

*Horngren's*  
FINANCIAL & MANAGERIAL  
ACCOUNTING

Miller-Nobles  
Mattison



SEVENTH EDITION

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HORNGREN'S  
**Financial & Managerial  
Accounting**  
THE FINANCIAL CHAPTERS

SEVENTH EDITION

**Tracie Miller-Nobles**

*Austin Community College*

**Brenda Mattison**

*Tri-County Technical College*

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# About the Authors



**Tracie L. Miller-Nobles, CPA**, is an associate professor at Austin Community College. She has teaching experience at the community college and university level. Prof. Miller-Nobles received her master's degree in accounting from Texas A&M University and is working on her doctoral degree in Adult Education also from Texas A&M University. Her research interest includes financial literacy education, adult learning theories, and online learning. She has public accounting experience with Deloitte Tax LLP.

Prof. Miller-Nobles is on the Board of Directors for the American Accounting Association (AAA) as Director-Focusing on Members. She has served in leadership roles for AAA's Teaching, Learning, and Curriculum section and AAA's Two Year College section and was a member of the Pathway's Commission on Accounting Higher Education. Prof. Miller-Nobles is also on the Board of Directors for Teachers of Accounting at Two-Year Colleges (TACTYC) as Secretary/Webmaster. She is an active member of the American Institute of Certified Public Accountants (AICPA) Consumer Financial Education Advocates committee. At the state level, she serves on the Relations with Educational Institutes for the Texas Society of Certified Public Accountants (TXCPA).

Tracie has received several teaching and professional awards including the AAA J. Michael and Mary Anne Cook Prize, TXCPA Outstanding Accounting Educator, TXCPA Rising Star, and the TXCPA Austin Chapter CPA of the Year. In her spare time, Tracie enjoys spending time with her husband, Kevin, his three kids, Caleb, Josh, and Meggie, her parents, Kipp and Sylvia, and sister, Michelle. She believes that camping and hiking is restorative and calming and that life was meant for good friends and great adventures. Tracie has been mentored by many wonderful colleagues and inspired by her students.

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

Brenda is a member of the American Accounting Association, Institute of Management Accountants, South Carolina Technical Education Association, and Teachers of Accounting at Two Year Colleges. She is currently serving on the Board of Directors as Vice President of Conference Administration of Teachers of Accounting at Two Year Colleges.

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

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



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# Financial & Managerial Accounting . . . Expanding on Proven Success

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## What's New to the Edition

**UPDATED!** End of Chapter exercises and problems have been updated with new years and company financial information.

**UPDATED!** Chapter openers, Tying It All Together features, and financial statement analysis companies (Kohl's and Target) have been updated with current company financial information.

**NEW FEATURE ON DATA ANALYTICS!** Data Analytics is becoming critically important in business—specifically in accounting. A new feature called Data Analytics in Accounting has been integrated throughout the narrative. In an increasingly competitive environment, having the ability to harness information to make sound business decisions is becoming crucial. Throughout the chapters, this feature highlights how real companies use Data Analytics to track inventory, monitor cash flow, forecast sales, and maximize profits. This feature also discusses emerging technologies, such as robotic process automation and artificial intelligence, and how they relate to businesses.

**NEW DATA ANALYTICS PROJECTS!** Each project contains a list of requirements, a dataset, a tutorial video, and instructions for using software such as Excel, Power BI, or Tableau to offer students hands-on practice in analyzing and reporting data. Using these tools, students learn how to extract and examine key information about a company related to its products, operations, and consumer buying habits. With this experience and knowledge, students are able to make smarter business decisions and are better prepared for the workforce.

**NEW COVERAGE ON EMPLOYABILITY!** The first courses in accounting are a great place to discuss the importance of accounting credentials in today's job market. Throughout the narrative, we highlight the role of accounting in businesses including the most relevant accounting credentials, as well as some new ones for students beginning their study of accounting. When discussing accounting in the business environment, in addition to the traditional career path (CPA), we also provide information about additional certifications available to accounting majors including Certified Management Accounting (CMA), Chartered Global Management Accountant (CGMA), and Certified Financial Planner (CFP).

## Chapter 1: Accounting and the Business Environment

- Added discussion on additional certifications available to accounting majors including Chartered Global Management Accountant and Certified Financial Planner.
- Added discussion on the need for technology skills and knowledge for accountants.
- Clarified the equity discussion to help students better understand the changes in equity based on customer feedback/requests.

## Chapter 2: Recording Business Transactions

- Added Data Analytics in Accounting feature about the chart of accounts.

## Chapter 5: Merchandising Operations

- Realigned the order of the purchase section to better explain how a company records purchase returns and corresponding payment.
- Realigned the order of sales section to better explain how a company records sales returns and corresponding receipt.
- Added T-accounts to help students understand the journal entries.
- Added customer and vendor names for Accounts Receivable and Accounts Payable.
- Moved adjusting sales revenue and merchandise inventory for estimated sales returns to LO4 which covers adjusting and closing entries for merchandisers.
- Realigned Appendix 5B purchases and sales sections to better explain how a company records these transactions.
- Clarified discussion of how a periodic inventory system records estimated sales returns.
- Modified Check Your Understanding F:5-2 to include the new accounts introduced under Revenue Recognition Standard.
- Reviewed EOC to ensure that all new accounts (Estimated Returns Inventory, Refunds Payable, and Sales Discounts Forfeited) were adequately covered in problems.

- Adjusted EOC to give options for professors who do not want to cover Sales Returns and Allowances (Estimated Returns Inventory and Refunds Payable).
- Optional online appendix (and associated End of Chapter exercises) available for faculty who would like to cover the gross method of recording accounting receivables.

## **Chapter 6: Merchandising Inventory**

- Added Data Analytics in Accounting feature discussing how companies track inventory.
- Added more explanation for how to calculate inventory cost flow for FIFO, LIFO, and weighted average under perpetual method.

## **Chapter 7: Internal Control and Cash**

- Added Data Analytics in Accounting feature on cryptocurrencies and blockchain.
- Added internal control procedures for accepting debit and credit card sales.
- Changed company used in Tying It All Together feature to Chipotle Mexican Grill and discussed the unauthorized malware activity that occurred in April 2017.

## **Chapter 8: Receivables**

- Changed company used in Tying It All Together feature from Sears to Amazon.com, Inc.

## **Chapter 9: Plant Assets, Natural Resources, and Intangibles**

- Added Data Analytics in Accounting feature on water and energy consumption.

## **Chapter 11: Current Liabilities and Payroll**

- Updated payroll tax amounts for 2019 (current at time of printing).

## **Chapter 14: The Statement of Cash Flows**

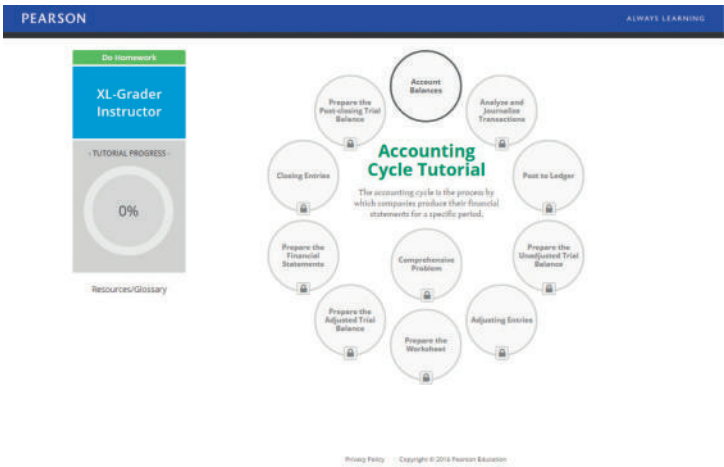
- Added Data Analytics in Accounting feature on monitoring cash flow.



# Solving Learning and Teaching Challenges

## Accounting Cycle Tutorial

This 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. A built-in comprehensive problem can be assigned to reinforce the lessons learned in the accounting cycle tutorial. Whether the Accounting Cycle Tutorial is used as a remediation self-study tool or course assignment, students have yet another resource to help them be successful with the accounting cycle.



## 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.

## 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 60 countries around the world. For the year ended December 31, 2018, the company reported revenues totaling \$4.5 billion with net income of \$769 million. (You can find Hyatt Hotels Corporation's annual report at <https://www.sec.gov/Archives/edgar/data/1468174/000146817419000009/h10-k123118.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 Retained Earnings account balance for net income or loss during the period and any dividends paid to 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 dividends 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; Interest Expense; and Dividends.

#### 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, such as Common Stock and Retained Earnings.

### > Tying It All Together F: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 2018 annual report (<https://www.sec.gov/Archives/edgar/data/1468174/000146817419000009/h10-k123118.htm#E3993A8AD84040710041937D19826344>).

**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 60 different countries. For the year ended December 31, 2018, Hyatt Hotels reported the following select account information (in millions):

Revenue	\$ 4,454
Selling, general, and administrative expense	4,122
Other Income	695
Interest Expense	76
Income Tax Expense	182
Dividends	68
Retained Earnings, December 31, 2017	3,118

#### Requirements

1. Journalize Hyatt Hotels Corporation's closing entries at December 31, 2018.
2. Determine Hyatt Hotels Corporation's ending Retained Earnings balance at December 31, 2018.
3. Review the Hyatt Hotels Corporation's balance sheet included in the 2018 annual report and find ending Retained Earnings, December 31, 2018. Does your ending Retained Earnings calculated in Requirement 2 match?



## 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.

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

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.

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

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

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

## Common Questions, Answered

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



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

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

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

## 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 e-commerce internal controls should be put into place?

Jason Kane works as an information technology auditor for Netproducts, a retailer that sells merchandise over the Internet. Jason has been assigned the responsibility of reviewing the existing procedures and suggesting internal controls that could best protect the company. Netproducts sells all its merchandise over the Internet and accepts only credit card payments. Netproducts tracks trend information about its sales and maintains all customer, product, and pricing information on the company's intranet. In addition, Netproducts keeps employee information such as annual leave, payroll deposits, and Social Security numbers on its intranet. What e-commerce controls should Jason suggest?

#### Solution

Jason should suggest that specific controls be put into place, such as using encryption technology and firewalls, to protect customer and employee information. He should recommend that customers be required to create an online account with a password for the site and that the company only use secured Internet networks. In addition, Netproducts should ensure that the customer and employee data are physically secured and that access to the data can be obtained only by authorized individuals.

## Things You Should Know

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

### > 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 retained earnings—shows how retained earnings changed during the period due to net income or net loss and dividends
  3. Balance sheet—reports assets, liabilities, and stockholders' 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.

## 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.

## End-of-Chapter Continuing and Comprehensive Problems

### > Continuing Problem

P-F:1-55 is the first problem in a continuing problem that will be used throughout the chapters to reinforce the concepts learned.

#### P-F:1-55 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 and Zack Wilson graduated from college about 10 years ago. They both worked for one of the "Big Four" accounting firms and became CPAs. Because they both love the outdoors, they decided to begin a new business that will combine their love of outdoor activities with their business knowledge. Amber and Zack decide that they will create a new corporation, Canyon Canoe Company, or CCC for short. The business began operations on November 1, 2024.

