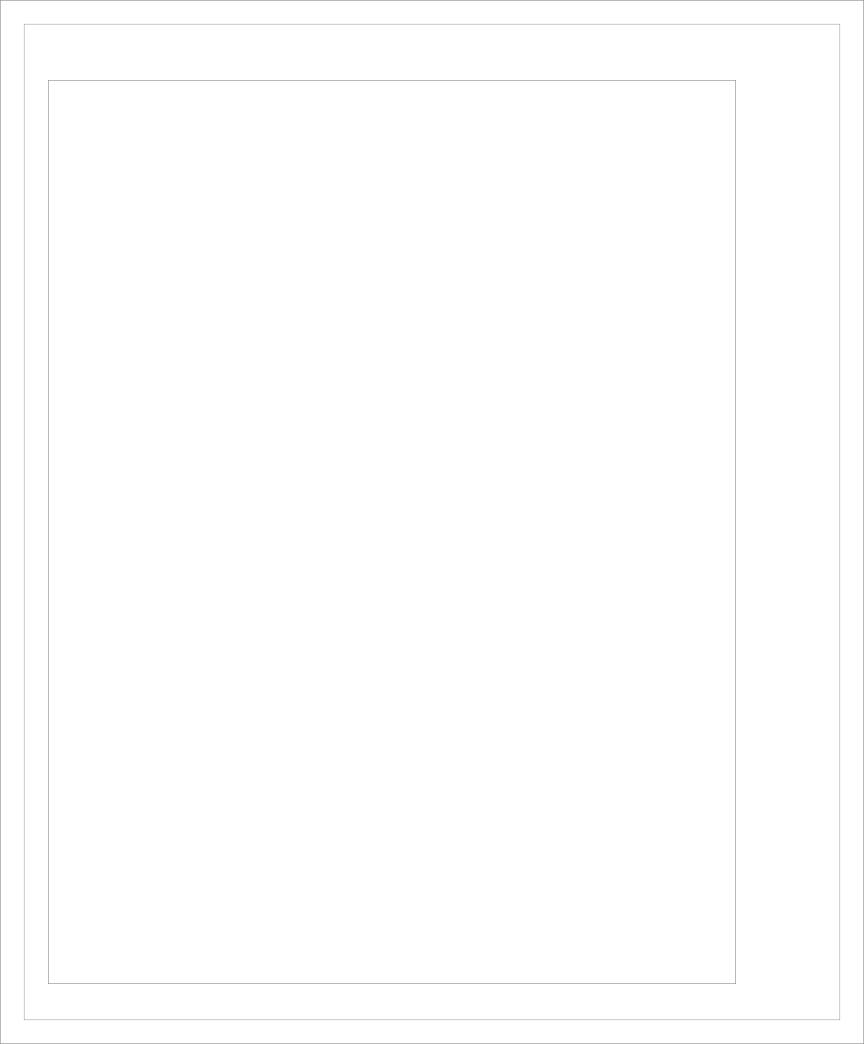


# College Accounting



#### **Fifth Edition**

# College Accounting

## **A Contemporary Approach**

#### M. DAVID HADDOCK JR., Ed.D., CPA

Professor of Accounting (Retired)
Chattanooga State Community College
Chattanooga, Tennessee

#### **JOHN ELLIS PRICE, Ph.D., CPA**

Professor of Accounting (Retired) University of North Texas Denton, Texas

## MICHAEL J. FARINA, MBA, CPA, CGMA

Professor of Accounting
Cerritos College
Norwalk, California





#### COLLEGE ACCOUNTING, FIFTH EDITION

Published by McGraw-Hill Education, 2 Penn Plaza, New York, NY 10121. Copyright © 2021 by McGraw-Hill Education. All rights reserved. Printed in the United States of America. Previous editions © 2017, 2015, and 2012. No part of this publication may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written consent of McGraw-Hill Education, including, but not limited to, in any network or other electronic storage or transmission, or broadcast for distance learning.

Some ancillaries, including electronic and print components, may not be available to customers outside the United States.

This book is printed on acid-free paper.

1 2 3 4 5 6 7 8 9 LWI 24 23 22 21 20

ISBN 978-1-260-78031-4 (bound edition) MHID 1-260-78031-7 (bound edition) ISBN 978-1-260-78035-2 (loose-leaf edition) MHID 1-260-78035-X (loose-leaf edition)

Executive Portfolio Manager: Steve Schuetz Product Developer: Michael McCormick Marketing Manager: Claire McLemore

Content Project Managers: Lori Koetters, Angela Norris

Senior Buyer: Laura Fuller Design: Matt Diamond

Content Licensing Specialist: Sarah Flynn

Cover Image: ©David Allen Photography/Shutterstock

Compositor: SPi Global

All credits appearing on page or at the end of the book are considered to be an extension of the copyright page.

Library of Congress Control Number: 2019948179

The Internet addresses listed in the text were accurate at the time of publication. The inclusion of a website does not indicate an endorsement by the authors or McGraw-Hill Education, and McGraw-Hill Education does not guarantee the accuracy of the information presented at these sites.

mheducation.com/highered

## About the Authors



Courtesy of M. David Haddock Jr.



Courtesy of John Ellis Price



Courtesy of Michael J. Farina

M. DAVID HADDOCK JR. serves as Chief Leadership Officer for a regional operator of senior living communities. He previously led the training efforts for one of the top 50 CPA firms in the United States. In a 35-year career in higher education, Dr. Haddock served in faculty and administrative roles at Auburn University at Montgomery, the University of Alabama in Birmingham, the University of West Georgia, and Chattanooga State Community College. At his retirement from higher education, he was professor of accounting and associate vice president for academic affairs at Chattanooga State Community College in Tennessee. In addition to his teaching, he also maintained a sole proprietorship accounting and tax practice for more than 20 years.

He received his BS in accounting and MS in adult education from the University of Tennessee and the EdD degree in administration of higher education from Auburn University. He is a licensed CPA in Tennessee.

Dr. Haddock served as chair of the Tennessee Society of CPAs and the Educational & Memorial Foundation of the TSCPAs for 2012–2013 and a member of AICPA Council. He is a frequent speaker for Continuing Professional Education programs.

**JOHN ELLIS PRICE** is a retired professor of accounting at the University of North Texas. Dr. Price has more than 36 years of experience in higher education with over half of those years serving in key leadership positions including as founding president and professor of accounting at the University of North Texas at Dallas. Dr. Price has previously held positions of professor and assistant professor, as well as chair and dean, at the University of North Texas, Jackson State University, and the University of Southern Mississippi. Dr. Price has also been active in the Internal Revenue Service as a member of the Commissioner's Advisory Group for two terms and as an Internal Revenue Agent.

Dr. Price is a certified public accountant who has twice received the UNT College of Business Administration's Outstanding Teaching Award and the university's President's Council Award. Majoring in accounting, he received his BBA and MS degrees from the University of Southern Mississippi and his PhD in accounting from the University of North Texas.

Dr. Price is a member of the Mississippi Society of Certified Public Accountants, the American Accounting Association, and the American Taxation Association (serving as past chair of the Subcommittee on Relations with the IRS and Treasury). Dr. Price has also served as chair of the American Institute of Certified Public Accountants Minority Initiatives Committee and as a member of the Foundation Trustees.

**MICHAEL J. FARINA** retired as professor of accounting and finance at Cerritos College in California June 2018, after 30 years of service to the college. He continues to teach college accounting and other courses as an adjunct professor at Cerritos College. Professor Farina is currently a member of an advisory committee at a credit union serving the educational community in California.

Prior to joining Cerritos College, Professor Farina was a manager in the audit department at a large multinational firm of certified public accountants and held management positions with other companies in private industry.

He received an AA in business administration from Cerritos College; a BA in business administration from California State University, Fullerton; and an MBA from the University of California, Irvine. Professor Farina is a member of Beta Gamma Sigma, an honorary fraternity for graduate business students. He is a licensed certified public accountant in California and a member of the American Institute of Certified Public Accountants and the California Society of Certified Public Accountants. Professor Farina is also a Chartered Global Management Accountant, a designation bestowed by a joint venture of the American Institute of Certified Public Accountants and the Chartered Institute of Management Accountants.

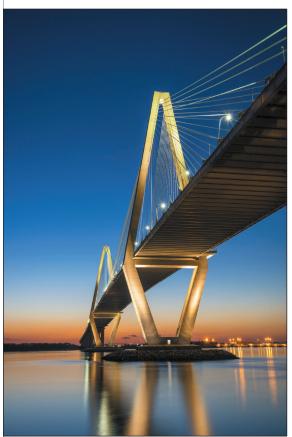
Professor Farina has received three Outstanding Faculty awards from Cerritos College. He was the co-chair of the Accounting and Finance Department at Cerritos College for over 20 years.

0 0

。 ·



## Haddock/Price/Farina



©David Allen Photography/Shutterstock

or students just embarking on a college career, an accounting course can seem daunting, like a rushing river with no clear path to the other side. As the most trusted and readable text on the market, *College Accounting: A Contemporary Approach* by Haddock, Price, and Farina presents material in a way that will help students understand the content better and more quickly. Through proven pedagogy, time-tested and accurate problem material, and a straightforward approach to the basics of accounting, Haddock/Price/Farina **bridges the rushing river**, offering first-time accounting students a path to understanding and mastery.

Whether a student is taking the course in preparation for a four-year degree or as the first step to a career in business, Haddock/Price/Farina guides him or her over the bridge to success. The authors represent the breadth of educational environments—a community college, a career school, and a four-year university—ensuring that the text is appropriate for all student populations. Throughout, they have adhered to a common philosophy about textbooks: They should be readable, contain many opportunities for practice, and be able to make accounting relevant for all.

## How Does Haddock/Price/Farina Bridge the Gap from Learning to Mastery?

College Accounting is designed to help students learn and master the material.

## Chapter Opener

Brief features about real-world companies—like Uber, H&R Block, Starbucks, and Carnival Cruise Lines—allow students to see how the chapter's information and insights apply to the world outside the classroom. Thinking Critically questions stimulate thought on the topics to be explored in the chapter.

## Accounting: The Language of Business

Chapter

www.uber.com

How do you get from the airport to your hotel when traveling on business? How do you get home from a party when it is not safe for you to drive? How do you get into the downtown business district for a meeting when parking is difficult and expensive? How do you get to any destination when taking your own vehicle is not convenient or possible? Taxis are not always available of affordable, and public transportation is difficult when in an unfamiliar city. Uber is a viable alternative to taxis and other forms of public transportation

Uber was created in 2009 as a private company in San Francisco, California on a smartphone app used to summon personal transportation from Uber drivers who use their own vehicles to transport customers. Uber's initial busi-

ness model as a personal transportation company has transformed to a multifaceted company that provides transportation food delivery, bicycle-sharing, and a transfer network company that operates in over 785 metropolitan areas worldwide

Although Uber has had a turbulent history since its founding as a private company, it has raised a massive amount of investment capital to fund its operations. In January 2018, Uber raised \$1.25 billion in cash from an investment group through a financing arrangement that valued the company at \$48 billion. In May 2018, Uber announced plans to have an initial public offering in 2019 that would change the company to a publicly traded company.

As Uber continues to grow and seek additional investment funding, accountants are pivotal in tracking and reporting the company's financial results and position in terms of revenues earned, expenses used, assets owned, and liabilities owed as well as calculating the company's net income (revenues - expenses) and net worth (assets - liabilities). Accountants are essential to the company's continued growth and success by providing financial information necessary for decision making.

#### thinking critically

Can you think of any organizations that would be interested in how Uber is performing?

## LEARNING OBJECTIVES

- 1-1 Define accounting.
- 1-2 Identify and discuss career opportunities in accounting.
- 1-3 Identify the users of financial information.
- 1-4 Compare and contrast the three types of business entities.
  - sering the process used to develop

#### Section 1

#### SECTION OBJECTIVES TERMS TO LEARN Record in equation form the financial effects of a business transaction balance sheet Learning the fundamental accounting equation is a basis for understanding business transactions equity >> 2-2 Define, identify, and understand the relationship between asset. liabilities liability, and ov WHY IT'S IMPORTANT owner's equity The relationship between assets, liabilities, and owner's equity is the basis for the entire accounting system.

#### **Property and Financial Interest**

The accounting process starts with the analysis of business transactions. A business transaction is any financial event that changes the resources of a firm. For example, purchases, sales, payments, and receipts of cash are all business transactions. The accountant analyzes each business transaction to decide what information to record and where to record it.

>> 2-1 OBJECTIVE form the financial effects of a business

#### **Beginning with Analysis**

Let's analyze the transactions of Eli's Consulting Services, a firm that provides a wide range of accounting and consulting services. Trayton Eli, CPA, has a master's degree in accounting. He is the sole proprietor of Eli's Consulting Services. Sergio Sanchez, the office manager, has an associate's degree in business and has taken 12 semester hours of accounting. The firm is located in a large office complex.

## **Learning Objectives**

Appearing in the chapter opener, section opener, and within the margins of the text, learning objectives alert students to what they should expect as they progress through the chapter. Many students question the relevance of what they're learning, which is why we explain "Why It's Important" at the beginning of each section within the chapter.

## **About Accounting**

These notes contain interesting examples of how accounting is used in the real world, providing relevance to students who might not be going on to a career in accounting.

۰ 。

#### ABOUT

ACCOUNTING **Accounting Software** The use of accounting software eliminates the need to prepare a worksheet. However, adjusting entries must always be made to properly reflect account balances at the end of a reporting period.



## recall

#### **Expense**

An expense is an outflow of cash, the use of other assets, or the incurring of a liability.

#### important!

#### **Balance Sheet Accounts**

The amounts on the balance sheet are carried forward to the next accounting period.

## **Recall and Important!**

Recall is a series of brief reinforcements that serve as reminders of material covered in *previous* chapters that are relevant to the new information being presented. Important! draws students' attention to critical materials introduced in the *current* chapter.

# **Business Transaction Analysis Models**

Instructors say mastering the ability to properly analyze transactions is critical to success in this course. Haddock/Price/Farina's step-by-step transaction analysis illustrations show how to identify the appropriate general ledger accounts affected, determine debit or credit activity, present the transaction in T-account form, and record the entry in the general journal.

#### **BUSINESS TRANSACTION**

**ANALYSIS** The liability account Salaries and Wages Payable is decreased by \$1,840.56. The asset account Cash is decreased by \$1.840.56 **DEBIT-CREDIT RULES** ٧ DEBIT Decreases to liability accounts are recorded as debits. Debit Salaries and Wages Payable for \$1,840.56. CREDIT Decreases to assets are credits. Credit Cash for \$1,840.56. T-ACCOUNT PRESENTATION Salaries and Wages Payable Cash 1,840.56 1,840.56 THE BOTTOM LINE ٧ **GENERAL JOURNAL ENTRY** Issue Paychecks GENERAL JOURNAL **Income Statement** No effect on net income

184056

On January 8, Brandon Express Company wrote five checks for payroll, check numbers 1601–1605.

## **The Bottom Line**

Jan. 8 Salaries and Wages Payable

Appears in the margins alongside select transactions and concepts in the text. These visuals offer a summary of the effects of these transactions—the end result—on the financial statements of a business.

0

To record payment of salaries and wages

for week ended Jan. 6

#### MANAGERIAL IMPLICATIONS <<

#### FINANCIAL INFORMATION

- Managers of a business make sure that the firm's accounting system produces financial information that is timely, accurate, and fair.
- Financial statements should be based on generally accepted accounting principles.
- Each year a publicly traded company must submit financial statements, including an independent auditor's report, to the SEC.
- Internal reports for management need not follow generally accepted accounting principles but should provide useful information that will aid in monitoring and controlling operations.
- Financial information can help managers to control present operations, make decisions, and plan for the future.
- The sound use of financial information is essential to good

#### THINKING CRITICALLY

If you were a manager, how would you use financial information to make decisions?

## Managerial Implications

Puts your students in the role of managers and asks them to apply the concepts learned in the chapter.

