



TENTH EDITION

# Financial Accounting

HARRISON . HORNGREN . THOMAS

# Financial Accounting

Tenth Edition

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Composition: S4Carlisle Publishing Services  
Printer/Binder: Courier/Kendallville  
Cover Printer: Lehigh-Phoenix Color/  
Hagerstown  
Typeface: 10/12 Caslon

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Library of Congress Cataloging-in-Publication Data  
Harrison, Walter T.

Financial accounting / Walter T. Harrison Jr., Baylor University, Charles T. Horngren, Stanford University, C. William (Bill) Thomas, Baylor University. — Tenth edition.

pages cm

Includes index.

ISBN-13: 978-0-13-342753-0

ISBN-10: 0-13-342753-6

1. Accounting. I. Horngren, Charles T., 1926- II. Thomas, C. William. III. Title.

HF5636.H37 2015

657—dc23

2013042426

10 9 8 7 6 5 4 3 2 1

**PEARSON**

ISBN 10: 0-13-342753-6

ISBN 13: 978-0-13-342753-0

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Professor Harrison, recipient of numerous teaching awards from student groups as well as from university administrators, has also taught at Cleveland State Community College, Michigan State University, the University of Texas, and Stanford University.

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Professor Harrison has lectured in several foreign countries and published articles in numerous journals, including *Journal of Accounting Research*, *Journal of Accountancy*, *Journal of Accounting and Public Policy*, *Economic Consequences of Financial Accounting Standards*, *Accounting Horizons*, *Issues in Accounting Education*, and *Journal of Law and Commerce*.

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A certified public accountant, Horngren served on the Accounting Principles Board for six years, the Financial Accounting Standards Board Advisory Council for five years, and the Council of the American Institute of Certified Public Accountants for three years. For six years he served as a trustee of the Financial Accounting Foundation, which oversees the Financial Accounting Standards Board and the Government Accounting Standards Board.

Horngren is a member of the Accounting Hall of Fame.

A member of the American Accounting Association, Horngren was its president and its director of research. He received its first annual Outstanding Accounting Educator Award.

The California Certified Public Accountants Foundation gave Horngren its Faculty Excellence Award and its Distinguished Professor Award. He was the first person to have received both awards.

The American Institute of Certified Public Accountants presented its first Outstanding Educator Award to Horngren.

Horngren was named Accountant of the Year, in Education, by the national professional accounting fraternity, Beta Alpha Psi.



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Thomas is the author of textbooks in auditing and financial accounting, as well as many articles in auditing, financial accounting and reporting, taxation, ethics and accounting education. His scholarly work focuses on the subject of fraud prevention and detection, as well as ethical issues among accountants in public practice. His most recent publication of national prominence is "The Rise and Fall of the Enron Empire" which appeared in the April 2002 *Journal of Accountancy*, and which was selected by Encyclopedia Britannica for inclusion in its *Annals of American History*. He presently serves as both technical and accounting and auditing editor of *Today's CPA*, the journal of the Texas Society of Certified Public Accountants, with a circulation of approximately 28,000.

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In memory of *Charles T. Horngren* 1926–2011

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

For our wives,

*Nancy and Mary Ann*

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# PREFACE

## CHANGES FOR THE TENTH EDITION

In general, the Tenth Edition content has been substantially redesigned and enhanced:

- The text font has been enlarged from the Ninth Edition to Tenth Edition to make the text easier to read.
- Chapter openers now only take up one or two pages, with a small silhouetted image of the spotlight company.
- Most financial statements, general ledger, and journal entries have been converted to Excel.
- Special sections called Try It in Excel have been added to every chapter, giving students explicit instructions as to how to access the chapter focus company's most recent financial statements in Excel from the website of the U.S. Securities and Exchange Commission ([www.sec.gov](http://www.sec.gov)).
- Other sections of most chapters give explicit instructions on how to build Excel templates that streamline and simplify various accounting tasks. These tasks include preparation of the adjusted trial balance worksheet, preparation of financial statements, computation of depreciation by various methods, and computation of effective-interest bond discount and premium amortization.
- In all chapters, a new “focus on analysis” company, Yum! Brands, Inc., was selected to replace Radio Shack. Selections of the financial statement appear in Appendix B.
- Demo Docs are removed from the text and are now relocated to MyAccountingLab.

Within Chapters 1 through 3:

- Chapter discussions were revised to be more integrative, using a continuing example of one company that carries through all three chapters.
- Excel is used as a facilitating tool to both prepare and analyze financial statements. Excel data files are available for problems in the end of chapter material for these chapters, also incorporating them into MyAccountingLab.
- Summary problems for each of these three chapters are reworked using the Excel format.

Below are the content changes to the Tenth Edition, listed chapter-by-chapter:

Chapter 1

- Chapter Opener: Spotlight company changed to The Gap, Inc.
- Provides detailed instructions as to how to access current financial statements of The Gap, Inc. in Excel on the website of the U. S. Securities and Exchange Commission (SEC).
- Real World Financial Statement changed to The Gap, Inc. and used to illustrate the interrelationships of the financial statements.
- Added coverage of the new financial reporting framework for small and midsize entities that are not public and that have no intention of going public.
- Updated information on international financial reporting standards (IFRS) in light of the more recent trend toward convergence rather than adoption of IFRS on the part of U.S. public companies.
- Chapter contains eight simulated Excel exercises and problems, gradable Excel exercises and problems in MyAccountingLab.

Chapter 2

- Chapter Opener: Spotlight company changed to Whole Foods Market, Inc.
- Real World company, Freddy's Auto Service, Inc., is used to illustrate recording of hypothetical transactions and posting entries.
- Provides instructions on how to access current financial statements of Whole Foods Market, Inc. in Excel on the website of the U. S. Securities and Exchange Commission (SEC).

- Provides detailed instructions as to how to prepare a financial statement in worksheet format using Excel.
- Detailed instructions provided as to how to prepare a trial balance using Excel.
- End of Chapter Summary Problem: Transactional analysis company name changed from Genie Car Wash, Inc. to Magee Service Center, Inc.
- Simulated Excel exercises and problems increased from two to six.

#### Chapter 3

- Provides instructions on how to access current financial statements of Starbucks Corporation in Excel on the website of the U. S. Securities and Exchange Commission (SEC).
- Provides detailed instructions as to how to prepare an adjusted trial balance worksheet using Excel.
- End of Chapter Summary Problem: Transactional analysis company name changed from Genie Car Wash, Inc. to Badger Ranch, Inc.
- Simulated Excel exercises and problems increased from 9 to 11.

#### Chapter 4

- Chapter Opener: Changed name of Spotlighted Cooking the Books company to Mid-Atlantic Manufacturing Company.
- Updated internal control discussion.
- Emphasized use of electronic bank reconciliations.
- Detailed instructions provided on how to prepare a cash budget using Excel.
- Two simulated Excel problems have been added.

#### Chapter 5

- Chapter Opener: Spotlight company changed to Apple, Inc.
- Provides detailed instructions on how to access current financial statements of Apple, Inc. in Excel on the website of the U. S. Securities and Exchange Commission (SEC).
- Updated and clarified discussion of accounting for short-term investments, illustrating distinction between accounting for trading securities and accounting for available-for-sale securities.
- Updated discussion on revenue recognition to correspond with new GAAP/IFRS standard.
- Simulated Excel exercises and problems increased from seven to eight.

#### Chapter 6

- Chapter Opener: Changed Spotlight company to Family Dollar Stores, Inc.
- Provides detailed instructions as to how to access current financial statements of Family Dollar Stores, Inc. in Excel on the website of the U. S. Securities and Exchange Commission (SEC).
- Expanded coverage (including journal entries) of how to account for purchase returns and discounts.
- Simulated Excel exercises and problems increased from 9 to 10.

