



FINANCIAL & MANAGERIAL ACCOUNTING

Needles ■ Powers ■ Crosson ■ 10e

Financial & Managerial Accounting

TENTH EDITION

Belverd E. Needles, Jr., Ph.D., C.P.A., C.M.A.
DePaul University

Marian Powers, Ph.D.
Northwestern University

Susan V. Crosson, M.S. Accounting, C.P.A.
Emory University



Australia • Brazil • Japan • Korea • Mexico • Singapore • Spain • United Kingdom • United States

This is an electronic version of the print textbook. Due to electronic rights restrictions, some third party content may be suppressed. Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. The publisher reserves the right to remove content from this title at any time if subsequent rights restrictions require it. For valuable information on pricing, previous editions, changes to current editions, and alternate formats, please visit www.cengage.com/highered to search by ISBN#, author, title, or keyword for materials in your areas of interest.

Financial & Managerial Accounting, 10e**Belverd Needles, Marian Powers, Susan Crosson**

Senior Vice President, LRS/Acquisitions &
Solutions Planning: Jack W. Calhoun

Editorial Director, Business & Economics:
Erin Joyner

Editor-in-Chief: Rob Dewey

Executive Editor: Sharon Oblinger

Development Editor: Krista Kellman

Editorial Assistant: A.J. Smiley

Sr. Brand Manager: Kristen Hurd

Sr. Market Development Manager:
Natalie Livingston

Sr. Marketing Communications Manager:
Sarah Greber

Marketing Coordinator: Eileen Corcoran

Sr. Content Project Manager: Scott Dillon

Media Editor: Lysa Kosins

Manufacturing Planner: Doug Wilke

Production Service: Cenveo Publisher Services

Sr. Art Director: Stacy Jenkins Shirley

Internal and Cover Designer: Craig Ramsdell

Cover Image: © Martin Marraud/Getty Images

Rights Acquisition Director: Audrey Pettengill

© 2014, 2011 South-Western, Cengage Learning

ALL RIGHTS RESERVED. No part of this work covered by the copyright herein may be reproduced, transmitted, stored, or used in any form or by any means graphic, electronic, or mechanical, including but not limited to photocopying, recording, scanning, digitizing, taping, web distribution, information networks, or information storage and retrieval systems, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without the prior written permission of the publisher.

For product information and technology assistance, contact us at
Cengage Learning Customer & Sales Support, 1-800-354-9706

For permission to use material from this text or product,
submit all requests online at **www.cengage.com/permissions**

Further permissions questions can be emailed to
permissionrequest@cengage.com

ExamView® is a registered trademark of eInstruction Corp.

The financial statements are included for illustrative and education purposes only. Nothing herein should be construed as financial advice.

Except where otherwise noted, all content in this title is © Cengage Learning.

Library of Congress Control Number: 2012955354

ISBN-13: 978-1-133-62699-2

ISBN-10: 1-133-62699-8

South-Western

5191 Natorp Boulevard
Mason, OH 45040
USA

Cengage Learning is a leading provider of customized learning solutions with office locations around the globe, including Singapore, the United Kingdom, Australia, Mexico, Brazil, and Japan. Locate your local office at: **www.cengage.com/global**

Cengage Learning products are represented in Canada by Nelson Education, Ltd.

For your course and learning solutions, visit **www.cengage.com**
Purchase any of our products at your local college store or at our preferred online store **www.cengagebrain.com**

BRIEF CONTENTS

	1	Uses of Accounting Information and the Financial Statements	2
SUPPLEMENT TO CHAPTER	1	How to Read an Annual Report	43
	2	Measurement Concepts: Recording Business Transactions	86
	3	Measuring Business Income: Adjusting the Accounts	136
SUPPLEMENT TO CHAPTER	3	Closing Entries and the Work Sheet	185
	4	Foundations of Financial Reporting and the Classified Balance Sheet	202
	5	Accounting for Merchandising Operations	240
	6	Inventories	286
	7	Cash and Internal Control	326
	8	Receivables	362
	9	Long-Term Assets	396
	10	Current Liabilities and Fair Value Accounting	440
	11	Long-Term Liabilities	484
	12	Stockholders' Equity	540
	13	The Statement of Cash Flows	594
SUPPLEMENT TO CHAPTER	13	The Direct Method of Preparing the Statement of Cash Flows	643
	14	Financial Statement Analysis	652
	15	Managerial Accounting and Cost Concepts	709
	16	Costing Systems: Job Order Costing	753
	17	Costing Systems: Process Costing	793
	18	Value-Based Systems: Activity-Based Costing and Lean Accounting	831
	19	Cost-Volume-Profit Analysis	871
	20	The Budgeting Process	907
	21	Flexible Budgets and Performance Analysis	955
	22	Standard Costing and Variance Analysis	997
	23	Short-Run Decision Analysis	1039
	24	Capital Investment Analysis	1073
	25	Pricing Decisions, Including Target Costing and Transfer Pricing	1101
	26	Quality Management and Measurement	1143

APPENDIX	A	Accounting for Unincorporated Businesses	1177
APPENDIX	B	Accounting for Investments	1192
APPENDIX	C	The Time Value of Money	1208
		Endnotes	1215
		Glossary	1219
		Company Name Index	1237
		Subject Index	1239

CONTENTS

CHAPTER 1	Uses of Accounting Information and the Financial Statements	2
	BUSINESS INSIGHT CVS CAREMARK 3	
	Concepts Underlying Accounting Measurement 4	
	Financial and Managerial Accounting 4	
	Accounting Measurement 5	
	Forms of Business Organization 6	
	Formation and Organization of a Corporation 8	
	Concepts Underlying Financial Position 9	
	Assets 10	
	Liabilities 10	
	Stockholders' Equity 10	
	Financial Statements 12	
	Income Statement 12	
	Statement of Retained Earnings 12	
	Balance Sheet 12	
	Statement of Cash Flows 14	
	Relationships Among the Financial Statements 15	
	Generally Accepted Accounting Principles 16	
	GAAP and the Independent CPA's Report 16	
	Organizations That Issue Accounting Standards 17	
	Other Organizations That Influence GAAP 17	
	Professional Conduct 18	
	Decision Makers: The Users of Accounting Information 19	
	Management 19	
	Users with a Direct Financial Interest 19	
	Users with an Indirect Financial Interest 20	
	Governmental and Not-for-Profit Organizations 20	
	Business Goals and Activities 21	
	Financial Analysis 22	
	Ethical Financial Reporting 23	
	REVIEW PROBLEM 24	
	CHAPTER REVIEW 26	
	CHAPTER ASSIGNMENTS 28	
SUPPLEMENT TO CHAPTER 1	HOW TO READ AN ANNUAL REPORT	43
	The Components of an Annual Report 43	
	Letter to the Shareholders 43	
	Financial Highlights 43	
	Description of the Company 44	
	Management's Discussion and Analysis 44	
	Financial Statements 44	
	Notes to the Financial Statements 48	
	Statements of Management's Responsibilities 50	
	Auditors' Reports 50	
	Excerpts from CVS Caremark Corporation's 2011 Annual Report 53	
	Excerpts from Southwest Airlines Co.'s 2011 Annual Report 75	
CHAPTER 2	Measurement Concepts: Recording Business Transactions	86
	BUSINESS INSIGHT THE BOEING COMPANY 87	
	Concepts Underlying Business Transactions 88	
	Recognition 88	
	Valuation 89	
	Classification 89	
	Double-Entry System 90	
	Accounts 90	
	Chart of Accounts 90	
	The T Account 92	
	Rules of Double-Entry Accounting 92	
	Normal Balance 93	
	Stockholders' Equity Accounts 94	
	The Accounting Cycle 94	
	Business Transaction Analysis 96	
	Summary of Transactions 103	
	The Trial Balance 104	
	Preparation and Use of a Trial Balance 105	
	Finding Trial Balance Errors 105	
	Recording and Posting Transactions 106	
	General Journal 106	

General Ledger	107
Some Notes on Presentation	109
Ethical Financial Reporting and Business Transactions	111
Recognition	111

Cash Flows and the Timing of Transactions	113
REVIEW PROBLEM	115
CHAPTER REVIEW	118
CHAPTER ASSIGNMENTS	119

CHAPTER 3 **Measuring Business Income: Adjusting the Accounts** 136

BUSINESS INSIGHT NETFLIX, INC.	137
Concepts Underlying Income Measurement	138
Net Income	138
Income Measurement Assumptions	139
Concepts Underlying Accrual Accounting	140
Recognizing Revenues	140
Recognizing Expenses	141
The Adjustment Process	142
Type 1 Adjustment: Allocating Recorded Costs (Deferred Expenses)	143
Type 2 Adjustment: Recognizing Unrecorded Expenses (Accrued Expenses)	146
Type 3 Adjustment: Allocating Recorded, Unearned Revenues (Deferred Revenues)	148

Type 4 Adjustment: Recognizing Unrecorded, Earned Revenues (Accrued Revenues)	150
A Note About Business Transactions	151
Using the Adjusted Trial Balance to Prepare Financial Statements	152
Adjusting Entries and the Financial Statements	154
Net Income: Ethical Measurement and Cash Flows	155
Ethical Considerations for Business	155
Using Accrual-Based Information to Make Management Decisions	156
REVIEW PROBLEM	158
CHAPTER REVIEW	162
CHAPTER ASSIGNMENTS	163

SUPPLEMENT TO CHAPTER 3 CLOSING ENTRIES AND THE WORK SHEET 185

Preparing Closing Entries	185
Step 1: Closing the Credit Balances	186
Step 2: Closing the Debit Balances	187
Step 3: Closing the Income Summary Account Balance	189
Step 4: Closing the Dividends Account Balance	190
The Accounts After Closing	191
The Work Sheet: An Accountant's Tool	192
Preparing the Work Sheet	192
ASSIGNMENTS	195

CHAPTER 4 **Foundations of Financial Reporting and the Classified Balance Sheet** 202

BUSINESS INSIGHT McDONALD'S CORPORATION	203
Concepts Underlying Financial Reporting	204
Objective of Financial Reporting	204
Qualitative Characteristics of Accounting Information	205
Accounting Conventions	206
Ethical Financial Reporting	208
Classified Balance Sheet	209
Assets	209
Liabilities	211
Stockholders' Equity	212
Overview of the Classified Balance Sheet Accounts	213
Using Classified Financial Statements	214
Evaluation of Liquidity	214
Evaluation of Profitability	215
REVIEW PROBLEM	224
CHAPTER REVIEW	226
CHAPTER ASSIGNMENTS	227

CHAPTER 5	Accounting for Merchandising Operations	240
	BUSINESS INSIGHT WALMART STORES, INC. 241	
	Concepts Underlying Merchandising Accounting 242	
	Forms of the Income Statement 244	
	Multistep Income Statement 244	
	Single-Step Income Statement 247	
	Terms of Sale 248	
	Sales and Purchases Discounts 248	
	Transportation Costs 249	
	Terms of Debit and Credit Card Sales 250	
	Perpetual Inventory System 251	
	Purchases of Merchandise 251	
	Sales of Merchandise 253	
	Periodic Inventory System 257	
	Purchases of Merchandise 258	
	Sales of Merchandise 260	
	Merchandising Transactions and the Financial Statements 263	
	The Operating Cycle and Foreign Business Transactions 264	
	Operating Cycle 264	
	Foreign Business Transactions 265	
	REVIEW PROBLEM 267	
	CHAPTER REVIEW 270	
	CHAPTER ASSIGNMENTS 271	

