

Horngren's
FINANCIAL & MANAGERIAL
ACCOUNTING

FIFTH EDITION

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HORNGREN'S
**Financial & Managerial
Accounting**

FIFTH EDITION

Tracie Miller-Nobles

Austin Community College

Brenda Mattison

Tri-County Technical College

Ella Mae Matsumura

University of Wisconsin-Madison

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Library of Congress Cataloging-in-Publication Data

Miller-Nobles, Tracie L.

Horngren’s financial & managerial accounting / Tracie L. Miller-Nobles, Brenda L. Mattison, Ella Mae Matsumura.—5 Edition.
pages cm

title: Financial and managerial accounting

Includes index.

ISBN 978-0-13-386629-2

1. Accounting. 2. Managerial accounting. I. Mattison, Brenda. II. Matsumura, Ella Mae, 1952– III. Title.

IV. Title: Financial and managerial accounting.

HF5636.H67 2016

657—dc23

2014021133

10 9 8 7 6 5 4 3 2 1

PEARSON

ISBN-13: 978-0-13-386629-2

ISBN-10: 0-13-386629-7

About the Authors



Tracie L. Miller-Nobles, CPA, received her bachelor's and master's degrees in accounting from Texas A&M University and is currently pursuing her Ph.D. in adult learning also at Texas A&M University. She is an Associate Professor at Austin Community College, Austin, TX. Previously she served as a Senior Lecturer at Texas State University, San Marcos, TX, and has served as department chair of the Accounting, Business, Computer Information Systems, and Marketing/Management department at Aims Community College, Greeley, CO. In addition, Tracie has taught as an adjunct professor at University of Texas and has public accounting experience with Deloitte Tax LLP and Sample & Bailey, CPAs.

Tracie is a recipient of the Texas Society of CPAs Rising Star Award, TSCPA's Outstanding Accounting Educator Award, NISOD Teaching Excellence Award and the Aims Community College Excellence in Teaching Award. She is a member of the Teachers of Accounting at Two Year Colleges, the American Accounting Association, the American Institute of Certified Public Accountants, and the Texas State Society of Certified Public Accountants. She is currently serving on the Board of Directors as secretary/webmaster of Teachers of Accounting at Two Year Colleges, as a member of the American Institute of

Certified Public Accountants nominations committee, and as chair of the Texas Society of CPAs Relations with Education Institutions committee. In addition, Tracie served on the Commission on Accounting Higher Education: Pathways to a Profession.

Tracie has spoken on such topics as using technology in the classroom, motivating non-business majors to learn accounting, and incorporating active learning in the classroom at numerous conferences. In her spare time she enjoys spending time with her friends and family and camping, kayaking, and quilting.

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

Brenda is a member of Teachers of Accounting at Two Year Colleges and the American Accounting Association. She is currently serving on the board of directors as Vice President of Conference Administration of Teachers of Accounting at Two Year Colleges.

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

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



Ella Mae Matsumura, Ph.D. is a professor in the Department of Accounting and Information Systems in the School of Business at the University of Wisconsin–Madison, and is affiliated with the university's Center for Quick Response Manufacturing. She received an A.B. in mathematics from the University of California, Berkeley, and M.Sc. and Ph.D. degrees from the University of British Columbia. Ella Mae has won two teaching excellence awards at the University of Wisconsin–Madison and was elected as a lifetime fellow of the university's Teaching Academy, formed to promote effective teaching. She is a member of the university team awarded an IBM Total Quality Management Partnership grant to develop curriculum for total quality management education.

Ella Mae was a co-winner of the 2010 Notable Contributions to Management Accounting Literature Award. She has served in numerous leadership positions in the American Accounting Association (AAA). She was coeditor of *Accounting Horizons* and has chaired and served on numerous AAA committees. She has been secretary-treasurer and president of the

AAA's Management Accounting Section. Her past and current research articles focus on decision making, performance evaluation, compensation, supply chain relationships, and sustainability. She coauthored a monograph on customer profitability analysis in credit unions.

Brief Contents

CHAPTER 1	Accounting and the Business Environment	1
CHAPTER 2	Recording Business Transactions	55
CHAPTER 3	The Adjusting Process	117
CHAPTER 4	Completing the Accounting Cycle	183
CHAPTER 5	Merchandising Operations	246
CHAPTER 6	Merchandise Inventory	324
CHAPTER 7	Internal Control and Cash	374
CHAPTER 8	Receivables	423
CHAPTER 9	Plant Assets, Natural Resources, and Intangibles	474
CHAPTER 10	Investments	523
CHAPTER 11	Current Liabilities and Payroll	555
CHAPTER 12	Long-Term Liabilities	596
CHAPTER 13	Stockholders' Equity	645
CHAPTER 14	The Statement of Cash Flows	698
CHAPTER 15	Financial Statement Analysis	764
CHAPTER 16	Introduction to Managerial Accounting	827
CHAPTER 17	Job Order Costing	871
CHAPTER 18	Process Costing	923
CHAPTER 19	Cost Management Systems: Activity-Based, Just-In-Time, and Quality Management Systems	989
CHAPTER 20	Cost-Volume-Profit Analysis	1045
CHAPTER 21	Variable Costing	1095
CHAPTER 22	Master Budgets	1136
CHAPTER 23	Flexible Budgets and Standard Cost Systems	1221
CHAPTER 24	Responsibility Accounting and Performance Evaluation	1279
CHAPTER 25	Short-Term Business Decisions	1329
CHAPTER 26	Capital Investment Decisions	1383
<hr/>		
APPENDIX A	—2013 Green Mountain Coffee Roasters, Inc. Annual Report	A-1
APPENDIX B	—Present Value Tables	B-1
APPENDIX C	—Accounting Information Systems	C-1
GLOSSARY		G-1
INDEX		I-1
PHOTO CREDITS		P-1

Contents

CHAPTER 1

Accounting and the Business Environment 1

Why Is Accounting Important? 2

- Decision Makers: The Users of Accounting Information 3
- The Accounting Profession 4

What Are the Organizations and Rules That Govern Accounting? 6

- Governing Organizations 6
- Generally Accepted Accounting Principles 6
- The Economic Entity Assumption 6
- The Cost Principle 9
- The Going Concern Assumption 10
- The Monetary Unit Assumption 10
- International Financial Reporting Standards 10
- Ethics in Accounting and Business 10

What Is the Accounting Equation? 11

- Assets 12
- Liabilities 12
- Equity 12

How Do You Analyze a Transaction? 13

- Transaction Analysis for Smart Touch Learning 13

How Do You Prepare Financial Statements? 19

- Income Statement 19
- Statement of Retained Earnings 20
- Balance Sheet 21
- Statement of Cash Flows 22

How Do You Use Financial Statements to Evaluate Business Performance? 24

- Green Mountain Coffee Roasters, Inc. 24
- Return on Assets (ROA) 24

■ Review 26

■ Assess Your Progress 31

■ Critical Thinking 53

CHAPTER 2

Recording Business Transactions 55

What Is an Account? 56

- Assets 56
- Liabilities 56
- Equity 58
- Chart of Accounts 58
- Ledger 59

What Is Double-Entry Accounting? 60

- The T-Account 60
- Increases and Decreases in the Accounts 60
- Expanding the Rules of Debit and Credit 61
- The Normal Balance of an Account 61
- Determining the Balance of a T-Account 62

How Do You Record Transactions? 63

- Source Documents—The Origin of the Transactions 63
- Journalizing and Posting Transactions 64
- The Ledger Accounts After Posting 75
- The Four-Column Account: An Alternative to the T-Account 77

What Is the Trial Balance? 79

- Preparing Financial Statements from the Trial Balance 79
- Correcting Trial Balance Errors 80

How Do You Use the Debt Ratio to Evaluate Business Performance? 81

■ Review 83

■ Assess Your Progress 90

■ Critical Thinking 115

CHAPTER 3

The Adjusting Process 117

What Is the Difference Between Cash Basis Accounting and Accrual Basis Accounting? 118

What Concepts and Principles Apply to Accrual Basis Accounting? 120

- The Time Period Concept 120
- The Revenue Recognition Principle 120
- The Matching Principle 121

What Are Adjusting Entries and How Do We Record Them? 122

- Deferred Expenses 123
- Deferred Revenues 129
- Accrued Expenses 130
- Accrued Revenues 133

