TWELFTH EDITION

Financial ACCOUNTING

THOMAS | TIETZ | HARRISON

Prepare, Apply, Confirm and Develop Employability Skills with MyLab Accounting

87%

of students said it helped them earn higher grades on homework, exams, or the course

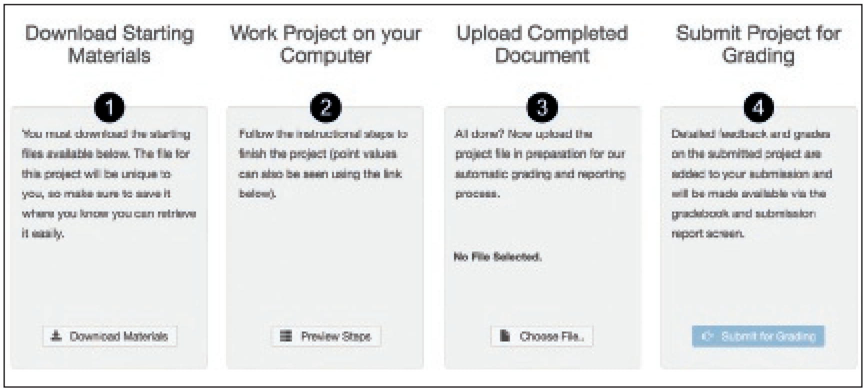
*Source: 2016 Student Survey, n=4608

MyLab™ Accounting is an online homework, tutorial, and assessment program constructed to work with this text to engage students and improve results. It was designed to help students develop and assess the skills and applicable knowledge that they will need to succeed in their courses and their future careers.

See what more than 25,000 students had to say about MyLab Accounting:

"[MyLab Accounting] offers extra assistance by allowing me to work through problems and better understand why the problem exists and how it should be solved."

Auto-Graded Excel Projects

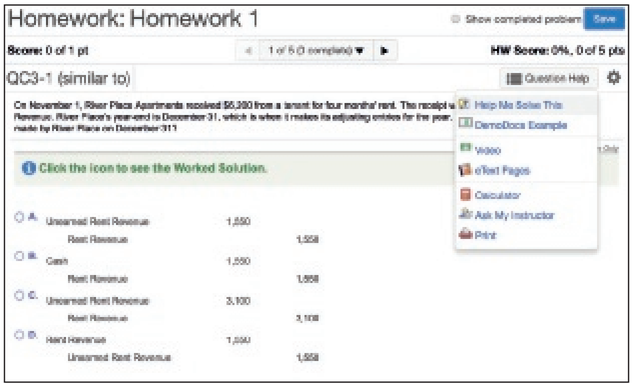


Using proven, field-tested technology, MyLab Accounting's new auto-graded Excel Projects allow instructors to seamlessly integrate Excel content into their course without having to manually grade spreadsheets. Students have the opportunity to practice important Accounting skills in Microsoft Excel, helping them to master key concepts and gain proficiency with Excel. Students simply download a spreadsheet, work live on an accounting problem in Excel, and then upload that file back into MyLab Accounting, where they receive reports on their work that provide personalized, detailed feedback to pinpoint where they went wrong on any step of the problem.