CHAPTER 6	Inventories	286
	BUSINESS INSIGHT CISCO SYSTEMS, INC. 287	
	Concepts Underlying Inventory Accounting 288	
	Accrual Accounting and Valuation of Inventories 288	
	Goods Flows and Cost Flows 289	
	Conservatism and the Lower-of-Cost-or-Market (LCM) Rule 289	
	Disclosure of Inventory Methods 290	
	Summary of Inventory Decisions 290	
	Inventory Cost Under the Periodic Inventory System 292	
	Specific Identification Method 292	
	Average-Cost Method 293	
	First-In, First-Out (FIFO) Method 293	
	Last-In, First-Out (LIFO) Method 294	
	Summary of Inventory Costing Methods 295	
	Impact of Inventory Decisions 296	
	Effects on the Financial Statements 296	
	Effects on Income Taxes 297	
	Effects on Cash Flows 297	
	Inventory Cost Under the Perpetual Inventory System 298	
	Specific Identification Method 298	
	Average-Cost Method 299	
	FIFO Method 299	
	LIFO Method 300	
	Summary of Inventory Costing Methods 300	
	Valuing Inventory by Estimation 301	
	Retail Method 301	
	Gross Profit Method 302	
	Inventory and the Financial Statements 302	
	Management Issues Related to Inventory 304	
	Evaluating the Level of Inventory 304	
	Inventory Management 305	
	Effects of Inventory Misstatements on Income Measurement 306	
	REVIEW PROBLEM 309	
	CHAPTER REVIEW 311	
	CHAPTER ASSIGNMENTS 312	

CHAPTER 7	Cash and Internal Control	326
	BUSINESS INSIGHT SUBWAY 327	
	Concepts Underlying Internal Control 328	
	The Need for Internal Controls 328	
	Components of Internal Control 329	
	Control Activities 329	
	Internal Control and Achieving Control Objectives 330	
	Limitations on Internal Control 331	
	Internal Control over Merchandising Transactions 332	
	Control of Cash Receipts 333	
	Control of Purchases and Cash Disbursements 333	
	Cash Equivalents and Cash Control 337	
	Cash Equivalents 337	
	Cash Control Methods 338	
	Petty Cash Funds 340	
	Establishing the Petty Cash Fund 340	
	Making Disbursements from the Petty Cash Fund 341	
	Reimbursing the Petty Cash Fund 341	
	Internal Control and the Financial Statements 343	
	Management Issues Related to Internal Control 344	
	Management's Responsibility for Internal Control 344	
	Independent Accountant's Audit of Internal Control 344	
	REVIEW PROBLEM 346	
	CHAPTER REVIEW 347	
	CHAPTER ASSIGNMENTS 348	

CHAPTER 8	Receivables	362
	BUSINESS INSIGHT HEWLETT-PACKARD (HP) COMPANY 363	
	Concepts Underlying Notes and Accounts Receivable 364	
	Accounts Receivable 364	
	Notes Receivable 365	
	The Allowance Method: Using Accrual Accounting to Value Receivables 366	
	Disclosure of Receivables 367	
	Uncollectible Accounts 368	
	Percentage of Net Sales Method 368	
	Accounts Receivable Aging Method 369	
	Comparison of the Two Methods 371	
	Writing Off Uncollectible Accounts 372	
	Common Calculations for Notes Receivable 373	
	Maturity Date 374	
	Duration of a Note 374	
	Interest 374	
	Maturity Value 375	
	Accrued Interest 375	
	Dishonored Note 375	
	Receivables and the Financial Statements 376	
	Evaluating the Level of Accounts Receivable and Ethical Ramifications 377	
	Receivables Turnover 377	
	Days' Sales Uncollected 378	
	Financing Receivables 378	
	Ethics and Estimates in Accounting for Receivables 380	
	REVIEW PROBLEM 382	
	CHAPTER REVIEW 383	
	CHAPTER ASSIGNMENTS 384	

CHAPTER 9	Long-Term Assets	396
	BUSINESS INSIGHT APPLE COMPUTER 397	
	Concepts Underlying Long-Term Assets 398	
	Classification, Accrual Accounting, and Disclosure of Long-Term Assets 398	
	Valuation and Disclosure of Long-Term Assets 399	
	Recognition of the Acquisition Cost of Long-Term Assets 400	
	Acquisition Cost of Property, Plant, and Equipment 402	
	Specific Applications of Determining the Acquisition Cost of Property, Plant, and Equipment 402	
	Depreciation 404	
	Factors in Computing Depreciation 405	
	Methods of Computing Depreciation 405	
	Special Issues in Determining Depreciation 409	
	Disposal of Depreciable Assets 410	
	Discarded Plant Assets 410	
	Plant Assets Sold for Cash 411	
	Exchanges of Plant Assets 413	
	Natural Resources 414	
	Depletion 414	
	Depreciation of Plant Assets Related to Natural Resources 415	
	Development and Exploration Costs in the Oil and Gas Industry 415	
	Intangible Assets 416	
	Research and Development Costs 419	
	Computer Software Costs 419	
	Goodwill 420	
	Long-Term Assets and the Financial Statements 420	
	Management Decisions Relating to Long-Term Assets 422	
	Acquiring and Financing Long-Term Assets 422	
	Ethics in Acquiring and Financing Long-Term Assets 423	
	REVIEW PROBLEM 425	
	CHAPTER REVIEW 427	
	CHAPTER ASSIGNMENTS 428	

CHAPTER 10	Current Liabilities and Fair Value Accounting	440
	BUSINESS INSIGHT MICROSOFT 441	
	Concepts Underlying Current Liabilities 442	
	Recognition 442	
	Valuation 442	
	Classification 442	
	Disclosure 443	
	Common Types of Current Liabilities 444	
	Definitely Determinable Liabilities 444	
	Estimated Liabilities 452	
	Contingent Liabilities and Commitments 456	
	Valuation Approaches to Fair Value Accounting 457	
	Interest, the Time Value of Money, and Future Value 458	
	Present Value 459	
	Present Value of an Ordinary Annuity 461	
	Applications Using Present Value 462	
	Valuing an Asset at Present Value 463	
	Present Value of a Deferred Payment 463	
	Other Applications 464	
	Current Liabilities and the Financial Statements 464	
	Business Issues Related to Current Liabilities 465	
	Working Capital and the Current Ratio 465	
	Evaluating Accounts Payable 465	
	REVIEW PROBLEM 468	
	CHAPTER REVIEW 470	
	CHAPTER ASSIGNMENTS 471	

CHAPTER 11 Long-Term Liabilities 484

BUSINESS INSIGHT McDONALD'S 485

Concepts Underlying Long-Term Liabilities 486

Recognition 486

Valuation 486

Classification 486

Disclosure 486

Types of Long-Term Debt 486

The Nature of Bonds 489

Bond Issue: Prices and Interest Rates 489

Characteristics of Bonds 490

Accounting for the Issuance of Bonds 491

Bonds Issued at Face Value 491

Bonds Issued at a Discount 492

Bonds Issued at a Premium 494

Bond Issue Costs 494

Using Present Value to Value a Bond 495

Amortization of Bond Discounts and Premiums 497

Amortizing a Bond Discount 497

Amortizing a Bond Premium 502

Retirement and Conversion of Bonds 506

Retirement of Bonds 506

Conversion of Bonds 507

Other Bonds Payable Issues 508

Sale of Bonds Between Interest Dates 508

Year-End Accrual of Bond Interest Expense 510

Long-Term Leases 512

Pension Liabilities 516

Long-Term Liabilities and the Financial Statements 516

Management Issues Related to Long-Term Debt Financing 518

Evaluating the Decision to Issue Long-Term Debt 518

Evaluating Long-Term Debt 519

Interest Coverage Ratio 519

Cash Flow Information 520

REVIEW PROBLEM 522

CHAPTER REVIEW 524

CHAPTER ASSIGNMENTS 526

CHAPTER 12 Stockholders' Equity 540

BUSINESS INSIGHT GOOGLE, INC. 541

Concepts Underlying the Corporate Form of Business 542

Advantages of Incorporation 542

Disadvantages of Incorporation 543

Equity Financing 543

Components of Stockholders' Equity 545

Characteristics of Preferred Stock 547

Issuance of Common Stock 549

Accounting for Par Value Stock 550

No-Par Stock 551

Issuance of Stock for Noncash Assets 552

Accounting for Treasury Stock 554

Purchase of Treasury Stock 554

Sale of Treasury Stock 555

Retirement of Treasury Stock 557

Accounting for Cash Dividends 559

Stock Dividends and Stock Splits 562

Stock Dividends 562

Stock Splits 564

The Statement of Stockholders' Equity and Book Value per Share 565

Statement of Stockholders' Equity 565

Book Value per Share 567

Stockholders' Equity and the Financial Statements 567

Evaluating Dividend Policies, Company Performance, and Stock Options 569

Dividend Yield 569

Return on Equity 569

Price-Earnings Ratio 570

Cash Flow Information 571

Stock Options as Compensation 571

REVIEW PROBLEM 573

CHAPTER REVIEW 575

CHAPTER ASSIGNMENTS 576

CHAPTER 13	The Statement of Cash Flows	594
	BUSINESS INSIGHT AMAZON.COM, INC. 595	
	Concepts Underlying the Statement of Cash Flows 596	
	Relevance of the Statement of Cash Flows 596	
	Classification of Cash Flows 597	
	Required Disclosure of Noncash Investing and Financing Transactions 599	
	Alternate Presentations of Operating Activities 599	
	Step 1: Determining Cash Flows from Operating Activities 601	
	Depreciation, Amortization, and Depletion 603	
	Gains and Losses 604	
	Changes in Current Assets 604	
	Changes in Current Liabilities 605	
	Schedule of Cash Flows from Operating Activities 607	
	Step 2: Determining Cash Flows from Investing Activities 608	
	Investments 609	
	Plant Assets 609	
	Step 3: Determining Cash Flows from Financing Activities 612	
	Bonds Payable 612	
	Common Stock 612	
	Retained Earnings 613	
	Treasury Stock 613	
	Step 4: Preparing the Statement of Cash Flows 614	
	Cash Flows and the Financial Statements 615	
	Analyzing Cash Flows 616	
	Cash Flow Ratios 616	
	Free Cash Flow 618	
	Asking the Right Questions About the Statement of Cash Flows 619	
	Ethical Considerations in Analyzing the Statement of Cash Flows 620	
	REVIEW PROBLEM 622	
	CHAPTER REVIEW 625	
	CHAPTER ASSIGNMENTS 626	

SUPPLEMENT TO CHAPTER 13	THE DIRECT METHOD OF PREPARING THE STATEMENT OF CASH FLOWS	643
--------------------------	--	-----

Determining Cash Flows from Operating Activities 643	Cash Payments for Operating Expenses 645
Cash Receipts from Sales 644	Cash Payments for Interest 646
Cash Receipts from Interest and Dividends 644	Cash Payments for Income Taxes 646
Cash Payments for Purchases 644	Compiling the Statement of Cash Flows 646
	ASSIGNMENTS 648