- |        |  |
|--------|--|
| Nov. 1 | Received \$16,000 cash to begin the company and issued common stock to Amber and Zack. |
| 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.   |

**Continuing Problem**—Starts in Chapter F: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.

**Practice Set**—Starts in Chapter F: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.

#### > Practice Set

##### **P-F:4-42 Completing the accounting cycle from adjusted trial balance to post-closing trial balance with an optional worksheet**

Refer to the Practice Set data provided in Chapters F:2 and F:3 for Crystal Clear Cleaning.

##### **Requirements**

1. Prepare a worksheet (optional) at November 30, 2024. Use the unadjusted trial balance from Chapter F:2 and the adjusting entries from Chapter F:3.
2. Prepare an income statement and statement of retained earnings for the month ended November 30, 2024. Also prepare a classified balance sheet at November 30, 2024, using the report format. Assume the Notes Payable is long-term. Use the worksheet prepared in Requirement 1 or the adjusted trial balance from Chapter F:3.
3. Prepare closing entries at November 30, 2024, and post to the accounts. Open T-accounts for Income Summary and Retained earnings. Determine the ending balance in each account. Denote each closing amount as *Clos.* and each account balance as *Balance*.
4. Prepare a post-closing trial balance at November 30, 2024.

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

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

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

**Comprehensive Problem for Chapters F:7, F:8, and F:9**—Covers cash, receivables, and long-term assets transactions and analysis.

**Comprehensive Problem for Chapters F:11, F:12, and F:13**—Covers payroll, other current liabilities, long-term liabilities, and stockholders' equity transactions and analysis.

**Comprehensive Problem for Appendix B**—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.

Dear Colleague,

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

This edition we again focus on ensuring that we produce a textbook that provides students with the content and resources they need to be successful. We continually update our pedagogy and content to represent the leading methods and topics necessary for student success. As authors, we reviewed each and every component to ensure the textbook, student resources, and instructor supplements are clear, consistent, and accurate. We value our ongoing conversations with our colleagues and our time engaged at professional conferences to confirm that our textbook is up-to-date and we are 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 Data Analytics in Accounting feature that highlights how companies used data analytics in the business environment. We also offer accompanying Data Analytics projects in MyLab Accounting for your students to learn how to apply data analytics to accounting problems. Financial Chapter 5 (Merchandising Operations) has been updated to provide better clarity and understanding based on the revised revenue recognition standard. All chapters went through a significant review with a focus of clarifying current coverage and expanding on content areas that needed more explanation.

We look forward to hearing from you and welcome your feedback and comments. Please do not hesitate to contact us at [HorngrensAccounting@pearson.com](mailto:HorngrensAccounting@pearson.com) or through our editor, Michael Trinchetto, [Michael.Trinchetto@pearson.com](mailto:Michael.Trinchetto@pearson.com).

Tracie L. Miller-Nobles, CPA      Brenda Mattison, CMA

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

Samad Adams, *Bristol Community College*

Sharon Agee, *Rollins College*

Markus Ahrens, *St. Louis Community College*

Janice Akao, *Butler County Community College*

Anna Alexander, *Caldwell Community College and Technical Institute*

Sheila Ammons, *Austin Community College*

Rai Lynn Anderson, *Northeast State Community College*

Sidney Askew, *Borough of Manhattan Community College*

John Babich, *Kankakee Community College*

Michael Barendse, *Grossmont College*

Robert Beatty, *Anne Arundel Community College*

Lana Becker, *East Tennessee State University*

Vikki Bentz, *Yavapai College*

Jeff Brennan, *Austin Community College*

Lisa Busto, *William Rainey Harper College*

Jennifer Cainas, *University of South Florida*

Anne Cardozo, *Broward College*

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

Martha Cavalaris, *Miami Dade College*

Donna Chadwick, *Sinclair Community College*

Matilda Channel-Ward, *University of Maryland, Baltimore County*

Colleen Chung, *Miami Dade College*

Tony Cioffi, *Lorain County Community College*

Tom Clement, *University of North Dakota*

Alan Czyzewski, *Indiana State University*

Geoffrey Danzig, *Miami Dade College–North*

Judy Daulton, *Piedmont Technical College*

Michelle Davidowitz, *Kingsborough Community College*

Annette Fisher Davis, *Glendale Community College*

Anthony Dellarte, *Luzerne County Community College*

Crystal Drum, *Guilford Technical Community College*

Mary Ewanechko, *Monroe Community College*

Elisa Fernandez, *Miami Dade College*

Julie Gilbert, *Triton College*

Lori Grady, *Bucks County Community College*

Marina Grau, *Houston Community College*

Gloria Grayless, *Sam Houston State University*

Becky Hancock, *El Paso Community College*

Dawn D. Hart, *Darton State College*

Lori Hatchell, *Aims Community College*

Shauna Hatfield, *Salt Lake Community College*

Sueann Hely, *West Kentucky Community & Technical College*

Neil Hesketh, *Saint Leo University*

Patricia Holmes, *Des Moines Area Community College*

Kay Jackson, *Tarrant County College*

Cynthia Johnson, *University of Arkansas, Little Rock*

Gina Jones, *Aims Community College*

Jeffrey Jones, *The College of Southern Nevada*

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

Naomi Karolinski, *Monroe Community College*

Anne Kenner, *Eastern Florida State College*

Stephanie (Sam) King, *Edison State College*

Emil Koren, *Saint Leo University*

Paul Koulakov, *Nashville State Community College*

Christy Land, *Catawba Valley Community College*

Suzanne Lay, *Colorado Mesa University*

Gary Laycock, *Ivy Tech Community College*

Cynthia Lewis, *Harford Community College*

Wayne Lewis, *Hudson Valley Community College*

Debbie Luna, *El Paso Community College*

Mabel Machin, *Valencia College*

Mostafa Maksy, *Kutztown University*

Richard Mandau, *Piedmont Technical College*

Christina Manzo, *Queensborough Community College*

Maria C. Mari, *Miami Dade College*

Cynthia J. Miller, *University of Kentucky*

Andrea Murowski, *Brookdale Community College*

Micki Nickla, *Ivy Tech Community College*

Joanne Orabone, *Community College of Rhode Island*

Robert Pacheco, *Massasoit Community College*

Kimberly Perkins, *Austin Community College*

Dorris Perryman, *Bristol Community College*

Denel Pierre, *Saint Leo University*

William Quilliam, *Florida Southern College*

Marcela Raphael, *Chippewa Valley Technical College*  
 Ryan Rees, *Salt Lake Community College*  
 Kathryn Reynolds, *Front Range Community College Larimer*  
 Alice Rivera, *Golden West College*  
 Cecile Robert, *Community College of Rhode Island*  
 Shani Nicole Robinson, *Sam Houston State University*  
 Eric Rothenburg, *Kingsborough Community College*  
 Carol Rowey, *Community College of Rhode Island*  
 Amanda J. Salinas, *Alto College*  
 Sayan Sarkar, *University of Texas, El Paso*  
 Maurice Savard, *East Stroudsburg University*  
 Constance Schwass, *West Shore Community College*  
 Perry Sellers, *Lone Star College*  
 Dennis Shea, *Southern New Hampshire University*  
 Jaye Simpson, *Tarrant County*  
 John Stancil, *Florida Southern*  
 Diana Sullivan, *Portland Community College*

Annette Taggart, *Texas A&M University—Commerce*  
 Linda Tarrago, *Hillsborough Community College*  
 Teresa Thompson, *Chaffey College*  
 Judy Toland, *Bucks County Community College*  
 Daniel Tschoop, *Saint Leo University*  
 Robin D. Turner, *Rowan-Cabarrus Community College*  
 William Van Glabek, *Edison State College*  
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 Christine Wayne, *William Rainey Harper College*  
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 Denise A. White, *Austin Community College*  
 Donald R. Wilke, *Northwest Florida State College*  
 Timothy Wiseman, *Saint Leo University*  
 Wanda Wong, *Chabot College*  
 Angela Woodland, *Montana State University*  
 Raymond Kurt Yann, *Saint Leo University*  
 Judy Zander, *Grossmont College*

## Accuracy Checkers:

James L. Baker, *Harford Community College*

Connie Belden, *Butler Community College*

## Supplements Authors and Reviewers:

Dave Alldredge, *Salt Lake Community College*  
 Sheila Ammons, *Austin Community College*  
 Sidney Askew, *Borough of Manhattan Community College, CUNY*  
 James L. Baker, *Harford Community College*  
 Connie Belden, *Butler Community College*  
 Alisa Brink, *Virginia Commonwealth University*  
 Helen Brubeck, *Saint Mary-of-the-Woods College*

Kate Demarest, *Carroll Community College*  
 Lori Hatchell, *Alms Community College*  
 Carol Hughes, *Asheville-Buncombe Technical Community College*  
 Brett Killion, *Lakeland College*  
 Diane O'Neill, *Seattle University*  
 Teresa Stephenson, *The University of South Dakota*  
 Stephanie Swaim, *North Lake College*

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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 | 4 Use the accounting equation to analyze transactions                                  |
| 2 Describe the organizations and rules that govern accounting                      | 5 Prepare financial statements   |
| 3 Describe the accounting equation and define assets, liabilities, and equity      | 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

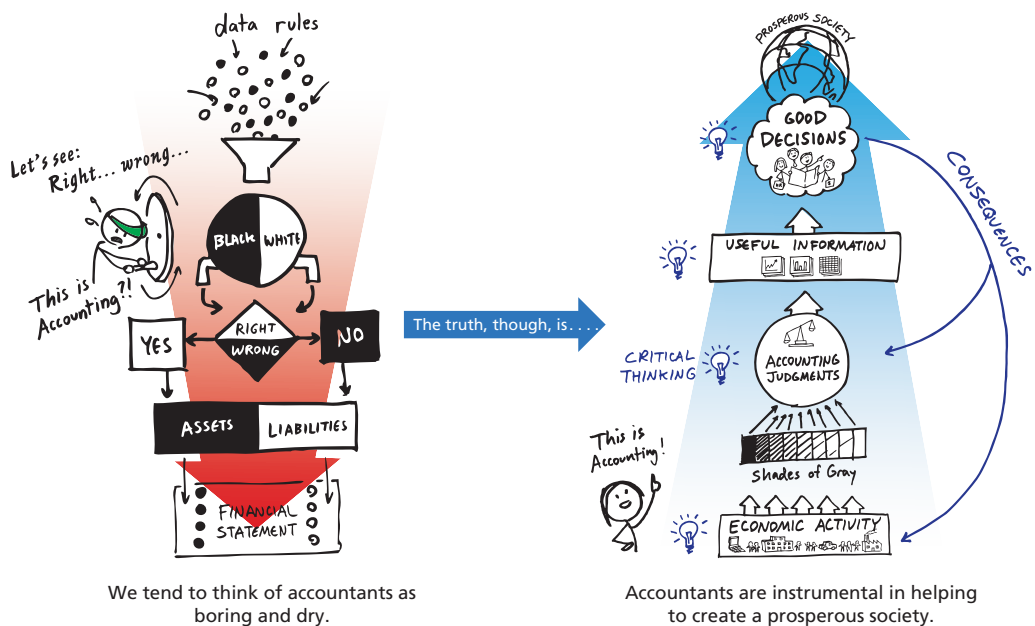
The information system that measures business activities, processes the information into reports, and communicates the results to decision makers.

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.