#### Chapter 7

- Chapter Opener: Retained Spotlight company, FedEx Corporation, and updated information used in chapter using the FedEx Corporation 2012 Annual Report.
- Provides detailed instructions as to how to access current financial statements of FedEx Corporation in Excel on the website of the U. S. Securities and Exchange Commission (SEC).
- Changed exhibits on three depreciation methods to Excel format, with detailed instructions as to how to use Excel to compute depreciation expense, accumulated depreciation, and asset book value.
- Simulated Excel exercises and problems increased from 9 to 11.

#### Chapter 8

- Chapter Opener: Retained spotlight company, Intel Corporation and updated information in chapter using the 2012 Intel Corporation Annual Report.

- Provides detailed instructions as to how to access current financial statements of Intel Corporation in Excel on the website of the U. S. Securities and Exchange Commission (SEC).
- Simulated Excel exercises and problems increased from 9 to 10.

#### Chapter 9

- Chapter Opener: Retained Spotlight company, Southwest Airlines, and updated information in chapter using the Southwest Airlines 2012 Annual Report.
- Provides detailed instructions as to how to access current financial statements of Southwest Airlines Company in Excel on the website of the U. S. Securities and Exchange Commission (SEC).
- Modified chapter exhibits for bond discount and premium amortization to Excel format, and provided detailed instructions as to how to prepare effective-interest amortization tables in Excel format.
- Simulated Excel exercises and problems increased from eight to nine.

#### Chapter 10

- Chapter Opener: Changed Spotlight company to The Home Depot, Inc., and updated information in chapter using the Home Depot, Inc. 2012 Annual Report.
- Provides detailed instructions as to how to access current financial statements of The Home Depot, Inc. in Excel on the website of the U. S. Securities and Exchange Commission (SEC).
- Relocated coverage of Statement of Stockholders' Equity from Chapter 11 to Chapter 10 and changed end of chapter material to reflect this modified coverage.
- Simulated Excel exercises and problems increased from five to six.

#### Chapter 11

- Chapter Opener: Retained Spotlight company, The Gap, Inc. and updated information in chapter using the The Gap, Inc. 2012 Annual Report.
- Provides detailed instructions as to how to access current financial statements of The Gap, Inc. in Excel on the website of the U. S. Securities and Exchange Commission (SEC).
- Moved coverage of Statement of Stockholders' Equity to Chapter 10 and deleted related end of chapter material in Chapter 11.
- Added a section on non-financial measures of performance, such as corporate social responsibility.
- Added a section on use of footnote disclosures in financial analysis, including segment information. Added end-of-chapter materials to reflect this expanded coverage.
- Simulated Excel exercises and problems increased from five to seven.

#### Chapter 12

- Chapter Opener: Retained Spotlight company, Google, Inc. and updated information in chapter using the Google 2012 Annual Report.
- Provides detailed instructions as to how to access current financial statements of Google, Inc. in Excel on the website of the U. S. Securities and Exchange Commission (SEC).
- Simulated Excel exercises and problems increased from four to seven.

#### Chapter 13

- Chapter Opener: Retained Spotlight company, Amazon.com, Inc. and updated information in chapter using the Amazon.com 2012 Annual Report.
- Provides detailed instructions as to how to access current financial statements of Amazon.com, Inc. in Excel on the website of the U. S. Securities and Exchange Commission (SEC).
- Provided detailed instructions as to how to use Excel to perform both horizontal and vertical analyses of comparative financial statements.
- Expanded analysis of Amazon.com, Inc., providing comprehensive tables of key financial ratios in Excel format.
- Simulated Excel exercises and problems increased from six to nine.

## »» VISUAL WALK-THROUGH

**NEW!**

### Try It in Excel

Describes line-by-line how to retrieve and prepare accounting information (such as adjusted trial balance worksheets, ratio computations, depreciation schedules, bond discount and premium amortization schedules, and financial statement analysis) in Excel.

### »» Try It in Excel

If you built the straight-line depreciation schedule in Exhibit 7-5 with Excel, changing the spreadsheet for units-of-production depreciation is a snap.

Steps 1–3 and 6–8 are identical. Only steps 4 and 5, dealing with columns C and D, change. You might want to start by opening the straight-line schedule you prepared and saving it under another name: “units-of-production depreciation.” Next, change the column headings for column C and column D. Column C should be labeled “Rate per unit.” Column D should be labeled “Number Units.” Assuming you do this, here are the modified steps 4 and 5 of the process we used before:

4. In column C, calculate a per-unit (rather than per-year as we did with straight-line) depreciation rate by dividing the depreciable cost (\$41,000 – \$1,000 in Exhibit 7-4) by the number of units (100,000 miles) to get a fixed depreciation rate per mile (\$0.40). Enter .4 in cell C3 and copy down through cell C7.
5. In cells D3 through D7, respectively, enter the number of miles driven in years 1 through 5 of the asset’s useful life. These are 20,000, 30,000, 25,000, 15,000, and 10,000, respectively.

All of the other amounts in the table will automatically recalculate to reflect units-of-production depreciation, exactly as shown in Exhibit 7-6. ■


**Excel! Integrated Throughout Text!**

Excel-based financial statements are used so that students will familiarize themselves with the accounting information format actually used in the business world.

FedEx Corporation Consolidated Balance Sheets (Partial, Adapted)		
(In millions of \$)		
	May 31, 2012	May 31, 2011
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 2,843	\$ 2,328
Receivables, less allowances of \$178 and \$182	4,704	4,581
Spare parts, supplies and fuel, less allowances	440	437
Deferred income taxes	533	610
Prepaid expenses and other	536	329
Total current assets	9,056	8,285
<b>PROPERTY AND EQUIPMENT, AT COST</b>		
Aircraft and related equipment	14,360	13,146
Package handling and ground support equipment	5,912	5,591
Computer and electronic equipment	4,646	4,408
Vehicles	3,654	3,294
Facilities and other	7,592	7,247
Gross property and equipment	36,164	33,686
Less accumulated depreciation and amortization	(18,916)	(18,143)
Net property and equipment	17,248	15,543
<b>OTHER LONG-TERM ASSETS</b>		
Goodwill	2,387	2,326
Other assets	1,212	1,231
Total other long-term assets	3,599	3,557
<b>TOTAL ASSETS</b>	<b>\$ 29,903</b>	<b>\$ 27,385</b>

FedEx Corporation Statement of Cash Flows (Partial, Adapted) Year Ended May 31, 2012	
(In millions)	
<b>Cash Flows from Operating Activities:</b>	
Net income	\$ 2,032
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	2,113
Other items (summarized)	690
Net cash provided by operating activities	4,835
<b>Cash Flows from Investing Activities:</b>	
Capital expenditures	(4,007)
Other asset acquisitions and dispositions, net	(42)
Net cash (used in) investing activities	(4,049)
<b>Cash Flows from Financing Activities:</b>	
Net cash (used in) financing activities	(244)
Effect of exchange rate changes on cash	(27)
<b>Net (increase) in cash and cash equivalents</b>	<b>515</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>2,328</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 2,843</b>



**NEW!** Accounting Cycle Examples Simplified

Accounting Cycle Tutorial (ACT)

For more practice and review of accounting cycle concepts in chapters 1 through 3, use ACT, the Accounting Cycle Tutorial, online at [www.myaccountinglab.com](http://www.myaccountinglab.com). The Tutorial portion of ACT reviews major concepts, the Application provides practice exercises, and the Glossary reviews important terms.