CHAPTER 14	Financial Statement Analysis	652
	BUSINESS INSIGHT STARBUCKS CORPORATION 653	
	Concepts Underlying Financial Performance Measurement 654	
	Standards of Comparison 655	
	Sources of Information 656	
	Tools and Techniques of Financial Analysis 658	
	Horizontal Analysis 658	
	Trend Analysis 660	
	Vertical Analysis 661	
	Financial Ratio Analysis 664	
	Comprehensive Illustration of Financial Ratio Analysis 664	
	Evaluating Profitability and Total Asset Management 665	
	Evaluating Liquidity 667	
	Evaluating Financial Risk 669	
	Evaluating Operating Asset Management 671	
	Supplemental Financial Ratios for Assessing Operating Asset Management and Liquidity 673	
	Evaluating Market Strength with Financial Ratios 674	
	Financial Statement Analysis and Performance Assessment 675	
	Evaluating Quality of Earnings 677	
	Accounting Methods 677	
	Accounting Estimates 678	
	One-Time Items 679	
	Management Compensation 681	
	REVIEW PROBLEM 683	
	CHAPTER REVIEW 687	
	CHAPTER ASSIGNMENTS 688	

CHAPTER 15	Managerial Accounting and Cost Concepts	709
	BUSINESS INSIGHT THE HERSHEY COMPANY 709	
	The Role of Managerial Accounting 710	
	Managerial Accounting and Financial Accounting: A Comparison 710	
	Concepts Underlying Costs 711	
	Cost Recognition 711	
	Cost Measurement 712	
	Financial Reporting 713	
	Cost Behavior 714	
	Value-Adding versus Non-Value-Adding Costs 715	
	Inventory Accounts in Manufacturing Organizations 716	
	Document Flows and Cost Flows Through the Inventory Accounts 716	
	The Manufacturing Cost Flow 718	
	Financial Statements and the Reporting of Costs 721	
	Income Statement and Accounting for Inventories 721	
	Statement of Cost of Goods Manufactured 723	
	Cost of Goods Sold and a Manufacturer's Income Statement 724	
	Measurement of Product Costs 725	
	Computing Product Unit Cost 725	
	Product Cost Measurement Methods 725	
	Computing Service Unit Cost 726	
	Managerial Accounting and the Management Process 727	
	Evaluating 729	
	Communicating 729	
	Standards of Ethical Conduct 730	
	TRILEVEL PROBLEM 732	
	CHAPTER REVIEW 735	
	CHAPTER ASSIGNMENTS 737	

CHAPTER 16	Costing Systems: Job Order Costing	753
	BUSINESS INSIGHT CLUB CAR, LLC 753	
	Concepts Underlying Product Costing Systems 754	
	Job Order and Process Costing Systems 754	
	Job Order Costing in a Manufacturing Company 755	
	Materials 755	
	Labor 757	
	Overhead 758	
	Completed Units 759	
	Sold Units 759	
	A Job Order Cost Card and the Computation of Unit Cost 760	
	A Manufacturer's Job Order Cost Card 760	
	Computation of Unit Cost 760	
	Job Order Costing in a Service Organization 761	
	Cost Allocation 763	
	Allocating the Costs of Overhead 764	
	Actual Cost of Goods Sold or Cost of Sales 765	
	Allocating Overhead: The Traditional Approach 767	
	Allocating Overhead: The ABC Approach 767	
	Product Unit Cost Information and the Management Process 768	
	Planning 768	
	Performing 768	
	Evaluating 768	
	Communicating 768	
	Supporting the Management Process 769	
	TRILEVEL PROBLEM 770	
	CHAPTER REVIEW 773	
	CHAPTER ASSIGNMENTS 775	

CHAPTER 17	Costing Systems: Process Costing	793
	BUSINESS INSIGHT DEAN FOODS 793	
	Concepts Underlying the Process Costing System 794	
	Patterns of Product Flows and Cost Flow Methods 795	
	Cost Flows Through the Work in Process Inventory Accounts 796	
	Computing Equivalent Production 796	
	Equivalent Production for Direct Materials 797	
	Equivalent Production for Conversion Costs 798	
	Summary of Equivalent Production 798	
	Preparing a Process Cost Report Using the FIFO Costing Method 799	
	Accounting for Units 801	
	Accounting for Costs 802	
	Assigning Costs 802	
	Process Costing for Two or More Production Departments 804	
	Preparing a Process Cost Report Using the Average Costing Method 806	
	Accounting for Units 806	
	Accounting for Costs 807	
	Assigning Costs 808	
	The Management Process and the Process Costing System 811	
	TRILEVEL PROBLEM 812	
	CHAPTER REVIEW 815	
	CHAPTER ASSIGNMENTS 817	

CHAPTER 18	Value-Based Systems: Activity-Based Costing and Lean Accounting	831
	BUSINESS INSIGHT LA-Z-BOY, INC. 831	
	Concepts Underlying Value-Based Systems 832	
	Value Chain Analysis 832	
	Supply Chains 832	
	Using Information from Value Chains and Supply Chains 833	
	Process Value Analysis 833	
	Value-Adding and Non-Value-Adding Activities 833	
	Activity-Based Management 835	
	Activity-Based Costing 835	
	The Cost Hierarchy and the Bill of Activities 835	
	The New Operating Environment and Lean Operations 839	
	Just-In-Time (JIT) 839	
	Continuous Improvement of the Work Environment 841	
	Accounting for Product Costs in a JIT Operating Environment 841	
	Backflush Costing 842	
	Cost Flows in Traditional and Backflush Costing 843	
	Management Tools for Continuous Improvement 846	
	Total Quality Management 846	
	Theory of Constraints 846	
	Comparison of ABM and Lean Operations 846	
	TRILEVEL PROBLEM 849	
	CHAPTER REVIEW 852	
	CHAPTER ASSIGNMENTS 853	

CHAPTER 19	Cost-Volume-Profit Analysis	871
	<p>BUSINESS INSIGHT FLICKR 871</p> <p>Concepts Underlying Cost Behavior 872</p> <p>Cost Behavior 872</p> <p>Mixed Costs and the Contribution Margin Income Statement 877</p> <p>The Scatter Diagram Method 877</p> <p>The High-Low Method 878</p> <p>Statistical Methods 879</p> <p>The Engineering Method 879</p> <p>Contribution Margin Income Statements 879</p> <p>Cost-Volume-Profit Analysis 881</p> <p>Breakeven Analysis 881</p> <p>Using an Equation to Determine the Breakeven Point 882</p> <p>The Breakeven Point for Multiple Products 883</p> <p>Using CVP Analysis to Plan Future Sales, Costs, and Profits 886</p> <p>Assumptions Underlying CVP Analysis 886</p> <p>Applying CVP to Target Profits 886</p> <p>TRILEVEL PROBLEM 890</p> <p>CHAPTER REVIEW 892</p> <p>CHAPTER ASSIGNMENTS 894</p>	
CHAPTER 20	The Budgeting Process	907
	<p>BUSINESS INSIGHT FRAMERICA CORPORATION 907</p> <p>Concepts Underlying the Budgeting Process 908</p> <p>The Master Budget 908</p> <p>Preparation of a Master Budget 910</p> <p>Budget Procedures 912</p> <p>Operating Budgets 912</p> <p>The Sales Budget 912</p> <p>The Production Budget 913</p> <p>The Direct Materials Purchases Budget 914</p> <p>The Direct Labor Budget 916</p> <p>The Overhead Budget 916</p> <p>The Selling and Administrative Expenses Budget 917</p> <p>The Cost of Goods Manufactured Budget 918</p> <p>Financial Budgets 920</p> <p>The Budgeted Income Statement 920</p> <p>The Capital Expenditures Budget 921</p> <p>The Cash Budget 921</p> <p>The Budgeted Balance Sheet 924</p> <p>Budgeting and the Management Process 926</p> <p>Advantages of Budgeting 926</p> <p>Budgeting and Goals 926</p> <p>Budgeting Basics 927</p> <p>TRILEVEL PROBLEM 929</p> <p>CHAPTER REVIEW 931</p> <p>CHAPTER ASSIGNMENTS 933</p>	
CHAPTER 21	Flexible Budgets and Performance Analysis	955
	<p>BUSINESS INSIGHT VAIL RESORTS 955</p> <p>Concepts Underlying Performance Analysis 956</p> <p>What to Measure, How to Measure 956</p> <p>Types of Responsibility Centers 957</p> <p>Organizational Structure and Performance Reports 959</p> <p>Performance Evaluation of Cost Centers and Profit Centers 961</p> <p>Flexible Budgets and Performance Analysis 961</p> <p>Evaluating Cost Center Performance Using Flexible Budgeting 962</p> <p>Evaluating Profit Center Performance Using Variable Costing 962</p> <p>Performance Evaluation of Investment Centers 964</p> <p>Return on Investment 964</p> <p>Residual Income 966</p> <p>Economic Value Added 967</p> <p>Performance Measurement 968</p> <p>Organizational Goals and the Balanced Scorecard 968</p> <p>Performance Evaluation and the Management Process 971</p> <p>Performance Incentives and Goals 972</p> <p>Linking Goals, Performance Objectives, Measures, and Performance Targets 972</p> <p>Performance-Based Pay 972</p> <p>The Coordination of Goals 972</p> <p>TRILEVEL PROBLEM 974</p> <p>CHAPTER REVIEW 977</p> <p>CHAPTER ASSIGNMENTS 979</p>	

CHAPTER 22	Standard Costing and Variance Analysis	997
	BUSINESS INSIGHT ROBOT CORPORATION 997 Concepts Underlying Standard Costing 998 Variance Analysis 999 Computing Standard Costs 999 Standard Direct Materials Cost 999 Standard Direct Labor Cost 1000 Standard Overhead Cost 1000 Total Standard Unit Cost 1001 The Role of Flexible Budgets in Variance Analysis 1001 Using Variance Analysis to Control Costs 1003 Computing and Analyzing Direct Materials Variances 1004 Computing Total Direct Materials Cost Variance 1004 Business Application 1006 Computing and Analyzing Direct Labor Variances 1007 Computing Total Direct Labor Cost Variance 1007 Business Application 1009 Computing and Analyzing Overhead Variances 1010 Computing Total Overhead Cost Variance 1010 Business Application 1015 Using Cost Variances to Evaluate Managers' Performance 1017 TRILEVEL PROBLEM 1019 CHAPTER REVIEW 1025 CHAPTER ASSIGNMENTS 1026	
CHAPTER 23	Short-Run Decision Analysis	1039
	BUSINESS INSIGHT BANK OF AMERICA 1039 Concepts Underlying Decision Analysis 1040 Concepts Underlying Incremental Analysis 1040 Incremental Analysis for Outsourcing Decisions 1043 Outsourcing Analysis 1043 Incremental Analysis for Special Order Decisions 1044 Special Order Analysis: Price and Relevant Cost Comparison 1045 Special Order Analysis: Minimum Bid Price for Special Order 1046 Incremental Analysis for Segment Profitability Decisions 1046 Segment Profitability Analysis 1046 Incremental Analysis for Sales Mix Decisions 1048 Sales Mix Analysis 1049 Incremental Analysis for Sell-or-Process-Further Decisions 1051 Sell-or-Process-Further Analysis 1051 The Management Process 1053 TRILEVEL PROBLEM 1054 CHAPTER REVIEW 1056 CHAPTER ASSIGNMENTS 1058	
CHAPTER 24	Capital Investment Analysis	1073
	BUSINESS INSIGHT AIR PRODUCTS AND CHEMICALS, INC. 1073 Concepts Underlying Long-Term Decision Analysis 1074 Capital Investment Analysis 1074 The Minimum Rate of Return on Investment 1075 Capital Investment Analysis Measures and Methods 1077 Expected Benefits from a Capital Investment 1077 Equal Versus Unequal Cash Flows 1077 Carrying Value of Assets 1077 Depreciation Expense and Income Taxes 1077 Disposal or Residual Values 1078 The Net Present Value Method 1079 Advantages of the Net Present Value Method 1079 The Net Present Value Method Illustrated 1079 Other Methods of Capital Investment Analysis 1081 The Payback Period Method 1081 The Accounting Rate-of-Return Method 1082 The Management Process 1085 TRILEVEL PROBLEM 1086 CHAPTER REVIEW 1088 CHAPTER ASSIGNMENTS 1089	