What Is the Purpose of the Adjusted Trial Balance, and How Do We Prepare It? 138

What Is the Impact of Adjusting Entries on the Financial Statements? 140

How Could a Worksheet Help in Preparing Adjusting Entries and the Adjusted Trial Balance? 141

APPENDIX 3A: Alternative Treatment of Recording Deferred Expenses and Deferred Revenues 143

What Is an Alternative Treatment of Recording Deferred Expenses and Deferred Revenues? 143

- Deferred Expenses 143
- Deferred Revenues 145

■ Review 146

■ Assess Your Progress 154

■ Critical Thinking 180

CHAPTER 4

Completing the Accounting Cycle 183

How Do We Prepare Financial Statements? 184

- Relationships Among the Financial Statements 185

How Could a Worksheet Help in Preparing Financial Statements? 189

- Section 5—Income Statement 189
- Section 6—Balance Sheet 189
- Section 7—Determine Net Income or Net Loss 189

What Is the Closing Process, and How Do We Close the Accounts? 191

- Closing Temporary Accounts—Net Income for the Period 193
- Closing Temporary Accounts—Net Loss for the Period 195

How Do We Prepare a Post-Closing Trial Balance? 197

What Is the Accounting Cycle? 199

How Do We Use the Current Ratio to Evaluate Business Performance? 200

APPENDIX 4A: Reversing Entries: An Optional Step 202

What Are Reversing Entries? 202

Accounting for Accrued Expenses 202

Accounting Without a Reversing Entry 203

Accounting With a Reversing Entry 204

■ **Review** 206

■ **Assess Your Progress** 214

■ **Comprehensive Problem 1 for Chapters 1–4** 241

■ **Comprehensive Problem 2 for Chapters 1–4** 242

■ **Critical Thinking** 243

CHAPTER 5

Merchandising Operations 246

What Are Merchandising Operations? 247

The Operating Cycle of a Merchandising Business 247

Merchandise Inventory Systems: Perpetual and Periodic Inventory Systems 249

How Are Purchases of Merchandise Inventory Recorded in a Perpetual Inventory System? 250

Purchase of Merchandise Inventory 251

Purchase Discounts 252

Purchase Returns and Allowances 253

Transportation Costs 254

Cost of Inventory Purchased 256

How Are Sales of Merchandise Inventory Recorded in a Perpetual Inventory System? 257

Sale of Merchandise Inventory 257

Sales Discounts 259

Sales Returns and Allowances 259

Transportation Costs—Freight Out 261

Net Sales Revenue and Gross Profit 261

What Are the Adjusting and Closing Entries for a Merchandiser? 262

Adjusting Merchandise Inventory Based on a Physical Count 262

Closing the Accounts of a Merchandiser 263

Worksheet for a Merchandising Business—Perpetual Inventory System 265

How Are a Merchandiser's Financial Statements Prepared? 266

Income Statement 266

Statement of Retained Earnings and the Balance Sheet 269

How Do We Use the Gross Profit Percentage to Evaluate Business Performance? 269

APPENDIX 5A: Accounting for Merchandise Inventory in a Periodic Inventory System 271

How Are Merchandise Inventory Transactions Recorded in a Periodic Inventory System? 271

Purchases of Merchandise Inventory 271

Sale of Merchandise Inventory 273

Adjusting and Closing Entries 273

Preparing Financial Statements 276

vi Contents

■ **Review** 281

■ **Assess Your Progress** 292

■ **Comprehensive Problem for Chapters 1–5** 320

■ **Critical Thinking** 321

CHAPTER 6

Merchandise Inventory 324

What Are the Accounting Principles and Controls That Relate to Merchandise Inventory? 325

Accounting Principles 325

Control Over Merchandise

Inventory 326

How Are Merchandise Inventory Costs Determined Under a Perpetual Inventory System? 327

Specific Identification Method 329

First-In, First-Out (FIFO) Method 330

Last-In, First-Out (LIFO) Method 331

Weighted-Average Method 333

How Are Financial Statements Affected by Using Different Inventory Costing Methods? 336

Income Statement 336

Balance Sheet 337

How Is Merchandise Inventory Valued When Using the Lower-of-Cost-or-Market Rule? 339

Computing the Lower-of-Cost-or-Market 339

Recording the Adjusting Journal Entry to Adjust Merchandise Inventory 339

What Are the Effects of Merchandise Inventory Errors on the Financial Statements? 341

How Do We Use Inventory Turnover and Days' Sales in Inventory to Evaluate Business Performance? 343

Inventory Turnover 344

Days' Sales in Inventory 344

APPENDIX 6A: Merchandise Inventory Costs Under a Periodic Inventory System 345

How Are Merchandise Inventory Costs Determined Under a Periodic Inventory System? 345

First-In, First-Out (FIFO) Method 346

Last-In, First-Out (LIFO) Method 347

Weighted-Average Method 347

■ **Review** 348

■ **Assess Your Progress** 355

■ **Critical Thinking** 372

CHAPTER 7

Internal Control and Cash 374

What Is Internal Control, and How Can It Be Used to Protect a Company's Assets? 375

Internal Control and the Sarbanes-Oxley Act 375

The Components of Internal Control 376

Internal Control Procedures 377

The Limitations of Internal Control—Costs and Benefits 379

What Are the Internal Control Procedures With Respect to Cash Receipts? 380

- Cash Receipts Over the Counter 380
- Cash Receipts by Mail 381

What Are the Internal Control Procedures With Respect to Cash Payments? 382

- Controls Over Payment by Check 382

How Can a Petty Cash Fund Be Used for Internal Control Purposes? 384

- Setting Up the Petty Cash Fund 385
- Replenishing the Petty Cash Fund 385
- Changing the Amount of the Petty Cash Fund 387

How Can the Bank Account Be Used as a Control Device? 387

- Signature Card 388
- Deposit Ticket 388
- Check 388
- Bank Statement 389
- Electronic Funds Transfers 389
- Bank Reconciliation 390
- Examining a Bank Reconciliation 393
- Journalizing Transactions from the Bank Reconciliation 394

How Can the Cash Ratio Be Used to Evaluate Business Performance? 395

- Review 396
- Assess Your Progress 404
- Critical Thinking 421

CHAPTER 8

Receivables 423

What Are Common Types of Receivables, and How Are Credit Sales Recorded? 424

- Types of Receivables 424
- Exercising Internal Control Over Receivables 425
- Recording Sales on Credit 425
- Recording Credit Card and Debit Card Sales 426
- Factoring and Pledging Receivables 428

How Are Uncollectibles Accounted for When Using the Direct Write-Off Method? 429

- Recording and Writing Off Uncollectible Accounts—Direct Write-Off Method 429
- Recovery of Accounts Previously Written Off—Direct Write-Off Method 429
- Limitations of the Direct Write-Off Method 430

How Are Uncollectibles Accounted for When Using the Allowance Method? 431

- Recording Bad Debts Expense—Allowance Method 431
- Writing Off Uncollectible Accounts—Allowance Method 432
- Recovery of Accounts Previously Written Off—Allowance Method 433
- Estimating and Recording Bad Debts Expense—Allowance Method 433
- Comparison of Accounting for Uncollectibles 438

How Are Notes Receivable Accounted For? 440

- Identifying Maturity Date 441
- Computing Interest on a Note 442

- Accruing Interest Revenue and Recording Honored Notes Receivable 442

- Recording Dishonored Notes Receivable 444

How Do We Use the Acid-Test Ratio, Accounts Receivable Turnover Ratio, and Days' Sales in Receivables to Evaluate Business Performance? 445

- Acid-Test (or Quick) Ratio 446
- Accounts Receivable Turnover Ratio 446
- Days' Sales in Receivables 447

- Review 448
- Assess Your Progress 454
- Critical Thinking 472

CHAPTER 9

Plant Assets, Natural Resources, and Intangibles 474

How Does a Business Measure the Cost of a Plant Asset? 475

- Land and Land Improvements 476
- Buildings 477
- Machinery and Equipment 477
- Furniture and Fixtures 477
- Lump-Sum Purchase 478
- Capital and Revenue Expenditures 479

What Is Depreciation, and How Is It Computed? 480

- Factors in Computing Depreciation 481
- Depreciation Methods 481
- Partial-Year Depreciation 487
- Changing Estimates of a Depreciable Asset 488
- Reporting Plant Assets 489