**Balance Sheet** 

Liabilities ↓ \$1,840.56

No effect on equity

Assets

↓ \$1,840.56



### Section Reviews—Now in Connect!

Each section concludes with a Self Review consisting of multiple-choice questions that are also available in Connect. A Comprehensive Self Review appears at the end of each chapter. Answers to the Comprehensive Self Review are provided at the end of the chapter.

#### Section 1 Review



- 1. The names of three accounting jobs include all but:
  - a. logistics manager.
  - b. accountant.
  - c. bookkeeper.
  - d. accounts payable clerk.
- 2. Accounting is called:
  - a. the language of economics.
  - b. the language of finance.
  - c. the language of business.
  - d. the language of commerce.
- 3. Financial statements are:

Objectives 2-1, 2-2

- a. accumulated financial data summarized in periodic reports
- b. accumulated transactions of the firm's sales activities.

- c. a summary of records and procedures that make up the accounting system.
- d. a summarized description of a firm's accounting system.
- 4. The organization that has the final say on financial accounting issues faced by publicly owned corporations is the:
  - a. Federal Trade Commission.
  - b. Securities and Exchange Commission.
  - c. Internal Revenue Service.
  - d. U.S. Treasury.
- As the owner of a small business, you have decided to apply for a loan to expand your locations. Information that you most likely will need to provide to the lender include all but:
  - a. current sales and expense figures.
  - b. projected sales and expense figures.
  - c. the cost of the expansion.
  - d. the average value of homes in your neighborhood.



following assets and liabilities. Determine the totals that would appear in the firm's funda accounting equation (Assets = Liabilities + Owner's Equity).

Cash \$ 99,000

 Cash
 \$ 99,000

 Laboratory Equipment
 155,000

 Laboratory Supplies
 21,600

 Loan Payable
 30,400

 Accounts Payable
 22,750

Exercise 2.2 Completing the accounting equation

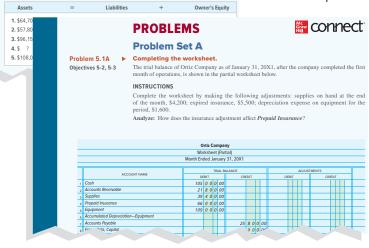
Objectives 2-1, 2-2

The fundamental accounting equations for sever

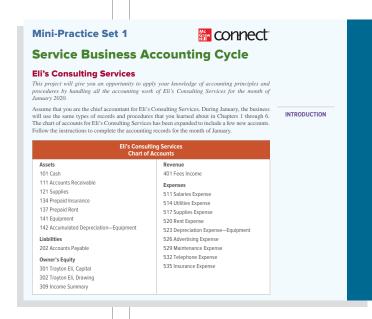
The fundamental accounting equations for several businesses follow. Supply the missing amounts

## **End of Chapter Material**

Haddock/Price/Farina includes robust end-of-chapter material to reinforce the content of the chapter, including Discussion Questions, Exercises, Problem Sets A and B, and Critical Thinking Problems. Problem Sets A and B and Critical Thinking Problems conclude with an **Analyze** question asking the student to evaluate each problem critically.



# How Can Haddock/Price/Farina Bridge the Gap from Learning to "Doing"?



# Mini-Practice Sets—Now in Connect!

Four Mini-Practice Sets are interspersed throughout the text. These practice sets are now assignable in Connect for completion online. Additionally, there are two full-length practice sets available as resources to complete offline. This means additional practice, but less cost, for your students.

#### **Business Connections**

Reinforces chapter materials from practical and real-world perspectives:

**Managerial Focus:** Applies accounting concepts to business situations.

#### Internal Control and Fraud Prevention:

Applies techniques discussed throughout the text for different classes of assets including cash, payroll, inventories, and property, plant, and equipment.

Financial Statement Analysis: Uses excerpts from real-world annual reports to illustrate actual business applications of chapter concepts. Excerpts from the 2018 Home Depot Financial Statements are included in Appendix A for use with some exercises. In others, students research a company's most recent financial reports on the Internet.

#### **BUSINESS CONNECTIONS** 1. As an owner or manager of a business, what questions would you ask to judge the firm's performance, control operations, make decisions, and plan for the future? 2. Why is financial information important? 3. Besides earning a profit, what other objectives might a business have? Can financial information play an important role in these objectives? 4. What kind of problems can you foresee if a business owner and/or manager does not have a basic knowledge of accounting? 5. What would you tell a small business owner who says he does not see a need for an accounting system in his business because he closely supervises the day-to-day operations and knows exactly what is happening with the business? 6. What is the role of the manager versus the accountant? 7. Does a business owner/manager need to worry about the separate entity assumption? Why or why not? 8. Why are international accounting standards important to management? **Choosing the Right Employees** Selecting the right employees is a critical step for enhancing the entity's system of internal control and fraud prevention. Reflected below are several possible ways to check the background control and fratul prevention. Retreated below as everla possible ways to check the obacground of employees. For each item listed, indicate why the background check is important, what type of information should be sought, and whether or not you believe you should get the candidate's consent before acquiring the information. 1. References 2. Employment history 3. Education, certifications, and licenses 4. Drug screening **Notes to Financial Statements** Within a company's annual report, a section called "Notes to Consolidated Financial Statements" offers general information about the company along with detailed notes related to its financial Financial Statement ANALYSIS statements Analyze Online: On the American Eagle Outfitters, Inc., website (www.ae.com), click on About AEO located at the bottom of the page. Then click on Investor Relations

**TeamWork:** Provides a collaborative learning activity to prepare students for teamoriented projects and work environments.

**Certified Bookkeeper Designation:** Throughout the text, end-of-chapter materials now include questions that will help aspiring bookkeepers to achieve the Certified Bookkeeper Designation.

. . .



## New to the Fifth Edition

- NEW Many bookkeepers aspire to become Certified Bookkeepers (CB), a designation
  that assures an individual possesses the level of knowledge and skills needed to carry
  out all key accounting functions through the adjusted trial balance, including payroll.
  Throughout the text, end-of-chapter materials now include questions that will help aspiring bookkeepers to achieve the Certified Bookkeeper Designation.
- NEW Throughout the text, internal control and fraud prevention techniques are discussed for different classes of assets including cash, payroll, inventories, and property, plant, and equipment. Internal Control and Fraud Prevention problems are included in every chapter.
- Chapter openers have been revised, featuring companies such as Apple, Boeing,
   Costco, Deloitte, Dr Pepper Snapple, Facebook, Ford, Southwest, Starbucks, Uber, and
   UPS, and the Financial Accounting Standards Board.
- Real-world examples throughout the text have been updated.
- **End-of-chapter** exercises, problems, and critical thinking problems have been revised and updated throughout the text.
- Section Reviews have been updated throughout and are now available in Connect.
- Chapter 1: New coverage on Internal Control, Fraud, and Certified Bookkeeper added.
- **Chapter 4**: Section on Correcting Journal and Ledger Errors rewritten to reflect current practice.
- Chapter 9: Updated and expanded the section Using Online Banking.
- Chapter 10: Updated and revised with the 2019 maximum earnings taxable for social security taxes throughout.
- Chapter 11: Examples updated throughout text, including social security amounts per new limits of taxable amount. Auto-graded tax form problems are now in Connect.
- Chapter 13: New real-world example focused on the inventory turnover, using Amazon's financial data.



## FOR INSTRUCTORS

### You're in the driver's seat.

Want to build your own course? No problem. Prefer to use our turnkey, prebuilt course? Easy. Want to make changes throughout the semester? Sure. And you'll save time with Connect's auto-grading too.

65%
Less Time
Grading



## They'll thank you for it.

Adaptive study resources like SmartBook® 2.0 help your students be better prepared in less time. You can transform your class time from dull definitions to dynamic debates. Find out more about the powerful personalized learning experience available in SmartBook 2.0 at www.mheducation.com/highered/connect/smartbook

Laptop: McGraw-Hill; Woman/dog: George Doyle/Getty Images

# Make it simple, make it affordable.



Connect makes it easy with seamless integration using any of the major Learning Management Systems—Blackboard®, Canvas, and D2L, among others—to let you organize your course in one convenient location. Give your students access to digital materials at a discount with our inclusive access program. Ask your McGraw-Hill representative for more information.

dlock: Jobalou/Getty Images

# Solutions for your challenges.



A product isn't a solution. Real solutions are affordable, reliable, and come with training and ongoing support when you need it and how you want it. Our Customer Experience Group can also help you troubleshoot tech problems—although Connect's 99% uptime means you might not need to call them. See for yourself at **status**. **mheducation.com** 

Checkmark: Jobalou/Getty Images





## **FOR STUDENTS**

## Effective, efficient studying.

Connect helps you be more productive with your study time and get better grades using tools like SmartBook 2.0, which highlights key concepts and creates a personalized study plan. Connect sets you up for success, so you walk into class with confidence and walk out with better grades.

## Study anytime, anywhere.

Download the free ReadAnywhere app and access your online eBook or SmartBook 2.0 assignments when it's convenient, even if you're offline. And since the app automatically syncs with your eBook and SmartBook 2.0 assignments in Connect, all of your work is available every time you open it. Find out more at www.mheducation.com/readanywhere

"I really liked this app—it made it easy to study when you don't have your textbook in front of you."

- Jordan Cunningham, Eastern Washington University



## No surprises.

The Connect Calendar and Reports tools keep you on track with the work you need to get done and your assignment scores. Life gets busy; Connect tools help you keep learning through it all.

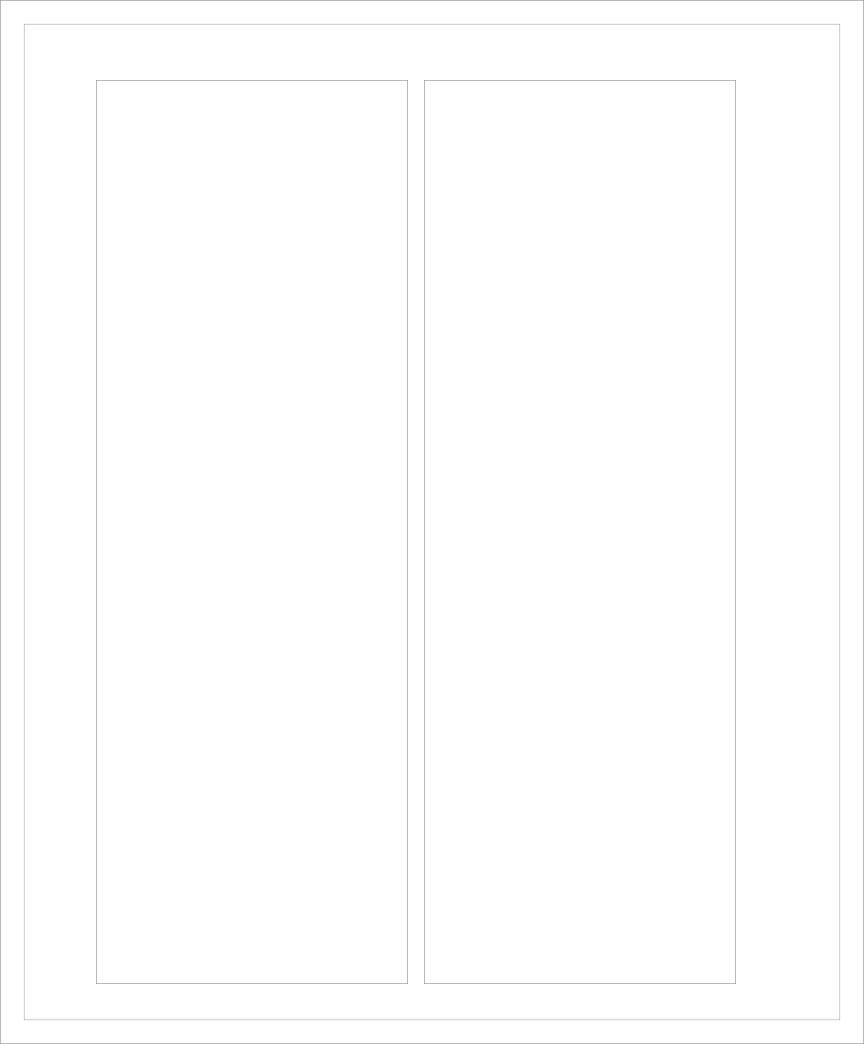
Calendar: owattaphotos/Getty Images

## Learning for everyone.

McGraw-Hill works directly with Accessibility Services Departments and faculty to meet the learning needs of all students. Please contact your Accessibility Services office and ask them to email accessibility@mheducation.com, or visit www.mheducation.com/about/accessibility for more information.



Top: Jenner Images/Getty Images, Left: Hero Images/Getty Images, Right: Hero Images/Getty Images





**Within Connect**, instructors and students have a wealth of material at their fingertips to help make the most of a course in accounting.

#### Student Resources

#### SmartBook 2.0®

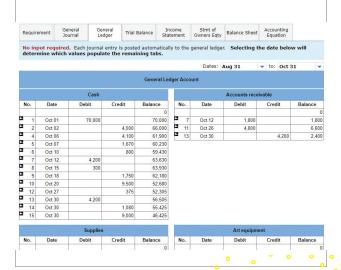
A personalized and adaptive learning tool used to maximize the learning experience by helping students study more efficiently and effectively. Smartbook 2.0 highlights where in the chapter to focus, asks review questions on the materials covered, and tracks the most challenging content for later review recharge. Smartbook 2.0 is available both online and offline.

#### Narrated PowerPoint Presentations

For students, the additional student resources include PowerPoint presentations for each chapter, in both narrated and non-narrated versions.

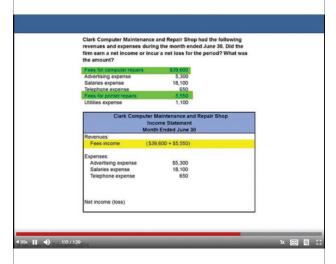
#### **General Ledger Problems**

General Ledger Problems expose students to general ledger software similar to that in practice, without the expense and hassle of downloading additional software. They offer students the ability to record financial transactions and see how these transactions flow into financial statements. Easy minimal-scroll navigation, instant "Check My Work" feedback, and fully integrated hyperlinking across tabs show how input data affect each stage of the accounting process. All are auto-gradable.



#### **Guided Examples**

Guided Examples provide a narrated, animated, stepby-step walk-through of Exercises similar to those assigned. These short presentations, which can be turned on or off by instructors, provide reinforcement when students need it most.