CHAPTER 25	Pricing Decisions, Including Target Costing and Transfer Pricing	1101
	<p>BUSINESS INSIGHT LAB 126 1101</p> <p>Concepts Underlying Pricing Decisions 1102</p> <p>Revenue Recognition and Pricing Policies 1102</p> <p>Pricing Policy Objectives 1102</p> <p>External and Internal Pricing Factors 1103</p> <p>Economic Pricing Concepts 1104</p> <p>Total Revenue and Total Cost Curves 1104</p> <p>Marginal Revenue and Marginal Cost Curves 1105</p> <p>Auction-Based Pricing 1106</p> <p>Cost-Based Pricing Methods 1107</p> <p>Gross Margin Pricing 1107</p> <p>Return on Assets Pricing 1108</p> <p>Summary of Cost-Based Pricing Methods 1109</p> <p>Pricing Services 1110</p> <p>Factors Affecting Cost-Based Pricing Methods 1111</p> <p>Pricing Based on Target Costing 1112</p> <p>Differences Between Cost-Based Pricing and Target Costing 1113</p> <p>Target Costing Analysis in an Activity-Based Management Environment 1114</p> <p>Pricing for Internal Providers of Goods and Services 1115</p> <p>Transfer Pricing 1116</p> <p>Developing a Transfer Price 1117</p> <p>Other Transfer Price Issues 1118</p> <p>Using Transfer Prices to Measure Performance 1118</p> <p>Pricing and the Management Process 1120</p> <p>TRILEVEL PROBLEM 1121</p> <p>CHAPTER REVIEW 1124</p> <p>CHAPTER ASSIGNMENTS 1125</p>	
CHAPTER 26	Quality Management and Measurement	1143
	<p>BUSINESS INSIGHT FACEBOOK 1143</p> <p>Concepts Underlying Quality 1144</p> <p>Recognition of Quality 1145</p> <p>Deming Prizes 1145</p> <p>EFQM Excellence Award 1145</p> <p>Malcolm Baldrige National Quality Award 1146</p> <p>ISO Standards 1146</p> <p>Financial and Nonfinancial Measures of Quality 1148</p> <p>Financial Measures of Quality 1148</p> <p>Nonfinancial Measures of Quality 1150</p> <p>Measuring Service Quality 1153</p> <p>Measuring Quality: An Illustration 1153</p> <p>Evaluating the Costs of Quality 1153</p> <p>Evaluating Nonfinancial Measures of Quality 1155</p> <p>The Role of Management Information Systems in Quality Management 1157</p> <p>Enterprise Resource Planning Systems and Software as a Service 1157</p> <p>Managers' Use of MIS 1157</p> <p>TRILEVEL PROBLEM 1159</p> <p>CHAPTER REVIEW 1161</p> <p>CHAPTER ASSIGNMENTS 1162</p>	
APPENDIX A	Accounting for Unincorporated Businesses	1177
APPENDIX B	Accounting for Investments	1192
APPENDIX C	The Time Value of Money	1208
	<p>Endnotes 1215</p> <p>Glossary 1219</p> <p>Company Name Index 1237</p> <p>Subject Index 1239</p>	

LATEST RESEARCH ON STUDENT LEARNING

We talked to over 150 instructors and discovered that current textbooks did not effectively:

- Help students logically process information
- Build on what students already know in a carefully guided sequence
- Reinforce core accounting concepts throughout the chapters
- Help students see how the pieces of accounting fit together

The Needles/Powers/Crosson series addresses these challenges by creating a better solution for you. This includes new features and a brand new structure for enhanced learning.

**We have worked hard to create a textbook
that mirrors the way you learn!**



© Martin Marraud/Getty Images

A LOGICAL METHODOLOGY TO BUILDING KNOWLEDGE: THE THREE SECTION APPROACH

Needles/Powers/Crosson continuously evolves to meet the needs of today's learner. As a result of our research, the chapters in Needles/Powers/Crosson have been organized into a **Three Section Approach**, which helps students more easily digest the content.

ThreeSection APPROACH

- 1 The first section is **Concepts** and focuses on the overarching accounting concepts that require consistent reiteration throughout the course.
- 2 With a clear understanding of the concepts, you can proceed to the second section, **Accounting Applications**. Here, you can practice the application of accounting procedures with features like “Apply It!” and a new transaction analysis model, which breaks down the transaction in a simple, visual format.
- 3 Finally, move to section three, **Business Applications**. This section illustrates how the concepts and procedures are used to make business decisions. Real company examples are used throughout the chapter to show the relevance of accounting.

“I think this new chapter structure would be much easier for students to read and comprehend.”

Shannon Ogden

Black River Technical College

TriLevel PROBLEM

TriLevel Problems within CengageNOW mirror the Three Section Approach and connect the sections—Concepts, Accounting Applications, and Business Applications. In this way, the problems teach you to think holistically about an accounting issue.

Breaking Down the Three Section Approach

SECTION 1: CONCEPTS

In Section 1, students experience the **Concepts** related to each chapter. In this case, *concepts* are the overarching accounting concepts that need to be reinforced throughout the accounting course, such as revenue recognition, the matching rule, valuation, classification, and disclosure.

Every chapter's Section 1 reinforces these key concepts so that once students understand the concepts, they can apply them to every aspect of the accounting system—from measuring to processing to communicating information about a business. This is a clear and logical way to present accounting.

SECTION 1

CONCEPTS

CONCEPTS

- Accrual accounting (matching principle)
- Valuation
- Disclosure

RELEVANT LEARNING OBJECTIVE

LO 1 Define receivables, and explain the allowance method for valuation of receivables as an application of accrual accounting.

LO 1 Concepts Underlying Notes and Accounts Receivable

The most common receivables are *accounts receivable* and *notes receivable*. The *allowance method* is used to apply *accrual accounting* to the *valuation* of accounts receivable. Proper *disclosure* in the financial statements and the notes to them is important for users of the statements to interpret them.

Accounts Receivable

Accounts receivable are short-term financial assets that arise from sales on credit and are often called **trade credit**. Terms of trade credit usually range from 5 to 60 days, depending on industry practice, and may allow customers to pay in installments. Credit sales or loans not made in the ordinary course of business, such as those made to employees, officers, or owners, should appear separately under asset titles like Receivables from Employees. Exhibit 1 shows the level of accounts receivable in selected industries.

“It does a very good job in explaining each concept and reinforcing each one by giving specific examples.”

Paul Jajjiram
Bronx Community College

SECTION 2: ACCOUNTING APPLICATIONS

In Section 2, students learn the accounting procedures and the technical **application** of concepts. Students can apply the fundamental concepts they have already learned in Section 1. Section 2 includes things like recording business transactions and creating financial statements in financial chapters, and then building budgets and creating schedules and reports in the managerial chapters.

SECTION 2

ACCOUNTING APPLICATIONS

ACCOUNTING APPLICATIONS

- Estimate uncollectible accounts and uncollectible accounts expense using
 - Percentage of net sales method
 - Accounts receivable aging method
- Write off uncollectible accounts
- Make common calculations for notes receivable

RELEVANT LEARNING OBJECTIVES

LO 2 Apply the allowance method of accounting for uncollectible accounts.

LO 3 Make common calculations for Notes Receivable.

LO 2 Uncollectible Accounts

The allowance account is necessary because the specific uncollectible accounts will not be identified until later. It is not like another contra account, Accumulated Depreciation, whose purpose is to show how much of the plant and equipment cost has been allocated as an expense to previous periods.

If management takes an optimistic view and projects a small loss from uncollectible accounts, the resulting net accounts receivable will be larger than if management takes a pessimistic view. The net income will also be larger under the optimistic view because the estimated expense will be smaller. The company's accountant makes an estimate based on past experience and current economic conditions. For example, losses from uncollectible accounts are normally expected to be greater in a recession than during a period of economic growth. The final decision on the amount of the expense will depend on objective information, such as the accountant's analyses, and on certain qualitative factors, such as how investors, bankers, creditors, and others view the performance of the debtor company. Regardless of the qualitative considerations, the estimated losses from uncollectible accounts should be realistic.

Two common methods of estimating uncollectible accounts expense are the percentage of net sales method and the accounts receivable aging method.

Percentage of Net Sales Method

The basis for the **percentage of net sales method** is the amount of this year's *net sales* that will not be collected. The answer determines the amount of uncollectible accounts expense for the year.

Uncollectible Accounts: The Percentage of Net Sales Method

Transaction The following balances represent Varta Company's ending figures for 2014:

"Section 2 walks through the accounting procedures very well. I like the use of a visual plus the narrative to explain the procedures."

Gerald Childs

Waukesha County Technical College

SECTION 3: BUSINESS APPLICATIONS

With a solid foundation of the fundamental accounting concepts as well as how to apply these concepts when performing accounting procedures, students are now ready for Section 3: **Business Applications**. This section teaches students how accounting information is used to make business decisions. Included here are topics like using ratios to evaluate a company's performance.

SECTION 3

BUSINESS APPLICATIONS

BUSINESS APPLICATIONS

- Receivables turnover
- Days' sales uncollected
- Financing receivables
 - Factoring of accounts receivable
 - Securitization of accounts receivable
 - Discounting of accounts receivable
- Ethics

RELEVANT LEARNING OBJECTIVE

- Lo 4** Show how to evaluate the level of receivables, and identify alternative means of financing receivables.

Lo 4 Evaluating the Level of Accounts Receivable and Ethical Ramifications

Receivables are an important asset for any company that sells on credit. For them, it is critical to manage the level of receivables. Two common measures of the effect of a company's credit policies are receivables turnover and days' sales uncollected. Further, many companies manage their receivables by using various means to finance them. Finally, the judgments in estimating uncollectible accounts are a temptation for unethical behavior.

Receivables Turnover

The **receivables turnover** shows how many times, on average, a company turned its receivables into cash during a period. It reflects the relative size of a company's accounts receivable and the success of its credit and collection policies. It may also be affected by external factors, such as seasonal conditions and interest rates.

The receivables turnover is computed by dividing net sales by the average accounts receivable (net of allowances). Theoretically, the numerator should be net credit sales; but since the amount of net credit sales is rarely available in public reports, investors use total net sales. Using data from **HP's** annual report (presented at the beginning of the chapter), we can compute the company's receivables turnover in 2011 as follows (dollar amounts are in millions).

RATIO

Receivables Turnover: How Many Times Did the Company Collect Its Accounts Receivable During an Accounting Period?

$$\text{Receivables Turnover} = \frac{\text{Net Sales}}{\text{Average Accounts Receivable}}$$

$$\frac{\$127,245}{(\$18,224 + \$18,481)/2} = \frac{\$127,245}{\$18,352.50} = 6.9 \text{ times}^*$$

* Rounded

"This is a nice and useful touch to help students tie everything together. The theory can be dry at times, so this recap helps engage the students' attention again."