How Are Disposals of Plant Assets Recorded? 490

- Discarding Plant Assets 490
- Selling Plant Assets 492

How Are Natural Resources Accounted For? 496

How Are Intangible Assets Accounted For? 497

- Accounting for Intangibles 497
- Specific Intangibles 497
- Reporting of Intangible Assets 500

How Do We Use the Asset Turnover Ratio to Evaluate Business Performance? 501

APPENDIX 9A: Exchanging Plant Assets 502

How Are Exchanges of Plant Assets Accounted For? 502

- Exchange of Plant Assets—Gain Situation 502
- Exchange of Plant Assets—Loss Situation 503

- Review 504
- Assess Your Progress 509
- Critical Thinking 521

CHAPTER 10

Investments 523

Why Do Companies Invest? 524

- Debt Securities Versus Equity Securities 524
- Reasons to Invest 524
- Classification and Reporting of Investments 525

How Are Investments in Debt Securities Accounted For? 527

- Purchase of Debt Securities 527
- Interest Revenue 527
- Disposition at Maturity 527

How Are Investments in Equity Securities Accounted For? 528

- Equity Securities with Less Than 20% Ownership (Cost Method) 528
- Equity Securities with 20% to 50% Ownership (Equity Method) 529
- Equity Securities with More Than 50% Ownership (Consolidations) 532

How Are Debt and Equity Securities Reported? 532

- Trading Investments 532
- Available-for-Sale Investments 534
- Held-to-Maturity Investments 536

How Do We Use the Rate of Return on Total Assets to Evaluate Business Performance? 537

- Review 538
- Assess Your Progress 544
- Critical Thinking 552

CHAPTER 11**Current Liabilities and Payroll 555****How Are Current Liabilities of Known Amounts Accounted For? 556**

- Accounts Payable 556
- Sales Tax Payable 557
- Income Tax Payable 557
- Unearned Revenues 558
- Short-Term Notes Payable 558
- Current Portion of Long-Term Notes Payable 560

How Do Companies Account for and Record Payroll? 560

- Gross Pay and Net (Take-Home) Pay 561
- Employee Payroll Withholding Deductions 561
- Payroll Register 564
- Journalizing Employee Payroll 565
- Employer Payroll Taxes 565
- Internal Control Over Payroll 567

How Are Current Liabilities That Must Be Estimated Accounted For? 568

- Bonus Plans 568
- Vacation, Health, and Pension Benefits 569
- Warranties 569

How Are Contingent Liabilities Accounted For? 571

- Remote Contingent Liability 571
- Reasonably Possible Contingent Liability 571
- Probable Contingent Liability 571

How Do We Use the Times-Interest-Earned Ratio to Evaluate Business Performance? 573

- Review 574
- Assess Your Progress 580
- Critical Thinking 594

CHAPTER 12**Long-Term Liabilities 596****How Are Long-Term Notes Payable and Mortgages Payable Accounted For? 597**

- Long-Term Notes Payable 597
- Mortgages Payable 598

What Are Bonds? 600

- Types of Bonds 602
- Bond Prices 602
- Present Value 603
- Bond Interest Rates 603
- Issuing Bonds Versus Issuing Stock 604

How Are Bonds Payable Accounted for Using the Straight-Line Amortization Method? 605

- Issuing Bonds Payable at Face Value 606
- Issuing Bonds Payable at a Discount 606
- Issuing Bonds Payable at a Premium 609

How Is the Retirement of Bonds Payable Accounted For? 611

- Retirement of Bonds at Maturity 611
- Retirement of Bonds Before Maturity 612

How Are Liabilities Reported on the Balance Sheet? 614**How Do We Use the Debt to Equity Ratio to Evaluate Business Performance? 615****APPENDIX 12A: The Time Value of Money 616****What Is the Time Value of Money, and How Is the Present Value of a Future Amount Calculated? 616**

- Time Value of Money Concepts 617
- Present Value of a Lump Sum 619
- Present Value of an Annuity 619
- Present Value of Bonds Payable 620

APPENDIX 12B: Effective-Interest Method of Amortization 622**How Are Bonds Payable Accounted for Using the Effective-Interest Amortization Method? 622**

- Effective-Interest Amortization for a Bond Discount 622
- Effective-Interest Amortization of a Bond Premium 623

- Review 625
- Assess Your Progress 630
- Critical Thinking 643

CHAPTER 13**Stockholders' Equity 645****What Is a Corporation? 646**

- Characteristics of Corporations 646
- Stockholders' Equity Basics 647

How Is the Issuance of Stock Accounted For? 650

- Issuing Common Stock at Par Value 650
- Issuing Common Stock at a Premium 650
- Issuing No-Par Common Stock 651
- Issuing Stated Value Common Stock 652
- Issuing Common Stock for Assets Other Than Cash 653
- Issuing Preferred Stock 654

How Is Treasury Stock Accounted For? 655

- Treasury Stock Basics 655
- Purchase of Treasury Stock 655
- Sale of Treasury Stock 655
- Retirement of Stock 658

How Are Dividends and Stock Splits Accounted For? 659

- Cash Dividends 659
- Stock Dividends 662

Stock Splits 666
Cash Dividends, Stock Dividends, and Stock Splits Compared 666

How Is Equity Reported for a Corporation? 667

Statement of Retained Earnings 667
Statement of Stockholders' Equity 668

How Do We Use Stockholders' Equity Ratios to Evaluate Business Performance? 669

Earnings per Share 669
Price/Earnings Ratio 670
Rate of Return on Common Stock 670

■ Review 672

■ Assess Your Progress 679

■ Critical Thinking 696

CHAPTER 14

The Statement of Cash Flows 698

What Is the Statement of Cash Flows? 699

Purpose of the Statement of Cash Flows 699
Classification of Cash Flows 700
Two Formats for Operating Activities 702

How Is the Statement of Cash Flows Prepared Using the Indirect Method? 702

Cash Flows from Operating Activities 705
Cash Flows from Investing Activities 709
Cash Flows from Financing Activities 711
Net Change in Cash and Cash Balances 714
Non-cash Investing and Financing Activities 715

How Do We Use Free Cash Flow to Evaluate Business Performance? 717

APPENDIX 14A: Preparing the Statement of Cash Flows by the Direct Method 718

How Is the Statement of Cash Flows Prepared Using the Direct Method? 718

Cash Flows from Operating Activities 718

APPENDIX 14B: Preparing the Indirect Statement of Cash Flows Using a Spreadsheet 724

How Is the Statement of Cash Flows Prepared Using the Indirect Method and a Spreadsheet? 724

■ Review 728

■ Assess Your Progress 734

■ Critical Thinking 762

CHAPTER 15

Financial Statement Analysis 764

How Are Financial Statements Used to Analyze a Business? 765

Purpose of Analysis 765
Tools of Analysis 765
Corporate Financial Reports 765

How Do We Use Horizontal Analysis to Analyze a Business? 767

Horizontal Analysis of the Income Statement 768
Horizontal Analysis of the Balance Sheet 769
Trend Analysis 770

How Do We Use Vertical Analysis to Analyze a Business? 771

Vertical Analysis of the Income Statement 772
Vertical Analysis of the Balance Sheet 772
Common-Size Statements 774
Benchmarking 775

How Do We Use Ratios to Analyze a Business? 776

Evaluating the Ability to Pay Current Liabilities 777
Evaluating the Ability to Sell Merchandise Inventory and Collect Receivables 779
Evaluating the Ability to Pay Long-Term Debt 782
Evaluating Profitability 784
Evaluating Stock as an Investment 787
Red Flags in Financial Statement Analyses 789

APPENDIX 15A: The Corporate Income Statement 792

How Is the Complete Corporate Income Statement Prepared? 792

Continuing Operations 793
Discontinued Operations 794
Extraordinary Items 794
Earnings per Share 795

■ Review 795

■ Assess Your Progress 803

■ Comprehensive Problem for Chapter 15 824

■ Critical Thinking 825

CHAPTER 16

Introduction to Managerial Accounting 827

Why Is Managerial Accounting Important? 828

Financial Versus Managerial Accounting 829
Management Accountability 830
Today's Business Environment 831
Ethical Standards 832