#### Instructor Resources

#### **Instructor's Resource Manual**

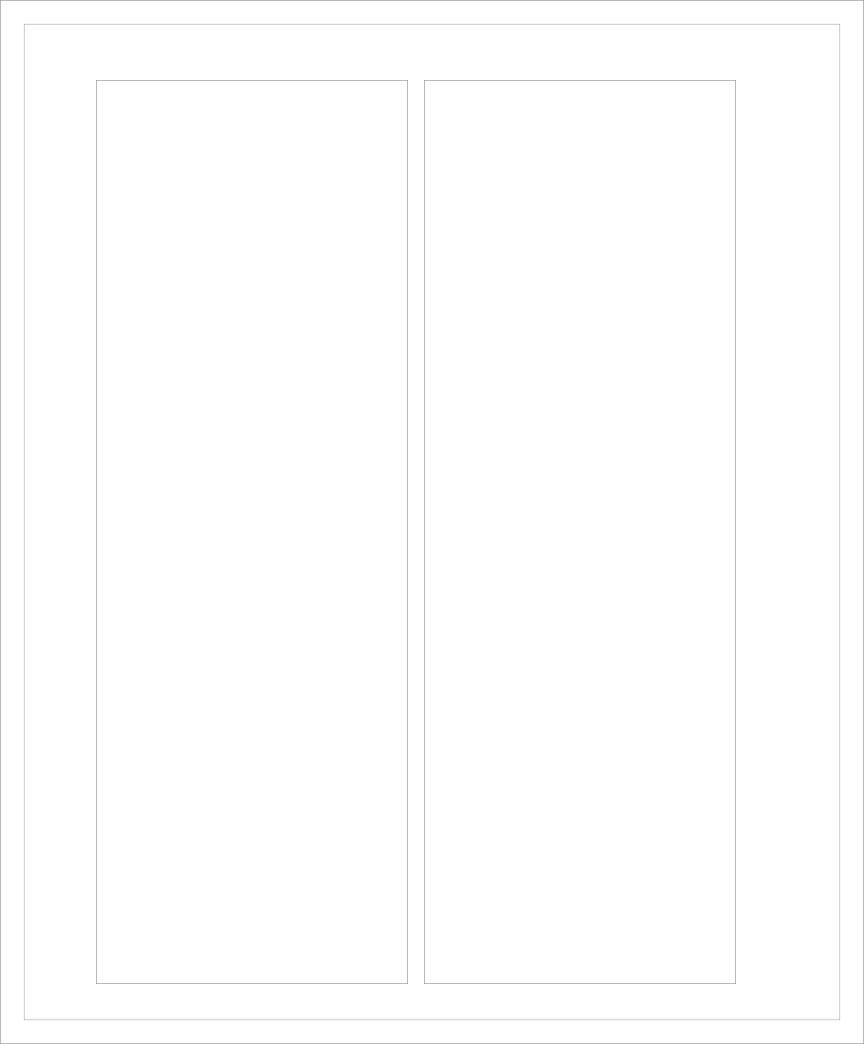
This manual provides for each chapter a map of related assignment materials; teaching objectives; a chapter overview and learning objectives; and a topical outline.

#### Solutions Manual

The Solutions Manual includes detailed solutions for every question, exercise, problem, and case in the text.

#### Test Bank / Test Builder

The Test Bank for each chapter has been updated to stay current with new and revised chapter material, with all questions available for assignment through Connect. Available within Connect, Test Builder is a cloud-based tool that enables instructors to format tests that can be printed or administered within an LMS. Test Builder offers a modern, streamlined interface for easy content configuration that matches course needs, without requiring a download. Test Builder provides a secure interface for better protection of content and allows for just-in-time updates to flow directly into assessments.



## **Acknowledgments**

The authors are deeply grateful to the following accounting educators for their input during development of *College Accounting*. The feedback from these knowledgeable instructors provided the authors with valuable assistance in meeting the changing needs of the college accounting classroom.

Shawn Abbot College of the Siskiyous

Cornelia Alsheimer Santa Barbara City College

Terry Anderson Golden West College

Julia Angel North Arkansas College

James R. Armbrester Lawson State Community College— Bessemer Campus

Laura Bantz McHenry County College

Sara Barritt Northeast Community College

Victoria Bentz Yavapai College

Anne Bikofsky College of Westchester

David Bland
Cape Fear Community College

Candace M. Boesiger College of Southern Idaho

Patrick Borja Citrus College

Kathy Bowen *Murray State College* 

Lisa Briggs Columbus State Community College

Robert Cabral *Oxnard Colleg*e

Tony Cardinalli Truckee Meadows Community College

Susana Castellanos-Gaona Golden West College

Gerald Caton Yavapai College

Steven L. Christian Jackson Community College Marilyn Ciolino Delgado Community College

Jean Condon Mid-Plains Community College Area (Nebraska)

Joan Cook Milwaukee Area Technical College

Susan Snow Davis Green River College

Gisela Dicklin Edmonds Community College

Michael Discello Pittsburgh Technical Institute

Sid Downey Cochise College

Nova Emmons Shawnee Community College

Steven Ernest Baton Rouge Community College

Ann Esarco McHenry County College

Brian Fink
Danville Community College

Paul Fisher
Rogue Community College

Allen Ford Institute for the Deaf, Rochester Institute of Technology

Jeff Forrest Saint Louis Community College

David Forsyth *Palomar College* 

Mark Fronke Cerritos College

Stephanie Gaspard Central Louisiana Technical Community College

Nancy Goehring Monterey Peninsula College

Renee Goffinet Spokane Community College

Jane Goforth

North Seattle Community College

Lori Grady
Buck County Community College

Gretchen Graham Community College of Allegheny County

Marina Grau Houston Community College Chad Grooms Gateway Community and Technical College

David Grooms Maui Community College

Sue Gudmunson Lewis-Clark State College

Rebecca Hancock
El Paso Community College

Christina Hata Miracosta College

Scott Hays Central Oregon Community College

Mary Jane Hollars
Vincennes University

R. Stephen Holman Elizabethtown Community and Technical College

Ray Ingram Southwest Georgia Technical College

Dennis Jirkovsky Indiana Business College

Stacy Johnson Iowa Central Community College

Jane Jones Mountain Empire Community College

Dmitriy Kalyagin Chabot College

Norm Katz National College–Stow

Amery Klappert Pima Community College

Sandra Kemper Front Range Community College

Michael Kingsbury College of the Desert

Patty Kolarik Hutchinson Community College

Elida Kraja Saint Louis Community College–Flors Valley

Greg Lauer North Iowa Area Community College

David Laurel
South Texas College
Rosemarie Le Coz

Cerritos College Thomas E. Lynch

Hocking College



Kara Mahon

Piedmont Technical College

Josephine Mathias

Mercer County Community College

Roger McMillian Mineral Area College

Angela Medlock

Arkansas Tech University Ozark Campus

Jim Meir

Cleveland State Community College

Michelle Meyer Joliet Junior College

John Miller

Metropolitan Community College

Lora Miller Centura College

Peter Neshwat Brookline College

Marc Newman
Hocking Technical College

Anthony Newton

Highline Community College

Kenneth Newton
Cleveland State Community College

Jon Nitschke Montana State University

Lizz Ott Casper College

Angela Payne Collin College Joel Peralto

University of Hawaii–Hawaii Community College

Shirley Powell

Arkansas State University

LaNita Ray

Cedar Valley College

Carol Reinke Empire College

Barbara Rice

KCTCS Gateway Community and Technical College

Revnold Robles

Texas State Technical College-Harlingen

Morgan Rockett

Moberly Area Community College

Joan Ryan

Clackamas Community College

Teri Samo Del Mar College

Patricia Scales Brookstone College

Michael Schaub Shasta College

Brian D. Schmoldt *Madison College* 

Angela Seidel Saint Francis University

Chuck Smith

*Iowa Western Community College* 

Tom Snavely Yavapai College

Vicky Splawn

Mid-America Christian University

Rick Street

Spokane Community College

Paul Swanson Illinois Central College

Domenico Tavella

Pittsburgh Technical Institute

Judy Toland

Bucks County Community College

**Donald Townsend** 

Forsyth Technical Community College

Yvette Travis

Bishop State Community College

Donna Viens

New England College of Business

Patricia Walczak

Lansing Community College

Pam Watkins

Durham Technical Community College

Linda Whitten Skyline College

Traci Wodlinger

Ozarks Technical Community College

Helen Zhang Skyline College

## Thank You . . .

**WE ARE GRATEFUL** for the outstanding support from McGraw-Hill Education. In particular, we would like to thank Tim Vertovec, managing director; Steve Schuetz, executive portfolio manager; Michele Janicek, lead product developer; Sarah Wood, freelance product developer (Core); Michael McCormick, product developer (Assessment); Lori Koetters and Angela Norris, content project managers; Laura Fuller, buyer; Matt Diamond, designer; and Sarah Flynn, content licensing specialist.

Finally, we would like to thank our supplement authors and accuracy checkers for their significant contributions: Eric Weinstein, Suffolk County Community College; Teresa Alenikov, Cerritos College; Debra Johnson, Cerritos College; Mark McCarthy, East Carolina University; M. Jeff Quinlan, Madison Area Technical College; Brian Schmoldt, Madison College; April Mohr, Jefferson Community and Technical College, SW; and Helen Roybark, Radford University.

David Haddock • John Price • Michael Farina

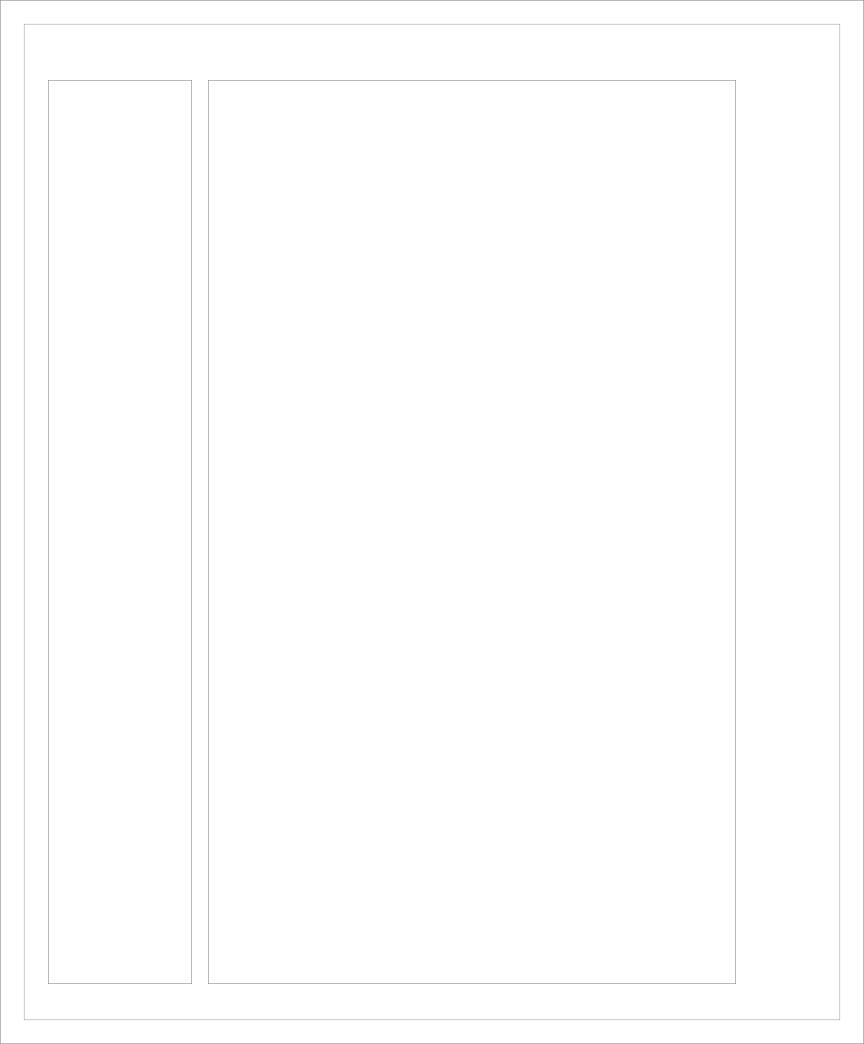




## **Brief Contents**

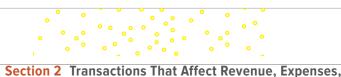
1	Accounting: The Language of Business	1
2	Analyzing Business Transactions	23
3	Analyzing Business Transactions Using T Accounts	55
4	The General Journal and the General Ledger	91
5	Adjustments and the Worksheet	125
6	Closing Entries and the Postclosing Trial Balance	165
7	Accounting for Sales, Accounts Receivable, and Cash Receipts	197
8	Accounting for Purchases, Accounts Payable,	
	and Cash Payments	235
9	Cash	281
10	Payroll Computations, Records, and Payment	321
11	Payroll Taxes, Deposits, and Reports	357
12	Accruals, Deferrals, and the Worksheet	391
13	Financial Statements and Closing Procedure	431







ontents	Preface			vi
Chapter 1	Accounting: The Language o	f Busir	less	1
•	Section 1 What Is Accounting?			
	The Need for Financial Informat	_		2
	Accounting Defined			2
	Accounting Careers			3
	Users of Financial Information			5
	Section 1 Review			8
	Section 2 Business and Acco	ounting	9	10
	Types of Business Entities  Generally Accepted Accounting	Princip	lac	10 12
	Section 2 Review	ТППСІРІ		14
	Chapter Review and Application	ıs		16
	Chapter Summary	16	Discussion Questions	18
	Learning Objectives Glossary	16 17	Problem Business Connections	19 20
	Comprehensive Self Review	18	Answers to Comprehensive Self Review	2
Chapter 2	Analyzing Business Transact	ions		23
•	Section 1 Property and Final	ncial Ir	nterest	24
	Beginning with Analysis			24
	Assets, Liabilities, and Owner's	Equity		29
	Section 1 Review			30
	Section 2 The Accounting Ed	quation	n and Financial Statements	31
	The Fundamental Accounting E	quation		31
	The Income Statement		- Balance Charl	36
	The Statement of Owner's Equit  The Importance of Financial Sta			37 40
	Section 2 Review	tements		40
	Chapter Review and Application	ıs		42
	Chapter Summary	42	Exercises	4
	Learning Objectives	42	Problems	47
	Glossary Comprehensive Self Review	43 43	Business Connections Answers to Comprehensive Self Review	5: 5:
	Discussion Questions	43		
Chapter 3	Analyzing Business Transact	ions U	sing T Accounts	55
•	Section 1 Transactions That			
	and Owner's Equit		, , , , , , , , , , , , , , , , , , , ,	56
	Asset, Liability, and Owner's Equ	-	ounts	56
	Account Balances			62
	Section 1 Review			64
	0 0 0 0 0		0	
		. 0		
		ه ه	o 5	



	Section 2 Transactions Tha		Revenue, Expenses,	
	and Withdrawals			65
	Revenue and Expense Accoun	its		65
	The Drawing Account			69
	The Rules of Debit and Credit			70
	The Trial Balance			72
	Financial Statements			73
	Chart of Accounts			73
	Permanent and Temporary Acc	counts		74
	Section 2 Review			75
	Chapter Review and Application	ne.		77
	Chapter Summary	77	Exercises	79
	Learning Objectives	77	Problems	81
	Glossary	77	Business Connections	88
	Comprehensive Self Review	78	Answers to Comprehensive Self Review	89
	Discussion Questions	78		
Chapter 4	The General Journal and the	e Gener	al Ledger	91
	Section 1 The General Jour	nal		92
	Journals			92
	The General Journal			92
	Section 1 Review			100
	Section 2 The General Ledg	ger		101
	Ledgers			101
	Correcting Journal and Ledger	Errors		105
	Section 2 Review			106
	Chapter Review and Application	ons		108
	Chapter Summary	108	Exercises	110
	Learning Objectives	108	Problems	112
	Glossary	109	Business Connections	122
	Comprehensive Self Review Discussion Questions	109 109	Answers to Comprehensive Self Review	123
Chapter 5	Adjustments and the Works	hoot		125
Chaptel 3	· ·	ileet		
	Section 1 The Worksheet			126
	The Trial Balance Section			126
	The Adjustments Section			127
	Section 1 Review			132
	Section 2 Financial Statem	ents		133
	The Adjusted Trial Balance Sec			133
	The Income Statement and Ba		not Sections	134
			eet Sections	134
	Preparing Financial Statements			
	Summary of Financial Stateme			146
	Journalizing and Posting Adjus	sting Entri	es	147
	Section 2 Review			149
	Chapter Review and Application	ons		150
	Chapter Summary	150	Exercises	152
	Learning Objectives	150	Problems	154
	Glossary	151	Business Connections	162
	Comprehensive Self Review	151	Answers to Comprehensive Self Review	163
	Discussion Questions	151 °	· .	
ii		• • •	• •	
		0	°°	
		. 0	• •	