A1	A	B	C	D	E
<b>The Gap, Inc.</b>					
<b>Consolidated Statement of Income (Adapted)</b>					
<b>12 Months Ended January 28, 2012</b>					
1					
2	Net sales	\$ 14,549			
3	Expenses	13,716			
4	Net income	\$ 833			
5					
<b>Consolidated Statement of Retained Earnings (Adapted)</b>					
1					
2	Beginning retained earnings	\$ 11,767			
3	Net income	833			
4	Cash dividends declared	(236)			
5	Ending retained earnings balance	\$ 12,364			
6					
<b>Consolidated Balance Sheet (Adapted)</b>					
1					
2	Assets				
3	Cash and cash equivalents	\$ 1,885			
4	All other assets	5,537			
5	Total assets	\$ 7,422			
6	Liabilities				
7	Total liabilities	\$ 4,667			
8	Stockholders' Equity				
9	Common stock and additional paid-in capital	2,922			
10	Retained earnings	12,364			
11	Other equity	(12,531)			
12	Total stockholders' equity	2,755			
13	Total liabilities and stockholders' equity	\$ 7,422			
14					
<b>Consolidated Statement of Cash Flows (Adapted)</b>					
1					
2	Net cash provided by operating activities	\$ 1,363			
3	Net cash used in investing activities	(154)			
4	Net cash used in financing activities	(602)			
5	Effect of foreign exchange rate fluctuations on cash	17			
6	Net increase (decrease) in cash and cash equivalents	324			
7	Cash and cash equivalents, beginning of year	1,561			
8	Cash and cash equivalents, end of year	\$ 1,885			
9					

**NEW!** Excel Opportunities in MyAccountingLab Increased

Now students can get even more real-world Excel practice in their classes in every chapter:



- Instructors have the option to assign students end-of-chapter questions that can be completed in an Excel-simulated environment. These selected questions are indicated with a green Excel marginal icon.
- Questions will be auto-graded, reported to, and visible in the grade book.
- Excel remediation will be available to students.

**E8-29B.** (Learning Objective 4: Prepare a consolidated balance sheet) Zeta, Inc., owns Theta Corp. These two companies' individual balance sheets follow:

A1	A	B	C	D	E
<b>Zeta, Inc.</b>					
<b>Consolidation Work Sheet</b>					
1					
2		Zeta, Inc.	Theta Corp.	Elimination	
3	Cash	\$ 48,000	\$ 18,000	Debit	Credit
4	Accounts receivable, net	82,000	58,000		
5	Note receivable from Zeta	—	33,000		
6	Inventory	54,000	83,000		
7	Investment in Theta	119,000	—		
8	Plant assets, net	288,000	98,000		
9	Other assets	29,000	11,000		
10	Total	\$ 620,000	\$ 301,000		
11					
12					
13	Accounts payable	\$ 49,000	\$ 35,000		
14	Notes payable	152,000	23,000		
15	Other liabilities	78,000	124,000		
16	Common stock	107,000	82,000		
17	Retained earnings	234,000	37,000		
18	Total	\$ 620,000	\$ 301,000		
19					

**Requirements**

1. Prepare a consolidated balance sheet of Zeta, Inc. It is sufficient to complete the consolidation work sheet. Use Exhibit 8-7 as a model.
2. What is the amount of stockholders' equity for the consolidated entity?

**E8-30B.** (Learning Objective 1: Analyze and report held-to-maturity security transactions) Assume that on September 30, 2014, Rentex, Inc., paid 96 for 7% bonds of Oleander Corporation as a long-term held-to-maturity investment. The maturity value of the bonds will be \$80,000 on September 30, 2019. The bonds pay interest on March 31 and September 30.

**P4-49A.** (Learning Objective 5: Construct and use a cash budget) Herman Knorr, chief financial officer of Dallas Wireless, is responsible for the company's budgeting process. Knorr's staff is preparing the Dallas Wireless cash budget for 2015. A key input to the budgeting process is last year's statement of cash flows, which follows (amounts in thousands):

A1	A	B	C
<b>Dallas Wireless</b>			
<b>Statement of Cash Flows</b>			
<b>For the Year Ended December 31, 2014</b>			
1			
2	(In thousands)		
3	<b>Cash Flows from Operating Activities</b>		
4	Collections from customers	\$ 61,000	
5	Interest received	400	
6	Cash payments for inventory	(46,000)	
7	Cash payments for operating expenses	(13,200)	
8	Net cash provided by operating activities	2,200	
9	<b>Cash Flows from Investing Activities</b>		
10	Purchases of equipment	(4,500)	
11	Purchases of investments	(800)	
12	Sales of investments	900	
13	Net cash used for investing activities	(4,400)	
14	<b>Cash Flows from Financing Activities</b>		
15	Payment of long-term debt	(200)	
16	Issuance of stock	1,400	
17	Payment of cash dividends	(500)	
18	Net cash provided by financing activities	700	
19	<b>Cash</b>		
20	Increase (decrease) in Cash	(1,500)	
21	Cash, beginning of year	3,100	
22	Cash, end of year	\$ 1,600	
23			

**Requirements**

1. Prepare the Dallas Wireless cash budget for 2015. Date the budget simply "2015," and denote the beginning and ending cash balances as "beginning" and "ending." Assume the company expects 2015 to be the same as 2014, but with the following changes:
  - a. In 2015, the company expects a 25% increase in collections from customers and a 26% increase in purchases of inventory.
  - b. There will be no sales of investments in 2015.
  - c. Dallas Wireless plans to issue no stock in 2015.
  - d. Dallas Wireless plans to end the year with a cash balance of \$1,600.

## > Stop & Think...

How would FedEx divide a \$120,000 lump-sum purchase price for land, building, and equipment with estimated market values of \$40,000, \$95,000, and \$15,000, respectively?

**Answer:**

	Estimated Market Value	Percentage of Total Market Value	×	Total Cost	=	Cost of Each Asset
Land.....	\$ 40,000	26.7%*	×	\$120,000	=	\$ 32,040
Building.....	95,000	63.3%	×	\$120,000	=	75,960
Equipment.....	15,000	10.0%	×	\$120,000	=	12,000
Total .....	<u>\$150,000</u>	<u>100.0%</u>				<u>\$120,000</u>

\*\$40,000/\$150,000 = 0.267, and so on

### Stop & Think...

Found within various points of a chapter, this tool includes a question-and-answer snapshot asking students to apply what they just learned.

## Challenge Problem

**P11-62.** (Learning Objectives 1, 2, 4, 5: Analyze how various transactions affect the income statement and EPS) Aerostar, Inc., operates as a retailer of casual apparel. A recent, condensed income statement for Aerostar follows:

	A	B	C
1	<b>Income Statement</b>		
2	<b>For the Year Ended January 31, 2012</b>		
3	Sales revenue		\$ 2,400,000
4	Operating expenses:		
5	Cost of goods sold	\$ 1,500,000	
6	Selling and administrative expenses	500,000	2,000,000
7	Operating income		400,000
8	Other revenue (expenses)		50,000
9	Income before tax		450,000
10	Income tax expense (40% tax rate)		180,000
11	Net income		\$ 270,000
12	Earnings per share (50,000 shares)		\$ 5.40

### Requirements

- Assume that the following transactions were inadvertently omitted at the end of the year. Using the categories in the table, indicate the effect of each of the transactions on each category; use + for increase, - for decrease, and NE for no effect. Provide dollar amounts for each column except Earnings per Share.

Transaction	Operating Income	Income Before Tax	Net Income	Earnings per Share
Unadjusted balances	400,000	450,000	270,000	
a.				
b.				
c.				
d.				
e.				
f.				
g.				
h.				
i.				
Totals				

- Purchased inventory on account from a German company. The price was 100,000 euros. The exchange rate of the euro was \$1.47.
- Sold inventory on account, \$120,000 (cost of inventory, \$75,000).

### Critical Thinking Challenge Problems Increased!

Additional problems developed to provide students with the opportunity for applied critical thinking.

*Dear Valued Colleagues,*

Welcome to the Tenth Edition of *Financial Accounting*. We are grateful for your support as an adopter of our text as we celebrate over 20 years of success in the market. The Tenth Edition of *Financial Accounting* has been improved in many respects, as explained below.

Several editions ago, we shifted the focus of *Financial Accounting* more toward meeting the needs of users of accounting information for a more balanced presentation. Despite this shift, we still cover the “basic nuts-and-bolts of financial accounting”—the accounting cycle and financial statement preparation. In this edition, we added more discussion of key financial ratios, detailing what those ratios measure and how they are used.