How Do Service, Merchandising, and Manufacturing Companies Differ? 833

Service Companies 833
Merchandising Companies 834
Manufacturing Companies 835

How Are Costs Classified? 836

Direct and Indirect Costs 836
Product Costs 837
Prime and Conversion Costs 837

How Do Manufacturing Companies Determine the Cost of Manufactured Products? 839

Calculating Cost of Goods Sold 839
Calculating Cost of Goods Manufactured 839
Flow of Costs Through the Inventory Accounts 842
Calculating Unit Product Cost 843

How Is Managerial Accounting Used in Service and Merchandising Companies? 844

Calculating Cost per Service 845
Calculating Cost per Item 845

■ Review 846

■ Assess Your Progress 850

■ Critical Thinking 869

CHAPTER 17

Job Order Costing 871

How Do Manufacturing Companies Use Job Order and Process Costing Systems? 872

Job Order Costing 873
Process Costing 873

How Do Materials and Labor Costs Flow Through the Job Order Costing System? 873

Materials 874
Labor 878

How Do Overhead Costs Flow Through the Job Order Costing System? 880

Before the Period—Calculating the Predetermined Overhead Allocation Rate 881
During the Period—Allocating Overhead 882
At the End of the Period—Adjusting for Overallocated and Underallocated Overhead 884

What Happens When Products Are Completed and Sold? 885

Transferring Costs to Finished Goods Inventory 885
Transferring Costs to Cost of Goods Sold 885

How Is the Manufacturing Overhead Account Adjusted? 887

Summary 888

How Do Service Companies Use a Job Order Costing System? 892

- Review 894
- Assess Your Progress 900
- Critical Thinking 921

CHAPTER 18

Process Costing 923

How Do Costs Flow Through a Process Costing System? 924

Job Order Costing Versus Process Costing 924
Flow of Costs Through a Process Costing System 925

What Are Equivalent Units of Production, and How are They Calculated? 927

Equivalent Units of Production 928
Conversion Costs 928

How Is a Production Cost Report Prepared? 929

Production Cost Report—First Process—Assembly Department 930
Production Cost Report—Second Process—Cutting Department 936

What Journal Entries Are Required in a Process Costing System? 944

Transaction 1—Raw Materials Purchased 944
Transaction 2—Raw Materials Used in Production 945
Transaction 3—Labor Costs Incurred 945
Transaction 4—Additional Manufacturing Costs Incurred 945
Transaction 5—Allocation of Manufacturing Overhead 946
Transaction 6—Transfer from the Assembly Department to the Cutting Department 946
Transaction 7—Transfer from Cutting Department to Finished Goods Inventory 946
Transaction 8—Puzzles Sold 946
Transaction 9—Adjust Manufacturing Overhead 947

How Can the Production Cost Report Be Used to Make Decisions? 948

APPENDIX 18A: Process Costing: First-In, First-Out Method 949

How Is a Production Cost Report Prepared Using the FIFO Method? 950

Comparison of Weighted-Average and FIFO Methods 959

- Review 960
- Assess Your Progress 967
- Critical Thinking 987

CHAPTER 19

Cost Management Systems: Activity-Based, Just-In-Time, and Quality Management Systems 989

How Do Companies Assign And Allocate Costs? 990

Single Plantwide Rate 991
Multiple Department Rates 993

How Is an Activity-Based Costing System Developed? 996

Step 1: Identify Activities and Estimate Their Total Costs 997
Step 2: Identify the Allocation Base for Each Activity and Estimate the Total Quantity of Each Allocation Base 998
Step 3: Compute the Predetermined Overhead Allocation Rate for Each Activity 999
Step 4: Allocate Indirect Costs to the Cost Object 1000
Traditional Costing Systems Compared with ABC Systems 1001

How Can Companies Use Activity-Based Management to Make Decisions? 1002

Pricing and Product Mix Decisions 1002
Cost Management Decisions 1003

Can Activity-Based Management Be Used in Service Companies? 1005

How Do Just-In-Time Management Systems Work? 1006

Just-In-Time Costing 1008
Recording Transactions in JIT 1009

How Do Companies Manage Quality Using a Quality Management System? 1012

Quality Management Systems 1012
The Four Types of Quality Costs 1013
Quality Improvement Programs 1013

- Review 1015
- Assess Your Progress 1021
- Critical Thinking 1042

CHAPTER 20

Cost-Volume-Profit Analysis 1045

How Do Costs Behave When There Is a Change in Volume? 1046

Variable Costs 1046
Fixed Costs 1047
Mixed Costs 1049

What Is Contribution Margin, and How Is It Used to Compute Operating Income? 1053

Contribution Margin 1053
Unit Contribution Margin 1054
Contribution Margin Ratio 1054
Contribution Margin Income Statement 1054

How Is Cost-Volume-Profit (CVP) Analysis Used? 1055

- Assumptions 1055
- Target Profit—Three Approaches 1056
- Breakeven Point—A Variation of Target Profit 1058
- CVP Graph—A Graphic Portrayal 1059

How Is CVP Analysis Used for Sensitivity Analysis? 1061

- Changes in the Sales Price 1061
- Changes in Variable Costs 1061
- Changes in Fixed Costs 1062

What Are Some Other Ways CVP Analysis Can Be Used? 1063

- Margin of Safety 1063
- Operating Leverage 1064
- Sales Mix 1066

■ Review 1069

■ Assess Your Progress 1076

■ Comprehensive Problem for Chapters 16–20 1091

■ Critical Thinking 1093

CHAPTER 21

Variable Costing 1095

How Does Variable Costing Differ from Absorption Costing? 1096

- Absorption Costing 1096
- Variable Costing 1096
- Comparison of Unit Product Costs 1097

How Does Operating Income Differ Between Variable Costing and Absorption Costing? 1098

- Production Equals Sales 1099
- Production Exceeds Sales 1100
- Production Is Less Than Sales 1102
- Summary 1105

How Can Variable Costing Be Used for Decision Making in a Manufacturing Company? 1106

- Setting Sales Prices 1106
- Controlling Costs 1106
- Planning Production 1107
- Analyzing Profitability 1107
- Analyzing Contribution Margin 1109
- Summary 1111

How Can Variable Costing Be Used for Decision Making in a Service Company? 1112

- Operating Income 1112
- Profitability Analysis 1113
- Contribution Margin Analysis 1114

■ Review 1116

■ Assess Your Progress 1120

■ Critical Thinking 1134

CHAPTER 22

Master Budgets 1136

Why Do Managers Use Budgets? 1137

- Budgeting Objectives 1137
- Budgeting Benefits 1137

- Budgeting Procedures 1140
- Budgeting and Human Behavior 1140

Are There Different Types of Budgets? 1141

- Strategic and Operational Budgets 1141
- Static and Flexible Budgets 1141
- Master Budgets 1142

How Are Operating Budgets Prepared for a Manufacturing Company? 1143

- Sales Budget 1144
- Production Budget 1145
- Direct Materials Budget 1146
- Direct Labor Budget 1147
- Manufacturing Overhead Budget 1148
- Cost of Goods Sold Budget 1149
- Selling and Administrative Expense Budget 1150

How Are Financial Budgets Prepared for a Manufacturing Company? 1151

- Capital Expenditures Budget 1151
- Cash Budget 1151
- Budgeted Income Statement 1159
- Budgeted Balance Sheet 1160
- Budgeted Statement of Cash Flows 1161

How Can Information Technology Be Used in the Budgeting Process? 1163

- Sensitivity Analysis 1163
- Budgeting Software 1163

APPENDIX 22A: Budgeting for Merchandising Companies 1164

How Are Operating Budgets Prepared for a Merchandising Company? 1165

- Sales Budget 1165
- Inventory, Purchases, and Cost of Goods Sold Budget 1167
- Selling and Administration Expense Budget 1168

How Are Financial Budgets Prepared for a Merchandising Company? 1169

- Capital Expenditures Budget 1169
- Cash Budget 1169
- Budgeted Income Statement 1172
- Budgeted Balance Sheet 1173
- Budgeted Statement of Cash Flows 1174

■ Review 1176

■ Assess Your Progress 1183

■ Critical Thinking 1218

CHAPTER 23

Flexible Budgets and Standard Cost Systems 1221

How Do Managers Use Budgets to Control Business Activities? 1223

- Performance Reports Using Static Budgets 1223
- Performance Reports Using Flexible Budgets 1223