Dennis Mullen
City College of San Francisco

EXAMPLES, ACTIVITIES, AND PRACTICE



Business Perspective

A Whirlwind Inventory Turnover—How Does Dell Do It?

Dell Computer Corporation turns its inventory over every 10 days. How can it do this when other computer companies have inventory on hand for 60 days or even longer? Technology and good inventory management are a big part of the answer.

Dell's speed from order to delivery sets the standard for the computer industry. Consider that a computer ordered by 9 A.M. can be delivered the next day by 9 P.M. How can Dell do this when it does not start ordering components and assembling computers until a customer places an order? First, Dell's suppliers keep components warehoused just minutes from Dell's factories, making efficient, just-in-time operations possible. Dell also saves time by sending an e-mail message for some finished products to a shipper, such as **United Parcel Service**, and the shipper picks up the product from a supplier and schedules it to arrive with the PC. In addition to contributing to a high inventory turnover, this practice saves Dell in freight costs. Dell is showing the world how to run a business in the cyber age by selling more than \$39 million worth of computers a day on its website.¹

© HP. / iStockphoto.com

Business Perspective

Throughout the chapter, **Business Perspective** features keep students engaged by providing real business context and examples from well-known companies, including **Google, CVS, Boeing, Ford Motor Company, Microsoft, L.L. Bean, and The Walt Disney Company.**

RECEIVABLES

Business Insight

Hewlett-Packard (HP) Company

Hewlett-Packard Company (HP) is one of the largest and best-known companies in the computer industry. It sells its computers, printers, and related products to individual consumers, small and large businesses, and government, health, and educational organizations. Like any company that sells on credit, HP must give its customers time to pay for their purchases while at the same time retaining enough cash to pay its suppliers. As you can see from HP's Financial Highlights, cash and accounts receivable have made up over 50 percent of the company's current assets in recent years.¹ HP must therefore plan and control its cash flows very carefully.

HP'S FINANCIAL HIGHLIGHTS (in millions)

	2011	2010	2009
Cash	\$ 8,043	\$ 10,929	\$ 13,279
Accounts receivable, net	18,224	18,481	16,537
Total current assets	51,021	54,184	52,539
Net revenue	127,245	126,033	114,552

- CONCEPT** ▶ How does HP apply accrual accounting to its receivables, and how does it properly disclose their value?
- ACCOUNTING APPLICATION** ▶ How can HP estimate the value of its receivables?
- BUSINESS APPLICATION** ▶ How can HP evaluate the effectiveness of its credit policies and the level of its accounts receivable?

A Look Back At: Hewlett-Packard Company



Hewlett-Packard Company

The beginning of this chapter focused on **Hewlett-Packard Company**. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

Section 1: Concepts

How does HP apply accrual accounting to its receivables, and how does it properly disclose their value?

Section 2: Accounting Applications

How can HP estimate the value of its receivables?

Section 3: Business Applications

How can HP evaluate the effectiveness of its credit policies and the level of its accounts receivable?

Business Insight and A Look Back At

Each chapter opens with a **Business Insight** that shows how a small company would use accounting information to make decisions. The Business Insight poses three questions—each of which will be answered in one of the three sections of the chapter. At the end of each chapter, **A Look Back At** revisits the Business Insight company to tie the three sections together.

Apply It! and Try It! ▶

Apply It! activities throughout the chapter illustrate and solve a short exercise and then reference end-of-chapter assignments where students can go to **Try It!** This provides students with an example to reference as they are working to complete homework, making getting started less intimidating.

APPLY IT!

Assume that on December 1, 2014, a company receives a 90-day, 8 percent, \$5,000 note and that the company prepares financial statements monthly.

- What is the maturity date of the note?
- How much interest will be earned on the note if it is paid when due?
- What is the maturity value of the note?
- If the company's fiscal year ends on December 31, describe the adjusting entry that would be made, including the amount.
- How much interest will be earned on this note in 2015?

SOLUTION

- Maturity date is March 1, 2015, determined as follows.

Days remaining in December (31 – 1)	30
Days in January	31
Days in February	28
Days in March	1
Total days	<u>90</u>
- Interest: $\$5,000 \times 8/100 \times 90/365 = \98.63^*
- Maturity value: $\$5,000 + \$98.63 = \$5,098.63$
- An adjusting entry to accrue 30 days of interest income in the amount of $\$32.88^*$ ($\$5,000 \times 8/100 \times 30/365$) would be needed.
- Interest earned in 2015: $\$65.75$ ($\$98.63 - \32.88)

* Rounded

TRY IT! SE6, SE7, SE8, E8A, E9A, E10A, E11A, E8B, E9B, E10B, E11B

Notes Receivable Calculations

SE8. On August 25, Intercontinental Company received a 90-day, 9 percent note in settlement of an account receivable in the amount of \$20,000. Determine the maturity date, amount of interest on the note, and maturity value. (Round to the nearest cent.)

Business Transaction Model ▶

A new business transaction model for all financial accounting chapters involving transactions visually guides students step-by-step through accounting for business transactions as follows:

- Statement of the transaction
- Analysis of the effect on the accounts
- Application of double-entry accounting in T accounts
- Illustration of the journal entry (linked to the T account showing the relationships between the methods and featuring accounting equations)
- Comments that offer supporting explanations regarding the significance of the transaction (often looping back to the concepts covered in Section 1)

Prepayment of Expenses in Cash

Transaction On July 3, Blue Design Studio, Inc., rents an office for and pays \$3,200 for two months' rent in advance.

Analysis The journal entry to record the prepayment of office rent in cash

▲ increases the asset account *Prepaid Rent* with a debit

▼ decreases the asset account *Cash* with a credit

Application of Double Entry

Assets		=	Liabilities	+	Stockholders' Equity
Cash					
Dr.	Cr.				
July 1	40,000		July 3	3,200	
Prepaid Rent					
Dr.	Cr.				
July 3	3,200				

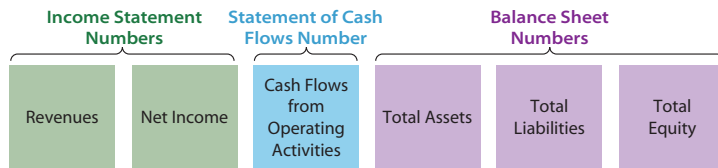
Journal Entry

July 3	Prepaid Rent	Dr.	3,200	Cr.	
	Cash				3,200

Comment A prepaid expense is *classified* as an asset because the expenditure will benefit future operations. This transaction does not affect the totals of assets or liabilities and stockholders' equity because it simply trades one asset for another asset. If the company had paid only July's rent, the stockholders' equity account *Rent Expense* would be *recognized* and debited because the total benefit of the expenditure would be used up in the current month.

RATIO

Profit Margin: How Much Income Does Each Dollar of Sales Generate?



$$\text{Profit Margin} = \frac{\text{Net Income}}{\text{Revenues}}$$

$$= \frac{\$71,524}{\$1,248,624}$$

$$= 0.057, \text{ or } 5.7\%$$



Based on Bizmin Industry Financial Report, December 2011.

Ratio Analysis Model

A new framework for teaching how to analyze company information and make informed decisions simplifies ratio analysis as follows:

- Key question regarding company performance (which the ratio answers)
- Elements of the financial statements that are needed to compute the ratio (focusing on revenue and net income from the income statement, cash flows from operating activities from the statement of cash flows, and total assets, total liabilities, and total equity from the balance sheet)
- Formula for the ratio (which links to the related elements of the financial statements)
- Computation/example
- Graph of industry averages
- Comments that explain what the ratio means (whether it's good or bad)

TRILEVEL PROBLEM: TYING IT ALL TOGETHER!

TriLevel

PROBLEM

NEW TriLevel Problems within CengageNOW follow the same Three Section Approach the book employs by including *Concepts*, *Accounting Applications*, and *Business Applications*. The problems reinforce and apply overarching concepts while also tying the three sections together to give students a complete understanding.

“Any time the students are engaged in the learning process and have to actively participate, I think they enhance their retention of the material. The ability to relate this to an actual company (whether real or not) allows students to see this information in practice.”

Chuck Smith
Iowa Western Community College

Transaction Analysis

The process of assigning business transactions to accounts is called .

One of the most important classification issues in accounting is the difference between an asset and their cost is classified as an . If the items will be used in the future, they are classified as .

Travis Services is an office cleaning company. Consider Travis Services' transactions during its first month.

(a) Received cash from Stanley Travis, in exchange for stock, \$18,680.
 (b) Performed services for a client on account, \$6,530.
 (c) Purchased equipment with cash, \$12,920.
 (d) Performed services for a customer who paid cash, \$7,150.
 (e) Purchased supplies with cash, \$3,480.

Use the following T accounts to record these transactions. You will need to record the transactions in (bottom) on the debit or credit side of the T account, whichever is appropriate.

Cash	Accounts Receivable	Supplies
Equipment	Fees Earned	Common Stock

As supplies are used, Travis Services debits Supplies Expense and credits Supplies.

Stanley Travis would like to charge Supplies Expense when the supplies are purchased. He wants to

- “Great idea. By increasing expenses Travis Services income is lowered and that translates to lower taxes.”
- “Accounting rules dictate that purchases that are consumed in future periods be classified as assets for purposes.”

© Cengage Learning 2014

96% of instructors surveyed said that the TriLevel Problem adequately coached students through thinking about an issue.

“The [TriLevel Problem] links procedure to the creation and use of information, and closes that loop between what students are doing and why it is useful.”

Andy Williams
Edmonds Community College

“It reviews everything students have learned in a format they will find useful, and it links the three areas together. I love this. Each one ending with a business application.”

Joan Ryan
Clackamas Community College

NEW CENGAGENOW FEATURES HELP STUDENTS MAKE CONNECTIONS

NEW Blueprint Problems ▶

In CengageNOW, these problems cover primary learning objectives and help students understand the fundamental accounting concepts and their associated building blocks—not just memorize the formulas or journal entries required for a single concept. *Blueprint Problems* include rich feedback and explanations, providing students with an excellent learning resource.

Blueprint Problem: Predetermined, overapplied, and underapplied overhead

The Nature of Overhead

Recall that unit costs include direct materials, direct labor, and overhead. The costs for direct materials and direct production or sales, and some overhead costs are unknown until the end of the period or early in the next period to determine unit costs, because overhead costs are not always directly related to units produced. Therefore, the beginning of the year, and applied to production throughout the year. This requires three steps:

1. Calculate the predetermined overhead rate.
2. Apply the overhead throughout the year.
3. Reconcile the applied and actual overhead at the end of the year.

Predetermined Overhead Rate

The overhead costs are allocated to jobs using a common measure related to each job; this measure is called should reflect the consumption or use of the overhead costs. There are basically three types of drivers (or cost

To calculate the predetermined overhead rate, you must first estimate the overhead costs for the year, as well

Match the type of driver with its cause.

Driver	Cause
1. <input type="text" value="Select"/>	<input type="text" value="Select"/>
2. <input type="text" value="Volume"/>	<input type="text" value="Select"/>
3. <input type="text" value="Cost"/>	<input type="text" value="Select"/>

Disposal of Fixed Assets

When a fixed asset is being disposed of (sold or discarded), an entry to record depreciation will most likely be necessary before recording the disposal of the asset, since the last depreciation entry for the asset, unless the amount of time is insignificant, such as a few days.