Chapter 6	Closing Entries and the Pos	tclosing	Trial Balance	165
	<b>Section 1</b> Closing Entries			166
	The Closing Process			166
	Section 1 Review			174
	Section 2 Using Accounting	g Inform	ation	179
	Preparing the Postclosing Trial	Balance		175
	Interpreting the Financial State	ements		176
	The Accounting Cycle			178
	Section 2 Review			180
	Chapter Review and Application	ons		181
	Chapter Summary	181	Exercises	183
	Learning Objectives	181 182	Problems Business Connections	18! 19:
	Glossary Comprehensive Self Review	182	Answers to Comprehensive Self Review	19
	Discussion Questions	182		
Mini-Practice Set 1	Service Business Accountin	a Cycle		195
	Eli's Consulting Services	9 0,0.0		19
Chapter <b>7</b>	Accounting for Sales, Accou	ınts Rec	eivable,	
Chapter <b>7</b>	and Cash Receipts Section 1 Understanding M	erchand	lising Companies	197 198
Chapter <b>7</b>	and Cash Receipts  Section 1 Understanding M  Recording Sales for Cash and	l <b>erchand</b> On Accou	lising Companies	<b>198</b>
Chapter <b>7</b>	and Cash Receipts  Section 1 Understanding M  Recording Sales for Cash and  Recording Sales with Sales Tax	l <b>erchand</b> On Accou x Payable	lising Companies nt for Cash and On Account	<b>198</b> 199 200
Chapter <b>7</b>	and Cash Receipts  Section 1 Understanding M  Recording Sales for Cash and  Recording Sales with Sales Tax  Recording Sales Returns and S	l <b>erchand</b> On Accou x Payable	lising Companies nt for Cash and On Account	198 199 200 201
Chapter <b>7</b>	and Cash Receipts  Section 1 Understanding M  Recording Sales for Cash and Recording Sales with Sales Tax  Recording Sales Returns and S  Credit Policies	l <b>erchand</b> On Accou x Payable Sales Allov	lising Companies nt for Cash and On Account vances	198 199 200 201 203
Chapter <b>7</b>	and Cash Receipts  Section 1 Understanding M  Recording Sales for Cash and  Recording Sales with Sales Tax  Recording Sales Returns and S	erchand On Accou x Payable Sales Allov	lising Companies nt for Cash and On Account vances	198 199 200 200 200 204
Chapter <b>7</b>	and Cash Receipts  Section 1 Understanding M  Recording Sales for Cash and Recording Sales with Sales Tax Recording Sales Returns and S  Credit Policies  Accounting for Different Types	erchand On Accou x Payable Sales Allov	lising Companies nt for Cash and On Account vances	198 199 200 200 200 204 204
Chapter 7	and Cash Receipts  Section 1 Understanding M  Recording Sales for Cash and Recording Sales with Sales Tax Recording Sales Returns and S Credit Policies Accounting for Different Types Accounting for Credit Card Sales Section 1 Review	erchand On Accou x Payable Sales Allov s of Credit	lising Companies nt for Cash and On Account vances Sales	198 199 200 200 200 204 204 204
Chapter 7	and Cash Receipts  Section 1 Understanding M  Recording Sales for Cash and Recording Sales with Sales Tax Recording Sales Returns and S  Credit Policies Accounting for Different Types Accounting for Credit Card Sal  Section 1 Review  Section 2 Special Topics in	erchand On Accou x Payable Sales Allov s of Credit	lising Companies nt for Cash and On Account vances Sales	198 199 200 201 202 204 204 206 207
Chapter 7	and Cash Receipts  Section 1 Understanding M  Recording Sales for Cash and Recording Sales with Sales Tax Recording Sales Returns and S Credit Policies Accounting for Different Types Accounting for Credit Card Sales Section 1 Review	erchand On Accou x Payable Sales Allov s of Credit	lising Companies nt for Cash and On Account vances Sales	198 199 200 203 204 204 204 207 207
Chapter 7	and Cash Receipts  Section 1 Understanding M  Recording Sales for Cash and Recording Sales with Sales Tax Recording Sales Returns and S  Credit Policies  Accounting for Different Types Accounting for Credit Card Sales  Section 1 Review  Section 2 Special Topics in Computing Trade Discounts Cash Discounts on Sales	erchand On Accou x Payable Gales Allov s of Credit les Mercha	lising Companies nt for Cash and On Account vances Sales ndising	198 199 200 201 203 204 206 207 207 208
Chapter 7	and Cash Receipts  Section 1 Understanding M  Recording Sales for Cash and Recording Sales with Sales Tax Recording Sales Returns and S  Credit Policies Accounting for Different Types Accounting for Credit Card Sal Section 1 Review  Section 2 Special Topics in Computing Trade Discounts	erchand On Accou x Payable Gales Allov s of Credit les Mercha	lising Companies nt for Cash and On Account vances Sales ndising	198 199 200 201 203 204 206 207 208 208
Chapter 7	and Cash Receipts  Section 1 Understanding M  Recording Sales for Cash and Recording Sales with Sales Tax Recording Sales Returns and S Credit Policies  Accounting for Different Types Accounting for Credit Card Sal Section 1 Review  Section 2 Special Topics in Computing Trade Discounts Cash Discounts on Sales Cash Discounts on Sales, with	erchand On Accou x Payable Sales Allov s of Credit des  Merchal	lising Companies nt for Cash and On Account vances Sales ndising	198 199 200 200 200 200 200 200 200 200 200 2
Chapter 7	and Cash Receipts  Section 1 Understanding M  Recording Sales for Cash and Recording Sales with Sales Tax Recording Sales Returns and S Credit Policies Accounting for Different Types Accounting for Credit Card Sales Section 1 Review  Section 2 Special Topics in Computing Trade Discounts Cash Discounts on Sales Cash Discounts on Sales, with Reporting Net Sales	derchand On Accou x Payable Gales Allov of Credit des  Merchal Sales Retr	lising Companies nt for Cash and On Account vances Sales ndising	198
Chapter 7	and Cash Receipts  Section 1 Understanding M Recording Sales for Cash and Recording Sales with Sales Tax Recording Sales Returns and S Credit Policies Accounting for Different Types Accounting for Credit Card Sal Section 1 Review  Section 2 Special Topics in Computing Trade Discounts Cash Discounts on Sales Cash Discounts on Sales, with Reporting Net Sales The Accounts Receivable Ledge	derchand On Accou x Payable Gales Allov of Credit des  Merchal Sales Retr	lising Companies nt for Cash and On Account vances Sales ndising	198 199 200 201 203 204 204 206 207 208 208 208 208
Chapter 7	and Cash Receipts  Section 1 Understanding M  Recording Sales for Cash and Recording Sales with Sales Tax Recording Sales Returns and S Credit Policies Accounting for Different Types Accounting for Credit Card Sales Section 1 Review  Section 2 Special Topics in Computing Trade Discounts Cash Discounts on Sales Cash Discounts on Sales The Accounts Receivable Ledge Schedule of Accounts Receivable	derchand On Accou x Payable Gales Allov of Credit des  Merchal Sales Retr	lising Companies nt for Cash and On Account vances Sales ndising	198 199 200 201 202 204 206 207 208 208 208 208 210
Chapter 7	and Cash Receipts  Section 1 Understanding M  Recording Sales for Cash and Recording Sales with Sales Tax Recording Sales Returns and S Credit Policies Accounting for Different Types Accounting for Credit Card Sales Section 1 Review  Section 2 Special Topics in Computing Trade Discounts Cash Discounts on Sales Cash Discounts on Sales Cash Discounts Receivable Ledg Schedule of Accounts Receivals Sales Taxes	erchand On Accou x Payable Gales Allov s of Credit des  Mercha Sales Reti ger ble	lising Companies nt for Cash and On Account vances Sales ndising	198 199 200 200 200 200 200 200 200 200 200 2
Chapter 7	and Cash Receipts  Section 1 Understanding M Recording Sales for Cash and Recording Sales with Sales Tax Recording Sales Returns and S Credit Policies Accounting for Different Types Accounting for Credit Card Sales Section 1 Review  Section 2 Special Topics in Computing Trade Discounts Cash Discounts on Sales Cash Discounts on Sales Cash Discounts Receivable Ledg Schedule of Accounts Receivate Sales Taxes Section 2 Review Chapter Review and Application	lerchand On Accou x Payable Gales Allov s of Credit des  Mercha Sales Reti ger ble  Dns 216	lising Companies nt for Cash and On Account vances Sales  ndising  urns	198 199 200 201 203 204 206 207 208 208 208 210 211 213 218
Chapter 7	and Cash Receipts  Section 1 Understanding M Recording Sales for Cash and Recording Sales with Sales Tax Recording Sales Returns and S Credit Policies Accounting for Different Types Accounting for Credit Card Sale Section 1 Review  Section 2 Special Topics in Computing Trade Discounts Cash Discounts on Sales Cash Discounts on Sales Cash Discounts Receivable Ledg Schedule of Accounts Receivate Sales Taxes Section 2 Review Chapter Review and Application Chapter Summary Learning Objectives	lerchand On Accou x Payable Gales Allov s of Credit des  Mercha Sales Retu ger ble  Dns 216 216	lising Companies nt for Cash and On Account vances Sales  ndising  urns  Exercises Problems	198 199 200 201 203 204 206 207 208 208 208 210 211 213 218 216 22
Chapter 7	and Cash Receipts  Section 1 Understanding M Recording Sales for Cash and Recording Sales with Sales Tax Recording Sales Returns and S Credit Policies Accounting for Different Types Accounting for Credit Card Sales Section 1 Review  Section 2 Special Topics in Computing Trade Discounts Cash Discounts on Sales Cash Discounts on Sales Cash Discounts Receivable Ledg Schedule of Accounts Receivate Sales Taxes Section 2 Review Chapter Review and Application	lerchand On Accou x Payable Gales Allov s of Credit des  Mercha Sales Reti ger ble  Dns 216	lising Companies nt for Cash and On Account vances Sales  ndising  urns	198 199 200 201 203 204 206 207 208 208 208 210 211 213 218

xxiii



n 1 Merchandising Proporting for Purchases chase Returns and Allowan ermining the Net Delivered ction 1 Review n 2 Accounts Payable Ledger edule of Accounts Payable Ledger edule of Accounts Payable chal Control of Purchases ction 2 Review endix to Chapter 8: The Perpter Review and Application thapter Summary earning Objectives clossary comprehensive Self Review discussion Questions  n 1 Cash Receipts n Transactions tion 1 Review n 2 Petty Cash and In Petty Cash Fund mal Control over Cash ction 2 Review n 3 Banking Procedu	ces Cost of F e rpetual Ir ons 258 258 258 259 259	nventory System  Exercises Problems Business Connections Answers to Comprehensive Self Review	231 23 24 24 24 24 24 25 26 27 27  28 28 28 28 28 28 28
counting for Purchases chase Returns and Allowan ermining the Net Delivered tion 1 Review  In 2 Accounts Payable Ledger edule of Accounts Payable Ledger redule of Accounts Payable real Control of Purchases tion 2 Review  The Period Review and Application of Payable remained to Chapter 8: The Period Review and Application of Purchases tion 2 Review and Application of Payable remained objectives allowed the property of the Period Review of Payable Review of Pa	ces Cost of F e rpetual Ir ons 258 258 258 259 259	nventory System  Exercises Problems Business Connections Answers to Comprehensive Self Review	23 23 24 24 24 24 25 25 27 27 27 28 28 28 28 28
chase Returns and Allowan ermining the Net Delivered tion 1 Review In 2 Accounts Payable Accounts Payable Ledger redule of Accounts Payable redule of Accoun	rpetual Inons  258 258 258 259 259	nventory System  Exercises Problems Business Connections Answers to Comprehensive Self Review	244 244 244 244 255 262 27 27  28 28 28 28 28
n 2 Accounts Payable Accounts Payable Ledger edule of Accounts Payable rnal Control of Purchases tion 2 Review endix to Chapter 8: The Pe pter Review and Application thapter Summary earning Objectives flossary comprehensive Self Review discussion Questions  n 1 Cash Receipts n Transactions tion 1 Review n 2 Petty Cash and In Petty Cash Fund rnal Control over Cash tion 2 Review	erpetual Ir ons 258 258 258 259 259	nventory System  Exercises Problems Business Connections Answers to Comprehensive Self Review	24 24 24 24 25 25 26 27 27 27 28 28 28 28 28
n 2 Accounts Payable Accounts Payable Ledger edule of Accounts Payable rnal Control of Purchases tion 2 Review endix to Chapter 8: The Pe pter Review and Application thapter Summary earning Objectives slossary comprehensive Self Review discussion Questions  n 1 Cash Receipts n Transactions tion 1 Review n 2 Petty Cash and In Petty Cash Fund rnal Control over Cash tion 2 Review	rpetual li ons 258 258 258 259 259	Exercises Problems Business Connections Answers to Comprehensive Self Review	24 24 24 24 25 25 26 27 27 27 28 28 28 28 28
Accounts Payable Ledger edule of Accounts Payable real Control of Purchases tion 2 Review endix to Chapter 8: The Perpter Review and Application thapter Summary earning Objectives elossary comprehensive Self Review discussion Questions  In 1 Cash Receipts in Transactions tion 1 Review in 2 Petty Cash and In Petty Cash Funding Control over Cash tion 2 Review	rpetual li ons 258 258 258 259 259	Exercises Problems Business Connections Answers to Comprehensive Self Review	244 244 242 25 25 26 26 27 27 27 28 28 28 28 28
edule of Accounts Payable mal Control of Purchases tion 2 Review endix to Chapter 8: The Perpter Review and Application thapter Summary earning Objectives slossary comprehensive Self Review discussion Questions  In 1 Cash Receipts in Transactions tion 1 Review in 2 Petty Cash and In Petty Cash Funding Control over Cash tion 2 Review	258 258 258 258 259 259	Exercises Problems Business Connections Answers to Comprehensive Self Review	244 244 25 25 26 27 27 28 28 28 28 28
enal Control of Purchases tion 2 Review endix to Chapter 8: The Pe pter Review and Application chapter Summary earning Objectives ellossary comprehensive Self Review eliscussion Questions  and Cash Receipts and Transactions tion 1 Review and 2 Petty Cash and In Petty Cash Fund and Control over Cash tion 2 Review	258 258 258 258 259 259	Exercises Problems Business Connections Answers to Comprehensive Self Review	244 24 25 25 26 27 27  28 28 28 28 28
endix to Chapter 8: The Perpter Review and Application thapter Summary earning Objectives elossary comprehensive Self Review eliscussion Questions  In 1 Cash Receipts in Transactions than 1 Review in 2 Petty Cash and In Petty Cash Funding Control over Cash than 2 Review	258 258 258 258 259 259	Exercises Problems Business Connections Answers to Comprehensive Self Review	24 25 25 26 26 27 27 27 28 28 28 28 28
endix to Chapter 8: The Perpter Review and Application chapter Summary earning Objectives clossary comprehensive Self Review cliscussion Questions  In 1 Cash Receipts and Transactions tion 1 Review and 2 Petty Cash and In Petty Cash Fund and Control over Cash tion 2 Review	258 258 258 258 259 259	Exercises Problems Business Connections Answers to Comprehensive Self Review	25 25 26 26 27 27 28 28 28 28 28
pter Review and Application Chapter Summary earning Objectives Flossary Comprehensive Self Review Discussion Questions  In 1 Cash Receipts In Transactions Lion 1 Review In 2 Petty Cash and In Petty Cash Fund In al Control over Cash Lion 2 Review  Lion 2 Review	258 258 258 258 259 259	Exercises Problems Business Connections Answers to Comprehensive Self Review	25 26 26 27 27 28 28 28 28 28
chapter Summary earning Objectives clossary comprehensive Self Review discussion Questions  The Cash Receipts of Transactions tion 1 Review of 2 Petty Cash and Interpretate Control over Cash tion 2 Review  The Cash Evice Cash tion 2 Review	258 258 258 259 259	Problems Business Connections Answers to Comprehensive Self Review	28 28 28 28 28
earning Objectives clossary comprehensive Self Review discussion Questions  In 1 Cash Receipts In Transactions Lion 1 Review In 2 Petty Cash and In Petty Cash Fund In al Control over Cash Lion 2 Review	258 258 259 259	Problems Business Connections Answers to Comprehensive Self Review	28 28 28 28 28
n 1 Cash Receipts Transactions tion 1 Review Petty Cash and In Petty Cash Fund Transaction over Cash Transaction 2 Review	259 259	Answers to Comprehensive Self Review	28 28 28 28 28
n 1 Cash Receipts n Transactions tion 1 Review n 2 Petty Cash and In Petty Cash Fund rnal Control over Cash tion 2 Review	259	·	28 28 28 28 28
n Transactions tion 1 Review n 2 Petty Cash and In Petty Cash Fund rnal Control over Cash tion 2 Review	nternal	Controls for Cash	28 28 28 28
n Transactions tion 1 Review n 2 Petty Cash and In Petty Cash Fund rnal Control over Cash tion 2 Review	nternal	Controls for Cash	28 <b>28</b> <b>28</b>
n Transactions tion 1 Review n 2 Petty Cash and In Petty Cash Fund rnal Control over Cash tion 2 Review	nternal	Controls for Cash	28 <b>28</b> <b>28</b>
tion 1 Review n 2 Petty Cash and In Petty Cash Fund rnal Control over Cash tion 2 Review	nternal	Controls for Cash	28 28
Petty Cash Fund rnal Control over Cash tion 2 Review	nternal	Controls for Cash	
Petty Cash Fund rnal Control over Cash tion 2 Review			
tion 2 Review			
			28
n 3 Banking Procedu			29
<u></u>	res		29
ing Checks			29
orsing Checks			29
paring the Deposit Slip			29
dling Postdated Checks			29
onciling the Bank Statemer			29
sting the Financial Record			29
	livities		30 30
			<b>30</b>
	ne		30
	303	Exercises	30
earning Objectives	303	Problems	30
•			31
	304	Allswers to complehensive sen keview	31
	rnal Control of Banking Act ng Online Banking <b>tion 3 Review</b>	rnal Control of Banking Activities ag Online Banking tion 3 Review pter Review and Applications Chapter Summary 303 Learning Objectives 303 Glossary 303 Comprehensive Self Review 304	rnal Control of Banking Activities ag Online Banking tion 3 Review pter Review and Applications Chapter Summary 303 Exercises Learning Objectives 303 Problems Glossary 303 Business Connections Comprehensive Self Review 304 Answers to Comprehensive Self Review