Why Do Managers Use a Standard Cost System to Control Business Activities? 1228

- Setting Standards 1228
- Standard Cost System Benefits 1230
- Variance Analysis for Product Costs 1231

How Are Standard Costs Used to Determine Direct Materials and Direct Labor Variances? 1233

- Direct Materials Variances 1234
- Direct Labor Variances 1236

How Are Standard Costs Used to Determine Manufacturing Overhead Variances? 1238

- Allocating Overhead in a Standard Cost System 1238
- Variable Overhead Variances 1239
- Fixed Overhead Variances 1241

What Is the Relationship Among the Product Cost Variances, and Who Is Responsible for Them? 1244

- Variance Relationships 1245
- Variance Responsibilities 1246

How Do Journal Entries Differ in a Standard Cost System? 1247

- Journal Entries 1247
- Standard Cost Income Statement 1251

- Review 1253
- Assess Your Progress 1261
- Critical Thinking 1276

CHAPTER 24

Responsibility Accounting and Performance Evaluation 1279

Why Do Decentralized Companies Need Responsibility Accounting? 1280

- Advantages of Decentralization 1280
- Disadvantages of Decentralization 1281
- Responsibility Accounting 1281

What Is a Performance Evaluation System, and How Is It Used? 1285

- Goals of Performance Evaluation Systems 1285
- Limitations of Financial Performance Measurement 1286
- The Balanced Scorecard 1286

How Do Companies Use Responsibility Accounting to Evaluate Performance in Cost, Revenue, and Profit Centers? 1289

- Controllable Versus Noncontrollable Costs 1290
- Responsibility Reports 1290

How Does Performance Evaluation in Investment Centers Differ From Other Centers? 1295

- Return on Investment (ROI) 1296
- Residual Income (RI) 1298
- Limitations of Financial Performance Measures 1300

How Do Transfer Prices Affect Decentralized Companies? 1302

- Objectives in Setting Transfer Prices 1302
- Setting Transfer Prices 1303

- Review 1305
- Assess Your Progress 1311
- Comprehensive Problem for Chapters 22–24 1323
- Critical Thinking 1327

CHAPTER 25

Short-Term Business Decisions 1329

How Is Relevant Information Used to Make Short-Term Decisions? 1330

- Relevant Information 1330
- Relevant Nonfinancial Information 1331
- Differential Analysis 1331

How Does Pricing Affect Short-Term Decisions? 1333

- Setting Regular Prices 1333
- Special Pricing 1337

How Do Managers Decide Which Products to Produce and Sell? 1341

- Dropping Unprofitable Products and Segments 1341
- Product Mix 1345
- Sales Mix 1348

How Do Managers Make Outsourcing and Processing Further Decisions? 1349

- Outsourcing 1349
- Sell or Process Further 1354

- Review 1356
- Assess Your Progress 1364
- Critical Thinking 1381

CHAPTER 26

Capital Investment Decisions 1383

What Is Capital Budgeting? 1384

- The Capital Budgeting Process 1384
- Focus on Cash Flows 1386

How Do the Payback and Accounting Rate of Return Methods Work? 1388

- Payback 1388
- Accounting Rate of Return (ARR) 1391

What Is the Time Value of Money? 1395

- Time Value of Money Concepts 1395
- Present Value of a Lump Sum 1397
- Present Value of an Annuity 1398
- Summary 1398

How Do Discounted Cash Flow Methods Work? 1400

- Net Present Value (NPV) 1401
- Internal Rate of Return (IRR) 1406
- Comparing Capital Investment Analysis Methods 1409
- Sensitivity Analysis 1409
- Capital Rationing 1413

- Review 1414
- Assess Your Progress 1421
- Comprehensive Problem for Chapters 25–26 1434
- Critical Thinking 1436

APPENDIX A—2013 Green Mountain Coffee Roasters, Inc. Annual Report A-1

APPENDIX B—Present Value Tables B-1

APPENDIX C—Accounting Information Systems C-1

GLOSSARY G-1

INDEX I-1

PHOTO CREDITS P-1

Changes to This Edition

General

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

NEW! Added three comprehensive problems in managerial chapters.

Chapter 1

NEW! Added discussion of the Pathways Commission and incorporated the Pathways' Vision Model.

Clarified and simplified the financial statement presentation.

Chapter 3

NEW! Added discussion of the new revenue recognition principle.

Replaced the word *prepaids* with *deferrals* to better align with the presentation of the other types of adjusting entries.

Chapter 4

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

Chapter 5

NEW! Added section on income tax expense and updated income statement presentation.

Chapter 9

Expanded the discussion on partial-year depreciation.

Chapter 11

NEW! Added a discussion on income taxes payable.

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

Chapter 13

Moved coverage of treasury stock before dividends to increase students' understanding of dividend transactions.

Modified the presentation of dividends to match the material presented in earlier chapters (Chapters 1–4).

Chapter 16

NEW! Added discussion of the Pathways Commission and incorporated the Pathways' Vision Model.

NEW! Included triple bottom line in Today's Business Environment section.

Expanded the cost flows exhibit to include T-accounts for manufacturing inventory accounts.

Chapter 17

Modified the exhibit on summary journal entries to include T-accounts for manufacturing inventory accounts and COGS.

Chapter 19

Clarified the explanation of the differences between target pricing and cost-based pricing.

Chapter 20

NEW! Added comprehensive problem for Chapters 16–20.

Chapter 24

NEW! Added comprehensive problem for Chapters 22–24.

Chapter 26

NEW! Added comprehensive problem for Chapters 25 and 26.

Financial & Managerial Accounting... Expanding on Proven Success

New to the Enhanced eText

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

NEW!

Try It! Solution Videos

Author recorded solution videos accompany Try Its! Just click on the Try It! box and watch the author will walk students through the problem and the solution.

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

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

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

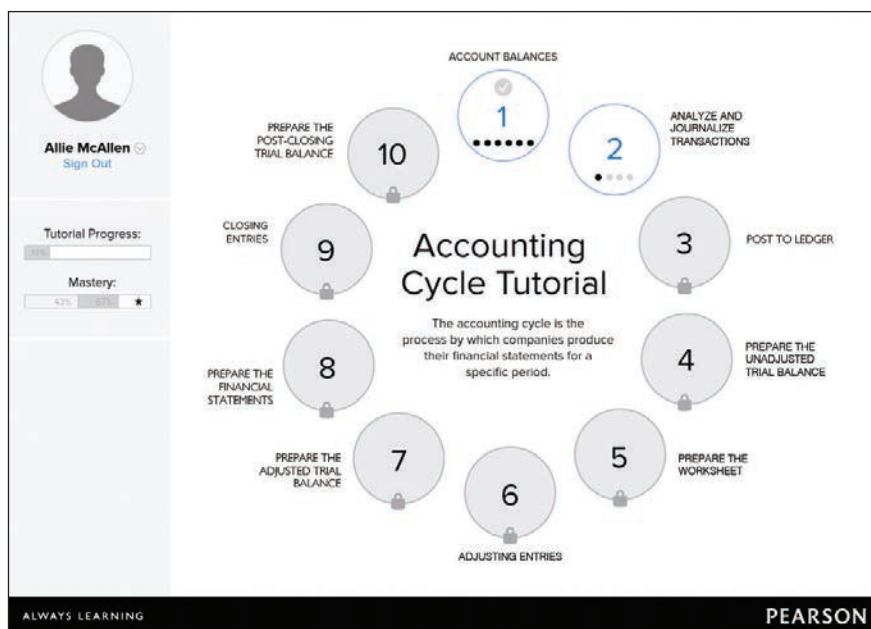
Deferral: Cash occurs before revenue or expense
Accrual: Cash occurs after revenue or expense

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

NEW!

Accounting Cycle Tutorial

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



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NEW!

Learning Catalytics—A “bring your own device” assessment and classroom activity system that expands the possibilities for student engagement. Using Learning Catalytics, you can deliver a wide range of auto-gradable or open-ended questions that test content knowledge and build critical thinking skills. Eighteen different answer types provide great flexibility, including graphical, numerical, textual input, and more.