The Pathways Vision Model (see Exhibit F:1-1), created by the Pathways Commission, provides a visual interpretation of what accountants really do. Accounting starts with

**Exhibit F:1-1** Pathways Vision Model



This work is by The Pathways Commission. The Pathways Vision Model: AI artwork: AAA Commons. American Accounting Association.



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 F: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.

### 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.

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

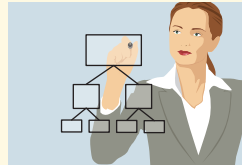
### Financial Accounting



#### 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?

## IFRS

Accounting is alive! As businesses evolve and the types 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 you see the IFRS heading.

## 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 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

### Creditor

Any person or business to whom a business owes money.

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

### Certified Public Accountants (CPAs)

Licensed professional accountants who serve the general public.

### Chartered Global Management Accountant (CGMA)

Professional accountant with advanced knowledge in finance, operations, strategy, and management.

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. Accountants can also obtain a **Chartered Global Management Accountant (CGMA)** designation. This distinguishes accountants who have advanced knowledge in finance, operations, strategy, and management. **The American Institute of Certified Public Accountants (AICPA) Web site** (<http://www.thiswaytocpa.com>) contains a wealth of information about becoming a CPA or CGMA, 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>).

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

### Certified Management Accountants (CMAs)

Professional accountants who specialize in accounting and financial management knowledge.







Another specialization in accounting is a **Certified Financial Planner**, or **CFP**. CFPs work with individuals to help them budget, plan for retirement, save for education, and manage their finances. Individuals who want to obtain their CFP must have the four E's: education, examination, experience, and ethics. You can find out more about becoming a CFP on the following Web site: <https://www.cfp.net/home>.

Studying accounting and becoming certified professionally can lead to a financially secure job. It's worth it for an accountant to spend the time and energy to get certified—certified accountants generally make 10–15% more than their noncertified colleagues when they enter the workforce. According to Robert Half's *2019 Salary Guide*, the top in-demand positions that rely on accounting skills are controllers, financial analysts, tax accountants, auditors, cost accountants, accounting clerks/bookkeepers, and business systems analysts. How much do these types of accountants make? Exhibit F:1-3 provides a snapshot of the earning potential for key positions.

**Certified Financial Planner (CFP)**  
Certified professional who specializes in budgeting, planning for retirement, and managing finances.

### Exhibit F:1-3 | Comparison of Accounting Positions

Position	Job Description	Salary Range
<b>Controllers</b>	Compile financial statements, interact with auditors, and oversee regulatory reporting.	\$92,000–\$207,750
<b>Financial analysts</b>	Review financial data and help to explain the story behind the numbers.	\$42,500–\$201,250
<b>Business systems analysts</b>	Use accounting knowledge to create computer systems.	\$42,500–\$185,000
<b>Tax accountants</b>	Help companies navigate tax laws.	\$39,500–\$212,250
<b>Auditors</b>	Perform reviews of companies to ensure compliance to rules and regulations.	\$39,500–\$208,750
<b>Cost accountants</b>	Typically work in a manufacturing business. Help analyze accounting data.	\$42,000–\$143,750
<b>Accounting clerks/Bookkeepers</b>	Record financial transactions and help prepare financial records.	\$28,250–\$65,750

Based on Robert Half's 2019 Salary Guide <https://www.roberthalf.com/salary-guide>

Accountants generally work either in corporate or industry accounting, public accounting, financial services, or governmental accounting. Corporate or industry accounting professionals are in demand in every sector of the business community, including manufacturing, construction, and healthcare. As the population of the world continues to age, accountants are in high demand in healthcare organizations to address billing and collections, data and business analysis, and changing revenue models. Corporate/industry accountants typically work for a single company, such as Amazon.com, Walmart, Dell, or UnitedHealthcare. Public accounting involves services such as auditing, tax preparation, and consulting. Well-known public accounting firms include Ernst & Young, Deloitte, PricewaterhouseCoopers (PwC), and KPMG. Accountants also work in financial services organizations such as banks. Other accountants work for federal, state, or local governments. Sought-after skills of accountants include being licensed or certified (e.g., CPA or CMA), data analytics, Excel, a strong work ethic, effective verbal and written communication, and leadership. 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 10% (faster than average) from 2016–2026.



## Data Analytics in Accounting

Today's accountants need to know more than just accounting knowledge. They also need to have an understanding of how technology is used to process financial information. Accounting and finance individuals actively work with information technology teams to develop accounting systems. Artificial intelligence, cloud-based systems, and robotic process automation are all changing the way companies handle financial information. Ideal accounting employees have knowledge in both accounting and technology.

### 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 MyLab Accounting or at <http://www.pearsonhighered.com/Horngren>.

For more practice, see Short Exercise S-F:1-1. [MyLab Accounting](#)

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

### Learning Objective 2

Describe the organizations and rules that govern accounting

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

### Governing Organizations

#### 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.

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**.<sup>1</sup> Relevant information allows users of the information to make a decision. Information that is faithfully representative is complete, neutral, and free from material error. These basic accounting assumptions and principles are part of the foundation for the financial reports that companies present.

### Faithful Representation

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

## 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 F:1-4 summarizes the similarities and differences among the four types of business organizations.

### 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.

## Distinguishing Characteristics and Organization of a Corporation

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

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

### Exhibit F:1-4 | Business Organizations

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

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

**Stockholder**

A person who owns stock in a corporation.

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

The ownership interest of a corporation is divided into shares of stock. A person becomes a stockholder by purchasing the stock of the corporation. The corporate charter specifies how much stock the corporation is authorized to issue (sell) to the public. Due to this fact, it is usually easier for corporations to raise capital.

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

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

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

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

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

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

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

- *Federal and state income taxes:* Corporate earnings are subject to double taxation. First, corporations pay their own income tax on corporate income. Then, the stockholders pay personal income tax on the dividends that they receive from corporations. This is different from sole proprietorships and partnerships, which pay no business income tax. Instead, the tax falls solely on the individual owners.



- *Annual franchise tax levied by the state:* The franchise tax is paid to keep the corporation charter in force and enables the corporation to continue in business.

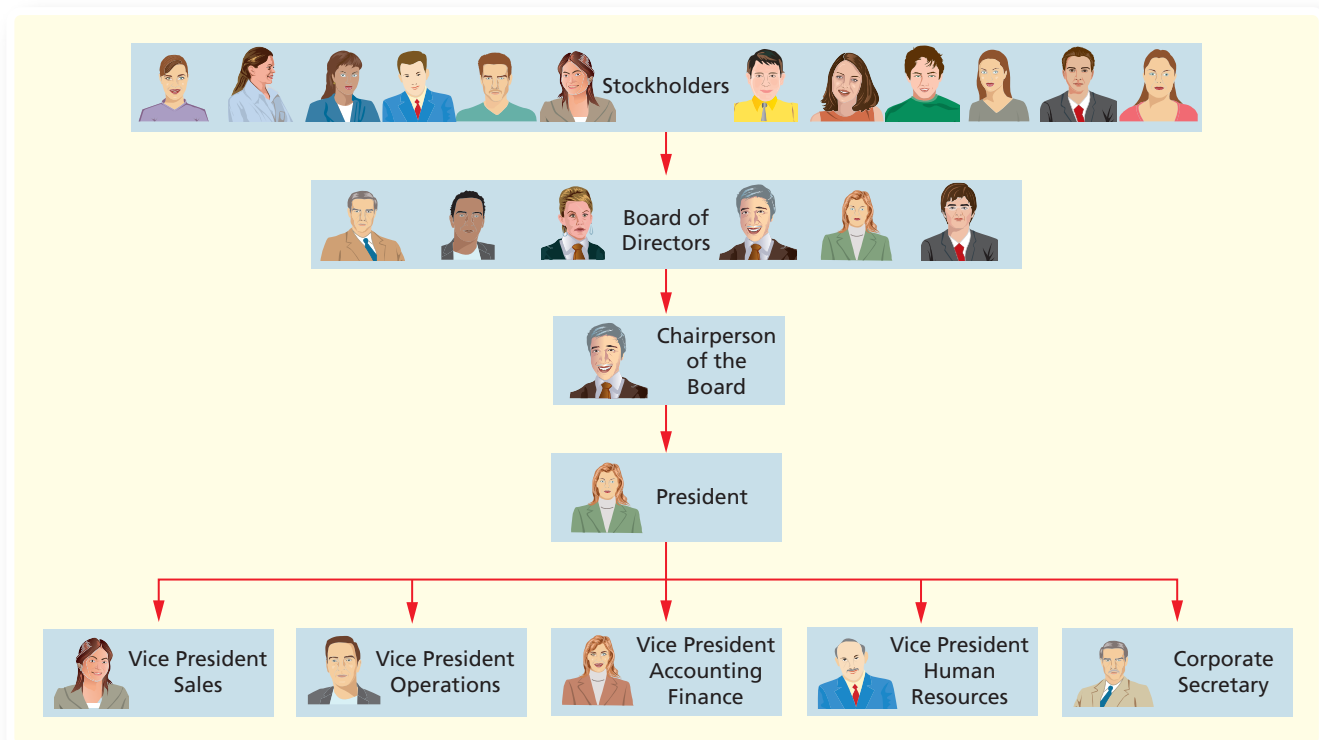
**Government Regulation** To protect persons who loan money to a corporation or who invest in its stock, states monitor the actions of corporations. Corporations are subjected to more governmental regulation than other forms of business, which is a disadvantage for corporations and can be expensive.

**Organization of a Corporation** As noted earlier, creation of a corporation begins when its organizers, called the *incorporators*, obtain a charter from the state. The charter includes the authorization for the corporation to issue a certain number of shares of stock, which represent the ownership in the corporation. The incorporators pay fees, sign the charter, and file the required documents with the state. Once the first share of stock is issued, the corporation comes into existence. The incorporators agree to a set of bylaws, which act as the constitution for governing the corporation. Bylaws are the rule book that guides the corporation.

The ultimate control of the corporation rests with the stockholders, who normally receive one vote for each share of stock they own. The stockholders elect the members of the board of directors, which sets policy for the corporation and appoints the officers. The board elects a chairperson, who usually is the most powerful person in the corporation. The board also designates the president, who as chief executive officer manages day-to-day operations. Most corporations also have vice presidents in charge of sales, operations, accounting and finance, and other key areas. Exhibit F:1-5 shows the authority structure in a corporation.

In order to demonstrate the economic entity assumption and several other concepts in this chapter, we will use a fictitious corporation—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.

#### Exhibit F:1-5 | Structure of a Corporation





Assume Sheena Bright started the business by organizing it as a corporation. She contributed cash of \$30,000 in exchange for stock 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.

## The Cost Principle

### Cost Principle

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

### IFRS

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.

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

### Going Concern Assumption

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

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

### Monetary Unit Assumption

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

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 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 166 nations/jurisdictions. 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.

### 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).



## 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.

### Public Company Accounting Oversight Board (PCAOB)

Monitors the work of independent accountants who audit public companies.

## 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 MyLab Accounting or at <http://www.pearsonhighered.com/Horngren>.





## WHAT IS THE ACCOUNTING EQUATION?

### Learning Objective 3

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

### Accounting Equation

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

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

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

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

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

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

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

### Assets

#### Assets

Economic resources that are expected to benefit the business in the future and something the business owns or has control of.