Pearson

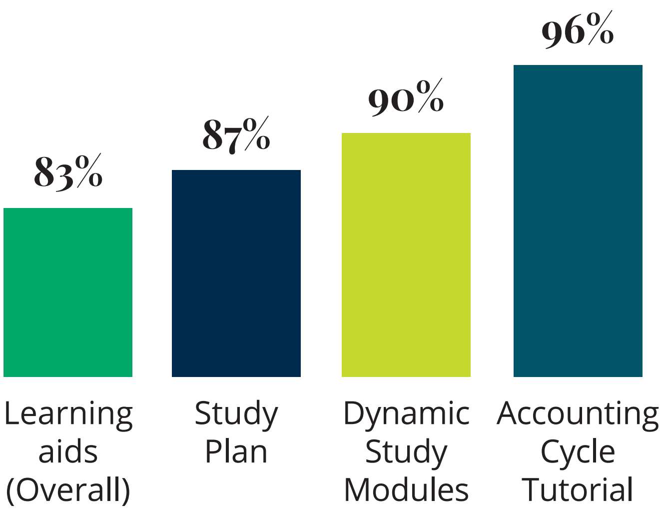
Question Help

MyLab Accounting homework and practice questions are correlated to the textbook, and many generate algorithmically to give students unlimited opportunity for mastery of concepts. If students get stuck, Learning Aids including Help Me Solve This, Demo Docs, videos and eText Pages walk them through the problem and identify helpful info in the text, giving them assistance when they need it most.



"Learning online can be a challenge. The Help Me Solve This option is incredibly helpful. It helped me see each step explained the way I needed it to be."

— Lauren Miller, Southern New Hampshire University



% of students who found learning tool helpful

Dynamic Study Modules help students study chapter topics effectively on their own by continuously assessing their **knowledge application** and performance in real time. These are available as graded assignments prior to class, and accessible on smart-phones, tablets, and computers.

Pearson eText enhances student learning—both in and outside the classroom. Worked examples and videos bring learning to life, while algorithmic practice and self-assessment opportunities test students' understanding of the material. Accessible anytime, anywhere via MyLab or the app.

The **MyLab Gradebook** offers an easy way for students and instructors to view course performance. Item Analysis allows instructors to quickly see trends by analyzing details like the number of students who answered correctly/incorrectly, time on task, and median time spend on a question by question basis. And because it's correlated with the AACSB Standards, instructors can track students' progress toward outcomes that the organization has deemed important in preparing students to be **leaders.**

90%

of students would tell their instructor to keep using MyLab Accounting

For additional details visit: www.pearson.com/mylab/accounting

This page intentionally left blank

Financial ACCOUNTING

TWELFTH EDITION

C. William (Bill) Thomas
Baylor University

Wendy M. Tietz
Kent State University

Walter T. Harrison Jr.
Baylor University

Charles T. Horngren
Stanford University

Pearson

330 Hudson Street, NY, NY 10013

Vice President, Business, Economics, and UK Courseware: Donna Battista
Director of Portfolio Management: Adrienne D'Ambrosio
Specialist Portfolio Manager: Lacey Vitetta
Development Editor: Amy Ray
Editorial Assistant: Elisa Marks
Vice President, Product Marketing: Roxanne McCarley
Senior Product Marketer: Tricia Murphy
Product Marketing Assistant: Marianela Silvestri
Manager of Field Marketing, Business Publishing: Adam Goldstein
Field Marketing Manager: Nayke Popovich
Vice President, Production and Digital Studio, Arts and Business: Etain O'Dea
Director of Production, Business: Jeff Holcomb
Managing Producer, Business: Melissa Feimer
Content Producer: Emily Thorne
Operations Specialist: Carol Melville
Design Lead: Kathryn Foot
Manager, Learning Tools: Brian Surette
Content Developer, Learning Tools: Sarah Peterson
Managing Producer, Digital Studio and GLP, Media Production and Development: Ashley Santora
Managing Producer, Digital Studio and GLP: James Bateman
Managing Producer, Digital Studio: Diane Lombardo
Digital Studio Producer: Mary Kate Murray
Digital Studio Producer: Alana Coles
Digital Content Team Lead: Noel Lotz
Digital Content Project Lead: Martha LaChance
Project Manager: Kathy Smith, Cenveo® Publisher Services
Interior Design: Cenveo® Publisher Services
Cover Design: Cenveo® Publisher Services
Cover Art: Bloomicon/Shutterstock; Garagestock/Shutterstock
Printer/Binder: LSC Communications, Inc./Kendallville
Cover Printer: Phoenix Color/Hagerstown

Acknowledgments of third-party content appear on the appropriate page within the text.