**Try It in Excel.** As educators, we often have conversations with those who recruit our students. Based on these conversations, we found that students often complete their study of financial accounting without sufficient knowledge of how to use Excel to perform accounting tasks. To respond to this concern, we have adapted most of the illustrations of key accounting tasks in the book to Excel format and have added new sections in key chapters entitled “Try It in Excel,” which describe line-by-line how to retrieve and prepare accounting information (such as adjusted trial balance worksheets, ratio computations, depreciation schedules, bond discount and premium amortization schedules, and financial statement analysis) in Excel format. In addition, we have designated many applications to homework exercises and problems that can be completed in Excel and that are automatically graded in MyAccountingLab.

**Student success.** We feel we have the most advanced student learning materials in the market with MyAccountingLab. These include automatically graded homework, DemoDocs, learning aid videos, and audio PowerPoints. We believe that the use of MyAccountingLab homework will greatly enhance student understanding of accounting with its instantaneous feedback. MyAccountingLab makes the study of financial accounting a more interactive and fun experience for students.

**Professor expectations.** As professors, we know that you want a book that contains the most relevant and technically correct content available. We also know that you want excellent end-of-chapter material that is as up-to-date and error-free as possible. We reviewed and created the end-of-chapter questions, exercises, problems, and cases taking into account the types of assignments we ourselves use in class and assign as homework. Based on comments from adopters, we have thoroughly reviewed every end-of-chapter exercise and problem, with the goal of eliminating redundancy and adding relevance. The textbook and solutions manual have been put through a rigorous accuracy check to ensure that they are as complete and error-free as possible.

We welcome your comments and suggestions. Please don't hesitate to send feedback about this book to: [HorngrensAccounting@pearson.com](mailto:HorngrensAccounting@pearson.com)

*Walter Harrison  
Bill Thomas*

## STUDENT AND INSTRUCTOR RESOURCES

### For Students

#### MyAccountingLab

MyAccountingLab online Homework and Assessment Manager includes:

- Pearson eText
- Simulated Excel exercises and problems
- Audio and Student PowerPoint® Presentations
- Data Files
- Accounting Cycle Tutorial
- Videos
- MP3 Files with Chapter Objectives and Summaries
- Demo Docs
- Flash Cards
- Working Papers

#### Student resource website: [pearsonhighered.com/harrison](http://pearsonhighered.com/harrison)

This website contains the following:

- Data Files: Select end-of-chapter problems have been set up in different software applications, including Excel, QuickBooks 2012, and general ledger software.
- Working Papers

### For Instructors

#### MyAccountingLab

#### Instructor Resource Center: [pearsonhighered.com/accounting](http://pearsonhighered.com/accounting)

For the instructor's convenience, the instructor resources are available on CD or can be downloaded from the textbook's catalog page ([pearsonhighered.com/harrison](http://pearsonhighered.com/harrison)) and MyAccountingLab.

Available resources include the following:

- Online Instructor's Manual: Includes chapter summaries, teaching tips provided by reviewers, pitfalls for new students, and "best of" practices from instructors across the country.

Additional resources offered in this online manual include the following:

- Introduction to the Instructor's Manual with a list of resources and a roadmap to help navigate what's available in MyAccountingLab.
- Instructor tips for teaching courses in multiple formats—traditional, hybrid, or online.
- "First Day of Class" student handout that includes tips for success in the course, as well as an additional document that shows students how to register and log on to MyAccountingLab.
- Sample syllabi for 10- and 16-week courses.
- Chapter overview and teaching outline that includes a brief synopsis and overview of each chapter.
- Key topics that walk instructors through what material to cover and what examples to use when addressing certain items within the chapter.
- Student chapter summary handout.
- Assignment grid that outlines all end-of-chapter exercises and problems, the topic being covered in that particular exercise or problem, estimated completion time, level of difficulty, and availability in Excel templates.
- Ten-minute quizzes that quickly assess students' understanding of the chapter material.
- Demonstration Problems for use in class.

- Instructor's Solutions Manual: Contains solutions to all end-of-chapter questions, including short exercises, exercises, and problems.
- TestBank: Includes more than 3,000 questions. Both objective-based questions and computational problems are available.
- PowerPoint Presentations: These presentations help facilitate classroom discussion by demonstrating where the numbers come from and what they mean to the concept at hand. Includes NEW Demonstration Problem slides:
  - Instructor PowerPoint Presentations—complete with lecture notes
  - Student PowerPoint Presentations
  - Audio Narrated PowerPoint Presentations
  - Clicker Response System (CRS) PowerPoint Presentations
- Working Papers and Solutions in Excel and PDF Format
- Image Library
- Data and Solution Files: Select end-of-chapter problems have been set up in different software applications, including QuickBooks 2012 and General Ledger. Corresponding solution files are also provided.

## ACKNOWLEDGMENTS

A special thank you to Betsy Willis and Mignon Worman Tucker for their dedication throughout the project. Thank you to Carolyn Streuly for her help with accuracy checking and to Jill Kolongowski for managing the supplements.

Thanks also to Carolyn Streuly for preparing the Test Bank, to Betsy Willis for preparing the Instructor's Resource Manual, and to Coby Harmon for preparing the PowerPoint presentation.

We would like to thank the following reviewers for the Tenth Edition for their valuable input: Mary Ewanechko, MBA, Monroe Community College; Dr. Geoffrey J. Gurka, PhD, Colorado Mesa University; Maria U. Ku, CPA, Accounting Instructor, Ohlone College & Diablo Valley College; Molly McFadden-May, MT (Master of Taxation), Tulsa Community College; and Sue Van Boven, Paradise Valley Community College.

In revising previous editions of *Financial Accounting*, we had the help of instructors from across the country who have participated in online surveys, chapter reviews, and focus groups. Their comments and suggestions for both the text and the supplements have been a great help in planning and carrying out revisions, and we thank them for their contributions.

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 Technical College  
 Allan Drebin, Northwestern University  
 Carolyn Dreher, Southern Methodist University  
 Emily Drogdt, Grand Valley State University  
 Carol Dutton, South Florida Community College  
 James Emig, Villanova University, PA  
 Ellen Engel, University of Chicago  
 Alan Falcon, Loyola Marymount University, CA  
 Janet Farler, Pima Community College, AZ  
 Dr. Andrew Felo, Penn State Great Valley  
 Ken Ferris, Thunderbird College, AZ  
 Dr. Mary Fischer, Professor of Accounting, The University  
 of Texas at Tyler  
 Dr. Caroline Ford, Baylor University  
 Clayton Forester, University of Minnesota  
 Lou Fowler, Missouri Western State College  
 Timothy Gagnon, Northeastern University  
 Terrie Gehman, Elizabethtown College, PA  
 Lucille Genduso, Nova Southeastern University, FL  
 Alvin Gerald Smith, University of Northern Iowa  
 Frank Gersich, Monmouth College, IL  
 Bradley Gillespie, Saddleback College, CA  
 Lisa Gillespie, Loyola University, Chicago  
 Marvin Gordon, University of Illinois at Chicago  
 Brian Green, University of Michigan at Dearborn  
 Anthony Greig, Purdue University  
 Ronald Guidry, University of Louisiana at Monroe  
 Konrad Gunderson, Missouri Western State College  
 William Hahn, Southeastern College, FL  
 Jack Hall, Western Kentucky University  
 Gloria Halpern, Montgomery College, MD  
 Penny Hanes, Associate Professor, Mercyhurst College  
 Dr. Heidi Hansel, Kirkwood Community College  
 Kenneth Hart, Brigham Young University, Idaho  
 Al Hartgraves, Emory University  
 Michael Haselkorn, Bentley University  
 Thomas Hayes, University of North Texas  
 Larry Hegstad, Pacific Lutheran University, WA  
 Candy Heino, Anoka-Ramsey Community College, MN  
 Mary Hollars, Vincennes University