The screenshot shows the Learning Catalytics interface. At the top, it says "learning catalytics" and "David Tennant | Log out". Below that, it displays "Session 71690166" and "many choice question". The question is: "Choose all of the accounts that would be listed on the balance sheet." The options are: A. Revenues, B. Losses, C. Assets, D. Liabilities, E. Expenses, F. Stockholders' equity, and G. Gains. A "Submit response" button is visible. At the bottom, there are links for "Refresh", "Send a message to the instructor", and "Join another session". The footer includes "ALWAYS LEARNING", "PEARSON", and "Copyright © 2014 Pearson or its affiliate(s). All rights reserved." with links for "Help | Support | Legal | Contact us".

NEW!

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

The screenshot shows an animated lecture slide titled "Depreciation". It features a diagram with two T-accounts. The left T-account is labeled "Furniture" and has a "Normal DR balance" arrow pointing to its debit side. Above it is a bracket labeled "Related Account". The right T-account is labeled "Accumulated Depreciation—Furniture" and has a "Normal CR balance" arrow pointing to its credit side. Above it is a bracket labeled "Contra Account". Below the diagram, the text reads: "A business may have a separate Accumulated Depreciation account for each depreciable asset". Two bullet points follow: "➤ Accumulated Depreciation - Furniture" and "➤ Accumulated Depreciation - Building". A laptop icon with "Smart Touch Learning" is shown. The footer includes "Copyright © 2016 Pearson Education, Inc." and "PEARSON".

End-of-Chapter Continuing and Comprehensive Problems

> Continuing Problem

Problem P1-54 is the first problem in a sequence that begins an accounting cycle. The cycle is continued in Chapter 2 and completed in Chapter 5.

P1-54 Using the accounting equation for transaction analysis, preparing financial statements, and calculating return on assets (ROA)

Daniels Consulting began operations and completed the following transactions during December 2016:

Dec. 2	Stockholders contributed \$20,000 cash in exchange for common stock.
2	Paid monthly office rent, \$2,000.
3	Paid cash for a computer, \$3,600. This equipment is expected to remain in service for five years.
4	Purchased office furniture on account, \$3,000. The furniture should last for five years.
5	Purchased office supplies on account, \$800.
9	Performed consulting service for a client on account, \$2,500.
12	Paid utilities expenses, \$150.
18	Performed service for a client and received cash of \$2,100.
21	Received \$2,400 in advance for client service to be performed in the future. (This increases the Unearned Revenue account, which is a liability. This account will be explained in more detail in Chapter 2.)

Continuing Problem—Starts in Chapter 1 and runs through the entire book exposing students to recording entries for a service company and then moving into recording transactions for a merchandiser later in the text. The managerial chapters emphasize the relevant topics for that chapter using a continuous company.

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

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

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

Comprehensive Problem for Chapters 1–5—Covers the entire accounting cycle for a merchandise company.

Comprehensive Problem for Chapter 15—Students use trend analysis and ratios to analyze a company for its investment potential.

NEW! **Comprehensive Problem for Chapters 16–20**—Covers fundamental managerial accounting concepts: job order costing, process costing, cost management systems, and cost-volume-profit analysis.

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

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

Comprehensive Problem for Appendix C—Uses special journals and subsidiary ledgers and covers the entire accounting cycle for a merchandise company. Students can complete this comprehensive problem using the MyAccountingLab General Ledger or Quickbooks™ software.

COMPREHENSIVE PROBLEM

> Comprehensive Problem for Chapters 16–20

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

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

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

For March 2016, the Savannah Shirt Company compiled the following data for the Cutting and Sewing Departments:

Chapter Openers

Chapter openers set up the concepts to be covered in the chapter using stories students can relate to. The implications of those concepts on a company's reporting and decision making processes are then discussed.

The Adjusting Process 3



Where's My Bonus?

Liam Mills was surprised when he opened his mail. He had just received his most recent quarterly bonus check from his employer, Custom Marketing, and the check was smaller than he expected. Liam worked as a sales manager and was responsible for product marketing and implementation in the southwest region of the United States. He was paid a monthly salary but also received a 3% bonus for all revenue generated from advertising services provided to customers in his geographical area. He was counting on his fourth quarter (October–December) bonus check to be large enough to pay off the credit card debt he had accumulated over the holiday break. It had been a great year-end for Liam. He had closed several open accounts, successfully signing several annual advertising contracts. In addition, because of his negotiating skills, he was able to collect half of the payments for services up front instead of waiting for his customers to pay every month. Liam expected that his bonus check would be huge because of this new business, but it wasn't.

The next day, Liam stopped by the accounting office to discuss his bonus check. He was surprised to learn that his bonus was calculated by the revenue earned by his company through December 31. Although Liam had negotiated to receive half of the payments up front, the business had not yet earned the revenue from those payments. Custom Marketing will not record revenue earned until the advertising services have been performed. Eventually, Liam will see the new business reflected in his bonus check, but he'll have to wait until the revenue has been earned.

How Was Revenue Earned Calculated?
At the end of a time period (often December 31), companies are required to accurately report revenues earned and expenses incurred during that time period. In order to do this, the company reviews the account balances as of the end of the time period and determines whether any adjustments are needed. For example, CC Media Holdings, Inc., the parent company of radio giant Clear Channel Communications and Clear Channel Outdoor Holdings, an outdoor advertising agency, must determine the amount of revenue earned from open advertising contracts. These contracts can cover only a few weeks or as long as several years. Only the amount earned in the current time period is reported as revenue on the income statement. Adjusting the books is the process of reviewing and adjusting the account balances so that amounts on the financial statements are reported accurately. This is what we will learn in this chapter.



Effect on the Accounting Equation

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

On November 10, Smart Touch Learning performed services for clients, for which the clients will pay the company later. The business earned \$3,000 of service revenue on account.

This transaction increased Accounts Receivable, so we debit this asset. Service Revenue is increased with a credit.

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

Date	Accounts and Explanation	Debit	Credit
Nov. 10	Accounts Receivable	3,000	
	Service Revenue		3,000
	<i>Performed services on account.</i>		

Instructor Tips & Tricks

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

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

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

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

Common Questions, Answered

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



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

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

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

Try It! Boxes

Found after each learning objective, Try Its! give students the opportunity to apply the concept they just learned to an accounting problem. Deep linking in the eText will allow students to practice in MyAccountingLab without interrupting their interaction with the eText.

Try It!

Total Pool Services earned \$130,000 of service revenue during 2016. Of the \$130,000 earned, the business received \$105,000 in cash. The remaining amount, \$25,000, was still owed by customers as of December 31. In addition, Total Pool Services incurred \$85,000 of expenses during the year. As of December 31, \$10,000 of the expenses still needed to be paid. In addition, Total Pool Services prepaid \$5,000 cash in December 2016 for expenses incurred during the next year.

1. Determine the amount of service revenue and expenses for 2016 using a cash basis accounting system.
2. Determine the amount of service revenue and expenses for 2016 using an accrual basis accounting system.

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

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

Redesigned

The redesign includes clean and consistent art for T-accounts, journal entries, financial statements, and the accounting equation. New art types include clear explanations and connection arrows to help students follow the transaction process.

$$\text{ASSETS} = \left\{ \begin{array}{l} \text{LIABILITIES} + \\ \text{EQUITY} \end{array} \right.$$

$$\text{EQUITY} = \text{Contributed Capital} + \text{Retained Earnings}$$

$$\text{Contributed Capital} = \text{Common Stock}$$

$$\text{Retained Earnings} = \text{Revenues} - \text{Expenses} - \text{Dividends}$$

IFRS

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



Decision Boxes

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

DECISIONS

Can we cut these costs?

The management team of Puzzle Me is looking at the production cost reports for July, and discussing opportunities for improvement. The production manager thinks the production process is very efficient, and there is little room for cost savings in conversion costs. The purchasing manager tells the team that he was recently approached by a supplier with an excellent reputation for quality. This supplier submitted a bid for cardboard that was a little thinner but would allow the company to decrease direct materials costs by 5%. What should the team do?

Solution

The production cost reports for the Assembly and Cutting Departments show direct materials costs of \$2.80 and \$0.50 per puzzle, for total direct materials cost of \$3.30 per puzzle. A decrease of 5% in direct materials costs would result in a savings

of \$0.165 per puzzle ($\$3.30 \times 5\%$) and decrease total costs from \$5.30 to \$5.135 per puzzle. Based on the completed production of 38,000 puzzles in July, the total cost savings would be \$6,270 per month ($\$0.165 \text{ per puzzle} \times 38,000 \text{ puzzles}$). The purchasing manager recommends using the new supplier.