xxiv



Chapter 10	Payroll Computations, Reco	ords, an	d Payment	321	
-	Section 1 Payroll Laws and Taxes Who Is an Employee?				
	Federal Employee Earnings ar	nd Withho	olding Laws	322	
	State and Local Taxes				
	Employer's Payroll Taxes and I		Costs	324 325	
	Employee Records Required by Law  Section 1 Review				
	Section 2 Calculating Earn	inas and	d Taxes	327	
	Computing Total Earnings of Employees				
	Determining Pay for Hourly En	nployees		328 334 334	
	Determining Pay for Salaried E	mployee	s		
	Recording Payroll Information	for Emplo	pyees		
	Section 2 Review			336	
	Section 3 Recording Payroll Information				
	Recording Payroll			337	
	Paying Employees			338	
	Individual Earnings Records  Completing January Payrolls			340 341	
	Section 3 Review			343	
	Chapter Review and Application	ons		344	
	Chapter Summary	344	Exercises	346	
	Learning Objectives	344	Problems	348	
	Glossary Comprehensive Self Review	344 345	Business Connections  Answers to Comprehensive Self Review	354 355	
	Discussion Questions	345			
Chapter 11	Payroll Taxes, Deposits, and	d Repor	ts	357	
-	Section 1 Social Security, N	/ledicare	e, and Employee		
	Income Tax			358	
	Payment of Payroll Taxes			358	
	Wage and Tax Statement, Forr	n W-2		366	
	Annual Transmittal of Wage an	id Tax Sta	tements, Form W-3	367	
	Section 1 Review			368	
	Section 2 Unemployment 1		•	<b>369</b> 369	
	Unemployment Compensation Insurance Taxes				
	Internal Control over Payroll O	perations	5	376	
	Section 2 Review			377	
	Chapter Review and Application Chapter Summary	ons 378	Exercises	<b>378</b> 380	
	Learning Objectives	378	Problems	381	
	Glossary	379	Business Connections	389	
	Comprehensive Self Review Discussion Questions	379 379	Answers to Comprehensive Self Review	390	
	Discussion Gaestions	3/3			

XXV



Chapter 12	Assurate Deferred and the	Made	h t	2
Chapter 12	Accruals, Deferrals, and the			3
	Section 1 Calculating and F  The Accrual Basis of Accounting		ng Adjustments	39
	Using the Worksheet to Record	9	nents	3
	Section 1 Review	a 7 tajaoti.		4
	Section 2 Completing the \	Vorkshe	eet	40
	Preparing the Adjusted Trial Ba	alance Se	ection	4
	Preparing Income Statement a		ce Sheet Sections	4
	Calculating Net Income or Net  Section 2 Review	LOSS		4 <b>4</b>
	Chapter Review and Application	ons		4
	Chapter Summary	409	Exercises	4
	Learning Objectives Glossary	409 409	Problems Business Connections	4
	Comprehensive Self Review Discussion Questions	410 410	Answers to Comprehensive Self Review	2
Chapter 13	Financial Statements and C	losing F	Procedure	4
	Section 1 Preparing the Fire	ancial S	Statements	4
	The Classified Income Stateme			4
	The Statement of Owner's Equ The Classified Balance Sheet	lity		4
	Section 1 Review			4
	Section 2 Completing the A	Account	ing Cycle	4
	Journalizing and Posting the A			4
	Journalizing and Posting the C		tries	4
	Preparing a Postclosing Trial B Interpreting the Financial State			4
	Journalizing and Posting Reve		ies	4
	Review of the Accounting Cyc	le		4
	Section 2 Review			4
	Chapter Review and Application Chapter Summary	ons 455	Exercises	4
	Learning Objectives	455	Problems	_
	Glossary Comprehensive Self Review	455 456	Business Connections	2
	Discussion Questions	457	Answers to Comprehensive Self Review	•
Mini-Practice Set 2	Merchandising Business Ac	countin	g Cycle	4
	The Fashion Rack		<b>,</b>	4



**Rules of Debit and Credit** 

Appendix A The Home Depot 2018 Financial Statements

Glossary

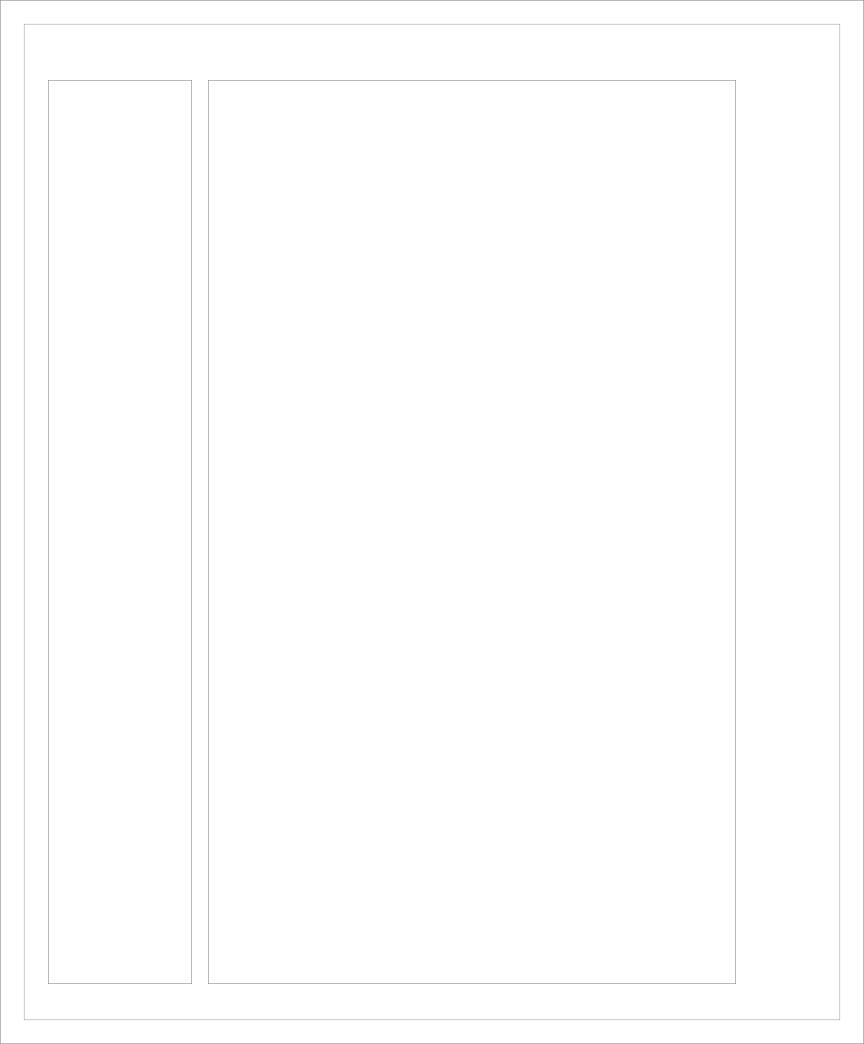
G-1

Index

I-1

Sample General Ledger Accounts

xxvii



# Accounting: The Language of Business

#### www.uber.com

How do you get from the airport to your hotel when traveling on business? How do you get home from a party when it is not safe for you to drive? How do you get into the downtown business district for a meeting when parking is difficult and expensive? How do you get to any destination when taking your own vehicle is not convenient or possible? Taxis are not always available or affordable, and public transportation is difficult when in an unfamiliar city. Uber is a viable alternative to taxis and other forms of public transportation.

Uber was created in 2009 as a private company in San Francisco, California, on a smartphone app used to summon personal transportation from Uber drivers who use their own vehicles to transport customers. Uber's initial busi-



©MikeDotta/Shutterstock

ness model as a personal transportation company has transformed to a multifaceted company that provides transportation, food delivery, bicycle-sharing, and a transfer network company that operates in over 785 metropolitan areas worldwide.

Although Uber has had a turbulent history since its founding as a private company, it has raised a massive amount of investment capital to fund its operations. In January 2018, Uber raised \$1.25 billion in cash from an investment group through a financing arrangement that valued the company at \$48 billion. In May 2018, Uber announced plans to have an initial public offering in 2019 that would change the company to a publicly traded company.

As Uber continues to grow and seek additional investment funding, accountants are pivotal in tracking and reporting the company's financial results and position in terms of revenues earned, expenses used, assets owned, and liabilities owed as well as calculating the company's net income (revenues – expenses) and net worth (assets – liabilities). Accountants are essential to the company's continued growth and success by providing financial information necessary for decision making.

## thinking critically

Can you think of any organizations that would be interested in how Uber is performing?

#### LEARNING OBJECTIVES

- **1-1** Define accounting.
- **1-2** Identify and discuss career opportunities in accounting.
- 1-3 Identify the users of financial information.
- **1-4** Compare and contrast the three types of business entities.
- **1-5** Describe the process used to develop generally accepted accounting principles.
- **1-6** Define the accounting terms new to this chapter.

#### **NEW TERMS**

accounting **Accounting Standards** Codification **Accounting Standards Update** accounting system auditing auditor's report **Certified Bookkeeper (CB)** certified public accountant (CPA) corporation creditor discussion memorandum economic entity entity exposure draft financial statements fraud

generally accepted accounting principles (GAAP) governmental accounting internal control international accounting management advisory services managerial accounting partnership public accountants separate entity assumption social entity sole proprietorship **Statements of Financial Accounting Standards** stockholders tax accounting

## Section 1

#### **SECTION OBJECTIVES**

>> 1-1 Define accounting.

#### WHY IT'S IMPORTANT

Business transactions affect many aspects of our lives.

>> 1-2 Identify and discuss career opportunities in accounting.

#### WHY IT'S IMPORTANT

There's something for everyone in the field of accounting. Accounting professionals are found in every workplace from public accounting firms to government agencies, from corporations to nonprofit organizations.

>> 1-3 Identify the users of financial information.

#### WHY IT'S IMPORTANT

A wide variety of individuals and businesses depend on financial information to make decisions.

#### **TERMS TO LEARN**

accounting
accounting system
auditing
Certified Bookkeeper (CB)
certified public accountant (CPA)
financial statements
fraud
governmental accounting
internal control
management advisory services
managerial accounting
public accountants
tax accounting

## What Is Accounting?

Accounting provides financial information about a business or a nonprofit organization. Owners, managers, investors, and other interested parties need financial information in order to make decisions. Because accounting is used to communicate financial information, it is often called the "language of business."

#### The Need for Financial Information

Suppose a relative leaves you a substantial sum of money and you decide to carry out your lifelong dream of opening a small sportswear shop. You rent space in a local shopping center, purchase fixtures and equipment, purchase goods to sell, hire salespeople, and open the store to customers. Before long you realize that, to run your business successfully, you need financial information about the business. You probably need information that provides answers to the following questions:

- How much cash does the business have?
- How much money do customers owe the business?
- What is the cost of the merchandise sold?
- What is the change in sales volume?
- How much money is owed to suppliers?
- What is the profit or loss?

As your business grows, you will need even more financial information to evaluate the firm's performance and make decisions about the future. An efficient accounting system allows owners and managers to quickly obtain a wide range of useful information. The need for timely information is one reason that businesses have an accounting system directed by a professional staff.

#### >> 1-1 OBJECTIVE

Define accounting.

## **Accounting Defined**

**Accounting** is the process by which financial information about a business is recorded, classified, summarized, interpreted, and communicated to owners, managers, and other interested parties. An **accounting system** is designed to accumulate data about a firm's financial affairs, classify

the data in a meaningful way, and summarize it in periodic reports called **financial statements.** Owners and managers obtain a lot of information from financial statements. The accountant

- establishes the records and procedures that make up the accounting system,
- supervises the operations of the system, and
- interprets the resulting financial information.

Most owners and managers rely heavily on the accountant's judgment and knowledge when making financial decisions.

## **Accounting Careers**

Many jobs are available in the accounting profession, and they require varying amounts of education and experience. Bookkeepers and accountants are responsible for keeping records and providing financial information about the business. Generally, bookkeepers are responsible for recording business transactions. In large firms, bookkeepers may also supervise the work of accounting clerks. Many bookkeepers are Certified Bookkeepers (CB), a designation that assures an individual possesses the level of knowledge and skills needed to carry out all key accounting functions through the adjusted trial balance, including payroll. To become a CB, one must meet three requirements: you must (1) pass the national certified bookkeepers exam, (2) sign a code of ethics, and (3) submit evidence of at least two years of full-time bookkeeping experience or 3,000 hours of part-time or freelance experience. Accounting clerks are responsible for the recordkeeping part of the accounting system—perhaps payroll, accounts receivable, or accounts payable. Accountants usually supervise bookkeepers and prepare the financial statements and reports of the business.

Newspapers and websites often have job listings for accounting clerks, bookkeepers, and accountants:

- Accounting clerk positions usually require one to two accounting courses and little or no experience.
- Bookkeeper positions usually require one to two years of accounting education plus experience as an accounting clerk.
- Accountant positions usually require a bachelor's degree but are sometimes filled by experienced bookkeepers or individuals with a two-year college degree. Most entry-level accountant positions do not have an experience requirement. Both the education and experience requirements for accountant positions vary according to the size of the firm.

Accountants usually choose to practice in one of three areas:

- public accounting
- managerial accounting
- governmental accounting

Table 1.1 shows a list of occupations with job duties that are similar to those of accountants and auditors.

## **Public Accounting**

Public accountants work for public accounting firms. Public accounting firms provide accounting services for other companies. Usually they offer three services:

- auditing
- tax accounting
- management advisory services

The largest public accounting firms in the United States are called the "Big Four." The Big Four are Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers.

Many public accountants are certified public accountants (CPAs). To become a CPA, an individual must have a certain number of college credits in accounting courses, demonstrate good personal character, pass the Uniform CPA Examination, and fulfill the experience requirements of the state of practice. CPAs must follow the professional code of ethics.

#### >> 1-2 OBJECTIVE

Identify and discuss career opportunities in accounting.