An entry for depreciation will:

- total expenses for the current period.
- the book value of the asset.
- the gain/loss calculation for the asset disposal.

After depreciation has been recorded (if necessary), any gain or loss is calculated and then the journal entry is recorded. The purchase price was \$50,000, the residual value was determined to be \$5,000 and the useful life is 5 years. The company disposed of the asset on July 1, 2009. Depreciation of \$4,500 was recorded on that day, resulting in independent scenarios. The gain/loss calculation and journal entry to record the disposal under each scenario.

Cash received:	Scenario A	Scenario B	Scenario C	Scenario D
	\$0	\$24,750	\$27,500	\$30,000

Scenario A: Gain/loss calculation:

Original cost, January 1, 2007	\$50,000
Less: Accumulated depreciation (as of July 1, 2009)	22,500
Book value, July 1, 2009	\$27,500
Cash received	0
Loss on disposal of asset	\$27,500

Asset disposal entry on July 1, 2009:

Accumulated Depreciation—Machine	22,500	
Loss on Disposal of Asset	27,500	
Machine		50,000

© Cengage Learning 2014


NEW Blueprint Connections ▲

Blueprint Connections in CengageNOW build upon concepts covered and introduced within the *Blueprint Problems*. These scenario-based exercises help reinforce students' knowledge of the concept.

NEW Animated Activities ▶

Animated Activities in CengageNOW are videos that guide students through selected core topics using a realistic company example to illustrate how the concepts relate to the everyday activities of a business.

	February 26, 2016	February 27, 2015
Assets		
Current assets		
Cash and cash equivalents	\$ 1,183,587	\$ 1,096,300
Short-term investment securities	605,608	431,476
Merchandise inventories	1,968,907	1,759,703
Other current assets	315,736	276,066
Total current assets	4,073,838	3,563,545
Long-term investment securities	121,446	132,860
Property and equipment, net	1,118,297	1,119,292
Other assets	334,632	336,633
Total assets	\$ 5,646,193	\$ 5,152,130

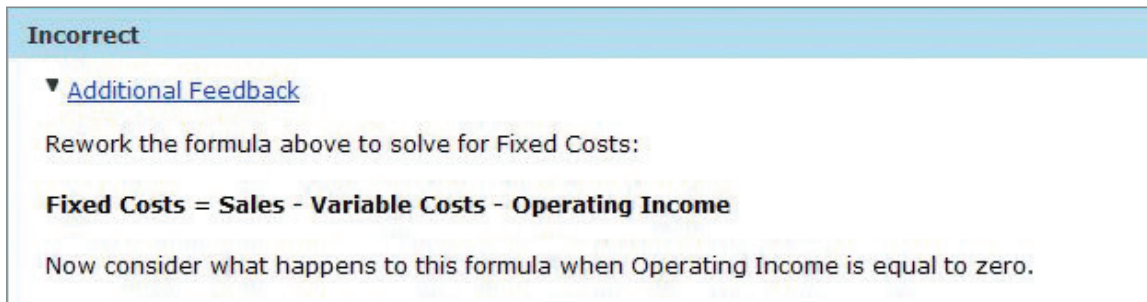


© Cengage Learning 2014

NEW CENGAGENOW FEATURES HELP STUDENTS MAKE CONNECTIONS

NEW Check My Work Feedback ▼

Written feedback is now available when students click on “Check My Work” in CengageNOW to provide students with valuable guidance as they work through homework items.



Incorrect

▼ [Additional Feedback](#)

Rework the formula above to solve for Fixed Costs:

Fixed Costs = Sales - Variable Costs - Operating Income

Now consider what happens to this formula when Operating Income is equal to zero.

© Cengage Learning 2014

NEW Post-submission Feedback ▼

After students have submitted their assignments for a grade in CengageNOW, they can go back and see the correct answers to better understand where they might have gotten off track.



▼ Hide Feedback

Incorrect

▼ [Additional feedback](#)

a. Sales minus sales returns and allowances and minus sales discounts equals net sales.
b. Net sales minus the cost of merchandise sold equals gross profit.
c. Gross profit minus operating expenses minus other revenue and expenses equals net income.

▼ [Solution](#)

Correct Response:

 eBook

Exercise 6-3
Income Statement for Merchandiser

For the fiscal year, sales were \$6,750,000, sales discounts were \$120,000, sales returns and allowances were \$90,000, and the cost of merchandise sold was \$4,000,000.

a. What was the amount of **net sales**?
\$ 6540000

b. What was the amount of **gross profit**?
\$ 2540000

c. If total operating expenses were \$1,200,000, could you determine net income?
No, there could be separately reported "other income" and "other expenses" items.

© Cengage Learning 2014

NEW Apply It Demos

These demonstration videos in CengageNOW will help students complete end-of-chapter questions from Section 2.

ACKNOWLEDGMENTS

In developing and refining the tenth edition of *Financial and Managerial Accounting*, we wanted to ensure that we were creating a textbook that truly reflected the way we teach accounting. To do so, we asked for feedback from over 150 professors, other professional colleagues, and students. We want to recognize those who made special contributions to our efforts in preparing this edition through their reviews, suggestions, and participation in surveys, interviews, and focus groups. We cannot begin to say how grateful we are for the feedback from the many instructors who have generously shared their responses and teaching experiences with us.

John G. Ahmad, *Northern Virginia Community College*
Robert Almon, *South Texas College*
Elizabeth Ammann, *Lindenwood University*
Paul Andrew, *SUNY, Morrisville*
Ryan Andrew, *Columbia College Chicago*
Sidney Askew, *Borough of Manhattan Community College*
Joe Atallah, *Irvine Valley College*
Shele Bannon, *Queensborough Community College*
Michael Barendse, *Grossmont College*
Beverly R. Beatty, *Anne Arundel Community College*
Robert Beebe, *Morrisville State College*
Teri Bernstein, *Santa Monica College*
Cynthia Bird, *Tidewater Community College*
David B. Bojarsky, *California State University*
Linda Bolduc, *Mount Wachusett Community College*
John Bongorno, *Cuyahoga Community College*
Anna Boulware, *St. Charles Community College*
Amy Bourne, *Oregon State University*
Thomas Branton, *Alvin Community College*
Billy Brewster, *University of Texas at Arlington*
Nina E. Brown, *Tarrant County College*
Tracy L. Bundy, *University of Louisiana at Lafayette*
Jacqueline Burke, *Hofstra University*
Marc L. Butterfield, *University of Utah*
Charles Caliendo, *University of Minnesota*
Gerald Childs, *Waukesha County Technical College*
James J. Chimenti, *Jamestown Community College*
Alice Chu, *Golden West College*
Sandra Cohen, *Columbia College*
Lisa Cole, *Johnson County Community College*
Debora Constable, *Georgia Perimeter College*
Barry Cooper, *Borough of Manhattan Community College*
Cheryl Copeland, *California State University, Fresno*
Susan Cordes, *Johnson County Community College*

Meg Costello, *Oakland Community College*
Richard Culp, *Ball State University*
Sue Cunningham, *Rowan Cabarrus Community College*
Robin D'Agati, *Palm Beach State College*
Emmanuel Danso, *Palm Beach State College*
Robert Derstine, *Kutztown University*
Michael Dole, *Marquette University*
Jap Efendi, *University of Texas at Arlington*
Dustin Emhart, *North Georgia Technical College*
Denise M. English, *Boise State University*
Michael Farina, *Cerritos College*
J. Thomas Franco, *Wayne County Community College*
Dean Gray, *Reedley College*
Timothy Green, *North Georgia Technical College*
Timothy Griffin, *Hillsborough Community College*
Teri Grimmer, *Portland Community College*
Michael J. Gurevitz, *Montgomery College*
Qian Hao, *Wilkes University*
Sara Harris, *Arapahoe Community College*
Syed Hasan, *George Mason University*
Wendy Heltzer, *DePaul University*
Merrily Hoffman, *San Jacinto College*
Shanelle Hopkins, *Carroll Community College*
David Hossain, *California State University, Los Angeles*
Phillip Imel, *NOVA Community College, Annadale*
ThankGod O. Imo, *Tompkins Cortland Community College*
Paul Jajairam, *Bronx Community College*
Gene Johnson, *Clark College*
Howard A. Kanter, *DePaul University*
Irene Kim, *George Washington University*
Christopher Kinney, *Mount Wachusett Community College*
Gordon Klein, *University of California, Los Angeles*
Shirly A. Kleiner, *Johnson County Community College*
Leon Korte, *University of South Dakota*

Lynn Krausse, *Bakersfield College*
 Les Kren, *University of Wisconsin, Milwaukee*
 Donnie Kristof-Nelson, *Edmonds Community College*
 Christopher Kwak, *De Anza College*
 Richard Lau, *California State University, Los Angeles*
 Suzanne R. Laudadio, *Durham Technical Community College*
 George Leonard, *St. Petersburg College*
 Lydia Leporte, *Tidewater Community College*
 Hui Lin, *DePaul University*
 Joseph Lipari, *Montclair State*
 Xiang Liu, *California State University, San Bernardino*
 Angelo Luciano, *Columbia College*
 Susan Lueders, *DePaul University*
 Cathy Lumbattis, *Southern Illinois University*
 Sakthi Mahenthiran, *Butler University*
 Eileen Marutzky, *DePaul University*
 Robert Maxwell, *College of the Canyons*
 Mark McCarthy, *DePaul University*
 Clarice McCoy, *Brookhaven College*
 Terra McGhee, *University of Texas at Arlington*
 Florence McGovern, *Bergen Community College*
 Cheryl McKay, *Monroe County Community College*
 John McQuilkin, *Roger Williams University*
 Jeanette Milius, *Iowa Western Community College*
 Jeanne K. Miller, *Cypress College*
 Rita Mintz, *Calhoun Community College*
 Jill Mitchell, *Northern Virginia Community College,
Annandale*
 Odell Moon, *Victor Valley College*
 Kathleen Moreno, *Abraham Baldwin Agricultural College*
 Walter Moss, *Cuyahoga Community College*
 Dennis Mullen, *City College of San Francisco*
 Elizabeth A. Murphy, *DePaul University*
 Penny Nunn, *Henderson Community College*
 Christopher O'Byrne, *Cuyamaca College*
 Shannon Ogden, *Black River Technical College*
 Glenn Pate, *Palm Beach State College*
 Sy Pearlman, *California State University, Long Beach*
 Rama Ramamurthy, *College of William & Mary*
 Lawrence A. Roman, *Cuyahoga Community College*
 Gregg Romans, *Ivy Tech Community College*
 Joan Ryan, *Clackamas Community College*
 Donna B. Sanders, *Guilford Technical Community College*
 Regina Schultz, *Mount Wachusett Community College*
 Jay Semmel, *Broward College*
 Andreas Simon, *California Polytechnic State University*
 Jaye Simpson, *Tarrant County College*
 Alice Sineath, *Forsyth Technical Community College*
 Kimberly Sipes, *Kentucky State University*
 Chuck Smith, *Iowa Western Community College*
 Robert K. Smolin, *Citrus College*
 Jennifer Sneed, *Arkansas State University, Newport*
 Lyle Stelter, *Dakota County Technical College*
 Rhonda Stone, *Black River Technical College*
 Gracelyn Stuart-Tuggle, *Palm Beach State College – Boca
Raton*
 Linda Tarrago, *Hillsborough Community College*
 Steve Teeter, *Utah Valley University*
 Don Trippeer, *SUNY Oneonta*
 Robert Urell, *Irvine Valley College*
 La Vonda Ramey, *Schoolcraft College*
 Patricia Walczak, *Lansing Community College*
 Scott Wandler, *University of New Orleans*
 Chris Widmer, *Tidewater Community College*
 Andy Williams, *Edmonds Community College*
 Wanda Wong, *Chabot College*
 Ronald Zhao, *Monmouth University*
 Teri Zuccaro, *Clarke University*

We also wish to express deep appreciation to colleagues at DePaul University, who have been extremely supportive and encouraging.