- Anit Hope, Tarrant County College, TX  
Thomas Huse, Boston College  
Fred R. Jex, Macomb Community College, MI  
Grace Johnson, Marietta College  
Celina Jozsi, University of South Florida  
John Karayan, Woodbury University  
Beth Kern, Indiana University, South Bend  
Irene Kim, The George Washington University  
Hans E. Klein, Babson College, MA  
Robert Kollar, Duquesne University  
Willem Koole, North Carolina State University  
Emil Koren, Hillsborough Community College, FL  
Dennis Kovach, Community College of Allegheny  
County–North Campus  
Ellen Landgraf, Loyola University Chicago  
Howard Lawrence, Christian Brothers University, TN  
Barry Leffkov, Regis College, MA  
Elliott Levy, Bentley University  
Chao-Shin Liu, Notre Dame  
Barbara Lougee, University of California, Irvine  
Heidemarie Lundblad, California State University,  
Northridge  
Joseph Lupino, Saint Mary's College of California  
Anna Lusher, West Liberty State College, WV  
Harriet Maccracken, Arizona State University  
Constance Malone Hylton, George Mason University  
Carol Mannino, Milwaukee School of Engineering  
Herb Martin, Hope College, MI  
Aziz Martinez, Harvard University, Harvard  
Business School  
Anthony Masino, Queens University / NC Central  
Lizbeth Matz, University of Pittsburgh, Bradford  
Bruce Maule, College of San Mateo  
Michelle McEacharn, University of Louisiana at Monroe  
Nick McGaughey, San Jose State University, CA  
Allison McLeod, University of North Texas  
Scott Miller, Gannon University  
Cynthia J. Miller, Gatton College of Business &  
Economics, University of Kentucky  
Cathleen Miller, University of Michigan–Flint  
Mary Miller, University of New Haven  
Mark Miller, University of San Francisco, CA  
Frank Mioni, Madonna University, MI  
Dr. Birendra (Barry) K. Mishra, University of California,  
Riverside  
Theodore D. Morrison III, Wingate University, NC  
Lisa Nash, Vincennes University  
Rosemary Nurre, College of San Mateo  
Bruce L. Oliver, Rochester Institute of Technology  
Stephen Owen, Hamilton College  
Charles Pedersen, Quinsigamond Community College, MA  
Richard J. Pettit, Mountain View College  
George Plesko, Massachusetts Institute of Technology  
David Plumlee, University of Utah  
Gregory Prescott, University of South Alabama  
Rama Ramamurthy, College of William and Mary  
Craig Reeder, Florida A&M University  
Barb Reeves, Cleary University  
Bettye Rogers–Desselle, Prairie View A&M University, TX  
Darren Roulstone, University of Chicago  
Norlin Rueschhoff, Notre Dame  
Anwar Salimi, California State Polytechnic  
University, Pomona  
Philippe Sammour, Eastern Michigan University  
Angela Sandberg, Jacksonville State University, AL  
George Sanders, Western Washington University, WA  
Betty Saunders, University of North Florida  
Albert A Schepanski, University of Iowa  
William Schmul, Notre Dame  
Arnie Schnieder, Georgia Tech at Atlanta  
Allmen School of Accountancy, University of Kentucky  
Gim Seow, University of Connecticut  
Itzhak Sharav, CUNY–Lehman Graduate School  
of Business  
Allan Sheets, International Business College  
Lily Sieux, California State University, East Bay  
James Smith, Community College of Philadelphia  
Virginia Smith, Saint Mary's College of California  
Beverly Soriano, Framingham State College, MA  
Vic Stanton, Stanford University  
Carolyn R. Stokes, Frances Marion University, SC  
J. B. Stroud, Nicholls State University, LA  
Gloria J. Stuart, Georgia Southern University  
Al Taccone, Cuyamaca College, CA  
Diane Tanner, University of North Florida  
Martin Taylor, University of Texas at Arlington  
Howard Toole, San Diego State University  
Vincent Turner, California State Polytechnic University,  
Pomona  
Marcia Veit, University of Central Florida  
Bruce Wampler, Louisiana State University, Shreveport  
Suzanne Ward, University of Louisiana at Lafayette  
Craig Weaver, University of California, Riverside  
Frederick Weis, Claremont McKenna College, CA  
Frederick Weiss, Virginia Wesleyan College  
Betsy Willis, Baylor University, Waco, TX  
Ronald Woan, Indiana University of Pennsylvania  
Allen Wright, Hillsborough Community College, FL  
Dr. Jia Wu, University of Massachusetts, Dartmouth  
Yanfeng Xue, George Washington University  
Barbara Yahvah, University of Montana–Helena  
Myung Yoon, Northeastern Illinois University  
Lin Zeng, Northeastern Illinois University  
Tony Zordan, University of St. Francis, IL

# 1

## The Financial Statements

### ► SPOTLIGHT: The Gap, Inc.

Where do you go when you need to shop for casual clothes and accessories? Perhaps you've recently needed to replace or replenish your supply of jeans, casual shirts, tees, or sweaters in order to return to campus this fall. How about a new jacket or a pair of khakis and a belt to complete your look for the first campus party? Your parents have probably been buying clothing for you at some Gap-affiliated store (GapKids, Gap, Banana Republic, or Old Navy) since you were a baby! Based in San Francisco, California, The Gap, Inc. has been offering quality clothing and accessories to its customers since 1969. Its global portfolio of distinct brands

crosses multiple demographic and geographic boundaries, with products designed for customers from a wide range of lifestyles and incomes. The company has a network of almost 3,500 company-operated and franchise store locations in the United States, Canada, the United Kingdom, France, Ireland, Japan, China, and Italy. The Gap, Inc.'s products are also available to customers in over 90 countries through company-owned websites. It operates under the brand names of Gap, babyGap, GapKids, Banana Republic, Old Navy, Piperlime, and Althea. Something you may not know is that The Gap, Inc., has been a top-rated corporate citizen several times since 2000 in a yearly report produced by *Corporate Responsibility Magazine*. In 2012, the company ranked #13 overall and #4 in employee relations on the magazine's list of 100 Best Corporate Citizens, measuring such areas as the environment, climate change, human rights, and philanthropy.

As you can see, The Gap, Inc., sells lots of clothing and accessories—its net sales were about \$14.5 billion for the year ended January 28, 2012 (see line 4 of The Gap, Inc.'s Consolidated Statements of Income on page 2). On these net sales, The Gap, Inc., earned net income of \$833 million for the year ended January 28, 2012 (line 10).

Q-Images/Alamy



	A	B	C	D	E
	<b>The Gap, Inc.</b>				
1	<b>Consolidated Statements of Income</b>				
2	<b>Adapted, in millions of \$</b>		<b>12 Months Ended</b>		
3		<b>Jan. 28, 2012</b>	<b>Jan. 29, 2011</b>		
4	Net sales	\$ 14,549	\$ 14,664		
5	Cost of goods sold and occupancy expenses	9,275	8,775		
6	Operating expenses	3,836	3,921		
7	Interest (income)/expense, net	69	(14)		
8	Income taxes	536	778		
9	Total expenses	13,716	13,460		
10	Net income	\$ 833	\$ 1,204		
11					

These terms—net sales and net income—may be unfamiliar to you now. But after you read this chapter, you'll be able to use these and other business terms. Welcome to the world of accounting! ●

**Each chapter of this book begins with an actual financial statement.** In this chapter, it's the Consolidated Statements of Income of The Gap, Inc., for the two years ended January 28, 2012 and January 29, 2011. The core of financial accounting revolves around the basic financial statements:

- Income statement (sometimes known as the statement of operations)
- Statement of retained earnings (usually included in the statement of stockholders' equity)
- Balance sheet (sometimes known as the statement of financial position)
- Statement of cash flows

**Financial statements** are the business documents that companies use to report the results of their activities to various user groups, which can include managers, investors, creditors, and regulatory agencies. In turn, these parties use the reported information to make a variety of decisions, such as whether to invest in or loan money to the company. To learn accounting, you must learn to focus on decisions.

In this chapter, we explain generally accepted accounting principles, their underlying assumptions and concepts, and the bodies responsible for issuing accounting standards. We discuss the judgment process that is necessary to making good accounting decisions. We also discuss the contents of the four basic financial statements that report the results of those decisions. In later chapters, we will explain in more detail how to construct the financial statements, as well as how user groups typically use the information contained in them to make business decisions.