#### **ABOUT**

#### ACCOUNTING

#### **Certified Bookkeeper Exam**

The Certified Bookkeeper exam consist of four parts. Part one deals with Adjustments and Error Corrections. Part two covers Payroll and Depreciation. Part three covers Inventory, and part four covers Internal Control and Fraud Prevention. To pass the exam, you must score 75% or higher on parts one and two (which are closed-book exams administered by computer), and you must score 70% or higher on parts three and four (which are openworkbook exams). In addition to passing the exam, you must also sign a Code of Ethics and meet either a full-time or part-time experience requirement.

 TABLE 1.1
 Occupations with Similar Job Duties to Accountants and Auditors

Occupation	Job Duties	Entry-Level Education
Bookkeeping, Accounting, and Auditing Clerks	Bookkeeping, accounting, and auditing clerks produce financial records for organizations. They record financial transactions, update statements, and check financial records for accuracy.	Some college, no degree
Budget Analysts	Budget analysts help public and private institutions organize their finances. They prepare budget reports and monitor institutional spending.	Bachelor's degree
Cost Estimators	Cost estimators collect and analyze data to estimate the time, money, resources, and labor required for product manufacturing, construction projects, or services. Some specialize in a particular industry or product type.	Bachelor's degree
Financial Analysts	Financial analysts provide guidance to businesses and individuals making investment decisions. They assess the performance of stocks, bonds, and other types of investments.	Bachelor's degree
Financial Managers	Financial managers are responsible for the financial health of an organization. They produce financial reports, direct investment activities, and develop strategies and plans for the long-term financial goals of their organization.	Bachelor's degree
Management Analysts	Management analysts, often called management consultants, propose ways to improve an organization's efficiency. They advise managers on how to make organizations more profitable through reduced costs and increased revenues.	Bachelor's degree
Personal Financial Advisors	Personal financial advisors give financial advice to people. They help with investments, taxes, and insurance decisions.	Bachelor's degree
Postsecondary Teachers	Postsecondary teachers instruct students in a wide variety of academic and vocational subjects beyond the high school level. They also conduct research and publish scholarly papers and books.	Doctoral or professional degree
Tax Examiners and Collectors, and Revenue Agents	Tax examiners and collectors and revenue agents ensure that governments get their tax money from businesses and citizens. They review tax returns, conduct audits, identify taxes owed, and collect overdue tax payments.	Bachelor's degree
Top Executives	Top executives devise strategies and policies to ensure that an organization meets its goals. They plan, direct, and coordinate operational activities of companies and public or private-sector organizations.	Bachelor's degree

Source: Bureau of Labor Statistics, U.S. Department of Labor, Occupational Outlook Handbook, 2017–18 Edition, Accountants and Auditors, on the Internet at http://www.bls.gov/ooh/business-and-financial/accountants-and-auditors.htm (visited September 29, 2018).

Auditing is the review of financial statements to assess their fairness and adherence to generally accepted accounting principles. Accountants who are CPAs perform financial audits.

Tax accounting involves tax compliance and tax planning. Tax compliance deals with the preparation of tax returns and the audit of those returns. Tax planning involves giving advice to clients on how to structure their financial affairs in order to reduce their tax liability.

Management advisory services involve helping clients improve their information systems or their business performance.

#### Managerial Accounting

Managerial accounting, also referred to as private accounting, involves working for a single business in industry. Managerial accountants perform a wide range of activities, including

- establishing accounting policies,
- managing the accounting system,
- preparing financial statements,
- interpreting financial information,
- providing financial advice to management,
- preparing tax forms,
- performing tax planning services, and
- preparing internal reports for management.

#### Governmental Accounting

Governmental accounting involves keeping financial records and preparing financial reports as part of the staff of federal, state, or local governmental units. Governmental units do not earn profits. However, governmental units receive and pay out huge amounts of money and need procedures for recording and managing this money.

Some governmental agencies hire accountants to audit the financial statements and records of the businesses under their jurisdiction and to uncover possible violations of the law. The Securities and Exchange Commission, the Internal Revenue Service, the Federal Bureau of Investigation, and Homeland Security employ a large number of accountants.

## Users of Financial Information

The results of the accounting process are communicated to many individuals and organizations. Who are these individuals and organizations, and why do they want financial information about a particular firm?

## Owners and Managers

Assume your sportswear shop is in full operation. One user of financial information about the business is you, the owner. You need information that will help you evaluate the results of your operations as well as plan and make decisions for the future. Questions such as the following are difficult to answer without financial information:

- Should you drop from the product line the long-sleeved pullover that is not selling well, or should you just reduce the price?
- How much should you charge for the denim jacket that you are adding to the product line?
- How much should you spend on advertising?
- How does this month's profit compare with last month's profit?
- Should you open a new store?

A major responsibility of owners and managers of an entity is **internal control** and the prevention of **fraud.** Internal controls are the company's policies and procedures in place to

#### ABOUT

#### **ACCOUNTING**

#### **Accounting Services**

The role of the CPA is expanding. In the past, accounting firms handled audits and taxes. Today accountants provide a wide range of services, including financial planning, investment advice, accounting and tax software advice, and profitability consulting. Accountants provide clients with information and advice on electronic business, health care performance measurement, risk assessment, business performance measurement, and information system reliability.

#### >> 1-3 OBJECTIVE

Identify the users of financial information.

safeguard assets, ensure reliability of accounting data, and promote compliance with management policies and applicable laws. The goal of internal control policies and procedures is the prevention of fraud, which is intentional or reckless acts that result in the confiscation of a firm's assets or the misrepresentation of the firm's accounting data. Common internal control and fraud prevention policies and procedures include written proof that transactions and payments are authorized and separating duties among employees. Throughout this text and end-ofchapter problems, internal control and fraud prevention techniques are discussed for different classes of assets including cash, payroll, inventories, and property, plant, and equipment.

#### Suppliers

A number of other people are interested in the financial information about your business. For example, businesses that supply you with sportswear need to assess the ability of your firm to pay its bills. They also need to set a credit limit for your firm.

#### **Banks**

What if you decide to ask your bank for a loan so that you can open a new store? The bank needs to be sure that your firm will repay the loan on time. The bank will ask for financial information prepared by your accountant. Based on this information, the bank will decide whether to make the loan and the terms of the loan.

#### Tax Authorities

The Internal Revenue Service (IRS) and other state and local tax authorities are interested in financial information about your firm. This information is used to determine the tax base:

- Income taxes are based on taxable income.
- Sales taxes are based on sales income.
- Property taxes are based on the assessed value of buildings, equipment, and inventory (the goods available for sale).

The accounting process provides all of this information.

#### Regulatory Agencies and Investors

If an industry is regulated by a governmental agency, businesses in that industry have to supply financial information to the regulating agency. For example, the Federal Communications Commission receives financial information from radio and television stations. The Securities and Exchange Commission (SEC) oversees the financial information provided by publicly owned corporations to their investors and potential investors. Publicly owned corporations trade their shares on stock exchanges and in over-the-counter markets. Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934 in order to protect those who invest in publicly owned corporations.

The SEC is responsible for reviewing the accounting methods used by publicly owned corporations. The SEC has delegated this review to the accounting profession but still has the final say on any financial accounting issue faced by publicly owned corporations. If the SEC does not agree with the reporting that results from an accounting method, the SEC can suspend trading of a company's shares on the stock exchanges.

Major changes were made to the regulatory environment in the accounting profession with the passage of the Public Company Accounting Reform and Investor Protection Act of 2002 (also known as the Sarbanes-Oxley Act) that was signed into law by President George W. Bush on August 2, 2002. The Act was the most far-reaching regulatory crackdown on corporate fraud and corruption since the creation of the Securities and Exchange Commission in 1934.

The Sarbanes-Oxley Act was passed in response to the wave of corporate accounting scandals starting with the demise of Enron Corporation in 2001, the arrest of top executives at WorldCom and Adelphia Communications Corporation, and ultimately the demise of Arthur Andersen, an international public accounting firm formerly a member of the "Big Five." Arthur Andersen was found guilty of an obstruction of justice charge after admitting that the firm destroyed thousands of documents and electronic files related to the Enron audit engagement. Although on May 31, 2008, the Supreme Court of the United States reversed the Andersen guilty verdict, Arthur Andersen has not returned as a viable business. As a result of the demise of Arthur Andersen, the "Big Five" are now the "Big Four."

The Act significantly tightens regulation of financial reporting by publicly held companies and their accountants and auditors. The Sarbanes-Oxley Act created a five-member Public Company Accounting Oversight Board. The Board has investigative and enforcement powers to oversee the accounting profession and to discipline corrupt accountants and auditors. The Securities and Exchange Commission oversees the Board. Two members of the Board are certified public accountants, to regulate the accountants who audit public companies, and the remaining three must not be and cannot have been CPAs. The chair of the Board may be held by one of the CPA members, provided that the individual has not been engaged as a practicing CPA for five years.

Major provisions of the Act include rules on consulting services, auditor rotation, criminal penalties, corporate governance, and securities regulation. The Act prohibits accountants from offering a broad range of consulting services to publicly traded companies that they audit and requires accounting firms to change the lead audit or coordinating partner and the reviewing partner for a company every five years. Additionally, it is a felony to "knowingly" destroy or create documents to "impede, obstruct or influence" any existing or contemplated federal investigation. Auditors are also required to maintain all audit or review work papers for seven years. Criminal penalties, up to 20 years in prison, are imposed for obstruction of justice, and the Act raises the maximum sentence for defrauding pension funds to 10 years.

Chief executives and chief financial officers of publicly traded corporations are now required to certify their financial statements and these executives will face up to 20 years in prison if they "knowingly or willfully" allow materially misleading information into their financial statements. Companies must also disclose, as quickly as possible, material changes in their financial position. Wall Street investment firms are prohibited from retaliating against analysts who criticize investment-banking clients of the firm. The Act contains a provision with broad new protection for whistle-blowers and lengthens the time that investors have to file lawsuits against corporations for securities fraud.

By narrowing the type of consulting services that accountants can provide to companies that they audit, requiring auditor rotation, and imposing stiff criminal penalties for violation of the Act, it appears that this legislation will significantly help to restore public confidence in financial statements and markets and change the regulatory environment in which accountants operate.

#### Customers

Customers pay special attention to financial information about the firms with which they do business. For example, before a business spends a lot of money on a new computer system, the business wants to know that the computer manufacturer will be around for the next several years in order to service the computer, replace parts, and provide additional components. The business analyzes the financial information about the computer manufacturer in order to determine its economic health and the likelihood that it will remain in business.

#### **Employees and Unions**

Often employees are interested in the financial information of the business that employs them. Employees who are members of a profit-sharing plan pay close attention to the financial results because they affect employee income. Employees who are members of a labor union use financial information about the firm to negotiate wages and benefits.

#### FIGURE 1.1

Users of Financial Information

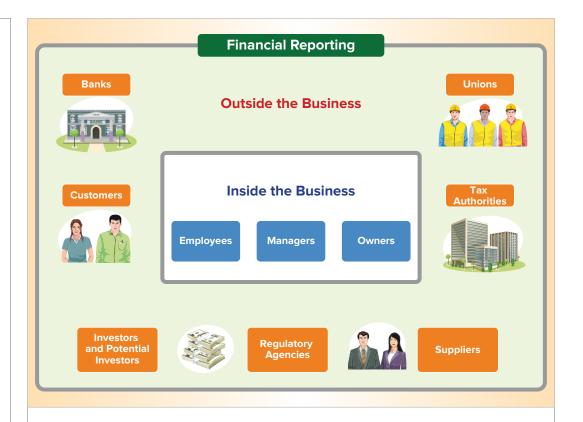


Figure 1.1 illustrates different financial information users. As you learn about the accounting process, you will appreciate why financial information is so important to these individuals and organizations. You will learn how financial information meets users' needs.

### Section 1 Review



- 1. The names of three accounting jobs include all but:
  - a. logistics manager.
  - b. accountant.
  - c. bookkeeper.
  - d. accounts payable clerk.
- 2. Accounting is called:
  - a. the language of economics.
  - b. the language of finance.
  - c. the language of business.
  - d. the language of commerce.
- 3. Financial statements are:
  - a. accumulated financial data summarized in periodic reports.
  - b. accumulated transactions of the firm's sales activities.

- c. a summary of records and procedures that make up the accounting system.
- d. a summarized description of a firm's accounting system.
- 4. The organization that has the final say on financial accounting issues faced by publicly owned corporations is the:
  - a. Federal Trade Commission.
  - **b.** Securities and Exchange Commission.
  - c. Internal Revenue Service.
  - d. U.S. Treasury.
- 5. As the owner of a small business, you have decided to apply for a loan to expand your locations. Information that you most likely will need to provide to the lender include all but:
  - a. current sales and expense figures.
  - b. projected sales and expense figures.
  - c. the cost of the expansion.
  - d. the average value of homes in your neighborhood.

- 6. One requirement for becoming a CPA is to pass the:
  - a. Final CPA Examination.
  - b. SEC Accounting Examination.
  - c. Uniform CPA Exam.
  - d. State Board Examination.
- 7. The CPA designation stands for:
  - a. Certified Public Analyst.
  - b. Certified Public Appraiser.
  - c. Certified Public Accountant.
  - d. Certified Public Associate.
- 8. The Certified Bookkeeper exam includes all of the parts below except:
  - a. Business Law.
  - b. Adjustments and Error Corrections.
  - c. Inventory.
  - d. Payroll and Depreciation.
- 9. To become a Certified Bookkeeper, one must meet all requirements below except:
  - a. Pass the national certified bookkeeper exam.
  - b. Sign a code of ethics.
  - c. Pass a criminal background check.
  - d. Submit evidence that you satisfy the experience requirements for the designation.

- 10. All of the following are users of accounting information except:
  - a. owners and managers.
  - b. banks and suppliers.
  - c. search engines on a website.
  - d. tax authorities and regulatory agencies.
- 11. All of the following are goals of internal control except:
  - a. policies and procedures to safeguard assets.
  - b. ensuring reliability of accounting data.
  - c. fraud prevention.
  - d. encouraging noncompliance with management policies and applicable laws.
- 12. Fraud is intentional or reckless acts that result in the confiscation of a firm's assets or the misrepresentation of the firm's accounting data.
  - a. True
  - b. False

## Section 2

### SECTION OBJECTIVES

>> 1-4 Compare and contrast the three types of business entities.

#### **WHY IT'S IMPORTANT**

Each type of business entity requires unique legal and accounting considerations.

> 1-5 Describe the process used to develop generally accepted accounting principles.

#### WHY IT'S IMPORTANT

Accounting professionals are required to use common standards and principles in order to produce reliable financial information.

### TERMS TO LEARN

**Accounting Standards** Codification **Accounting Standards Update** auditor's report corporation creditor discussion memorandum economic entity entity exposure draft generally accepted accounting principles (GAAP) international accounting partnership separate entity assumption social entity sole proprietorship **Statements of Financial Accounting Standards** stockholders

## **Business and Accounting**

The accounting process involves recording, classifying, summarizing, interpreting, and communicating financial information about an economic or social entity. An **entity** is recognized as having its own separate identity. An entity may be an individual, a town, a university, or a business. The term **economic entity** usually refers to a business or organization whose major purpose is to produce a profit for its owners. **Social entities** are nonprofit organizations, such as cities, public schools, and public hospitals. This book focuses on the accounting process for businesses, but keep in mind that nonprofit organizations also need financial information.

#### >> 1-4 OBJECTIVE

Compare and contrast the three types of business entities.

### **Types of Business Entities**

The three major legal forms of business entity are the sole proprietorship, the partnership, and the corporation. In general, the accounting process is the same for all three forms of business. Later in the book you will study the different ways certain transactions are handled depending on the type of business entity. For now, however, you will learn about the different types of business entities.

### Sole Proprietorships

A **sole proprietorship** is a business entity owned by one person. The life of the business ends when the owner is no longer willing or able to keep the business going. Many small businesses are operated as sole proprietorships.