Finally, very important to the quality of this book are our Developmental Editor, Krista Kellman; Executive Editor, Sharon Oblinger; and Senior Brand Manager, Kristen Hurd.

ABOUT THE AUTHORS

Belverd E. Needles, Jr., received B.B.A. and M.B.A. degrees from Texas Tech University and his Ph.D. degree from the University of Illinois at Urbana-Champaign. He teaches financial accounting, managerial accounting, and auditing at DePaul University, where he is an internationally recognized expert in international accounting and education. He has published in leading journals and is the author or editor of more than 20 books and monographs. His current research relates to international financial reporting, performance measurement, and corporate governance of high-performance companies in the United States, Europe, India, and Australia. His textbooks are used throughout the world and have received many awards, including (in 2008) the McGuffey Award from the Text and Academic Authors Association. Active in many academic and professional organizations, he is immediate past Vice-President-Education of the American Accounting Association. He has received the Distinguished Alumni Award from Texas Tech University, the Illinois CPA Society Outstanding Educator Award and its Life-Time Achievement Award, the Joseph A. Silvoso Faculty Award of Merit from the Federation of Schools of Accountancy, the Ledger & Quill Award of Merit, and the Ledger & Quill Teaching Excellence Award. He was named Educator of the Year by the American Institute of CPAs, Accountant of the Year for Education by the national honorary society Beta Alpha Psi, and Outstanding International Accounting Educator by the American Accounting Association. He has received the Excellence in Teaching Award from DePaul University.

Marian Powers received her B.S. degree from Chicago State University and her Ph.D. degree from University of Illinois at Urbana-Champaign. In addition to the Kellogg School of Management at Northwestern University, she has taught financial accounting at the University of Illinois, Chicago, and at the Lake Forest Graduate School of Management. Internationally recognized as a dynamic teacher in executive education, she specializes in teaching nonfinancial managers how to read and understand internal and external financial reports, including the impact of international financial reporting standards (IFRS). Her current research relates to international financial reporting, performance measurement, and corporate governance of high-performance companies in the United States, Europe, India, and Australia. Her research has been published in leading journals. Her textbooks, coauthored with Belverd E. Needles, Jr., are used throughout the world and have received many awards, including the Textbook Excellence Award and the McGuffey Award from the Text and Academic Authors Association. She has also coauthored three interactive multimedia software products. She currently serves on the Board of the CPA Endowment Fund of Illinois and is immediate past-chair of the Board of Governors of the Winnetka Community House. She is a member of International Association of Accounting Education and Research, and Illinois CPA Society. She has served on the Board of Directors of the Illinois CPA Society, the Educational Foundation of Women in Accounting, and both the national as well as Chicago chapters of ASWA.

Susan V. Crosson received her B.B.A. degree in economics and accounting from Southern Methodist University and her M.S. degree in accounting from Texas Tech University. She is currently teaching in the Goizueta Business School at Emory University in Atlanta, Georgia. Until recently, she was the Accounting Faculty Lead and Professor at Santa Fe College in Gainesville, Florida. She has also been on the faculty of the University of Florida; Washington University in St. Louis; University of Oklahoma; Johnson County Community College in Kansas; and Kansas City Kansas Community College. She is internationally known for her YouTube accounting videos as an innovative application of pedagogical strategies. In recognition of her professional and academic activities, she was a recipient of the Outstanding Service Award from the American Accounting Association (AAA), an Institute of Management Accountants' Faculty Development Grant to blend technology into the classroom, the Florida Association of Community Colleges Professor of the Year Award for Instructional Excellence, and the University of Oklahoma's Halliburton Education Award for Excellence. Currently, she serves as President of the Teaching, Learning, and Curriculum section of the AAA. Recently, she served as a Supply Chain Leader for The Commission on Accounting Higher Education, which published *“Pathways to a Profession,” Charting a National Strategy for the Next Generation of Accountants*. She has also served on various committees for the AICPA, Florida Institute of CPAs, and the Florida Association of Accounting Educators.

Financial & Managerial Accounting

TENTH EDITION

CHAPTER 1

LEARNING OBJECTIVES

- LO 1** Define *accounting*, explain the concepts underlying accounting measurement, explain the three forms of business entities, and describe the characteristics of a corporation.
- LO 2** Define *financial position*, and state the accounting equation.
- LO 3** Identify the four basic financial statements and their interrelationships.
- LO 4** Explain how generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) relate to financial statements and the independent CPA's report, and identify the organizations that influence GAAP.
- LO 5** Identify the users of accounting information, and identify business goals, activities, and performance measures.
- LO 6** Explain the importance of ethics in financial reporting.



USES OF ACCOUNTING INFORMATION AND THE FINANCIAL STATEMENTS

Business Insight CVS Caremark

CVS Caremark operates a chain of more than 7,300 stores. Its pharmacies fill more than 1 billion prescriptions each year. Over the last five years, CVS has opened or purchased 2,600 new stores and more than doubled its sales and profits. This performance places it among the fastest-growing retail companies.

Why is CVS considered successful? Customers give the company high marks because of the quality of the products that it sells and the large selection of good service that its stores offer. Investment firms and others with a stake in CVS evaluate the company's success in financial terms.

Whether a company is large or small, the same financial measures are used to evaluate its management and to compare it with other companies. In this chapter, as you learn more about accounting and the business environment, you will become familiar with these financial measures.

CVS's Financial Highlights (In millions)

	2011	2010	2009
Net revenues	107,100	95,778	98,215
Net earnings	3,457	3,424	3,696
Total assets	64,543	62,169	61,641
Stockholders' equity	38,051	37,700	35,768

Note: Most companies list the most recent year of information in the first column, as shown here.

1. **CONCEPT** ► What is accounting, and what are the concepts that underlie it?
2. **ACCOUNTING APPLICATION** ► What financial statements does CVS need to present to its investors to evaluate its performance?
3. **BUSINESS APPLICATION** ► What are two principal financial goals investors will be able to determine by reviewing CVS's financial statements?

SECTION 1

CONCEPTS

CONCEPTS

- Accounting measurement
- Business transactions
- Money measure
- Separate entity
- Assets
- Liabilities
- Stockholders' equity

RELEVANT LEARNING OBJECTIVES

LO 1 Define *accounting*, explain the concepts underlying accounting measurement, explain the three forms of business entities, and describe the characteristics of a corporation.

LO 2 Define *financial position*, and state the accounting equation.

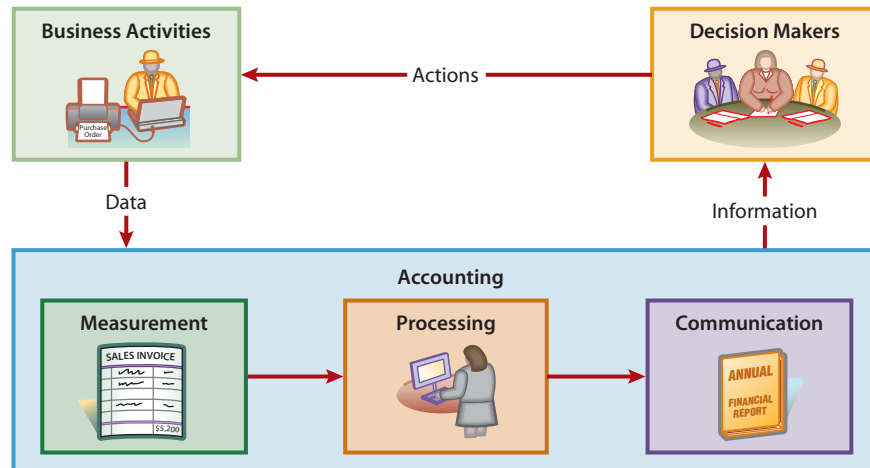
LO 1 Concepts Underlying Accounting Measurement

Accounting is an information system that measures, processes, and communicates financial information about a business.¹ Accountants focus on the needs for financial information, whether the decision makers are inside or outside a business or other economic entity. An **economic entity** is a unit that exists independently, such as a business, hospital, or a governmental body. Accountants supply the information decision makers need to make “reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities.”² As shown in Exhibit 1, accounting is a link between business activities and decision makers.

- Accounting measures business activities by recording data about them for future use.
- The data are stored until needed and then processed to become useful information.
- The information is communicated through reports to decision makers.
- Based on information from accounting, decision makers take actions that affect subsequent business activities.

In other words, data about business activities are the input to the accounting system, and useful information for decision makers is the output.

Exhibit 1
Accounting as an Information System



© Cengage Learning 2014

Financial and Managerial Accounting

Accounting's role of measuring, processing, and communicating financial information is usually divided into financial accounting and managerial accounting. Although the functions of financial accounting and managerial accounting overlap, they can be distinguished by the principal users of their information.

Financial Accounting External decision makers use **financial accounting** to evaluate how well the business has achieved its goals. These reports, called **financial statements**,

are a central feature of accounting. **CVS**, whose stock is traded on the New York Stock Exchange, sends its financial statements to its owners (called *stockholders*), its banks and other creditors, and government regulators. Financial statements report on a business's financial performance and are used extensively both inside and outside a business to evaluate its financial success.

It is important to distinguish accounting from bookkeeping and management information systems.

- **Bookkeeping** is the process of recording financial transactions and keeping financial records. It is mechanical and repetitive, yet an important part of accounting that is usually handled by computers.
- **Management information systems (MIS)** consist of the interconnected subsystems, including accounting, that provide the information needed to run a business.

Managerial Accounting Internal decision makers use information provided by **managerial accounting** about operating, investing, and financing activities. Managers and employees need information about how they have done in the past and what they can expect in the future. For example, **Gap, Inc.**, a retail clothing business, needs an operating report that tells how much was sold at each store and what costs were incurred, and it needs a budget that projects each store's sales and costs for the next year.

Accounting Measurement

To make an *accounting measurement*, the accountant must answer four basic questions:

- What is measured?
- When should the measurement be made?
- What value should be placed on what is measured?
- How should what is measured be classified?

Accountants debate the answers to these questions constantly, and the answers change as new knowledge and practice require. But the basis of today's accounting practice rests on a number of widely accepted concepts and conventions. We begin by focusing on the first question: What is measured? We discuss the other three questions in the next chapter.

Business Transactions **Business transactions** are economic events that affect a business's financial position. Businesses can have hundreds or even thousands of transactions every day. These transactions are the raw material of accounting reports.

A transaction can be an exchange of value (a purchase, sale, payment, collection, or loan) between two or more parties. A transaction also can be an economic event that does not involve an exchange. Some examples of nonexchange transactions are losses from fire, flood, explosion, and theft; physical wear and tear on machinery and equipment; and the day-by-day accumulation of interest.