## Learning Objectives

- 1. Explain** why accounting is the language of business
- 2. Explain and apply** underlying accounting concepts, assumptions, and principles
- 3. Apply** the accounting equation to business organizations
- 4. Evaluate** business operations through the financial statements
- 5. Construct** financial statements and **analyze** the relationships among them
- 6. Evaluate** business decisions ethically



### Try It in Excel®

You can access the most current annual report of The Gap, Inc., in Excel® format at [www.sec.gov](http://www.sec.gov). Using the “filings” link on the toolbar at the top of the page, select “company filings search.” This will take you to the “EDGAR Company Filings” page. Type “Gap” in the company name box, and select “search.” This will produce the “EDGAR Search Results” page showing the company name. Click on the “CIK” link beside the company name. This will pull up all of the reports the company has filed with the SEC. Under the “filing type” box, type “10-K,” and click the “search” box. Form 10-K is the SEC form for the company’s latest annual report. Find the year that you wish to view. Click on the “Interactive Data” box, which takes you to the “View Filing Data” page. Find and click on the “View Excel Document” link at the top of this page. You may choose to either open or download the Excel files containing the company’s most recent financial statements. ■

MyAccountingLab

The Gap, Inc.’s managers make lots of decisions. Which product is selling fastest—khakis, jeans, or casual slacks? Are tees more profitable than collared shirts? Should the company expand operations into Eastern Europe or the Middle East? Accounting information helps companies make these decisions.

Take a look at The Gap, Inc.’s Consolidated Statements of Income on page 2. Focus on net income (line 10). Net income (profit) is the excess of revenues (net sales) over expenses. You can see that The Gap, Inc., earned \$833 million of net income in the year ended January 28, 2012. That’s good news because it means that The Gap, Inc., had \$833 million more revenue (net sales) than expenses for the year.

The Gap, Inc.’s Consolidated Statements of Income present more interesting news. Net sales (line 4) declined by about 0.8% during the period compared with the previous year (from \$14,664 million to \$14,549 million). Furthermore, net income declined by 31% (from \$1,204 million to \$833 million).

Suppose you have \$10,000 to invest. What information would you need before deciding to invest that money in stock of The Gap, Inc.? Let’s see how accounting works.

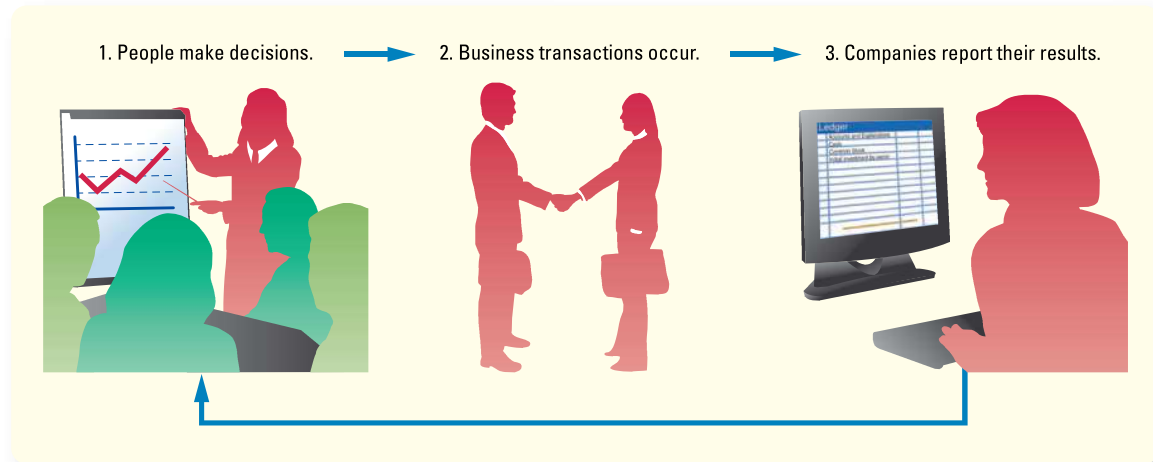
## EXPLAIN WHY ACCOUNTING IS THE LANGUAGE OF BUSINESS

**Accounting** is an information system. It measures business activities, processes data into reports, and communicates results to decision makers. Accounting is “the language of business.” The better you understand the language, the better you can manage your finances, as well as those of your business.

Accounting produces financial statements, which report information about a business. The financial statements measure performance and communicate where a business stands in financial terms. In this chapter we focus on The Gap, Inc. After completing this chapter, you’ll begin to understand financial statements.

Don’t confuse bookkeeping and accounting. Bookkeeping is a mechanical part of accounting, just as arithmetic is a part of mathematics. Exhibit 1-1 on page 4 illustrates the flow of accounting

- 1 Explain** why accounting is the language of business

**Exhibit 1-1** | The Flow of Accounting Information

information and helps illustrate accounting's role in business. The accounting process begins and ends with people making decisions.

### Who Uses Accounting Information?

Decision makers use many types of information; a banker needs information to decide who gets a loan or The Gap, Inc., uses accounting to decide where to locate a new store. Let's see how decision makers use accounting information.

- *Individuals.* People like you manage their personal bank accounts, decide whether to rent an apartment or buy a house, and budget the monthly income and expenditures of their businesses. Accounting provides the necessary information to allow individuals to make these decisions.
- *Investors and creditors.* Investors and creditors provide the money to finance The Gap, Inc. Investors want to know how much income they can expect to earn on an investment. Creditors want to know when and how The Gap, Inc., is going to pay them back. These decisions also require accounting information.
- *Regulatory bodies.* All kinds of regulatory bodies use accounting information. For example, the Internal Revenue Service (IRS) and various state and local governments require businesses, individuals, and other types of organizations to pay income, property, excise, and other taxes. The U.S. Securities and Exchange Commission (SEC) requires companies whose stock is traded publicly to provide it with many kinds of periodic financial reports. All of these reports contain accounting information.
- *Nonprofit organizations.* Nonprofit organizations—churches, hospitals, and charities such as Habitat for Humanity and the Red Cross—base many of their operating decisions on accounting data. In addition, these organizations have to file periodic reports of their activities with the IRS and state governments, even though they may owe no taxes.

### Two Kinds of Accounting: Financial Accounting and Management Accounting

Both *external* and *internal users* of accounting information exist. We can therefore classify accounting into two branches.

**Financial accounting** provides information for decision makers outside the entity, such as investors, creditors, government agencies, and the public. This information must be relevant for the needs of decision makers and must faithfully give an accurate picture of the entity's economic activities. This textbook focuses on financial accounting.

**Management accounting** provides information for managers of The Gap, Inc. Examples of management accounting information include budgets, forecasts, and projections that are used in making the strategic decisions of the entity. Internal information must still be accurate and



relevant for the decision needs of managers. Management accounting is covered in a separate course that usually follows this one.

### Organizing a Business

Accounting is used in every type of business. A business generally takes one of the following forms:

- Proprietorship
- Partnership
- Limited-liability company (LLC)
- Corporation

Exhibit 1-2 compares ways to organize a business.

**Exhibit 1-2** | The Various Forms of Business Organization

	Proprietorship	Partnership	LLC	Corporation
1. <i>Owner(s)</i>	Proprietor—one owner	Partners—two or more owners	Members	Stockholders—generally many owners
2. <i>Personal liability of owner(s) for business debts</i>	Proprietor is personally liable	General partners are personally liable; limited partners are not	Members are <i>not</i> personally liable	Stockholders are <i>not</i> personally liable

**Proprietorship.** A **proprietorship** has a single owner, called the proprietor. Dell Computer started out in the college dorm room of Michael Dell, the owner. Proprietorships tend to be small retail stores or solo providers of professional services—physicians, attorneys, or accountants. Legally, the business *is* the proprietor, and the proprietor is personally liable for all the business’s debts. But for accounting purposes, a proprietorship is a distinct entity, separate from its proprietor. Thus, the business records should not include the proprietor’s personal finances.