The owner of a sole proprietorship is legally responsible for the debts and taxes of the business. If the business is unable to pay its debts, the **creditors** (those people, companies,

or government agencies to whom the business owes money) can turn to the owner for payment. The owner may have to pay the debts of the business from personal resources, including personal savings. When the time comes to pay income taxes, the owner's income and the income of the business are combined to compute the total tax responsibility of the owner.

It is important that the business transactions be kept separate from the owner's personal transactions. If the owner's personal transactions are mixed with those of the business, it will be difficult to measure the performance of the business. The term separate **entity assumption** describes the concept of keeping the firm's financial records separate from the owner's personal financial records.

### **Partnerships**

A partnership is a business entity owned by two or more people. The partnership structure is common in businesses that offer professional services, such as law firms, accounting firms, architectural firms, medical practices, and dental practices. At the beginning of the partnership, two or more individuals enter into a contract that details the rights, obligations, and limitations of each partner, including

- the amount each partner will contribute to the business,
- each partner's percentage of ownership,
- each partner's share of the profits,
- the duties each partner will perform, and
- the responsibility each partner has for the amounts owed by the business to creditors and tax authorities.

The partners choose how to share the ownership and profits of the business. They may share equally or in any proportion agreed upon in the contract. When a partner leaves, the partnership is dissolved and a new partnership may be formed with the remaining partners.

Partners are individually, and as a group, responsible for the debts and taxes of the partnership. If the partnership is unable to pay its debts or taxes, the partners' personal property, including personal bank accounts, may be used to provide payment. It is important that partnership transactions be kept separate from the personal financial transactions of the partners.

Under the Limited Liability Partnership Act of most states, a Limited Liability Partnership (LLP) may be formed. An LLP is a general partnership that provides some limited liability for all partners. LLP partners are responsible and have liability for their own actions and the actions of those under their control or supervision. They are not liable for the actions or malfeasance of another partner. Except for the limited liability aspect, LLPs generally have the same characteristics, advantages, and disadvantages as any other partnership.

### Corporations

A corporation is a business entity that is separate from its owners. A corporation has a legal right to own property and do business in its own name. Corporations are very different from sole proprietorships and partnerships.

**Stock**, issued in the form of stock certificates, represents the ownership of the corporation. Corporations may be *privately* or *publicly* owned. Privately owned corporations are also called *closely held* corporations. The ownership of privately owned corporations is limited to specific individuals, usually family members. Stock of closely held corporations is not traded on an exchange. In contrast, stock of publicly owned corporations is bought and sold on stock exchanges and in over-the-counter markets. Most large corporations have issued (sold) thousands of shares of stock.

An owner's share of the corporation is determined by the number of shares of stock held by the owner compared to the total number of shares issued by the corporation. Assume that

### important!

### Separate Entity Assumption

For accounting purposes, all forms of business are considered separate entities from their owners. However, the corporation is the only form of business that is a separate legal entity.

Hector Flores owns 600 shares of Sample Corporation. If Sample Corporation has issued 2,000 shares of stock, Flores owns 30 percent of the corporation (600 shares  $\div$  2,000 shares = 0.30 or 30%). Some corporate decisions require a vote by the owners. For Sample Corporation, Flores has 600 votes, one for each share of stock that he owns. The other owners have 1,400 votes.

Subchapter S corporations, also known as S corporations, are entities formed as corporations that meet the requirements of Subchapter S of the Internal Revenue Code to be treated essentially as a partnership so the corporation pays no income tax. Instead, shareholders include their share of corporate profits, and any items that require special tax treatment, on their individual income tax returns. Otherwise, S corporations have all of the characteristics of regular corporations. The advantage of the S corporation is that the owners have limited liability and avoid double taxation.

One of the advantages of the corporate form of business is the indefinite life of the corporation. A sole proprietorship ends when the owner dies or discontinues the business. A partnership ends on the death or withdrawal of a partner. In contrast, a corporation does not end when ownership changes. Some corporations have new owners daily because their shares are actively traded (sold) on stock exchanges.

Corporate owners, called **stockholders** or *shareholders*, are not personally responsible for the debts or taxes of the corporation. If the corporation is unable to pay its bills, the most stockholders can lose is their investment in the corporation. In other words, the stockholders will not lose more than the cost of the shares of stock.

The accounting process for the corporate entity, like that of the sole proprietorship and the partnership, is separate from the financial affairs of its owners. Usually this separation is easy to maintain. Most stockholders do not participate in the day-to-day operations of the business.

A limited liability company (LLC) combines the best features of a partnership with those of a corporation even though, from a legal perspective, it is neither. While offering its owners the limited liability of a corporation, an LLC with more than one owner generally is treated as a partnership for tax purposes. The limited liability extends to all the LLC's owners. So the LLC is similar to a limited partnership with no general partners. Unlike an S corporation, an LLC may have an unlimited number of owners who can be almost any type of entity. Under special IRS regulations, an LLC may elect to be taxed as a corporation or as a partnership. If the LLC elects to be treated as a partnership, it should file a Form 1065, U.S. Return of Partnership Income. If the LLC elects to be treated as a corporation, it should file a Form 1120, U.S. Corporation Income Tax Return. If the LLC elects to be treated as an S corporation, it should file a Form 1120S, U.S. Income Tax Return for an S Corporation.

Table 1.2 summarizes the business characteristics for sole proprietorships, partnerships, and corporations.

### **Generally Accepted Accounting Principles**

The Securities and Exchange Commission has the final say on matters of financial reporting by publicly owned corporations. The SEC has delegated the job of determining proper accounting standards to the accounting profession. However, the SEC sometimes overrides decisions the accounting profession makes. To fulfill its responsibility, the accounting profession has developed, and continues to develop, generally accepted accounting principles (GAAP). Generally accepted accounting principles must be followed by publicly owned companies unless they can show that doing so would produce information that is misleading.

TABLE 1.2 **Major Characteristics of Business Entities** 

Characteristic	Type of Business Entity					
	Sole Proprietorship	Partnership	Corporation			
Ownership	One owner	Two or more owners	One or more owners, even thousands			
Life of the business	Ends when the owner dies, is unable to carry on operations, or decides to close the firm	Ends when one or more partners withdraw, when a partner dies, or when the partners decide to close the firm	Can continue indefinitely; ends only when the business goes bankrupt or when the stockholders vote to liquidate			
Responsibility for debts of the business	Owner is responsible for the firm's debt when the firm is unable to pay	Partners are responsible individually and jointly for the firm's debts when the firm is unable to pay	Stockholders are not responsible for the firm's debts; they can lose only the amount they invested			

### The Development of Generally Accepted Accounting Principles

Generally accepted accounting principles are developed by the Financial Accounting Standards Board (FASB), which is composed of five full-time members. Prior to 2009, the FASB issued 168 **Statements of Financial Accounting Standards.** The FASB developed these statements and, before issuing them, obtained feedback from interested people and organizations.

First, the FASB wrote a discussion memorandum to explain the topic being considered. Then public hearings were held where interested parties could express their opinions, either orally or in writing. The groups that consistently expressed opinions about proposed FASB statements were the SEC, the American Institute of Certified Public Accountants (AICPA), public accounting firms, the American Accounting Association (AAA), and businesses with a direct interest in a particular statement.

The AICPA is a national association for certified public accountants. The AAA is a group of accounting educators. AAA members research possible effects of a proposed FASB statement and offer their opinions to the FASB.

After public hearings, the FASB released an exposure draft, which described the proposed statement. Then the FASB received and evaluated public comment about the exposure draft. Finally, FASB members voted on the statement. If at least four members approved, the statement was issued.

The above process was used until 2009. Effective July 1, 2009, the source of authoritative U.S. GAAP is the FASB Accounting Standards Codification, which is communicated through an Accounting Standards Update (Update). The Codification reorganizes U.S. GAAP pronouncements into approximately 90 accounting topics. It also includes relevant U.S. Securities and Exchange Commission guidance that follows the same topical structure in separate sections in the Codification.

Updates are now published on these accounting topics for all authoritative U.S. GAAP promulgated by the FASB, regardless of the form in which such guidance may have been issued prior to the release of the FASB Codification. An Update summarizes the key provisions of the project that led to the Update, details the specific amendments to the FASB Codification, and explains the basis for the Board's decision.

Accounting principles vary from country to country. **International accounting** is the study of the accounting principles used by different countries. In 1973, the International Accounting Standards Committee (IASC) was formed. Recently, the IASC's name was changed to the International Accounting Standards Board (IASB). The IASB deals with issues caused by the lack of uniform accounting principles. The IASB also makes recommendations to enhance comparability of reporting practices.

### >> 1-5 OBJECTIVE

Describe the process used to develop generally accepted accounting principles.

### important!

#### **GAAP**

The SEC requires all publicly owned companies to follow generally accepted accounting principles. As new standards are developed or refined, accountants interpret the standards and adapt accounting practices to the new standards.

### MANAGERIAL IMPLICATIONS <<

### FINANCIAL INFORMATION

- Managers of a business make sure that the firm's accounting system produces financial information that is timely, accurate, and fair.
- Financial statements should be based on generally accepted accounting principles.
- Each year a publicly traded company must submit financial statements, including an independent auditor's report, to the SEC.
- Internal reports for management need not follow generally accepted accounting principles but should provide useful information that will aid in monitoring and controlling operations.

- Financial information can help managers to control present operations, make decisions, and plan for the future.
- The sound use of financial information is essential to good management.

#### **THINKING CRITICALLY**

If you were a manager, how would you use financial information to make decisions?

### The Use of Generally Accepted Accounting Principles

Every year, publicly traded companies submit financial statements to the SEC. The financial statements are audited by independent certified public accountants. The CPAs are called *independent* because they are not employees of the company being audited and they do not have a financial interest in the company. The financial statements include the auditor's report. The **auditor's report** contains the auditor's opinion about the fair presentation of the operating results and financial position of the business. The auditor's report also confirms that the financial information is prepared in conformity with generally accepted accounting principles. The financial statements and the auditor's report are made available to the public, including existing and potential stockholders.

Businesses and the environment in which they operate are constantly changing. The economy, technology, and laws change. Generally accepted accounting principles are changed and refined as accountants respond to the changing environment.

## Section 2 Review



- Generally accepted accounting principles are accounting standards that are changed and refined in response to changes in the environment in which businesses operate.
  - a. True
  - b. False
- 2. Generally accepted accounting principles are not needed to ensure that financial information is fairly presented in the operating results and financial positions of firms.
  - a. True
  - b. False
- 3. Generally accepted accounting principles are developed by the Financial Accounting Standards Board (FASB) through proposed statements and solicitation of feedback.

from interested individuals, groups, and companies.

Subsequently, the FASB evaluates the opinions received and votes on the statements.

- a. True
- b. False
- 4. A nonprofit organization such as a public school is a(n):
  - a. social unit.
  - b. economic unit.
  - c. economic entity.
  - d. social entity.
- 5. You plan to open a business with two of your friends. You would like to form a corporation, but your friends prefer the partnership form of business. All of the following are advantages of the corporation except:

		Accounting: The Language of Business	CHAPTER 1 15
6.	<ul> <li>a. a corporation is a separate, distinct, legal entity.</li> <li>b. the corporation's earnings are only taxed once.</li> <li>c. a corporation has limited liability.</li> <li>d. ease of raising capital.</li> <li>An organization that has two or more owners who are legally responsible for the debts and taxes of the business is a: <ul> <li>a. social entity.</li> <li>b. partnership.</li> <li>c. sole proprietorship.</li> <li>d. corporation.</li> </ul> </li> </ul>	7. A limited liability company may cho partnership or corporation. a. True b. False	

# Chapter

### **REVIEW Chapter Summary**

Accounting is often called the "language of business." The financial information about a business is communicated to interested parties in financial statements.

## **Learning Objectives**

### 1-1 Define accounting.

Accounting is the process by which financial information about a business is recorded, classified, summarized, interpreted, and communicated to owners, managers, and other interested parties. Accurate accounting information is essential for making business decisions.

### 1-2 Identify and discuss career opportunities in accounting.

- There are many job opportunities in accounting.
- Accounting clerk positions, such as accounts receivable clerk, accounts payable clerk, and payroll clerk, require the least education and experience.
- Bookkeepers usually have experience as accounting clerks and a minimum of one to two years of accounting education. Certified Bookkeepers (CB) are individuals who have passed a three-part exam that aims to assure the level of knowledge and skills needed to carry out all key accounting functions through the adjusted trial balance, including payroll.
- Most entry-level accounting positions require a college degree or significant experience as a bookkeeper.
- Accountants usually specialize in one of three major areas: public, managerial, or governmental accounting.
  - Some accountants work for public accounting firms and perform auditing, tax accounting, or management advisory functions.
  - Other accountants work in private industry where they set up and supervise accounting systems, prepare financial reports, prepare internal reports, or assist in determining the prices to charge for the firm's products.
  - Still other accountants work for government agencies. They keep track of public funds and expenditures, or they audit the financial records of businesses and individuals to determine whether the records are in compliance with regulatory laws, tax laws, and other laws. The Securities and Exchange Commission, the Internal Revenue Service, the Federal Bureau

of Investigation, and Homeland Security employ many accountants.

### 1-3 Identify the users of financial information.

All types of businesses need and use financial information. Users of financial information include owners and managers, employees, suppliers, banks, tax authorities, regulatory agencies, and investors. Nonprofit organizations need similar financial information.

A major responsibility of owners and managers of an entity is internal control and the prevention of fraud. Internal controls are the company's policies and procedures to safeguard assets, ensure reliability of accounting data, and promote compliance with management policies and applicable laws.

# 1-4 Compare and contrast the three types of business

- A sole proprietorship is a business entity owned by one person. The life of the business ends when the owner is no longer willing or able to keep the business going.
- A partnership is owned by two or more people. The owners are legally responsible for the debts and taxes of the business. Limited liability companies (LLC) are recognized by most states. LLCs can elect to be taxed as a partnership or corporation.
- A corporation is a separate legal entity from its

Note that all three types of business entities are considered separate entities for accounting purposes.

### Describe the process used to develop generally accepted accounting principles.

- The SEC has delegated the authority to develop generally accepted accounting principles to the accounting profession. The Financial Accounting Standards Board handles this task. A series of steps used by the FASB includes issuing a discussion memorandum, an exposure draft, and a statement of principle.
- The SEC oversees the Public Company Accounting Oversight Board that was created by the Sarbanes-Oxley Act. The Board regulates

financial reporting by accountants and auditors of publicly held companies.

Each year, firms that sell stock on stock exchanges or in over-the-counter markets must publish audited financial reports that follow generally

accepted accounting principles. They must submit their reports to the SEC. They must also make the reports available to stockholders.

1-6 Define the accounting terms new to this chapter.