Cataloging-in-Publication Data is available on file at the Library of Congress

1 17

Pearson

ISBN 10: 0-13-472598-0
ISBN 13: 978-0-13-472598-7

For my wife, Mary Ann.
C. William (Bill) Thomas

To my husband, Russ, who steadfastly supports me in every endeavor.
Wendy M. Tietz

About the Authors

C. William (Bill) Thomas is the J.E. Bush Professor of Accounting and a Master Teacher at Baylor University. A Baylor University alumnus, he received both his BBA and MBA there and went on to earn his PhD from The University of Texas at Austin.

With primary interests in the areas of financial accounting and auditing, Dr. Thomas has served as the J.E. Bush Professor of Accounting since 1995. He has been a member of the faculty of the Accounting and Business Law Department of the Hankamer School of Business since 1971 and served as chair of the department for 12 years. He has been recognized as an Outstanding Faculty Member of Baylor University as well as a Distinguished Professor for the Hankamer School of Business. Dr. Thomas has received many awards for outstanding teaching, including the Outstanding Professor in the Executive MBA Programs as well as the designation of Master Teacher.

Thomas is the author of textbooks in auditing and financial accounting, as well as many articles in auditing, financial accounting and reporting, taxation, ethics, and accounting education. His scholarly work focuses on the subject of fraud prevention and detection, as well as ethical issues among accountants in public practice. He presently serves as the accounting and auditing editor of *Today's CPA*, the journal of the Texas Society of Certified Public Accountants, with a circulation of approximately 28,000.

Thomas is a Certified Public Accountant in Texas. Prior to becoming a professor, Thomas was a practicing accountant with the firms of KPMG, LLP, and BDO Seidman, LLP. He is a member of the American Accounting Association, the American Institute of CPAs and Association of International Certified Professional Accountants, and the Texas Society of Certified Public Accountants.

Wendy M. Tietz is a professor in the Department of Accounting in the College of Business Administration at Kent State University. She teaches introductory financial and managerial accounting in a variety of formats, including large sections, small sections, and online sections.

Dr. Tietz is a Certified Public Accountant (Ohio), a Certified Management Accountant, and a Chartered Global Management Accountant. She is a member of the American Accounting Association, the Institute of Management Accountants, the American Institute of CPAs and Association of International Certified Professional Accountants, and the Sustainability Accounting Standards Board Alliance. She has published articles in such journals as *Issues in Accounting Education*, *Accounting Education: An International Journal*, *IMA Educational Case Journal*, and *Journal of Accounting & Public Policy*. Dr. Tietz is also the coauthor of a managerial accounting textbook, *Managerial Accounting*, with Dr. Karen Braun. She received the 2017 Bea Sanders/AICPA Innovation in Teaching Award for her web tool for financial accounting instructors, the Accounting Case Template. In 2016, Dr. Tietz was awarded the Jim Bulloch Award for Innovations in Management Accounting Education from the American Accounting Association/Institute of Management Accountants for her accounting educator blog, *Accounting in the Headlines*. She also received the 2014 Bea Sanders/AICPA Innovation in Teaching Award for her blog. She regularly presents at AAA regional and national meetings. She is intensely interested in the power of storytelling, interactivity, and social media as educational practices to promote engagement and understanding.

Dr. Tietz earned her PhD from Kent State University. She received both her MBA and BSA from the University of Akron. Prior to teaching, she worked in industry for several years, both as a controller for a financial institution and as the operations manager and controller for a recycled plastics manufacturer.

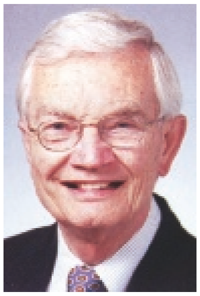
Walter T. Harrison Jr. is professor emeritus of accounting at the Hankamer School of Business, Baylor University. He received his BBA from Baylor University, his MS from Oklahoma State University, and his PhD from Michigan State University.