**Partnership.** A **partnership** has two or more parties as co-owners, and each owner is a partner. Individuals, corporations, partnerships, or other types of entities can be partners. Income and losses of the partnership “flow through” to the partners, and they recognize them based on their agreed-upon percentage interest in the business. The partnership is not a tax-paying entity. Instead, each partner takes a proportionate share of the entity’s taxable income and pays tax according to that partner’s individual or corporate rate. Many retail establishments, professional service firms (law, accounting, etc.), real estate, and oil and gas exploration companies operate as partnerships. Many partnerships are small or medium-sized but some are gigantic, with thousands of partners. Partnerships are governed by agreement, usually spelled out in writing in the form of a contract between the partners. General partnerships have mutual agency and unlimited liability, meaning that each partner may conduct business in the name of the entity and can make agreements that legally bind all partners without limit for the partnership’s debts. Partnerships are therefore quite risky, because an irresponsible partner can create large debts for the other general partners without their knowledge or permission. This feature of general partnerships has spawned the creation of limited-liability partnerships (LLPs).

A *limited-liability partnership* is one in which a wayward partner cannot create a large liability for the other partners. In LLPs, each partner is liable for partnership debts only up to the extent of his or her investment in the partnership, plus his or her proportionate share of the liabilities. Each LLP, however, must have one general partner with unlimited liability for all partnership debts.

**Limited-Liability Company (LLC).** A **limited-liability company** is one in which the business (and not the owner) is liable for the company’s debts. An LLC may have one owner or many owners, called *members*. Unlike a proprietorship or a general partnership, the members of an LLC do *not* have unlimited liability for the LLC’s debts. An LLC pays no business income tax. Instead, the LLC’s income “flows through” to the members, and they pay income tax at their own tax rates, just as they would if they were partners. Today, many multiple-owner businesses are organized as LLCs, because members of an LLC effectively enjoy limited liability while still being taxed like members of a partnership.



**Corporation.** A **corporation** is a business owned by the **stockholders**, or **shareholders**, who own **stock** representing shares of ownership in the corporation. One of the major advantages of doing business in the corporate form is the ability to raise large sums of capital from issuance of stock to the public. All types of entities (individuals, partnerships, corporations, or other types) may be shareholders in a corporation. Even though proprietorships and partnerships are more numerous, corporations transact much more business and are larger in terms of assets, income, and number of employees. Most well-known companies, such as The Gap, Inc., Amazon.com, Inc., Google, General Motors, Toyota, and Apple, Inc., are corporations. Their full names include *Corporation* or *Incorporated* (abbreviated as *Corp.* and *Inc.*) to indicate that they are corporations—for example, Starbucks Corporation. A few bear the name *Company*, such as Ford Motor Company.

A corporation is formed under state law. Unlike proprietorships and partnerships, a corporation is legally distinct from its owners. The corporation is like an artificial person and possesses many of the same rights that a person has. The stockholders have no personal obligation for the corporation's debts. So, stockholders of a corporation have limited liability, as do limited partners and members of an LLC. However, unlike partnerships or LLCs, a corporation pays a business income tax as well as many other types of taxes. Furthermore, the shareholders of a corporation are effectively taxed twice on distributions received from the corporation (called dividends). Thus, one of the major disadvantages of the corporate form of business is *double taxation of distributed profits*.

Ultimate control of a corporation rests with the stockholders, who generally get one vote for each share of stock they own. Stockholders elect the **board of directors**, which sets policy and appoints officers. The board elects a chairperson, who holds the most power in the corporation and often carries the title chief executive officer (CEO); it also appoints the president as chief operating officer (COO). Corporations have vice presidents in charge of sales, accounting, finance (the chief financial officer or CFO), and other key areas.

## EXPLAIN AND APPLY UNDERLYING ACCOUNTING CONCEPTS, ASSUMPTIONS, AND PRINCIPLES

### 2 Explain and apply underlying accounting concepts, assumptions, and principles

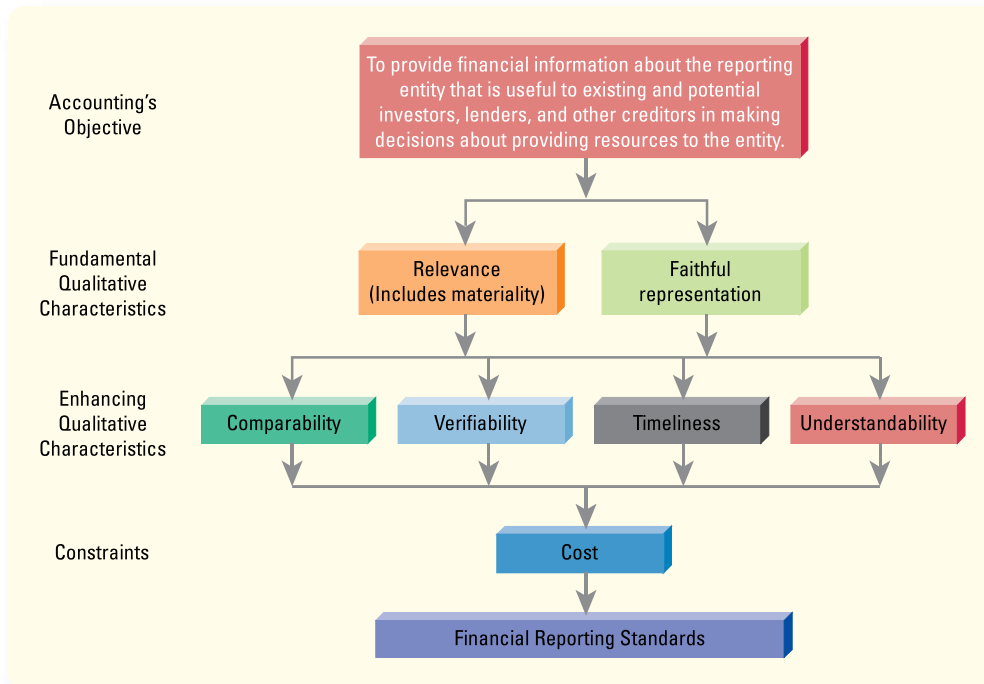
Accountants follow professional frameworks for measurement and disclosure of financial information. The most common of these frameworks is called **generally accepted accounting principles (GAAP)**. In the United States, the **Financial Accounting Standards Board (FASB)** formulates GAAP. The **International Accounting Standards Board (IASB)** sets global—or international financial reporting standards (IFRS), as discussed in a later section.

Exhibit 1-3 gives an overview of the joint conceptual framework of accounting developed by the FASB and the IASB. Financial reporting standards (whether U.S. or international), at the bottom, follow this conceptual framework. The overall *objective* of accounting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.

To be useful, information must have the fundamental qualitative characteristics, which include

- relevance, and
- faithful representation.

To be relevant, information must be capable of making a difference to the decision maker, in helping them to predict or confirm value. In addition, the information must be *material*, which means it must be important enough to the informed user so that, if it were omitted or incorrect, it would make a difference in the user's decision. Only information that is material needs to be separately *disclosed* (listed or discussed) in the financial statements. If not, it does not need separate disclosure but may be combined with other information. To make a faithful representation, the information must be complete, neutral (free from bias), and free from error (accurate). Accounting information must focus on the *economic substance* of a transaction, event, or circumstance, which may or may not always be the same as its legal form. Faithful representation makes the information *reliable* to users.

**Exhibit 1-3** | Conceptual Foundations of Accounting

Based on Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB), *Joint Conceptual Framework for Reporting* (2010).

Accounting information must also have a number of *enhancing or supplementary qualitative characteristics*. These include

- comparability,
- verifiability,
- timeliness, and
- understandability.