To be recorded, a transaction must relate directly to a business entity. Suppose a customer buys toothpaste from **CVS** but buys shampoo from a competing store because CVS is out of shampoo. The transaction in which the toothpaste was sold is entered in CVS's records. However, the purchase of the shampoo is not entered in CVS's records because, even though it indirectly affects CVS economically (by losing a sale), it does not involve a direct exchange of value between CVS and the customer.

Money Measure All business transactions are recorded in terms of money. This concept is called **money measure**. Of course, nonfinancial information may also be recorded, but a business's transactions and activities are measured through the recording of monetary amounts. Money is the only factor common to all business transactions, and thus it is the only unit of measure capable of producing financial data that can be compared. The monetary unit a business uses depends on the country in which the business resides. For example, in the United States, the basic unit of money is the dollar.

In China, it is the yuan; in Japan, the yen; in the European Union (EU), the euro; and in the United Kingdom, the pound. In international transactions, exchange rates must be used to translate from one currency to another. An **exchange rate** is the value of one currency in terms of another. For example, a British person purchasing goods from a U.S. company like **CVS** and paying in U.S. dollars must exchange British pounds for U.S. dollars before making payment. In effect, currencies are goods that can be bought and sold.

Exhibit 2 illustrates the exchange rates for several currencies in dollars. It shows the exchange rate for British pounds as \$1.59 per pound on a particular date. Like the prices of many goods, currency prices change daily according to supply and demand. For example, a year and a half earlier, the exchange rate for British pounds was \$1.63.

Exhibit 2 Examples of Foreign Exchange Rates

Country	Price in \$U.S.	Country	Price in \$U.S.
Australia (dollar)	1.07	Hong Kong (dollar)	0.13
Brazil (real)	0.58	Japan (yen)	0.012
Britain (pound)	1.59	Mexico (peso)	0.08
Canada (dollar)	1.00	Russia (ruble)	0.03
European Union (euro)	1.32	Singapore (dollar)	0.79

Source: *The Wall Street Journal*, February 18, 2012.

STUDY NOTE: For accounting purposes, a business is always separate and distinct from its owners, creditors, and customers.

Separate Entity For accounting purposes, a business organization is a **separate entity**, distinct not only from its creditors and customers but also from its owners. It should have its own set of financial records, and its records and reports should refer only to its own affairs.

For example, Just Because Flowers Company should have a bank account separate from the account of Molly Dar, the owner. Molly Dar may own a home, a car, and other property, and she may have personal debts; but these are not the resources or debts of Just Because Flowers. Molly Dar may own another business, say a stationery shop. If she does, she should have a completely separate set of records for each business.

Forms of Business Organization

The three basic forms of business organization recognized as separate entities are the sole proprietorship, the partnership, and the corporation.

Sole Proprietorship A **sole proprietorship** is a business owned by one person. The owner takes all the profits or losses of the business and is liable for all its obligations. As Exhibit 3 shows, sole proprietorships represent the largest number of businesses in the United States, but typically they are the smallest in size.

Partnership A **partnership** is like a sole proprietorship in most ways, but it has two or more owners. The partners share the profits and losses of the business according to a prearranged formula. Generally, any partner can obligate the business to another party, and the personal resources of each partner can be called on to pay the obligations. A partnership must be dissolved if the ownership changes, as when a partner leaves or dies. If the business is to continue as a partnership after this occurs, a new partnership must be formed.

Corporation Both the sole proprietorship and the partnership are convenient ways of separating the owners' commercial activities from their personal activities. Legally,

STUDY NOTE: A key disadvantage of a partnership is the unlimited liability of its owners. Unlimited liability can be avoided by organizing the business as a corporation or, in some states, by forming what is known as a limited liability partnership (LLP).



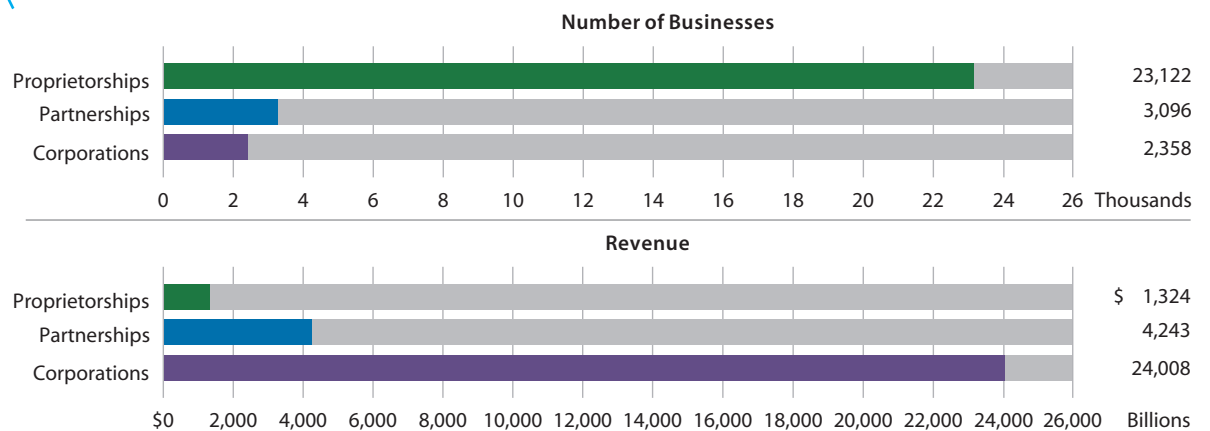
Oleg V. Ivanov/Shutterstock.com

Ron Jon Surf Shop was founded in New Jersey in 1959. The corporation now includes nine store locations, a surf school, and a resort including a restaurant.

however, there is no economic separation between the owners and the businesses. A **corporation**, on the other hand, is a business unit chartered by the state and legally separate from its owners (the stockholders). The **stockholders**, whose ownership is represented by shares of stock, do not directly control the corporation's operations. Instead, they elect a board of directors to run the corporation for their benefit. In exchange for their limited involvement in the corporation's operations, stockholders enjoy **limited liability**; that is, their risk of loss is limited to the amount they paid for their shares. Thus, stockholders are often willing to invest in risky, but potentially profitable, activities. Also, because stockholders can sell their shares without dissolving the corporation, the life of a corporation is unlimited and not subject to the whims or health of a proprietor or a partner.

The characteristics of corporations make them very efficient in amassing capital, which enables them to grow extremely large. As Exhibit 3 shows, even though corporations are fewer in number than sole proprietorships and partnerships, they contribute much more to the U.S. economy in monetary terms. For example, in 2011, **ExxonMobil** generated more revenues than all but 28 of the world's countries.³

Exhibit 3
Number and Receipts (Revenues) of U.S. Proprietorships, Partnerships, and Corporations



Source: U.S. Treasury Department, Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2012.



© Alija / iStockphoto.com

Business Perspective

Are Most Corporations Big or Small Businesses?

Most people think of corporations as large national or global companies whose shares of stock are held by thousands of people and institutions. Indeed, corporations can be huge and have many stockholders. However, of the approximately 4 million corporations in the United States, only about 15,000 have stock that is publicly bought and sold. The vast majority of corporations are small businesses privately held by a few stockholders. Illinois alone has more than 250,000 corporations. Thus, the study of corporations is just as relevant to small businesses as it is to large ones.

Formation and Organization of a Corporation

To form a corporation, most states require individuals, called *incorporators*, to sign an application and file it with the proper state official. This application contains the **articles of incorporation**. If approved by the state, these articles, which form the company charter, become a contract between the state and the incorporators. The company is then authorized to do business as a corporation.

The authority to manage a corporation is delegated by its stockholders to a board of directors and by the board of directors to the corporation's officers. That is, the stockholders elect a board of directors, which sets corporate policies and chooses the corporation's officers, who in turn carry out the corporate policies in their management of the business, as shown in Exhibit 4.

Exhibit 4
The Corporate Organization



© Cengage Learning 2014

Stockholders A unit of ownership in a corporation is called a **share of stock**. The articles of incorporation state the maximum number of shares that a corporation is authorized to issue. The number of shares held by stockholders is the outstanding stock, which may be less than the number authorized in the articles of incorporation. To invest in a corporation, a stockholder transfers cash or other resources to the corporation. In return, the stockholder receives shares of stock representing a proportionate share of ownership. Afterward, the stockholder may transfer the shares at will. Corporations may have more than one kind of stock, but here we refer only to **common stock**.

Board of Directors A corporation's **board of directors** decides on major business policies. Among the board's specific duties are authorizing contracts, setting executive salaries, and arranging major loans with banks. The financial scandals at **Enron**, **WorldCom**, and other companies highlighted the importance of **corporate governance**, which is the oversight of a corporation's management and ethics by its board of directors. The composition of the board of directors varies from company to company, but generally corporate governance is strengthened when it includes several officers of the corporation and several outsiders. The outsiders are called *independent directors* because they do not directly participate in managing the business.

To strengthen corporate governance, the Sarbanes-Oxley Act requires boards of directors to establish an **audit committee** made up of the independent directors who have financial expertise. The purpose of this provision is to ensure that boards of directors are objective in evaluating management's performance. The audit committee is also responsible for engaging the corporation's independent auditors and reviewing their work. Another of the committee's functions is to ensure that adequate systems exist to safeguard the corporation's resources and that accounting records are reliable. In short, the audit committee is the front line of defense against fraudulent financial reporting.

Management Management, appointed by the board of directors to carry out corporate policies and run day-to-day operations, consists of the operating officers—generally the president, or chief executive officer; vice presidents; chief financial officer; and chief operating officer. Besides being responsible for running the business, management has the duty of reporting the financial results of its administration to the board of directors and the stockholders. Though management must, at a minimum, make a comprehensive annual report, it generally reports more often. The annual reports of large public corporations are available to the public. Excerpts from many of them appear throughout this book.

APPLY IT!

Match each description with the appropriate term.

- | | |
|--|---|
| <ol style="list-style-type: none"> 1. Owners have limited liability 2. Requires an exchange of value between two or more parties 3. Owned by only one person 4. Multiple co-owners 5. An amount associated with a business transaction 6. Management appointed by board of directors 7. Distinct from customers, lenders, and owners 8. Biggest segment of the economy | <ol style="list-style-type: none"> a. Business transactions b. Corporation(s) c. Money measure d. Partnership e. Sole proprietorship f. Separate entity |
|--|---|

SOLUTION

1. b; 2. a; 3. e; 4. d; 5. c; 6. b;
7. f; 8. b

TRY IT! SE1, SE2, E1A, E2A, E3A, E12A, E1B, E2B, E3B, E12B

LO 2 Concepts Underlying Financial Position

Financial position refers to a company’s economic resources, such as cash, inventory, and buildings, and the claims against those resources at a particular time. Another term for claims is *equities*.

Every corporation has two types of equities: creditors’ equities, such as bank loans, and stockholders’ equity. The sum of these equities equals a company’s resources:

$$\text{Economic Resources} = \text{Creditors' Equities} + \text{Stockholders' Equity}$$

In accounting terminology, economic resources are called *assets* and creditors’ equities are called *liabilities*. So the equation can be written like this:

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

This equation is known as the **accounting equation (A = L + SE)**. The two sides of the equation must always be equal, or “in balance,” as shown in Exhibit 5. To evaluate the financial effects of business activities, it is important to understand their effects on this equation.

Exhibit 5
The Accounting Equation