An **asset** is an economic resource that is expected to benefit the business in the future. Assets are something of value that the business owns or has control of. Cash, Merchandise Inventory, Furniture, and Land are examples of assets.

### Liabilities

#### Liabilities

Debts that are owed to creditors.

Claims to those assets come from two sources: liabilities and equity. **Liabilities** are debts that are owed to creditors. Liabilities are something the business owes and represent the creditors' claims on the business's assets. For example, a creditor who has loaned money to a business has a claim to some of the business's assets until the business pays the debt. Many liabilities have the word *payable* in their titles. Examples include Accounts Payable, Notes Payable, and Salaries Payable.

### Equity

#### Equity

The owners' claims to the assets of the business.

The owners of a corporation are referred to as stockholders (also called *shareholders*). The owners' claims to the assets of the business are called **equity** (also called *stockholders' equity*). Equity represents the amount of assets that are left over after the company has paid its liabilities. It is the company's net worth.

#### Contributed Capital

Owner contributions to a corporation.

Equity consists of two main components: contributed capital and retained earnings. Owner contributions to a corporation are referred to as **contributed capital**. A stockholder can contribute cash or other assets (such as equipment) to the business and receive capital. Contributed capital (also called *paid-in capital*) is the amount contributed to the corporation by its owners (the stockholders). The basic element of contributed capital is stock, which the corporation issues to the stockholders as evidence of their ownership. **Common stock** represents the basic ownership of every corporation.

#### Common Stock

Represents the basic ownership of a corporation.

#### Retained Earnings

Equity earned by profitable operations of a corporation that is not distributed to stockholders.

**Retained earnings** is the equity earned by profitable operations that is not distributed to stockholders. There are three types of events that affect retained earnings: dividends, revenues, and expenses. A profitable corporation may make distributions to stockholders





in the form of **dividends**. Dividends can be paid in the form of cash, stock, or other property. A corporation may or may not make dividend payments to the stockholders. Dividends represent decreases in retained earnings and, therefore, decrease stockholders' equity.

**Revenues** are earnings that result from delivering goods or services to customers. Examples of revenues are Sales Revenue, Service Revenue, and Rent Revenue. Revenues increase a corporation's retained earnings and, therefore, increase stockholders' equity.

**Expenses** are the costs of selling goods or services. Expenses are the opposite of revenues and, therefore, decrease retained earnings and stockholders' equity. Examples of expenses are Rent Expense, Salaries Expense, Advertising Expense, and Utilities Expense. The difference between revenue and expenses is net income or net loss. **Net income** occurs when total revenues are greater than total expenses. A net loss is the opposite. A **net loss** occurs when total expenses are greater than total revenues.

The accounting equation can now be expanded to show the components of equity.

$$\begin{array}{c} \text{ASSETS} \\ \hline \end{array} \left. \vphantom{\begin{array}{c} \text{ASSETS} \\ \hline \end{array}} \right\} = \left\{ \begin{array}{c} \text{LIABILITIES} + \\ \hline \text{Contributed} \\ \text{Capital} + \\ \hline \text{Common} - \text{Dividends} + \text{Revenues} - \text{Expenses} \\ \text{Stock} \end{array} \right. \begin{array}{c} \text{EQUITY} \\ \hline \text{Retained Earnings} \\ \hline \end{array}$$

A corporation can determine the change in equity from the beginning of the year to the end of the year by using the expanded components of equity. Issuances of common stock and revenues earned during the year will always increase equity, and dividends distributed and expenses incurred during the year always decrease equity. Therefore, a corporation's ending equity is calculated as follows:

$$\text{Beginning Equity} + \text{Issuance of Common Stock} - \text{Dividends Distributed} + \text{Revenues} - \text{Expenses} = \text{Ending Equity}$$

## Try It!

16. Using the expanded accounting equation, solve for the missing amount.

Assets	\$ 71,288
Liabilities	2,260
Common Stock	?
Dividends	14,420
Revenues	53,085
Expenses	28,675

Check your answer online in MyLab Accounting or at <http://www.pearsonhighered.com/Horngren>.

For more practice, see Short Exercises S-F:1-6 through S-F:1-8. [MyLab Accounting](#)

### Dividend

A distribution of a corporation's earnings to stockholders.

### Revenues

Amounts earned from delivering goods or services to customers.

### Expenses

The costs of selling goods or services.

### Net Income

The result of operations that occurs when total revenues are greater than total expenses.

### Net Loss

The result of operations that occurs when total expenses are greater than total revenues.

## HOW DO YOU ANALYZE A TRANSACTION?

Accounting is based on actual transactions. A **transaction** is any event that affects the financial position of the business *and* can be measured with faithful representation. Transactions affect what the company has (assets), owes (liabilities), and/or its net worth (equity). Many

### Learning Objective 4

Use the accounting equation to analyze transactions



Transaction

An event that affects the financial position of the business and can be measured with faithful representation.

events affect a company, including economic booms and recessions. Accountants, however, do not record the effects of those events. An accountant records only those events that have dollar amounts that can be measured reliably, such as the purchase of a building, a sale of merchandise, and the payment of rent.

Transaction Analysis for Smart Touch Learning

To illustrate accounting for a business, we'll use Smart Touch Learning, the business introduced earlier. We'll account for the transactions of Smart Touch Learning during November 2024 and show how each transaction affects the accounting equation.

Transaction 1—Stockholder Contribution

Assume Sheena Bright contributes \$30,000 cash to Smart Touch Learning, a corporation, in exchange for stock. The e-learning business receives \$30,000 cash and issues common stock to Sheena Bright. The effect of this transaction on the accounting equation of the business is as follows:

ASSETS		}	=	{	LIABILITIES	+	EQUITY
							Contributed Capital
	Cash						Common Stock
(1)	+30,000						+30,000

Let's take a close look at the transaction above following these steps:

**Step 1: Identify the accounts and the account type.** Each transaction must affect at least two accounts but could affect more than two. The two accounts involved in this transaction are *Cash (Asset)* and *Common Stock (Equity)*.

**Step 2: Decide if each account increases or decreases.** Remember to always view this from the *business's* perspective, not from the stockholders' or customers' perspective. *Cash increases*. The business has more cash than it had before. *Common Stock increases*. The business received a \$30,000 contribution and issued stock.

**Step 3: Determine if the accounting equation is in balance.** For each transaction, the amount on the left side of the equation must equal the amount on the right side.  $\$30,000 = \$30,000$

Transaction 2—Purchase of Land for Cash

The business purchases land for an office location, paying cash of \$20,000. This transaction affects the accounting equation of Smart Touch Learning as follows:

<u>ASSETS</u>			}	=	{	<u>LIABILITIES</u>	+	<u>EQUITY</u>
								<u>Contributed Capital</u>
	Cash	+ Land						+ Common Stock
Bal.	\$30,000							\$30,000
(2)	<u>-20,000</u>	+ <u>20,000</u>						
Bal.	<u>\$10,000</u>	+ <u>\$20,000</u>						<u>\$30,000</u>

Let's review the transaction using the steps we learned:

**Step 1: Identify the accounts and the account type.** The two accounts involved are *Cash (Asset)* and *Land (Asset)*.



**Step 2: Decide if each account increases or decreases.** *Cash decreases.* The business paid cash and therefore has less cash. *Land increases.* The business now has land.

**Step 3: Determine if the accounting equation is in balance.**  $\$10,000 + \$20,000 = \$30,000$

### Transaction 3—Purchase of Office Supplies on Account

Smart Touch Learning buys office supplies on account (also called *buying on credit*), agreeing to pay \$500 within 30 days. This transaction increases both the assets and the liabilities of the business as follows:

ASSETS				}	=	LIABILITIES + EQUITY	
Cash	Office Supplies	Land				Accounts Payable	Contributed Capital Common Stock
Bal. \$10,000		\$20,000					\$30,000
(3)	+500					+500	
Bal. \$10,000	+ \$500	+ \$20,000				\$500	+ \$30,000

**Step 1: Identify the accounts and the account type.** The two accounts involved are *Office Supplies (Asset)* and *Accounts Payable (Liability)*. Office Supplies is an asset, not an expense, because the supplies are something of value that the company has. The office supplies aren't used up yet but will be in the future. The liability created by purchasing "on account" is an **Accounts Payable**, which is a short-term liability that will be paid in the future. A payable is always a liability.

#### Accounts Payable

A short-term liability that will be paid in the future.

**Step 2: Decide if each account increases or decreases.** *Office Supplies increases.* The business now has more office supplies than it had before. *Accounts Payable increases.* The business now owes more debt than it did before.

**Step 3: Determine if the accounting equation is in balance.**  $\$10,000 + \$500 + \$20,000 = \$500 + \$30,000$

Notice how the steps help when analyzing transactions. It's important that, as you are learning, you use the steps to complete the transactions. Moving forward, try writing the steps out yourself before looking at the transaction analysis.

### Transaction 4—Earning of Service Revenue for Cash

Smart Touch Learning earns service revenue by providing training services for clients. The business earns \$5,500 of revenue and collects this amount in cash. The effect on the accounting equation is an increase in Cash and an increase in Service Revenue as follows:

ASSETS				}	=	LIABILITIES + EQUITY		
Cash	Office Supplies	Land				Accounts Payable	Contributed Capital Common Stock	Retained Earnings Service Revenue
Bal. \$10,000	\$500	\$20,000				\$500	\$30,000	
(4) +5,500								+5,500
Bal. \$15,500	+ \$500	+ \$20,000				\$500	+ \$30,000	+ \$5,500



A revenue transaction grows the business, as shown by the increases in assets and equity.

### Transaction 5—Earning of Service Revenue on Account

Smart Touch Learning performs a service for clients who do not pay immediately. The business receives the clients' promise to pay \$3,000 within one month. This promise is an asset, an **Accounts Receivable**, because the business expects to receive the cash in the future. In accounting, we say that Smart Touch Learning performed this service *on account*. It is in performing the service (doing the work), not collecting the cash, that the company *earns* the revenue. As in Transaction 4, increasing revenue increases equity. Smart Touch Learning records the earning of \$3,000 of revenue on account as follows:

#### Accounts Receivable

The right to receive cash in the future from customers for goods sold or for services performed.

ASSETS					LIABILITIES +		EQUITY		
Cash	+ Accounts Receivable	+ Office Supplies	+ Land		Accounts Payable	+ Contributed Capital	+ Retained Earnings		
Bal. \$15,500		+ \$500	+ \$20,000		\$500	+ \$30,000	+ \$5,500		
(5)	+3,000						+3,000		
Bal. \$15,500	+ \$3,000	+ \$500	+ \$20,000		\$500	+ \$30,000	+ \$8,500		

*The term on account can be used to represent either Accounts Receivable or Accounts Payable. If the business will be receiving cash in the future, the company will record an Accounts Receivable. If the business will be paying cash in the future, the company will record an Accounts Payable.*

### Transaction 6—Payment of Expenses with Cash

The business pays \$3,200 in cash expenses: \$2,000 for office rent and \$1,200 for employee salaries. The effects on the accounting equation are as follows:

ASSETS					LIABILITIES +		EQUITY			
Cash	+ Accounts Receivable	+ Office Supplies	+ Land		Accounts Payable	+ Contributed Capital	+ Retained Earnings			
Bal. \$15,500	+ \$3,000	+ \$500	+ \$20,000		\$500	+ \$30,000	+ \$8,500			
(6) -3,200								-2,000	-1,200	
Bal. \$12,300	+ \$3,000	+ \$500	+ \$20,000		\$500	+ \$30,000	+ \$8,500	- \$2,000	- \$1,200	

Expenses have the opposite effect of revenues. Expenses shrink the business, as shown by the decreased balances of assets and equity. Each expense is recorded separately. We record the cash payment in a single amount for the sum of the expenses: \$3,200 (\$2,000 + \$1,200). Notice that the accounting equation remains in balance (\$12,300 + \$3,000 + \$500 + \$20,000 = \$500 + \$30,000 + \$8,500 - \$2,000 - \$1,200).