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

A member of the American Accounting Association and the American Institute of CPAs and Association of International Certified Professional Accountants, Professor Harrison has served as chairman of the Financial Accounting Standards Committee of the American Accounting Association, on the Teaching/Curriculum Development Award Committee, on the Program Advisory Committee for Accounting Education and Teaching, and on the Notable Contributions to Accounting Literature Committee.

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

Professor Harrison has received scholarships, fellowships, and research grants or awards from PricewaterhouseCoopers, Deloitte & Touche, the Ernst & Young Foundation, and the KPMG Foundation.



Charles T. Horngren (1926–2011) was the Edmund W. Littlefield Professor of Accounting, emeritus, at Stanford University. A graduate of Marquette University, he received his MBA from Harvard University and his PhD from the University of Chicago. He was also the recipient of honorary doctorates from Marquette University and DePaul University.

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

Horngren is a member of the Accounting Hall of Fame. As a member of the American Accounting Association, Horngren was its president and its director of research. He received its first annual Outstanding Accounting Educator Award. The California Certified Public Accountants Foundation gave Horngren its Faculty Excellence Award and its Distinguished Professor Award. He was the first person to have received both awards. The American Institute of Certified Public Accountants presented its first Outstanding Educator Award to Horngren. Horngren was named Accountant of the Year, in Education, by the national professional accounting fraternity, Beta Alpha Psi. Professor Horngren was also a member of the Institute of Management Accountants, from whom he received its Distinguished Service Award. He was a member of the institute's Board of Regents, which administers the Certified Management Accountant examinations.

Horngren is an author of these other accounting books published by Pearson: *Cost Accounting: A Managerial Emphasis*, Fifteenth Edition, 2015 (with Srikant M. Datar and Madhav V. Rajan); *Introduction to Financial Accounting*, Eleventh Edition, 2014 (with Gary L. Sundem, John A. Elliott, and Donna Philbrick); *Introduction to Management Accounting*, Sixteenth Edition, 2014 (with Gary L. Sundem, Jeff Schatzberg, and Dave Burgstahler); *Horngren's Financial & Managerial Accounting*, Fifth Edition, 2016 (with Tracie L. Miller-Nobles, Brenda L. Mattison, and Ella Mae Matsumura); and *Horngren's Accounting*, Eleventh Edition, 2016 (with Tracie L. Miller-Nobles, Brenda L. Mattison, and Ella Mae Matsumura). Horngren was the consulting editor for Pearson's Charles T. Horngren Series in Accounting.

Brief Contents

Contents

Chapter 3

Chapter 4

Preface

Financial Accounting gives readers a solid foundation in the fundamentals of accounting and the basics of financial statements, and then builds upon that foundation to offer more advanced and challenging concepts and problems. This scaffolded approach helps students to better understand the meaning and relevance of financial information and see its significance within a real-world context, as well as develop the skills needed to analyze financial information in both their courses and career.

Financial Accounting has a long-standing reputation in the marketplace for being readable and easy to understand. It drives home fundamental concepts using relevant examples from real-world companies in a reader-friendly way without adding unnecessary complexity. While maintaining hallmark features of accuracy, readability, and ease of understanding, the Twelfth Edition includes updated explanations, coverage, and ratio analysis with decision-making guidelines. These time-tested methodologies with the latest technology ensure that students learn basic concepts in accounting in a way that is relevant, stimulating, and fun, while exercises and examples from real-world companies help students gain a better grasp of the course material.

NEW TO THE TWELFTH EDITION

All Chapters

- New serial case on The Cheesecake Factory appears in every chapter in the end-of-chapter material.
- Throughout the book, an emphasis has been placed on making content flexible and modular to suit individual instructor preferences.
- Chapter content has been streamlined throughout the book to focus on the major concepts. References to material beyond the scope of an introductory financial accounting course have been eliminated to reduce "noise" in the learning process.