Alternate Solution

The marketing manager has a different perspective. He points out that most of the puzzles produced are for toddlers. Based on market research, the adults who purchase these puzzles like the sturdy construction. If Puzzle Me changes materials and the puzzles do not stand up well to the treatment they receive by young children, the company could rapidly lose market share. The marketing manager does not recommend using a thinner cardboard.

> Things You Should Know

1. How do we prepare financial statements?

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

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

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

Things You Should Know

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

Dear Colleague,

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

First, we made certain that our content was clear, consistent, and above all, accurate. As authors, we reviewed each chapter to ensure that students understand what they are reading and that there is consistency from chapter to chapter. In addition, our textbook goes through a multi-level accuracy check which includes the author team working every single accounting problem and having a team of accounting professors from across the nation review for accuracy. Next, through ongoing conversations with our colleagues and our time engaged at professional conferences, we confirmed that our pedagogy and content represents the leading methods used in the classroom and provides your students with the foundation they need to be successful in their future academic and professional careers. Lastly, we concentrated on student success and providing resources for professors to create an active and engaging classroom.

Student success. Using our experience as educators, our team carefully considered how students learn, what they learn, and where they struggle the most. We understand that sometimes there is a gap in students' understanding between the textbook content and what is done in the classroom or in an online environment, so we have included in the textbook and enhanced eText several great learning aids for students. *Instructor Tips and Tricks* and *Common Questions Answered* address areas that are typically challenging for students. These aids provide handy memory tools or address common student misconceptions or confusion. We also realized that students use our enhanced eText to study on their own time and we have built in many new features to bring learning to life and to allow students to apply the concepts they are reading about outside of the classroom. Available through MyAccountingLab, students have the opportunity to watch author recorded solution videos, practice the accounting cycle using an interactive tutorial, and watch in-depth author-driven animated lectures that cover every learning objective.

Professor expectations. As professors, we know it's critical to have excellent end-of-chapter material and instructor resources. With these expectations, all end-of-chapter problems have been revised and our author team, along with our trusted accuracy checkers, have checked every problem for accuracy and consistency. In addition to financial comprehensive problems, three NEW comprehensive problems have been added to the managerial content. These problems cover multiple chapters and encourage students to think reflectively about prior material learned and the connections between accounting concepts. We have also reviewed and updated ALL instructor resources to accompany this edition of the book. In addition, the PowerPoint presentations and Test Bank have had significant revisions based upon your feedback and needs.

Expanding on the proven success of our last edition, we believe that our enhancements to *Horngren's Financial and Managerial Accounting*, along with MyAccountingLab, will help your students achieve success in accounting. We welcome your feedback, suggestions, and comments. Please don't hesitate to contact us at HorngrensAccounting@pearson.com.

Tracie L. Miller-Nobles, CPA Brenda Mattison Ella Mae Matsumura, PhD

Instructor and Student Resources

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

For Instructors

MyAccountingLab

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

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

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

Online Instructor's Resource Manual:

Course Content:

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

Chapter Content:

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

Online Instructor's Solutions Manual:

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

Online Test Bank:

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

PowerPoint Presentations:*Instructor PowerPoint Presentations:*

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

Student PowerPoint Presentations:

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

Demonstration Problem PowerPoint Presentations:

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

Clicker Response System (CRS) PowerPoint Presentations:

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

Image Library:

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

Working Papers and Solutions:

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

Data and Solutions Files:

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

For Students

MyAccountingLab

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

- | | |
|--------------------------|-------------------------------------|
| • Pearson Enhanced eText | • Working Papers |
| • Data Files | • Student PowerPoint® Presentations |
| • Animated Lectures | • Accounting Cycle Tutorial |
| • Demo Docs | • Flash Cards |

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

The book's Web site contains the following:

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

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

Acknowledgments

Acknowledgments for This Edition:

Tracie Miller–Nobles would like to thank her parents and sister: Kipp and Sylvia Miller and Michelle Miller. She would also like to express her gratitude to her many colleagues and friends who encourage and support her. In addition, she would like to thank Kevin Morris for always making her laugh and for being the best camping buddy she could ever ask for. Here's to many more trails.

Brenda Mattison has always had the loving support of her family and wishes to express her gratitude to them, especially her husband, Grant Mattison, who has been a constant and stable influence and inspiration for more than 25 years. Her family's faith in her, along with her faith in God, provided the solid foundation that allowed her to develop her gift of teaching and achieve her dreams while helping others to achieve theirs.

Ella Mae Matsumura thanks her family for their longstanding love and support in her endeavors: husband, Kam-Wah Tsui; son, David Tsui; sister and late parents, Linda, Lester, and Eda Matsumura. She would also like to express her appreciation to: the numerous colleagues and friends who have encouraged her and helped her grow as a scholar and a person; the many students who have provided constructive feedback that has shaped her teaching; and her faith community for its enduring love and affirmation.

The authors would like to sincerely thank Lacey Vitetta, Roberta Sherman, Mary Kate Murray, Andra Skaalrud, Alison Haskins, and Donna Battista for their unwavering support of this edition. They express their extreme pleasure in working with each of them and are appreciative of their guidance, patience, and belief in the success of this project.

Contributor:

Lori Hatchell, *Aims Community College*

Advisory Panels, Focus Group Participants, and Reviewers:

Samad Adams, *Bristol Community College*

Sharon Agee, *Rollins College*

Markus Ahrens, *St. Louis Community College*

Janice Akao, *Butler County Community College*

Anna Alexander, *Caldwell Community College and Technical Institute*

Sheila Ammons, *Austin Community College*

Sidney Askew, *Borough of Manhattan Community College*

Michael Barendse, *Grossmont College*

Vikki Bentz, *Yavapai College*

Jennifer Cainas, *University of South Florida*

Anne Cardozo, *Broward College*

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

Martha Cavalaris, *Miami Dade College*

Donna Chadwick, *Sinclair Community College*

Colleen Chung, *Miami Dade College*

Tom Clement, *University of North Dakota*

Geoffrey Danzig, *Miami Dade College–North*

Judy Daulton, *Piedmont Technical College*

Michelle Davidowitz, *Kingsborough Community College*

Annette Fisher Davis, *Glendale Community College*

Anthony Dellarte, *Luzerne County Community College*

Crystal Drum, *Guilford Technical Community College*

Mary Ewanechko, *Monroe Community College*

Elisa Fernandez, *Miami Dade College*

Lori Grady, *Bucks County Community College*

Marina Grau, *Houston Community College*

Gloria Grayless, *Sam Houston State University*

Dawn D. Hart, *Darton State College*

Lori Hatchell, *Aims Community College*

Shauna Hatfield, *Salt Lake Community College*

Patricia Holmes, *Des Moines Area Community College*

Cynthia Johnson, *University of Arkansas, Little Rock*

Jeffrey Jones, *The College of Southern Nevada*

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

Anne Kenner, *Brevard Community College*

Stephanie (Sam) King, *Edison State College*

Paul Koulakov, *Nashville State Community College*

Christy Land, *Catawba Valley Community College*

Wayne Lewis, *Hudson Valley Community College*

Mabel Machin, *Valencia College*

Mostafa Maksy, *Kutztown University*

Richard Mandau, *Piedmont Technical College*

Maria C. Mari, *Miami Dade College*

Cynthia J. Miller, *University of Kentucky*

Joanne Orabone, *Community College of Rhode Island*

Kimberly Perkins, *Austin Community College*

William Quilliam, *Florida Southern College*

Marcela Raphael, *Chippewa Valley Technical College*

Ryan Rees, *Salt Lake Community College*

Cecile Robert, *Community College of Rhode Island*

Shani Nicole Robinson, *Sam Houston State University*

Carol Rowey, *Community College of Rhode Island*

Amanda J. Salinas, *Palo Alto College*

Dennis Shea, *Southern New Hampshire University*
Jaye Simpson, *Tarrant County*
John Stancil, *Florida Southern*
Diana Sullivan, *Portland Community College*
Annette Taggart, *Texas A&M University–Commerce*
Linda Tarrago, *Hillsborough Community College*
Teresa Thompson, *Chaffey College*
Judy Toland, *Bucks County Community College*