### Transaction 7—Payment on Account (Accounts Payable)

The business pays \$300 to the store from which it purchased office supplies in Transaction 3. In accounting, we say that the business pays \$300 *on account*. The effect on the accounting equation is a decrease in Cash and a decrease in Accounts Payable as shown here:

ASSETS					}	=	LIABILITIES +		EQUITY						
Cash	+	Accounts Receivable	+	Office Supplies			Land	Accounts Payable	+	Contributed Capital		+	Retained Earnings		
										Common Stock			Service Revenue	Rent Expense	Salaries Expense
Bal. \$12,300	+	\$3,000	+	\$500	+	\$20,000	\$500	+	\$30,000	+	\$8,500	–	\$2,000	–	\$1,200
(7) –300							–300								
Bal. \$12,000	+	\$3,000	+	\$500	+	\$20,000	\$200	+	\$30,000	+	\$8,500	–	\$2,000	–	\$1,200

The payment of cash on account has no effect on the amount of Office Supplies (Asset). Smart Touch Learning has not increased the amount of its office supplies; instead, it is paying off a liability (Accounts Payable decreased \$300) with cash (Cash decreased \$300). **To record an increase to Office Supplies, in this transaction, would be accounting for the purchase of office supplies twice.** We have already recorded the purchase of office supplies in Transaction 3; in this transaction, we are now ready to record only the payment on account.

Why didn't we record an increase to Office Supplies? We are making a payment for the supplies; wouldn't we increase Office Supplies and decrease Cash?



### Transaction 8—Collection on Account (Accounts Receivable)

In Transaction 5, the business performed services for clients on account. Smart Touch Learning now collects \$2,000 from a client. We say that Smart Touch Learning collects the cash *on account*. The business will record an increase in the asset Cash. Should it also record an increase in Service Revenue? No, because the business already recorded the revenue when it earned the revenue in Transaction 5. The phrase “collect cash on account” means to record an increase in Cash and a decrease in Accounts Receivable. Accounts Receivable is decreased because the \$2,000 that the business was to collect at some point in the future is being collected today. The effect on the accounting equation is as follows:

ASSETS					}	=	LIABILITIES +		EQUITY							
Cash	+	Accounts Receivable	+	Office Supplies			Land	Accounts Payable	+	Contributed Capital		+ Retained Earnings				
										Common Stock	+	Service Revenue	– Rent Expense	– Salaries Expense		
Bal. \$12,000	+	\$3,000	+	\$500	+	\$20,000		Accounts Payable	+	Common Stock	+	Service Revenue	–	Rent Expense	–	Salaries Expense
(8) +2,000		–2,000						\$200	+	\$30,000	+	\$8,500	–	\$2,000	–	\$1,200
Bal. \$14,000	+	\$1,000	+	\$500	+	\$20,000		\$200	+	\$30,000	+	\$8,500	–	\$2,000	–	\$1,200

This transaction is recorded as an increase in one asset (Cash) and a decrease in another asset (Accounts Receivable). Is the accounting equation still in balance? Yes. **As long as you record an increase and decrease of the same amount on one side of the accounting equation, the accounting equation remains in balance.** In other words, total Assets, Liabilities, and Equity are all unchanged from the preceding total. Why? Because Smart Touch Learning exchanged one asset (Cash) for another (Accounts Receivable), causing a zero effect on the total amount of assets in the accounting equation (+\$2,000 – \$2,000 = \$0).

Don't I have to put an amount on the left side of the accounting equation and an amount on the right side of the accounting equation for the equation to balance?







### Transaction 9—Payment of Cash Dividend

Smart Touch Learning distributes a \$5,000 cash dividend to the stockholder, Sheena Bright. The effect on the accounting equation is as follows:

ASSETS					=	LIABILITIES +		EQUITY										
Cash	+	Accounts Receivable	+	Office Supplies		+	Land	Accounts Payable	+	Contributed Capital		+	Retained Earnings					
										Common Stock	Dividends		+	Service Revenue	–	Rent Expense	–	Salaries Expense
Bal. \$14,000	+	\$1,000	+	\$500	+	\$20,000	\$200	+	\$30,000	–		+	\$8,500	–	\$2,000	–	\$1,200	
(9) –5,000											–5,000							
Bal. \$ 9,000	+	\$1,000	+	\$500	+	\$20,000	\$200	+	\$30,000	–	\$5,000	+	\$8,500	–	\$2,000	–	\$1,200	

The dividend decreases the business's cash and equity. *Dividends do not represent an expense because they are not related to the earning of revenue. Therefore, dividends do not affect the business's net income or net loss.*

A summary of all nine transactions for Smart Touch Learning is presented in Exhibit F:1-6.

**Exhibit F:1-6** Analysis of Transactions, Smart Touch Learning

1. Received \$30,000 cash and issued common stock to Sheena Bright, stockholder
2. Paid \$20,000 cash for land
3. Bought \$500 of office supplies on account
4. Received \$5,500 cash from clients for service revenue earned
5. Performed services for clients on account, \$3,000
6. Paid cash expenses: office rent, \$2,000; employee salaries, \$1,200
7. Paid \$300 on the accounts payable created in Transaction 3
8. Collected \$2,000 on the accounts receivable created in Transaction 5
9. Paid cash dividends of \$5,000 to stockholder, Sheena Bright

ASSETS					=	LIABILITIES		+	EQUITY					
Cash	+ Accounts Receivable	+ Office Supplies	+ Land	Accounts Payable		+	Common Stock	+ Contributed Capital	- Dividends	Retained Earnings				
										+ Service Revenue	- Rent Expense	- Salaries Expense		
(1)	+30,000													
(2)	-20,000			+20,000										
Bal.	\$10,000			+ \$20,000										
(3)			+500											
Bal.	\$10,000		+ \$500	+ \$20,000										
(4)	+5,500													
Bal.	\$15,500		+ \$500	+ \$20,000										
(5)		+3,000												
Bal.	\$15,500	+ \$3,000	+ \$500	+ \$20,000										
(6)	-3,200													
Bal.	\$12,300	+ \$3,000	+ \$500	+ \$20,000										
(7)	-300													
Bal.	\$12,000	+ \$3,000	+ \$500	+ \$20,000										
(8)	+2,000	-2,000												
Bal.	\$14,000	+ \$1,000	+ \$500	+ \$20,000										
(9)	-5,000													
Bal.	\$ 9,000	+ \$1,000	+ \$500	+ \$20,000										
<u>\$30,500</u>						<u>\$30,500</u>			<u>\$30,500</u>					



## Try It!

17. Using the information provided, analyze the effects of Lawlor Lawn Service's transactions on the accounting equation.

May 1	Received \$1,700 and issued common stock.
May 3	Purchased a mower on account, \$1,440.
May 5	Performed lawn services for client on account, \$200.
May 17	Paid \$60 cash for gas used in mower.
May 28	Paid cash dividends of \$300.

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

For more practice, see Short Exercises S-F:1-9 and S-F:1-10. [MyLab Accounting](#)

## HOW DO YOU PREPARE FINANCIAL STATEMENTS?

We have now recorded Smart Touch Learning's transactions, and they are summarized in Exhibit F:1-6. Notice how total assets equal total liabilities plus equity (\$30,500 = \$30,500).

But a basic question remains: How will people actually use this information? The information in Exhibit F:1-6 does not tell a lender whether Smart Touch Learning can pay off a loan. The exhibit does not tell whether the business is profitable.

To address these important questions, we need financial statements. **Financial statements** are business documents that are used to communicate information needed to make business decisions. Four financial statements are prepared. These statements are prepared in the order listed in Exhibit F:1-7.

Because financial statements are used to communicate information, they always include a heading with important details about the reports. The standard three-line heading tells the reader of the statement who, what, and when—the name of the business, the title of the report, and the specific date or time period of the report.

### Learning Objective 5

Prepare financial statements

### Financial Statements

Business documents that are used to communicate information needed to make business decisions.

### Exhibit F:1-7 | Financial Statements

Financial Statement	Information Provided and Purpose	How Is It Prepared?
Income statement	Provides information about profitability for a particular period for the company	Revenues – Expenses = Net Income or Net Loss
Statement of retained earnings	Informs users about how much of the earnings were kept and reinvested in the company	Retained Earnings, Beginning + Net Income or – Net Loss for the period – Dividends for the period = Retained Earnings, Ending
Balance sheet	Provides valuable information to financial statement users about economic resources the company has (assets) as well as debts the company owes (liabilities), and allows decision makers to determine their opinion about the financial position of the company	Assets = Liabilities + Stockholders' Equity
Statement of cash flows	Reports on a business's cash receipts and cash payments for a period of time	Cash flows from operating activities Cash flows from investing activities Cash flows from financing activities



## Income Statement

### Income Statement

Reports the *net income* or *net loss* of the business for a specific period.

Let's start by reviewing the **income statement**. The income statement (also called the *statement of earnings*) presents a summary of a business entity's revenues and expenses for a period of time, such as a month, quarter, or year. The income statement tells us whether the business enjoyed net income or suffered a net loss. Remember:

- Net income means total revenues are greater than total expenses.
- Net loss means total expenses are greater than total revenues.

It's important to remember that the only two types of accounts that are reported on the income statement are revenues and expenses. Exhibit F:1-8 shows the income statement for Smart Touch Learning. Every income statement contains similar information.

### Exhibit F:1-8 | Income Statement

<b>SMART TOUCH LEARNING</b> Income Statement Month Ended November 30, 2024	
Revenues:	
Service Revenue	\$ 8,500
Expenses:	
Rent Expense	\$ 2,000
Salaries Expense	1,200
Total Expenses	3,200
Net Income	<u>\$ 5,300</u>

The heading includes the name of the business, the title of the statement, and the time period. An income statement always represents a period of time, for example, a month or year.

The revenue accounts are always listed first and then subtotaled if necessary.

Net income is calculated as total revenues minus total expenses.

Each expense account is listed separately from largest to smallest and then subtotaled if necessary.

## Statement of Retained Earnings

### Statement of Retained Earnings

Reports how the company's retained earnings balance changed from the beginning to the end of the period.

The next statement prepared is the **statement of retained earnings**. The statement of retained earnings shows the changes in retained earnings for a business entity during a time period, such as a month, quarter, or year.

Review the statement of retained earnings for Smart Touch Learning in Exhibit F:1-9. Notice that the net income for the month is the net income that was calculated on the income statement. This is the main reason why the income statement is prepared before the statement of retained earnings. The net income (or net loss) must first be calculated on the income statement and then carried to the statement of retained earnings.

