pathways Vision Model



We tend to think of accountants as boring and dry.

Accountants are instrumental in helping to create a prosperous society.




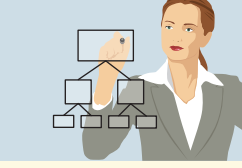
the public understand what accounting is. The model is intended to explain in a visual way what accountants really do. Accounting starts with economic activities that accountants review and evaluate using critical thinking and judgment to create useful information that helps individuals make good decisions.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

Decision Makers: The Users of Accounting Information

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

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

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

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

Individuals

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

Businesses

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

Financial Accounting

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

Managerial Accounting

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



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

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



Investors

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

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

Creditors

Any person or business to whom a business owes money is a **creditor**. Before extending credit to a business, a creditor evaluates the company's ability to make the payments by reviewing its financial statements. Creditors follow the same process when you need to borrow money for a new car or a house. The creditor reviews accounting data to determine your ability to make the loan payments. What does your financial position tell the creditor about your ability to repay 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 Internal Revenue Service (IRS) can disallow tax deductions, resulting in a higher tax bill plus interest and penalties.

Accounting Matters

What do businesses such as Amazon.com, Walmart, or even your local sandwich shop across from campus have in common? They all rely upon accounting information to make business decisions. Even if you don't plan on majoring in accounting, the knowledge of accounting helps all businesses plan for the future and evaluate past performance. The skills you learn in this class will help you be a better business professional. Businesses can't function, though, without accountants. That is why a degree in accounting opens so many doors upon graduation. A bachelor's degree in accounting could lead you to several different accounting careers.

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

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

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.





Studying accounting and becoming certified professionally can lead to a financially secure job. According to Robert Half's *2016 Salary Guide*, the top positions in demand that rely on accounting skills are controllers, financial analysts, tax accountants, auditors, cost accountants, paraprofessional/bookkeeper, and business systems analysts. How much do these types of accountants make? Exhibit 1-3 provides a snapshot of the earning potential for key positions.

Exhibit 1-3 | Comparison of Accounting Positions

Position	Job Description	Salary Range
Controllers	Compile financial statements, interact with auditors, and oversee regulatory reporting.	\$83,250–\$234,750
Financial analysts	Review financial data and help to explain the story behind the numbers.	\$48,250–\$136,500
Business systems analysts	Use accounting knowledge to create computer systems.	\$46,250–\$131,000
Tax accountants	Help companies navigate tax laws.	\$48,250–\$135,250
Auditors	Perform reviews of companies to ensure compliance to rules and regulations.	\$48,250–\$141,250
Cost accountants	Typically work in a manufacturing business. Help analyze accounting data.	\$46,500–\$121,500
Paraprofessional/Bookkeeper	Record financial transactions and help prepare financial records.	\$43,250–\$63,250

Accountants generally work either in public, private, or governmental accounting. Public accounting involves services such as auditing and tax preparation. Well-known public accounting firms include Ernst & Young, Deloitte, PwC, and KPMG. Private accounting involves working for a single company such as Amazon.com, Walmart, or Dell. Other accountants work for the federal or state governments. Wherever accountants work, demand for their services is high. According to the U.S. Bureau of Labor Statistics, employment of accountants and auditors is expected to grow 11% from 2014–2024.

Try It!

Match the accounting terminology to the definitions.

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

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



WHAT ARE THE ORGANIZATIONS AND RULES THAT GOVERN ACCOUNTING?

Learning Objective 2

Describe the organizations and rules that govern accounting

Financial Accounting Standards Board (FASB)

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

Securities and Exchange Commission (SEC)

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

Generally Accepted Accounting Principles (GAAP)

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

Faithful Representation

Providing information that is complete, neutral, and free from error.

Economic Entity Assumption

An organization that stands apart as a separate economic unit.

Sole Proprietorship

A business with a single owner.

Partnership

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

Corporation

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

Limited-Liability Company (LLC)

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

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

Governing Organizations

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

Generally Accepted Accounting Principles

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

The Economic Entity Assumption

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

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

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

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

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


Exhibit 1-4 | Business Organizations

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

The Cost Principle

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

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

The Going Concern Assumption

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

The Monetary Unit Assumption

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

Cost Principle

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



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

Going Concern Assumption

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



Monetary Unit Assumption

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

International Financial Reporting Standards (IFRS)

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

International Accounting Standards Board (IASB)

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

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

International Financial Reporting Standards

The concepts and principles that we have discussed so far apply to businesses that follow U.S. GAAP and are traded on a U.S. stock exchange, such as the New York Stock Exchange. The SEC requires that U.S. businesses follow U.S. GAAP. Companies who are incorporated in or do significant business in another country might be required to publish financial statements using **International Financial Reporting Standards (IFRS)**, which are published by the **International Accounting Standards Board (IASB)**. IFRS is a set of global accounting standards that are used by more than 116 nations. They are generally less specific and based more on principle than U.S. GAAP. IFRS leaves more room for professional judgment. For example, unlike U.S. GAAP, IFRS allows periodic revaluation of certain assets and liabilities to restate them to market value, rather than keeping them at historical cost. At one point in time it was thought that the SEC would endorse IFRS. However, the SEC has backed away from this strategy and is currently considering whether a single set of global accounting standards is achievable.

Ethics in Accounting and Business

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

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

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

Audit

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

Sarbanes-Oxley Act (SOX)

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



Try It!

Match the accounting terminology to the definitions.

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

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

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

WHAT IS THE ACCOUNTING EQUATION?

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

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

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

Learning Objective 3

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

Accounting Equation

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

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

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

$$\$230,000 = \$120,000 + ?$$

$$\$230,000 = \$120,000 + \$110,000$$