### Glossary

**Accounting** (p. 2) The process by which financial information about a business is recorded, classified, summarized, interpreted, and communicated to owners, managers, and other interested parties

Accounting Standards Codification (p. 13) The source of authoritative U.S. GAAP

Accounting Standards Update (p. 13) Changes to Accounting Standards Codification are communicated through Accounting Standards Update covering approximately 90 topics

**Accounting system** (p. 2) A process designed to accumulate, classify, and summarize financial data

Auditing (p. 5) The review of financial statements to assess their fairness and adherence to generally accepted accounting principles

Auditor's report (p. 14) An independent accountant's review of a firm's financial statements

Certified Bookkeeper (CB) (p. 3) A designation that assures an individual possesses the level of knowledge and skill needed to carry out all key functions through the adjusted trial balance, including payroll

Certified public accountant (CPA) (p. 3) An independent accountant who provides accounting services to the public for a fee

Corporation (p. 11) A publicly or privately owned business entity that is separate from its owners and has a legal right to own property and do business in its own name; stockholders are not responsible for the debts or taxes of the business

**Creditor** (p. 10) One to whom money is owed

**Discussion memorandum** (p. 13) An explanation of a topic under consideration by the Financial Accounting Standards Board

Economic entity (p. 10) A business or organization whose major purpose is to produce a profit for its owners

Entity (p. 10) Anything having its own separate identity, such as an individual, a town, a university, or a business

**Exposure draft** (p. 13) A proposed solution to a problem being considered by the Financial Accounting Standards Board

Financial statements (p. 3) Periodic reports of a firm's financial position or operating results

**Fraud** (p. 5) Intentional or reckless acts that result in confiscation of a firm's assets or the misrepresentation of the firm's accounting data

Generally accepted accounting principles (GAAP) (p. 12) Accounting standards developed and applied by professional accountants

Governmental accounting (p. 5) Accounting work performed for a federal, state, or local governmental unit

Internal control (p. 5) A company's policies and procedures to safeguard assets, ensure reliability of accounting data, and promote compliance with management policies and applicable laws

**International accounting (p. 13)** The study of accounting principles used by different countries

Management advisory services (p. 5) Services designed to help clients improve their information systems or their business performance

Managerial accounting (p. 5) Accounting work carried on by an accountant employed by a single business in industry; the branch of accounting that provides financial information about business segments, activities, or products

**Partnership** (p. 11) A business entity owned by two or more people who carry on a business for profit and who are legally responsible for the debts and taxes of the business

Public accountants (p. 3) Members of firms that perform accounting services for other companies

**Separate entity assumption** (p. 11) The concept that a business is separate from its owners; the concept of keeping a firm's financial records separate from the owner's personal financial records

Social entity (p. 10) A nonprofit organization, such as a city, public school, or public hospital

**Sole proprietorship** (p. 10) A business entity owned by one person, who is legally responsible for the debts and taxes of the business

Statements of Financial Accounting Standards (p. 13) Accounting principles established by the Financial Accounting Standards Board

**Stock** (p. 11) Certificates that represent ownership of a corporation

**Stockholders** (p. 12) The owners of a corporation; also called shareholders

**Tax accounting** (p. 5) A service that involves tax compliance and tax planning

### Comprehensive Self Review

- What is the purpose of accounting?
- What does the accounting process involve?
- What is the purpose of the auditor's report?
- What are the three major types of business entities?
- 5. How is the ownership of a corporation different from that of a sole proprietorship?

(Answers to Comprehensive Self Review are at the end of the chapter.)

### **Discussion Questions**

- 1. What types of people or organizations are interested in financial information about a firm, and why are they interested in this information?
- 2. Why is it important for business records to be separate from the records of the business's owner or owners? What is the term accountants use to describe this separation of personal and business records?
- **3.** What are the three types of business entities, and how do they differ?
- **4.** What are the major functions or activities performed by accountants in private industry?
- **5.** What is tax planning?
- **6.** What types of services do public accountants provide?
- 7. What are the three major areas of accounting?
- **8.** What is the purpose of the Financial Accounting Standards Board?
- **9.** What groups consistently offer opinions about proposed FASB statements?
- **10.** What is the function of the Securities and Exchange Commission?
- 11. What led to the passage of the Public Company Accounting Reform and Investor Protection Act of 2002?
- **12.** What is the purpose of the Public Company Accounting Oversight Board?
- **13.** What does the Certified Bookkeeper (CB) designation imply?
- **14.** How does one become a Certified Bookkeeper (CB)?
- **15.** What is a limited liability company (LLC)?
- **16.** Define internal control.

- **17.** Define fraud.
- **18.** What is the goal of internal control?
- **19.** Name two common internal control and fraud prevention procedures.
- 20. Employees sometimes make mistakes and errors in recording accounting transactions. Is this considered fraud?

### **PROBLEM**

### Critical Thinking Problem

### Which Type of Business Entity?

Since graduating from college five years ago, you have worked for a national chain of men's clothing stores. You have held several positions within the company and are currently manager of a local branch store.

Over the past three years, you have observed a pattern in the purchases of men's suits. You establish that the majority of men's suit purchases are black, brown, blue, gray, and olive. You also noticed that French cuff shirts are now fashionable, but few stores carry a wide color selection. Because you have always wanted to be in business for yourself, you decide to open a shop that will sell suits that are black, brown, blue, gray, and olive and to carry a wide array of colors of French cuff shirts. Your store will also sell fashionable ties and cuff links. You have decided that your store will brand itself for focusing on men's fashion; therefore, the name for your store will be "The Style Shop." You have discussed your plan with a number of people in the industry, and they believe your idea is a viable one and have encouraged you to pursue your dream of becoming an entrepreneur.

A new upscale outdoor shopping mall is opening nearby, and you have decided that now is the time to take the plunge and go into business for yourself. After developing a comprehensive business plan that includes marketing strategies and financial projections, you decide to open The Style Shop in the new mall.

One of the things you must decide in the process of transforming your idea into reality is the form of ownership for your new business. Should it be organized as a sole proprietorship, a partnership, or a corporation?

What advantages or disadvantages are there to each choice? What do you think of the proposed name for the business, The Style Shop? Use the chart below to organize your thoughts.

<b>Business Entity</b>	Advantages	Disadvantages
Sole Proprietorship		
Partnership		
Limited Liability Partnership		
Limited Liability Company		
Corporation		
S Corporation		

Managerial | FOCUS

**Internal Control and** FRAUD PREVENTION



**Financial Statement ANALYSIS** 

TEAMWORK

### **BUSINESS CONNECTIONS**

### **Know Accounting**

- 1. As an owner or manager of a business, what questions would you ask to judge the firm's performance, control operations, make decisions, and plan for the future?
- 2. Why is financial information important?
- 3. Besides earning a profit, what other objectives might a business have? Can financial information play an important role in these objectives?
- 4. What kind of problems can you foresee if a business owner and/or manager does not have a basic knowledge of accounting?
- 5. What would you tell a small business owner who says he does not see a need for an accounting system in his business because he closely supervises the day-to-day operations and knows exactly what is happening with the business?
- **6.** What is the role of the manager versus the accountant?
- 7. Does a business owner/manager need to worry about the separate entity assumption? Why or why not?
- **8.** Why are international accounting standards important to management?

### Choosing the Right Employees

Selecting the right employees is a critical step for enhancing the entity's system of internal control and fraud prevention. Reflected below are several possible ways to check the background of employees. For each item listed, indicate why the background check is important, what type of information should be sought, and whether or not you believe you should get the candidate's consent before acquiring the information.

- 1. References
- 2. Employment history
- **3.** Education, certifications, and licenses
- 4. Drug screening

#### **Notes to Financial Statements**

Within a company's annual report, a section called "Notes to Consolidated Financial Statements" offers general information about the company along with detailed notes related to its financial statements.

Analyze Online: On the American Eagle Outfitters, Inc., website (www.ae.com), click on About AEO located at the bottom of the page. Then click on Investor Relations.

#### Analyze:

- **1.** What types of merchandise does this company sell?
- 2. Who are the potential users of the information presented? Why would this information be helpful to these users?
- 3. How many AE company-owned stores are there, and what are their worldwide locations?
- 4. Would American Eagle Outfitters, Inc., be considered an economic entity or a social entity? Why?

### **Determining Information**

Restful Sleep Mattress company is planning to expand into selling bedroom furniture. This expansion will require a loan from the bank. The bank has requested financial information. In a group, discuss the information the bank would require. What information, if any, would you provide to the bank?

### Answers to Comprehensive Self Review

- 1. To gather and communicate financial information about a business.
- 2. Recording, classifying, summarizing, interpreting, and communicating financial information about a business.
- 3. To obtain the objective opinion of a professional accountant from outside the company that the statements fairly present the operating results and financial position of the business and that the information was prepared according to GAAP.
- **4.** Sole proprietorship, partnership, and corporation.
- **5.** A sole proprietorship is a business entity owned by one person. A corporation is a separate legal entity that has a legal right to own property and do business in its own name.

#### www.aa.com

The first American Airlines flight was flown on March 15, 1926, when Charles Lindbergh flew an American aircraft carrying U.S. mail from St. Louis, Missouri, to Chicago, Illinois. With a 90-year-plus history, American Airlines Group is the world's largest airlines measured by fleet size, profit, revenue, passengers transported, and revenue per passenger mile. American Airlines Group was formed on December 9, 2013, with the closing of the merger between American Airlines and US Airways Group. The company is listed on the NASDAQ Global Select Marker under the ticker symbol AAL.



VIAVAL/Shutterstock

American Airlines and American Eagle fly an average of nearly 6,700 flights per day to more than 50 countries with approximately 350 destinations. After moving its headquarters from New York to Dallas/Fort Worth, Texas, in 1979, American Airlines changed to a hub-and-spoke system. American offers hubs in Charlotte, North Carolina; Chicago, Illinois; Dallas/Fort Worth, Texas; Los Angeles, California; Miami, Florida; New York, New York; Philadelphia, Pennsylvania; Phoenix, Arizona; and Washington, D.C. In 1999, American Airlines, British Airways, Cathay Pacific, Canadian Airlines, and Qantas founded the global airline alliance Oneworld. Alliance members serve more than 1,000 destinations with more than 14,000 daily flights to over 150 countries.

Running an airline is no easy task, and over the years American has had a turbulent history; from employee strikes, to bankruptcy, to mergers, the airline has survived every threat of demise to emerge stronger and better after every challenge. Think of all of the things that could go wrong and all of the financial transactions that take place on a daily basis. The airline has to buy planes, equipment, and supplies and keep all of its customers safe to their final destinations. It also has to pay employees, pay for repairs on its equipment, and buy insurance, just to name a few expenses. Then, it has to sell enough tickets in order to be able to generate money to pay for all of these things. Yikes! That is a lot of cash coming in and going out. American Airlines is uniquely American, proud, innovative, strong, and forward thinking. Today's American Airlines prides itself on providing its customers with a memorable flying experience that triggers thoughts of a world of possibilities for future travel opportunities.

### thinking critically

How does American keep track of all of these transactions so that it can continue to run its airline profitably?

### LEARNING OBJECTIVES

- 2-1 Record in equation form the financial effects of a business transaction.
- 2-2 Define, identify, and understand the relationship between asset, liability, and owner's equity accounts.
- **2-3** Analyze the effects of business transactions on a firm's assets, liabilities, and owner's equity and record these effects in accounting equation form.
- 2-4 Prepare an income statement.
- 2-5 Prepare a statement of owner's equity and a balance sheet.
- **2-6** Define the accounting terms new to this chapter.

### **NEW TERMS**

accounts payable accounts receivable assets balance sheet break even **business transaction** capital equity

expense fair market value

fundamental accounting equation

income statement liabilities net income

net loss on account owner's equity

revenue

statement of owner's equity

withdrawals

## Section 1

### **SECTION OBJECTIVES**

> 2-1 Record in equation form the financial effects of a business transaction.

#### WHY IT'S IMPORTANT

Learning the fundamental accounting equation is a basis for understanding business transactions.

>> 2-2 Define, identify, and understand the relationship between asset, liability, and owner's equity accounts.

#### WHY IT'S IMPORTANT

The relationship between assets, liabilities, and owner's equity is the basis for the entire accounting system.

### **TERMS TO LEARN**

accounts payable
assets
balance sheet
business transaction
capital
equity
liabilities
on account

owner's equity

## **Property and Financial Interest**

The accounting process starts with the analysis of business transactions. A **business transaction** is any financial event that changes the resources of a firm. For example, purchases, sales, payments, and receipts of cash are all business transactions. The accountant analyzes each business transaction to decide what information to record and where to record it.

#### >> 2-1 OBJECTIVE

Record in equation form the financial effects of a business transaction.

### **Beginning with Analysis**

Let's analyze the transactions of Eli's Consulting Services, a firm that provides a wide range of accounting and consulting services. Trayton Eli, CPA, has a master's degree in accounting. He is the sole proprietor of Eli's Consulting Services. Sergio Sanchez, the office manager, has an associate's degree in business and has taken 12 semester hours of accounting. The firm is located in a large office complex.

Every month, Eli's Consulting Services bills clients for the accounting and consulting services provided that month. Customers can also pay in cash when the services are rendered.

### Starting a Business

Let's start from the beginning. Trayton Eli obtained the funds to start the business by withdrawing \$100,000 from his personal savings account. The first transaction of the new business was opening a checking account in the name of Eli's Consulting Services. The separate bank account helps Eli keep his financial interest in the business separate from his personal funds.

When a business transaction occurs, it is analyzed to identify how it affects the equation *property equals financial interest*. This equation reflects the fact that in a free enterprise system, all property is owned by someone. In this case, Eli owns the business because he supplied the property (cash).

Use these steps to analyze the effect of a business transaction:

- 1. Describe the financial event.
  - Identify the property.
  - Identify who owns the property.
  - Determine the amount of increase or decrease.

**2.** Make sure the equation is in balance.

Property = Financial Interest

### **BUSINESS TRANSACTION**

Trayton Eli withdrew \$100,000 from personal savings and deposited it in a new checking account in the name of Eli's Consulting Services.

#### **ANALYSIS**

V

- a. The business received \$100,000 of *property* in the form of cash.
- a. Eli had a \$100,000 financial interest in the business.

Note that the equation *property* equals *financial interest* remains in balance. The total of one side of the equation must always equal the total of the other side.

	=	Financial Interest
Cash	=	Trayton Eli, Capital
+\$100,000		
		+\$100,000
\$100,000	=	\$100,000
	+\$100,000	Cash = +\$100,000

An owner's financial interest in the business is called **equity**, or **capital**. Trayton Eli has \$100,000 equity in Eli's Consulting Services.

### **Purchasing Equipment for Cash**

The first priority for office manager Sergio Sanchez was to get the business ready for opening day on December 1.

### **BUSINESS TRANSACTION**

Eli's Consulting Services issued a \$5,000 check to purchase a computer and other equipment.

#### **ANALYSIS**



- b. The firm purchased new property (equipment) for \$5,000.
- b. The firm paid out \$5,000 in cash.

The equation remains in balance.

	Property			=	Financial Interest
	Cash	+	Equipment	=	Trayton Eli, Capital
Previous balances	\$100,000			=	\$100,000
(b) Purchased equipment		+	\$5,000		
(b) Paid cash	-5,000				
New balances	\$95,000	+	\$5,000	=	\$100,000

Notice that there is a change in the composition of the firm's property. Now the firm has cash and equipment. The equation shows that the total value of the property remains the same, \$100,000. Trayton Eli's financial interest, or equity, is also unchanged. Note that property (Cash and Equipment) is equal to financial interest (Trayton Eli, Capital).

These activities are recorded for the business entity Eli's Consulting Services. Trayton Eli's personal assets, such as his personal bank account, house, furniture, and automobile, are kept separate from the property of the firm. Nonbusiness property is not included in the accounting records of the business entity.

### **Purchasing Equipment on Credit**

Sanchez purchased additional office equipment. Office Plus, the store selling the equipment, allows Eli's Consulting Services 60 days to pay the bill. This arrangement is called buying on account. The business has a charge account, or open-account credit, with its suppliers. Amounts that a business must pay in the future are known as accounts payable. The companies or individuals to whom the amounts are owed are called *creditors*.

### **BUSINESS TRANSACTION**

Eli's Consulting Services purchased office equipment on account from Office Plus for \$6,000.

#### **ANALYSIS**



- c. The firm purchased new property (equipment) that cost \$6,000.
- c. The firm owes \$6,000 to Office Plus.

The equation remains in balance.

	Property		=	Financial Interest			
	Cash	+	Equipment	=	Accounts Payable	+	Trayton Eli, Capital
Previous balances	\$95,000	+	\$ 5,000	=			\$100,000
(c) Purchased equip.		+	6,000	=			
(c) Incurred debt				=	+\$6,000		
New balances	\$95,000	+	\$11,000	=	\$6,000	+	\$100,000

Office Plus is willing to accept a claim against Eli's Consulting Services until the bill is paid. Now there are two different financial interests or claims against the firm's property—the creditor's claim (Accounts Payable) and the owner's claim (Trayton Eli, Capital). Notice that