**Exhibit F:1-9** | **Statement of Retained Earnings**

<b>SMART TOUCH LEARNING</b> Statement of Retained Earnings Month Ended November 30, 2024	
Retained Earnings, November 1, 2024	\$ 0
Net income for the month	5,300
	<hr/> 5,300
Dividends	(5,000)
Retained Earnings, November 30, 2024	<u><u>\$ 300</u></u>

## Balance Sheet

Reports on the assets, liabilities, and stockholders' equity of the business as of a specific date.

## Balance Sheet

The **balance sheet** (also called the *statement of financial position*) lists a business entity's assets, liabilities, and stockholders' equity as of a specific date, usually the end of a month, quarter, or year. **The balance sheet is a snapshot of the entity. An investor or creditor can quickly assess the overall health of a business by viewing the balance sheet.**

Review the balance sheet for Smart Touch Learning in Exhibit F:1-10. Every balance sheet is prepared in a similar manner.

What does the balance sheet tell an investor or creditor?



## Exhibit F:1-10 | Balance Sheet

Each asset account is listed separately and then totaled. Cash is always listed first.

The heading again shows the name of the business and the title of the financial statement. Notice that the date is different. The balance sheet shows the date as a specific date, not a period of time.

Liabilities are listed separately and then totaled. Liabilities that are to be paid first are listed first.

Retained Earnings is taken directly from the statement of retained earnings.

The balance sheet must always balance.  
Assets = Liabilities + Stockholders' Equity

SMART TOUCH LEARNING			
Balance Sheet			
November 30, 2024			
Assets		Liabilities	
Cash	\$ 9,000	Accounts Payable	\$ 200
Accounts Receivable	1,000		
Office Supplies	500	Stockholders' Equity	
Land	20,000	Common Stock	30,000
		Retained Earnings	300
		Total Stockholders' Equity	30,300
Total Assets	<u>\$ 30,500</u>	Total Liabilities and Stockholders' Equity	<u>\$ 30,500</u>



## TYING IT ALL TOGETHER

At the beginning of the chapter, we introduced **Starbucks Corporation** as a leading retailer in the specialty coffee market. Starbucks purchases and roasts high-quality coffees and sells other beverages (such as tea). In addition, Starbucks sells a variety of fresh food items including snack offerings.

### What type of asset accounts would Starbucks have and what financial statement would those assets be reported on?

Starbucks reports many assets on its balance sheet, including the following: Cash; Accounts Receivable; Inventories; and Property, Plant, and Equipment.

### If Starbucks owed money to a vendor, how would this be reported on its financial statements?

Money owed to a vendor is reported on the balance sheet as Accounts Payable. As of October 1, 2017, Starbucks Corporation reported \$782.5 million of Accounts Payable. This represents an increase in debt from the previous year of \$730.6 million.

### How does Starbucks earn revenue and where would this be reported on its financial statements?

Starbucks reports three main revenue sources on its income statement: revenue received from operating stores owned by the company, revenue received from stores licensed to sell Starbucks products, and revenue from consumer packaged goods such as packaged coffee and other beverages sold at grocery stores. The largest source of revenue for Starbucks comes from its company-operated stores and represents 79% of total revenue.

### What type of expenses might Starbucks have and what financial statement would this be reported on?

Starbucks reports its expenses on the income statement. Its largest expense for the year ended October 1, 2017, is Cost of Sales at \$9,038.2 million (i.e., the cost to purchase the items it sells). The income statement also includes store operating expenses of \$6,493.3 million for costs (such as utilities, salaries, and benefits for employees). Starbucks also reports \$553.8 million in other operating expenses for the year ending October 1, 2017. Other operating expenses might include items such as advertising expenses.

*When you are preparing the financial statements, start by identifying which account goes on which statement. Each account will only go on one statement, except for Retained Earnings and Cash. For example, Service Revenue is only reported on the income statement. Liabilities, such as Accounts Payable, are only reported on the balance sheet. Cash and Retained Earnings appear on two statements. Cash is reported on the balance sheet and statement of cash flows, and Retained Earnings is reported on the statement of retained earnings and balance sheet.*

### Statement of Cash Flows

Reports on a business's cash receipts and cash payments for a specific period.

Would the purchase of supplies on account be reported on the statement of cash flows?

### Statement of Cash Flows

The **statement of cash flows** reports the cash coming in (positive amounts) and the cash going out (negative amounts) during a period. It only reports transactions that involve cash because it reports the net increase or decrease in *cash* during the period and the ending *cash* balance. **If a transaction does not involve cash, such as the purchase of supplies on account, it will not be reported on the statement of cash flows.**

The statement of cash flows is divided into three distinct sections: operating, investing, and financing. *Operating activities* involve cash receipts for services and cash payments for expenses. *Investing activities* include the purchase and sale of land and equipment for cash. *Financing activities* include cash contributions by stockholders, cash dividends paid to the stockholders, cash received from borrowing, and cash paid when loans are repaid.

Take a look at the statement of cash flows for Smart Touch Learning (Exhibit F:1-11). Notice the important items that the statement of cash flows contains.





**Exhibit F:1-11 | Statement of Cash Flows**

SMART TOUCH LEARNING Statement of Cash Flows Month Ended November 30, 2024		
Cash flows from operating activities:		
Receipts:		
Collections from customers		\$ 7,500
Payments:		
To suppliers	\$ (2,300)	
To employees	(1,200)	(3,500)
Net cash provided by operating activities		4,000
Cash flows from investing activities:		
Acquisition of land	(20,000)	
Net cash used by investing activities		(20,000)
Cash flows from financing activities:		
Issued common stock	30,000	
Payment of cash dividends	(5,000)	
Net cash provided by financing activities		25,000
Net increase in cash		9,000
Cash balance, November 1, 2024		0
Cash balance, November 30, 2024		<u>\$ 9,000</u>

The heading includes the name of the business, the title of the statement, and the time period. A statement of cash flows always represents a period of time.

Each dollar amount is calculated by evaluating the cash column on Exhibit F:1-6. For example, collections from customers is calculated by adding the cash received from customers in Transaction 4 (\$5,500) plus Transaction 8 (\$2,000).

Operating activities involve cash receipts for services provided and cash payments for expenses paid.

Investing activities include the purchase and sale of land and equipment for cash.

Financing activities include issuance of stock to stockholders and payment of cash dividends.

The ending cash balance must match the cash balance on the balance sheet.

## Try It!

18. Using the following information, complete the income statement, statement of retained earnings, and balance sheet for DR Painting for the month of March 2024. The business began operations on March 1, 2024.

Accounts Receivable	\$ 1,400	Salaries Expense	\$ 800
Accounts Payable	1,000	Service Revenue	7,000
Cash	22,300	Office Supplies	1,800
Stock issued during March	40,000	Truck	20,000
Dividends paid during March	1,500	Utilities Expense	200

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

For more practice, see Short Exercises S-F:1-11 through S-F:1-15. [MyLab Accounting](#)



## HOW DO YOU USE FINANCIAL STATEMENTS TO EVALUATE BUSINESS PERFORMANCE?

### Learning Objective 6

Use financial statements and return on assets (ROA) to evaluate business performance

Each of the financial statements provides different information about the company to the users of the financial statements. Review Exhibit F:1-7 for the information provided and the purpose of each financial statement.

### Kohl's Corporation

In this chapter, we have reviewed the transactions and financial statements of Smart Touch Learning, a fictitious company. Now it's time to apply what we have learned to a real-world company. In each chapter, we will review the financial statements of **Kohl's Corporation** to learn how to apply the concepts presented in the chapter to evaluate its business performance. Kohl's Corporation is a moderately priced retailer of apparel, footwear, accessories, beauty, and home products with more than 1,159 department stores, a website, 12 FILA outlets, and four Off-Aisle clearance centers. Kohl's has a merchandise mix that includes both national brands (61% of total sales in 2018) and private and exclusive brands (39% of total sales in 2018). Its private brands include Apt. 9, Croft & Barrow, Jumping Beans, SO, and Sonoma Goods for Life.

Take a moment to review the 2018 financial statements for Kohl's Corporation. Visit <http://www.pearsonhighered.com/Horngren> for a link to Kohl's Corporation's annual report. Let's start by identifying the financial statements that we've discussed in this chapter. The income statement is presented on page 37 of the annual report and is called the *Consolidated Statements of Income*. Notice that the income statement calculates net income (revenue minus expenses). Kohl's net income for the year ending February 2, 2019, was \$801 (in millions) or \$801,000,000.

The balance sheet is presented on page 36 of the annual report. Can you find assets, liabilities, and equity? As we have learned in this chapter, Kohl's assets of \$12,469 million are equal to its liabilities and equity, \$12,469 million.

### Return on Assets (ROA)

One of the many tools that users of financial statements can use to determine how well a company is performing is the company's **return on assets (ROA)**. Return on assets measures how profitably a company uses its assets. Return on assets is calculated by dividing net income by average total assets. Average total assets is calculated by adding the beginning and ending total assets for the time period and then dividing by two.

### Return on Assets (ROA)

Measures how profitably a company uses its assets. Net income / Average total assets.

## DECISIONS

### How can individuals make decisions about investing in the stock market?

Lori Cummings just inherited \$10,000 from her grandmother. She has decided that she will invest the money in the stock market. She is thinking about investing in one of her favorite clothing stores. The problem is she can't decide between Kohl's or Target.

How should Lori decide between the companies? What resources should she use?

### Solution

Lori should begin by reviewing the financial statements of each business. She can locate them on the companies' Web sites or on the Securities and Exchange Commission's Web site (<http://www.sec.gov/edgar.shtml>). She should review the income statements and compare net income. Which business was

more profitable? She should look at the balance sheets, carefully reviewing each part of the accounting equation. What was the dollar amount of assets? How much debt does the business have? In addition, she could go online and research the individual companies using a Web site such as Yahoo! Finance. These Web sites provide news and information about the company, such as current headlines, key statistics, and industry comparisons.

Lori should also consider diversifying her investment. Diversifying involves investing in more than one company and in a variety of industries and companies of different sizes. Diversification reduces the risk of an investment. Lori should consider investing half of the \$10,000 in a company in a different industry, such as her favorite restaurant or food manufacturer.



$$\begin{aligned}\text{Return on assets} &= \text{Net income} / \text{Average total assets} \\ \text{Average total assets} &= (\text{Beginning total assets} + \text{Ending total assets}) / 2\end{aligned}$$

Let's take a moment to calculate Kohl's return on assets and measure how profitably it uses its assets. On its 2018 income statement, Kohl's reported net income of \$801 million. The corporation reported beginning total assets (found on the balance sheet) of \$13,389 million and ending total assets of \$12,469 million. Kohl's return on assets for 2018 is (all amounts in millions):

$$\begin{aligned}\text{Return on assets} &= \$801 / ((\$13,389 + \$12,469) / 2) \\ &= \$801 / \$12,929 \\ &= 0.0620 = 6.2\%\end{aligned}$$

How do we as an investor know if 6.2% is good or bad? We have to compare the return on assets of competing companies such as **Target Corporation** and J.C. Penney Corporation, Inc. What if we told you that Target Corporation's return on assets was 7.2% and J.C. Penney Corporation's return on assets was (3.2%)? Due to Kohl's and Target's higher ROAs, we now know that both of these companies have a stronger return on assets than does J.C. Penney Corporation. What does this mean? It means that Kohl's and Target produce more profit per every dollar of assets than J.C. Penney does. In fact, J.C. Penney did not earn a profit in 2018, but instead had a net loss as indicated by its negative ROA.