Chapter 1

- Updated and shortened the Disney case significantly, as well as the introduction, so students can more easily understand the major points.
- Shortened and eliminated many references to upcoming chapters and material (e.g., removed material on the board of directors and how corporate governance works since this is covered later in the text; "carrying value" and "high-quality earnings" were also removed since these concepts were too high level in the introductory chapter).
- Significantly shortened the discourse on GAAP versus IRFS.
- Updated Ethisphere's list of the World's Most Ethical Companies.

Chapter 2

- Combined learning objectives 1 and 2.
- Updated the Disney case.
- Streamlined the coverage of the different types of accounts.

- Deleted the "Account Formats" section.
- Deleted "Analyzing Transactions Using Only T-Accounts" section.

Chapter 3

- Significantly shortened the Global View box on the rules for recognizing revenue under U.S. GAAP versus IRFS.

Chapter 4

- Reversed Learning Objectives 3 and 4; "Evaluate Internal Controls" now comes before "Preparing a Bank Reconciliation."
- Eliminated Learning Objective 5, "Construct and Use a Cash Budget" and the associated materials in the chapter.
- Significantly shortened the Green Valley introductory case.
- Streamlined the coverage on the details of SOX.
- Streamlined the sections related to internal controls.
- Updated the section on computer controls to include malware, spyware, and ransomware.
- Streamlined the bank reconciliation and journal transactions sections.

Chapter 5

- This chapter underwent a major revision, so the Learning Objectives are significantly different.
- Short-term investments were moved from Chapter 5 to Appendix E.
- Updated the Apple introductory case.
- Sales Returns and Allowances and Sales Discounts are now separate learning objectives to allow for flexibility in coverage.
- Sales Returns and Allowances and Sales Discounts sections have been updated to reflect changes in revenue recognition standards.
- Sales Returns and Allowances section has been significantly pared down.
- New "Cooking the Books" on OCZ Technology Groups discusses misleading revenue recognition techniques.
- Several topics were eliminated, including internal controls over cash collections on account, credit card and debit card sales, and factoring.

Chapter 6

- Under Armour, Inc. case is updated and significantly streamlined.
- Discussion on consignment inventory has been pared down and focused.
- Updated and streamlined the section on periodic versus perpetual inventory systems.
- Section on keeping track of perpetual inventories under the LIFO and the weighted-average cost methods was eliminated.

- Streamlined the material on the disclosure principle.
- New "Cooking the Books" on LogiTech International's write down of inventory of parts related to its unsuccessful streaming device.

Chapter 7

- Updated the FedEx introductory case.
- Pared down the "Cooking the Books" feature on Waste Management.
- Significantly pared down the conditions and details related to asset impairment rules under U.S. GAAP versus IFRS.

Chapter 8

- Current and Contingent Liabilities, which were previously covered in Chapter 9, are now covered in this chapter.
- Long Term Investments is now covered in Appendix E.
- Time Value of Money is now covered in Appendix F.
- Updated the Amazon introductory case.
- New "Cooking the Engines" feature on the Volkswagen scandal as an example of disclosure principles for contingent liabilities.

Chapter 9

- Current and contingent liabilities are now in Chapter 8.
- Learning Objective 4, "Analyze and Differentiate Financing with Debt vs. Equity," has been moved to Chapter 10, which covers stockholders' equity.
- Shortened and updated Southwest Airlines introductory case.
- Clarified and streamlined the lease section to correspond with the FASB's revised standard.
- Added new Learning Objective on the impact of leverage on financial statements.

Chapter 10

- Learning Objective 5 has been changed from "Use Stock Values in Decision Making" to "Evaluate a Company's Performance Using New Ratios."
- Moved discussion of EPS calculations and PE ratio previously covered in Chapter 11 (Income Statement) to this chapter.
- Emphasized the coverage of EPS and removed coverage of the book value per share.
- Coverage of debt versus equity financing has been moved to this chapter (it was previously covered in Chapter 9, Liabilities).
- Updated and shortened the Home Depot introductory case.
- Tightened up the coverage of corporations and corporate governance.
- Eliminated several topics, including: redeemable preferred stock, redemption value, and liquidation value.