*Comparability* means that the accounting information for a company must be prepared in such a way as to be capable of being compared with information from other companies in the same period; it should also be *consistent* with similar information for that company in previous periods. *Verifiability* means that the information must be capable of being checked for accuracy, completeness, and reliability. The process of verifying information is often done by *internal* as well as *external auditors*. Verifiability enhances the reliability of information and thus makes the information more representative of economic reality. *Timeliness* means that the information must be made available to users early enough to help them make decisions, thus making the information more relevant to their needs. *Understandability* means the information must be sufficiently transparent so that it makes sense to reasonably informed users of the information (investors, creditors, regulatory agencies, and managers).

Accounting information is costly to produce. A primary constraint in the decision to disclose accounting information is that the *cost of disclosure should not exceed the expected benefits* to users. The management of an entity is primarily responsible for preparing accounting information. Managers must exercise judgment in determining whether the information is necessary for a complete understanding of economic facts and is not excessively costly to provide.

This course will expose you to GAAP as well as to relevant international financial reporting standards (IFRS). We summarize GAAP in Appendix D and IFRS in Appendix E. In the following section, we briefly summarize some of the basic assumptions and principles that underlie the application of these standards.

## The Entity Assumption

The most basic accounting assumption (underlying idea) is the **entity**, which is any organization (or person) that stands apart as a separate economic unit. Sharp boundaries are drawn around each entity so as not to confuse its affairs with those of others.

Consider Glenn K. Murphy, chairman of the board and CEO of The Gap, Inc. Mr. Murphy likely owns several homes, automobiles, and other personal assets. In addition, he may owe money on some personal loans. All these assets and liabilities belong to Mr. Murphy and have nothing to do with The Gap, Inc. Likewise, The Gap, Inc.'s cash, computers, and inventories belong to the company and not to Murphy. Why? Because the entity assumption draws a sharp boundary around each entity; in this case, The Gap, Inc., is one entity, and Glenn K. Murphy is a second, separate entity.

Let's consider the various types of retail outlets that make up The Gap, Inc. Top managers evaluate company-operated stores separately from franchise stores. If company-operated store sales were falling, The Gap, Inc., should identify the reason. But if sales figures from all the company-operated and franchise stores were combined in a single total, managers couldn't tell how differently each unit was performing. To correct the problem, managers need accounting information for each division (entity) in the company. They also need separate information for each geographic region (country). Thus, each type of store and each region keeps its own records in order to be evaluated separately.

## The Continuity (Going-Concern) Assumption

In measuring and reporting accounting information, we assume that the entity will continue to operate long enough to sell its inventories and convert any receivables to cash, and to use other existing assets (such as land, buildings, equipment, and supplies) for their intended purposes, and settle its obligations in the normal course of business. This is called the **continuity (going-concern) assumption**.

Consider the alternative to the **going-concern assumption**: the quitting concern, or going out of business assumption. An entity that is not continuing would have to sell all of its assets in the process. In that case, the most *relevant* measure of the value of the assets would be their liquidating values (or the amount the company can receive for the assets when sold in order to go out of business). But going out of business is the exception rather than the rule. Therefore, the continuity assumption says that a business should stay in business long enough to convert its inventories and receivables to cash and pay off its obligations in the ordinary course of business, and to continue this process of operating into the future.

## The Historical Cost Principle

The **historical cost principle** states that assets should be recorded at their *actual cost*, measured on the date of purchase as the amount of cash paid plus the dollar value of all noncash consideration (other assets, privileges, or rights) also given in exchange. For example, suppose The Gap, Inc., purchases a building for a new store. The building's current owner is asking \$600,000 for the building. The management of The Gap, Inc., believes the building is worth \$585,000 and offers the present owner that amount. Two real estate professionals appraise the building at \$610,000. The buyer and seller compromise and agree on a price of \$590,000 for the building. The historical cost principle requires The Gap, Inc., to initially record the building at its actual cost of \$590,000—not at \$585,000, \$600,000, or \$610,000, even though those amounts were what some people believed the building was worth. At the point of purchase, \$590,000 is both the *relevant* amount for the building's worth and the amount that *faithfully represents* a reliable figure for the price the company paid for it.

The *historical cost principle* and the *continuity assumption* (discussed previously), also maintain that The Gap, Inc.'s accounting records should continue to use historical cost to value the asset for as long as the business holds it. Why? Because cost is a *verifiable* measure that is relatively *free from bias*. Suppose that The Gap, Inc., owns the building for six years. Real estate prices increase during this period. As a result, at the end of the period, the building can be sold for \$650,000. Should The Gap, Inc., increase the carrying value of the building on the company's books to \$650,000? No. According to the historical cost principle, the building remains on The Gap, Inc.'s books at its historical cost of \$590,000. According to the continuity assumption, The Gap, Inc., intends to stay in business and use the building, not to sell it, so its historical cost is the most

relevant and the most faithful representation of its carrying value. It is also the most easily verifiable (auditable) amount. Should the company decide to sell the building later at a price above or below its carrying value, it will record the cash received, remove the carrying value of the building from the books, and record a gain or a loss for the difference at that time.

The historical cost principle is not used as widely in the United States as it once was. Accounting is moving in the direction of reporting more and more assets and liabilities at their fair values. **Fair value** is the amount that the business could sell the asset for, or the amount that the business could pay to settle the liability. The FASB has issued guidance for companies to report many assets and liabilities at fair values.<sup>1</sup> Moreover, in recent years, the FASB has agreed to “harmonize” GAAP with International Financial Reporting Standards (IFRS). These standards generally allow for broader measurement of different types of assets with fair values than GAAP, which may cause more assets to be revalued periodically to fair market values. We will discuss the trend toward globalization of accounting standards on the next page, and we will illustrate it in later chapters throughout the book.

### The Stable-Monetary-Unit Assumption

In the United States, we record transactions in dollars because that is our medium of exchange. British accountants record transactions in pounds sterling, Japanese in yen, and some continental Europeans in euros.

Unlike a liter or a mile, the value of a dollar changes over time. A rise in the general price level is called *inflation*. During inflation, a dollar will purchase less food, less toothpaste, and less of other goods and services. When prices are stable—there is little inflation—a dollar’s purchasing power is also stable.

Under the **stable-monetary-unit assumption**, accountants assume that the dollar’s purchasing power is stable over time. We ignore inflation, and this allows us to add and subtract dollar amounts as though the dollar over successive years has a consistent amount of purchasing power. This is important because businesses that report their financial information publicly usually report comparative financial information (that is, the current year along with one or more prior years). If we could not assume a stable monetary unit, assets and liabilities denominated in prior years’ dollars would have to be adjusted to current year price levels. Inflation has been at very low levels in developed countries for several decades and is expected to remain so for the foreseeable future. Thus, inflation adjustments to accounting information to make it comparable over time are not considered necessary.

#### Global View

**International Financial Reporting Standards (IFRS)** We live in a global economy! The global credit crisis of 2008 originated in the United States but rapidly spread throughout the world. Investors in the United States can easily trade stocks on the Hong Kong, London, and Brussels stock exchanges over the Internet. Each year, American companies such as Starbucks Corporation, The Gap Inc., McDonalds Corp., Microsoft Corp., and The Walt Disney Company conduct billions of dollars of business around the globe. Conversely, foreign companies such as Nokia, Samsung, Toyota, and Nestlé conduct billions of dollars of business in the United States. American companies have merged with foreign companies to create international conglomerates such as Pearson (the publisher of this textbook) and Anheuser-Busch InBev (producers of alcoholic beverages). No matter where your career starts, it is very likely that it will eventually take you into global markets.

<sup>1</sup>In 2013, the American Institute of Certified Public Accountants (AICPA) adopted a separate “financial reporting framework for small and medium-sized entities” (FRF-SME) that avoids some of the complexities of full-blown GAAP. Many SMEs are owner-managed, and prepare financial statements mostly for the use of their bankers, who do not require all of the complex disclosures of GAAP. FRF-SME is less complicated than GAAP, and, while it requires accrual accounting, it emphasizes use of historical cost more than fair values for assets. Most of the principles we employ in this text are applicable to both FRF-SMEs and GAAP. Accrual accounting is discussed in Chapter 3.