As you learn more about accounting, you will explore more financial tools that are available to help investors evaluate a company's performance. Only after an investor looks at the big picture of a company will he or she have a good sense of the company's investment potential.

## Try It!

19. Using the following information, calculate the return on assets.

Net income for November, 2024	\$ 5,000
Total assets, November 1, 2024	76,000
Total assets, November 30, 2024	80,250

Check your answer online in MyLab Accounting or at <http://www.pearsonhighered.com/Horngren>.

For more practice, see Short Exercise S-F:1-16. [MyLab Accounting](#)

# REVIEW

## > Things You Should Know

### 1. Why is accounting important?

- Accounting is the language of business.
- Accounting is used by decision makers including individuals, businesses, investors, creditors, and taxing authorities.
- Accounting can be divided into two major fields: financial accounting and managerial accounting.
- Financial accounting is used by external decision makers, and managerial accounting is used by internal decision makers.
- All businesses need accountants. Accountants work in corporate or industry accounting, public accounting, financial services, and governmental accounting.
- Accountants can be licensed or certified as a Certified Public Accountant (CPA), Chartered Global Management Accountant (CGMA), Certified Management Accountant (CMA), or Certified Financial Planner (CFP).

### 2. What are the organizations and rules that govern accounting?

- Generally Accepted Accounting Principles (GAAP) are the rules that govern accounting in the United States.
- The Financial Accounting Standards Board (FASB) is responsible for the creation and governance of accounting standards.
- Economic entity assumption: Requires an organization to be a separate economic unit such as a sole proprietorship, partnership, corporation, or limited-liability company.
- Cost principle: Acquired assets and services should be recorded at their actual cost.
- Going concern assumption: Assumes that an entity will remain in operation for the foreseeable future.
- Monetary unit assumption: Assumes financial transactions are recorded in a monetary unit.

### 3. What is the accounting equation?

- $\text{Assets} = \text{Liabilities} + \text{Equity}$ 
  - Assets: Items the business owns or controls (examples: cash, furniture, land)
  - Liabilities: Items the business owes (examples: accounts payable, notes payable, salaries payable)
  - Equity: Stockholders' claims to the assets through contributed capital and retained earnings (examples: common stock, dividends, revenues, expenses)

### 4. How do you analyze a transaction?

- A transaction affects the financial position of a business and can be measured with faithful representation.
- Transactions are analyzed using three steps:
  - Step 1:** Identify the accounts and account type (Asset, Liability, or Equity).
  - Step 2:** Decide whether each account increases or decreases.
  - Step 3:** Determine whether the accounting equation is in balance.

## 5. How do you prepare financial statements?

- Financial statements are prepared in the following order:
  1. Income statement:
    - Reports the net income or net loss of a business for a specific period.
    - $\text{Revenues} - \text{Expenses} = \text{Net Income or Net Loss}$
  2. Statement of retained earnings:
    - Reports on the changes in retained earnings for a specific period.
    - $\text{Beginning Retained Earnings} + \text{Net Income (or} - \text{Net Loss)} - \text{Dividends} = \text{Ending Retained Earnings}$
  3. Balance sheet:
    - Reports on an entity's assets, liabilities, and stockholders' equity as of a specific date.
    - $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$
  4. Statement of cash flows:
    - Reports on a business's cash receipts and cash payments for a specific period.
    - Includes three sections:
      - Cash flows from operating activities: Involves cash receipts for services and cash payments for expenses.
      - Cash flows from investing activities: Includes the purchase and sale of land and equipment for cash.
      - Cash flows from financing activities: Includes cash contributions by stockholders, cash dividends paid to the stockholders, cash received from borrowing, and cash paid to repay loans.

## 6. How do you use financial statements to evaluate business performance?

- Income statement evaluates profitability.
- Statement of retained earnings shows the amount of earnings that were kept and reinvested in the company.
- Balance sheet details the economic resources the company has, the debts the company owes, and the company's net worth.
- Statement of cash flows shows the change in cash.
- $\text{Return on assets (ROA)} = \text{Net income} / \text{Average total assets}$ .

## > Check Your Understanding

*Check your understanding of the chapter by completing this problem and then looking at the solution. Use this practice to help identify which sections of the chapter you need to study more.*

Ron Smith opens an apartment-locator business near a college campus. The company will be named Campus Apartment Locators. During the first month of operations, July 2024, the business completes the following transactions:

- a. Receives a \$35,000 contribution from Ron Smith and issues common stock to Ron Smith.
- b. Purchases \$350 of office supplies on account.
- c. Pays cash of \$30,000 to acquire a lot next to campus.
- d. Locates apartments for clients and receives cash of \$1,900.
- e. Pays \$100 on the accounts payable the business created in Transaction (b).
- f. Pays cash expenses for office rent, \$400, and utilities, \$100.
- g. Pays cash dividends of \$1,200 to stockholders.



**Requirements**

1. Analyze the preceding transactions in terms of their effects on the accounting equation of Campus Apartment Locators. Use Exhibit F:1-6 as a guide. (See Learning Objective 4)
2. Prepare the income statement, statement of retained earnings, balance sheet, and statement of cash flows of the business after recording the transactions. (See Learning Objective 5)
3. Calculate the return on assets (ROA). (See Learning Objective 6)

**> Solution****Requirement 1**

ASSETS					=	LIABILITIES		+	EQUITY								
Cash	+	Office Supplies	+	Land		Accounts Payable	+	Contributed Capital	+	Retained Earnings							
										Dividends	+	Service Revenue	–	Rent Expense	–	Utilities Expense	
(a)	+35,000							+35,000									
(b)			+350				+350										
Bal.	<u>\$35,000</u>	+	<u>\$350</u>				<u>\$350</u>	+	<u>\$35,000</u>								
(c)	–30,000				+30,000												
Bal.	<u>\$5,000</u>	+	<u>\$350</u>	+	<u>\$30,000</u>		<u>\$350</u>	+	<u>\$35,000</u>								
(d)	+1,900										+1,900						
Bal.	<u>\$6,900</u>	+	<u>\$350</u>	+	<u>\$30,000</u>		<u>\$350</u>	+	<u>\$35,000</u>		+	<u>\$1,900</u>					
(e)	–100						–100										
Bal.	<u>\$6,800</u>	+	<u>\$350</u>	+	<u>\$30,000</u>		<u>\$250</u>	+	<u>\$35,000</u>		+	<u>\$1,900</u>					
(f)	–500												–400		–100		
Bal.	<u>\$6,300</u>	+	<u>\$350</u>	+	<u>\$30,000</u>		<u>\$250</u>	+	<u>\$35,000</u>		+	<u>\$1,900</u>	–	<u>\$400</u>	–	<u>\$100</u>	
(g)	–1,200									–1,200							
Bal.	<u>\$5,100</u>	+	<u>\$350</u>	+	<u>\$30,000</u>		<u>\$250</u>	+	<u>\$35,000</u>	–	<u>\$1,200</u>	+	<u>\$1,900</u>	–	<u>\$400</u>	–	<u>\$100</u>
<u>\$35,450</u>						<u>\$35,450</u>											

**Requirement 2**

CAMPUS APARTMENT LOCATORS	
Income Statement	
Month Ended July 31, 2024	
Revenues:	
Service Revenue	\$ 1,900
Expenses:	
Rent Expense	\$ 400
Utilities Expense	100
Total Expenses	500
Net Income	<u>\$ 1,400</u>

**CAMPUS APARTMENT LOCATORS**  
Statement of Retained Earnings  
Month Ended July 31, 2024

Retained Earnings, July 1, 2024	\$ 0
Net income for the month	1,400
	<u>1,400</u>
Dividends	(1,200)
Retained Earnings, July 31, 2024	<u>\$ 200</u>

**CAMPUS APARTMENT LOCATORS**  
Balance Sheet  
July 31, 2024

Assets		Liabilities	
Cash	\$ 5,100	Accounts Payable	\$ 250
Office Supplies	350		
Land	30,000	<b>Stockholders' Equity</b>	
		Common Stock	35,000
		Retained Earnings	200
		Total Stockholders' Equity	<u>35,200</u>
Total Assets	<u>\$ 35,450</u>	Total Liabilities and Stockholders' Equity	<u>\$ 35,450</u>

**CAMPUS APARTMENT LOCATORS**  
Statement of Cash Flows  
Month Ended July 31, 2024

Cash flows from operating activities:	
Receipts:	
Collections from customers	\$ 1,900
Payments:	
To suppliers	(600)
Net cash provided by operating activities	<u>1,300</u>
Cash flows from investing activities:	
Acquisition of land	\$ (30,000)
Net cash used by investing activities	<u>(30,000)</u>
Cash flows from financing activities:	
Issued common stock	35,000
Payment of cash dividends	(1,200)
Net cash provided by financing activities	<u>33,800</u>
Net increase in cash	<u>5,100</u>
Cash balance, July 1, 2024	0
Cash balance, July 31, 2024	<u>\$ 5,100</u>

## Requirement 3

Return on assets = Net income / Average total assets  
 Average total assets = (Beginning total assets + Ending total assets) / 2  
 Average total assets = (\$0 + \$35,450) / 2 = \$17,725  
 Return on assets = \$1,400 / \$17,725 = 0.079 = 7.9%

## &gt; Key Terms

Accounting (p. 1-2)	Dividend (p. 1-13)	Managerial Accounting (p. 1-3)
Accounting Equation (p. 1-12)	Economic Entity Assumption (p. 1-7)	Monetary Unit Assumption (p. 1-10)
Accounts Payable (p. 1-15)	Equity (p. 1-12)	Net Income (p. 1-13)
Accounts Receivable (p. 1-16)	Expenses (p. 1-13)	Net Loss (p. 1-13)
Assets (p. 1-12)	Faithful Representation (p. 1-7)	Partnership (p. 1-7)
Audit (p. 1-11)	Financial Accounting (p. 1-3)	Public Company Accounting Oversight Board (PCAOB) (p. 1-11)
Balance Sheet (p. 1-21)	Financial Accounting Standards Board (FASB) (p. 1-6)	Retained Earnings (p. 1-12)
Certified Financial Planner (CFP) (p. 1-5)	Financial Statements (p. 1-19)	Return on Assets (ROA) (p. 1-24)
Certified Management Accountants (CMAs) (p. 1-4)	Generally Accepted Accounting Principles (GAAP) (p. 1-6)	Revenues (p. 1-13)
Certified Public Accountants (CPAs) (p. 1-4)	Going Concern Assumption (p. 1-10)	Sarbanes-Oxley Act (SOX) (p. 1-11)
Chartered Global Management Accountant (CGMA) (p. 1-4)	Income Statement (p. 1-20)	Securities and Exchange Commission (SEC) (p. 1-6)
Common Stock (p. 1-12)	International Accounting Standards Board (IASB) (p. 1-10)	Sole Proprietorship (p. 1-7)
Contributed Capital (p. 1-12)	International Financial Reporting Standards (IFRS) (p. 1-10)	Statement of Cash Flows (p. 1-22)
Corporation (p. 1-7)	Liabilities (p. 1-12)	Statement of Retained Earnings (p. 1-20)
Cost Principle (p. 1-10)	Limited-Liability Company (LLC) (p. 1-7)	Stockholder (p. 1-8)
Creditor (p. 1-4)		Transaction (p. 1-13)

## &gt; Quick Check

## Learning Objective 1

1. Accounting is the information system that
  - a. measures business activities.
  - b. communicates the results to decision makers.
  - c. processes information into reports.
  - d. All of the above

## Learning Objective 1

2. Which of the following is not an external user of a business's financial information?
  - a. Taxing authorities
  - b. Customers
  - c. Employees
  - d. Investors

## Learning Objective 2

3. Generally Accepted Accounting Principles (GAAP) are currently formulated by the
  - a. Financial Accounting Standards Board (FASB).
  - b. Securities and Exchange Commission (SEC).