Accuracy Checkers:

James L. Baker, *Harford Community College*
Nancy Emerson, *North Dakota State University*
Richard Mandau, *Piedmont Technical College*

Supplements Authors and Reviewers:

David Dearman, *Piedmont Technical College*
Kelly Damron, *Glendale Community College*
Helen Brubeck, *Saint Mary-of-the-Woods College*
Brett Killion, *Lakeland College*
Sheila Ammons, *Austin Community College*

Robin D. Turner, *Rowan-Cabarrus Community College*
William Van Glabek, *Edison State College*
Stanley Walker, *Georgia Northwestern Tech*
Deb Weber, *Hawkeye Community College*
Denise A. White, *Austin Community College*
Donald R. Wilke, *Northwest Florida State College*
Wanda Wong, *Chabot College*
Judy Zander, *Grossmont College*

Carolyn Streuly
Carol Hughes, *Asheville-Buncombe Technical Community College*

Dave Alldredge, *Salt Lake Community College*
Michelle Suminski, *Marygrove College*
Connie Belden, *Butler Community College*
Kate Demarest, *Carroll Community College*

The authors would like to express their gratitude for the diligent and exemplary work of all of our contributors, reviewers, accuracy checkers, and supplement authors. Each of you played a part in making this book successful! Thank you!

Accounting and the Business Environment

1



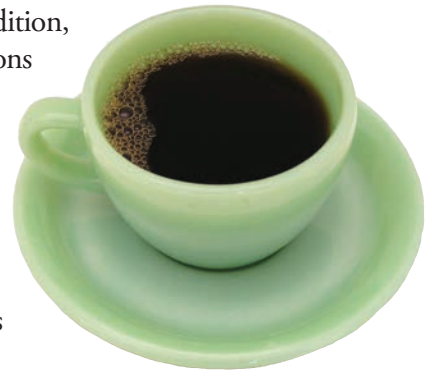
Coffee, Anyone?

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

his bank. After the meeting, Aiden felt overwhelmed and unsure of the future of his business.

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

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



Why Study Accounting?

The situation that Aiden faced is similar to the situations faced in the founding of most businesses. **Starbucks Corporation**, for example, first opened its doors in Seattle, Washington, in 1971. Three partners, Jerry Baldwin, Zev Siegl, and Gordon Bowker, were inspired by a dream of selling high-quality coffee. We know their dream was successful because Starbucks currently has more than 19,000 stores in 60 countries. How did Starbucks grow from a small one-store shop to what it is today? The partners understood accounting—the language of business. They understood how to measure the activities of the business, process that information into reports (financial statements), and then use those reports to make business decisions. Your knowledge of accounting will help you better understand businesses. It will make you a better business owner, employee, or investor.





Chapter 1 Learning Objectives



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

WHY IS ACCOUNTING IMPORTANT?

Learning Objective 1

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

Accounting

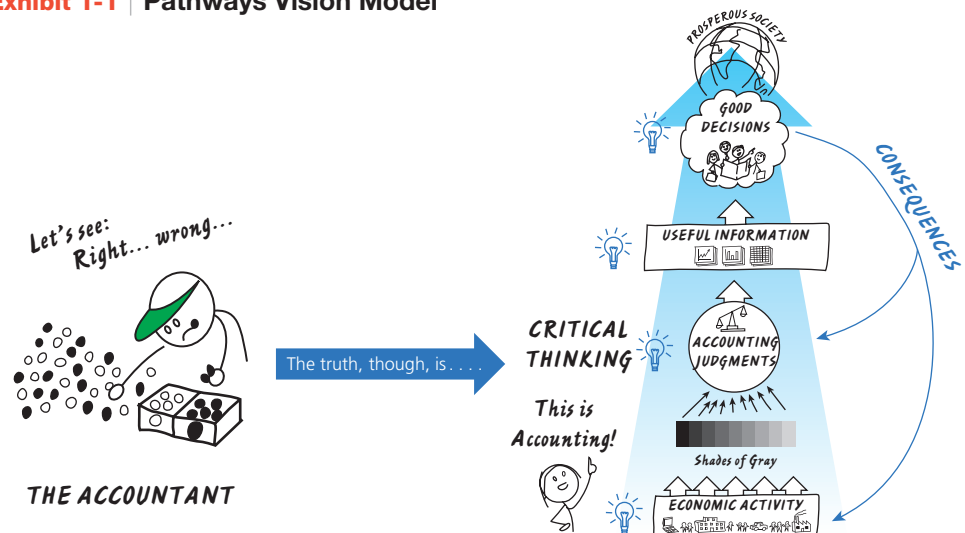
The information system that measures business activities, processes the information into reports, and communicates the results to decision makers.

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

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

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

Exhibit 1-1 Pathways Vision Model



We tend to think of accountants as boring and dry.

Accountants are instrumental in helping to create a prosperous society.




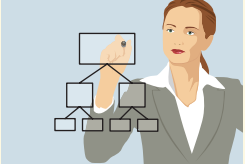
the public understand what accounting is. The model is intended to explain in a visual way what accountants really do. Accounting starts with economic activities that accountants review and evaluate using critical thinking and judgment to create useful information that helps individuals make good decisions.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

Decision Makers: The Users of Accounting Information

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

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

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

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

Individuals

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

Businesses

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

Financial Accounting

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

Managerial Accounting

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



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

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



Creditor

Any person or business to whom a business owes money.

Certified Public Accountants (CPAs)

Licensed professional accountants who serve the general public.

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

Certified Management Accountants (CMAs)

Certified professionals who specialize in accounting and financial management knowledge. They typically work for a single company.

Investors

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

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

Creditors

Any person or business to whom a business owes money is a **creditor**. Before extending credit to a business, a creditor evaluates the company's ability to make the payments by reviewing its financial statements. Creditors follow the same process when you need to borrow money for a new car or a house. The creditor reviews accounting data to determine your ability to make the loan payments. What does your financial position tell the creditor about your ability to pay the loan? Are you a good risk for the bank?

Taxing Authorities

Local, state, and federal governments levy taxes. Income tax is calculated using accounting information. Good accounting records can help individuals and businesses take advantage of lawful deductions. Without good records, the IRS can disallow tax deductions, resulting in a higher tax bill plus interest and penalties.

The Accounting Profession

What do businesses such as Amazon.com, Walmart, or even your local sandwich shop across from campus have in common? They all need accountants! That is why a degree in accounting opens so many doors upon graduation.

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

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

Studying accounting and becoming certified professionally can lead to a financially secure job. According to Robert Half's *2014 Salary Guide*, the top positions in demand that rely on accounting skills are controllers, financial analysts, tax accountants, auditors, cost accountants, and business systems analysts. How much do these types of accountants make? Exhibit 1-3 provides a snapshot of the earning potential for key positions.


Exhibit 1-3 | Comparison of Accounting Positions

Position	Job Description	Salary Range
Controllers	Compile financial statements, interact with auditors, and oversee regulatory reporting.	\$89,000–\$216,000
Financial analysts	Review financial data and help to explain the story behind the numbers.	\$41,250–\$125,000
Business systems analysts	Use accounting knowledge to create computer systems.	\$44,250–\$107,250
Tax accountants	Help companies navigate tax laws.	\$44,000–\$190,750
Auditors	Perform reviews of companies to ensure compliance to rules and regulations.	\$44,500–\$184,750
Cost accountants	Typically work in a manufacturing business. Help analyze accounting data.	\$43,000–\$113,000
Paraprofessional/Bookkeeper	Record financial transactions and help prepare financial records.	\$39,750–\$59,250

Accountants generally work either in public, private, or governmental accounting. Public accounting involves services such as auditing and tax preparation. Well-known public accounting firms include Ernst & Young, Deloitte, PwC, and KPMG. Private accounting involves working for a single company such as Amazon.com, Walmart, or Dell. Other accountants work for the federal or state governments. Wherever accountants work, demand for their services is high. According to the U.S. Bureau of Labor Statistics, employment of accountants and auditors is expected to grow 13% from 2012–2022.



Recently, the AICPA added a certification program in international accounting for those CPAs who want to specialize in global commerce.

Try It!

Match the accounting terminology to the definitions.

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

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