- c. Institute of Management Accountants (IMA).  
d. American Institute of Certified Public Accountants (AICPA).
4. Which type of business organization is owned by only one owner?  
a. Corporation  
b. Partnership  
c. Sole proprietorship  
d. Items a, b, and c are all correct.
5. Which of the following characteristics best describes a corporation?  
a. A business with a single owner  
b. Is not taxed  
c. Stockholders not personally liable for entity's debts  
d. Not a separate taxable entity
6. Which of the following requires accounting information to be complete, neutral, and free from material error?  
a. Faithful representation concept  
b. Cost principle  
c. Economic entity assumption  
d. Going concern assumption
7. At the end of a recent year, Global Cleaning Service, a full-service house and office cleaning service, had total assets of \$3,630 and equity of \$2,280. How much were Global Cleaning Service's liabilities?  
a. \$5,910  
b. \$3,630  
c. \$1,350  
d. \$2,280
8. Consider the overall effects on Global Cleaning Service from selling and performing services on account for \$6,400 and paying expenses totaling \$2,500. What is Global Cleaning Service's net income or net loss?  
a. Net income of \$3,900  
b. Net loss of \$3,900  
c. Net income of \$6,400  
d. Net income of \$8,900
9. Assume that Global Cleaning Service performed cleaning services for a department store on account for \$180. How would this transaction affect Global Cleaning Service's accounting equation?  
a. Increase both assets and liabilities by \$180  
b. Increase both assets and equity by \$180  
c. Increase both liabilities and equity by \$180  
d. Decrease liabilities by \$180, and increase equity by \$180
10. The balance sheet reports the  
a. financial position on a specific date.  
b. results of operations on a specific date.  
c. financial position for a specific period.  
d. results of operations for a specific period.
11. Assume Global Cleaning Service had net income of \$570 for the year. Global Cleaning Service's beginning and ending total assets were \$4,520 and \$4,180, respectively. Calculate Global Cleaning Service's return on assets for the year.  
a. 12.6%  
b. 13.6%  
c. 13.1%  
d. 7.63%

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**Learning Objective 2**  
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**Learning Objective 2**  
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**Learning Objective 5**  
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**Learning Objective 6**  
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**Check your answers at the end of the chapter.**

# ASSESS YOUR PROGRESS

## > Review Questions

1. What is accounting?
2. Briefly describe the two major fields of accounting.
3. Describe the various types of individuals who use accounting information and how they use that information to make important decisions.
4. What are various certifications available for accountants? Briefly explain each certification.
5. What is the role of the Financial Accounting Standards Board (FASB)?
6. Explain the purpose of Generally Accepted Accounting Principles (GAAP), including the organization currently responsible for the creation and governance of these standards.
7. Describe the similarities and differences among the four different types of business entities discussed in the chapter.
8. A business purchases an acre of land for \$5,000. The current market value is \$5,550, and the land was assessed for property tax purposes at \$5,250. What value should the land be recorded at, and which accounting principle supports your answer?
9. What does the going concern assumption mean for a business?
10. Which concept states that accounting information should be complete, neutral, and free from material error?
11. Financial statements in the United States are reported in U.S. dollars. What assumption supports this statement?
12. Explain the role of the International Accounting Standards Board (IASB) in relation to International Financial Reporting Standards (IFRS).
13. What is the accounting equation? Briefly explain each of the three parts.
14. How does retained earnings increase? What are the two ways that retained earnings decreases?
15. How is net income calculated? Define *revenues* and *expenses*.
16. What are the steps used when analyzing a business transaction?
17. List the four financial statements. Briefly describe each statement.
18. What is the calculation for ROA? Explain what ROA measures.

## Short Exercises

### Learning Objective 1

#### S-F:1-1 Identifying users of accounting information

For each user of accounting information, identify if the user would use financial accounting or managerial accounting.

- |                            |                             |
|----------------------------|-----------------------------|
| a. investor                | e. controller               |
| b. banker                  | f. stockholder              |
| c. IRS                     | g. human resources director |
| d. manager of the business | h. creditor                 |



**S-F:1-2 Determining organizations that govern accounting**

Suppose you are starting a business, Wholly Shirts, to imprint logos on T-shirts. In organizing the business and setting up its accounting records, you take your information to a CPA to prepare financial statements for the bank. Name the organization that governs the majority of the guidelines that the CPA will use to prepare financial statements for Wholly Shirts. What are those guidelines called?

**Learning Objective 2****S-F:1-3 Identifying types of business organizations**

Chloe Michaels plans on opening Chloe Michaels Floral Designs. She is considering the various types of business organizations and wishes to organize her business with unlimited life and wants owners of the business to not be held personally liable for the business's debts. Additionally, Chloe wants the business to be a separate taxable entity. Which type of business organization will meet Chloe's needs best?

**Learning Objective 2****S-F:1-4 Identifying types of business organizations**

You would like to start a cellular telephone equipment service business. You are considering organizing the business as a sole proprietorship. Identify the advantages and disadvantages of owning a sole proprietorship.

**Learning Objective 2****S-F:1-5 Applying accounting assumptions and principles**

Michael McNamee is the proprietor of a property management company, Apartment Exchange, near the campus of Pensacola State College. The business has cash of \$8,000 and furniture that cost \$9,000 and has a market value of \$13,000. The business debts include accounts payable of \$6,000. Michael's personal home is valued at \$400,000, and his personal bank account has a balance of \$1,200. Consider the accounting principles and assumptions discussed in the chapter, and identify the principle or assumption that best matches the situation:

**Learning Objective 2**

- Michael's personal assets are not recorded on the Apartment Exchange's balance sheet.
- The Apartment Exchange records furniture at its cost of \$9,000, not its market value of \$13,000.
- The Apartment Exchange reports its financial statements in U.S. dollars.
- Michael expects the Apartment Exchange to remain in operation for the foreseeable future.

**S-F:1-6 Using the accounting equation**

Thompson Handyman Services has total assets for the year of \$18,400 and total liabilities of \$9,050.

**Learning Objective 3****Requirements**

- Use the accounting equation to solve for equity.
- If next year's assets increased by \$4,300 and equity decreased by \$3,850, what would be the amount of total liabilities for Thompson Handyman Services?

**Learning Objective 3 S-F:1-7 Using the accounting equation**

Roland's Overhead Doors reports the following financial information:

Assets	\$ 45,800
Liabilities	17,220
Common Stock	27,460
Dividends	6,500
Revenues	8,850
Expenses	?

**Requirements**

1. Use the accounting equation to solve for the missing information.
2. Did Roland's Overhead Doors report net income or net loss?

**Learning Objective 3 S-F:1-8 Identifying accounts**

Consider the following accounts:

- |                        |                     |
|------------------------|---------------------|
| a. Accounts Payable    | f. Service Revenue  |
| b. Cash                | g. Office Supplies  |
| c. Common Stock        | h. Dividends        |
| d. Accounts Receivable | i. Land             |
| e. Rent Expense        | j. Salaries Expense |

Identify each account as Asset, Liability, or Equity.

**Learning Objective 4 S-F:1-9 Using the accounting equation to analyze transactions**

Tiny Town Kennel earns service revenue by caring for the pets of customers. Tiny Town Kennel is organized as a corporation. During the past month, Tiny Town Kennel has the following transactions:

- Received \$520 cash for service revenue earned.
- Paid \$325 cash for salaries expense.
- Received a \$1,000 contribution in exchange for common stock.
- Earned \$640 for service revenue, but the customer has not paid Tiny Town Kennel yet.
- Received utility bill of \$85, which will be paid next month.
- Cash dividends of \$100 were paid to stockholders.

Indicate the effects of the business transactions on the accounting equation for Tiny Town Kennel. Transaction (a) is answered as a guide. Use the following accounts: Cash, Accounts Receivable, Accounts Payable, Common Stock, Dividends, Service Revenue, Salaries Expense, and Utilities Expense.

*a. Increase asset (Cash); Increase equity (Service Revenue)*

**Learning Objective 4 S-F:1-10 Using the accounting equation to analyze transactions**

Elaine's Inflatables earns service revenue by providing party planning services and inflatable playscapes. Elaine's Inflatables is organized as a corporation. During the past month, Elaine's Inflatables had the following transactions:

- Received contributions of \$10,000 in exchange for common stock.
- Purchased equipment for \$5,000 on account.

- c. Paid \$400 for office supplies.
- d. Earned and received \$2,500 cash for service revenue.
- e. Paid \$400 for wages to employees.
- f. Cash dividends of \$1,000 were paid to stockholders.
- g. Earned \$1,000 for services provided. Customer has not yet paid.
- h. Paid \$1,000 for rent.
- i. Received a bill for \$250 for the monthly utilities. The bill has not yet been paid.

Indicate the effects of the business transactions on the accounting equation for Elaine's Inflatables. Transaction (a) is answered as a guide. Use the following accounts: Cash, Accounts Receivable, Supplies, Equipment, Accounts Payable, Common Stock, Dividends, Service Revenue, Wages Expense, Rent Expense, and Utilities Expense.

a. *Increase asset (Cash); Increase equity (Common Stock)*

### S-F:1-11 Identifying accounts on the financial statements

Consider the following accounts:

- |                        |                     |
|------------------------|---------------------|
| a. Accounts Payable    | f. Service Revenue  |
| b. Cash                | g. Office Supplies  |
| c. Common Stock        | h. Dividends        |
| d. Accounts Receivable | i. Land             |
| e. Rent Expense        | j. Salaries Expense |

Identify the financial statement (or statements) that each account would appear on. Use I for Income Statement, RE for Statement of Retained Earnings, B for Balance Sheet, and C for Statement of Cash Flows.

### Use the following information to answer Short Exercises S-F:1-12 through S-F:1-14.

Centerpiece Arrangements has just completed operations for the year ended December 31, 2024. This is the third year of operations for the company. The following data have been assembled for the business:

Insurance Expense	\$ 4,500	Salaries Expense	\$ 46,000
Service Revenue	70,000	Accounts Payable	17,600
Utilities Expense	1,400	Office Supplies	1,700
Rent Expense	16,000	Dividends	4,800
Common Stock	9,000	Accounts Receivable	8,000
Cash	7,200	Equipment	12,100
Retained Earnings, January 1, 2024	5,100		

### S-F:1-12 Preparing the income statement

Prepare the income statement of Centerpiece Arrangements for the year ended December 31, 2024.

### S-F:1-13 Preparing the statement of retained earnings

Prepare the statement of retained earnings of Centerpiece Arrangements for the year ended December 31, 2024.

### S-F:1-14 Preparing the balance sheet

Prepare the balance sheet of Centerpiece Arrangements as of December 31, 2024.

### Learning Objective 5

### Learning Objective 5

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