Chapter 11

- Some material previously found in Chapter 11 moved to Chapter 12, including earnings quality, footnotes, and differentiating between management and auditor responsibilities; revenue recognition moved to Chapter 5; earnings per share moved to Chapter 10.
- Coverage of Statement of Cash Flows moved from Chapter 12 in previous edition to Chapter 11.
- Updated and shortened the Google introductory case.
- Condensed the material on noncash activities.

Chapter 12

- Coverage of material previously found in Chapter 11 can now be found in this chapter, including: earnings quality, discussion on footnotes, and differentiating between management and auditor responsibilities.
- Under Armour's competitive position extensively updated.
- Several topics were eliminated, including: discussion of classes of stock (A, B, etc.), book value per share, Economic Value Added (EVA), and weighted average cost of capital.

Appendix E

- This new appendix combines and greatly condenses the coverage of all the investments in marketable securities, both short- and long-term (formerly in Chapters 5 and 8). All related problem materials were correspondingly shortened.

Appendix F

- This new appendix covers the time value of money, which was formerly located in Chapter 8. All related problem materials were correspondingly shortened.

SOLVING TEACHING AND LEARNING CHALLENGES

Dear Valued Colleagues,

Welcome to the Twelfth Edition of *Financial Accounting*. We are grateful for your support as an adopter of our text as we celebrate over 30 years of success in the market. The Twelfth Edition of *Financial Accounting* has been improved in many respects, as explained below.

Twelve chapters now rather than thirteen. We streamlined the content and the writing in this edition. We focused on students when working on this edition—we made the content more relevant to today's students with new stories and eliminated topics that are not relevant to introductory financial accounting. The first section of the book continues to be focused on the accounting cycle and basic financial statement preparation. The middle section of the book covers assets, liabilities, and stockholders' equity. The final two chapters cover the statement of cash flows and financial statement analysis. In this edition, the topics of investments and the time value of money are now appendices rather than a chapter. Chapter 9, Liabilities, from the 11th edition has been split into two chapters in this 12th edition: Chapter 8, Current Liabilities and Chapter 9, Long-Term Liabilities. We also integrated or eliminated the topics that were formerly in Chapter 11, Evaluating Performance: Earnings Quality, the Income Statement, and the Statement of Comprehensive Income, into other chapters. The book now has 12 chapters, making the content fit into a 15- or 16-week semester easily. We also focused on making the writing in the book more clear and understandable.

Author-created instructor resources. This book has a variety of instructor resources created by one of the authors, Wendy Tietz, to help instructors be both more efficient and more effective in their teaching. She has created 2–4 multiple-choice questions for each Accounting in the Headlines blog post. Those questions are in MyLab Accounting. She has also created a Learning Catalytics polling question for each blog post that is designed to start the conversation about that particular blog post. Dr. Tietz has created approximately 4–10 short videos about the major concepts in each chapter. In addition, she has created step-by-step videos for 3–6 of the homework exercises in each chapter. All of these videos are assignable through MyLab Accounting.

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

Student success. We feel we have the most advanced student learning materials in the market with MyLab Accounting. These include automatically graded homework, DemoDocs, and learning aid videos. We believe that the use of MyLab Accounting homework will greatly enhance student understanding of accounting with its instantaneous feedback. MyLab Accounting makes the study of financial accounting a more interactive and fun experience for students. In addition, we have adopted a scaffolding approach in the book and its resources. Chapter content and the end-of-chapter material build from the basic short exercise featuring a single concept to more advanced problems featuring multiple learning objectives. The student can practice at the basic level and then build upon that success to advance to more challenging problems.

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

We welcome your comments and suggestions. Please don't hesitate to send feedback about this book to HorngrensAccounting@pearson.com. You are also welcome to reach out directly to author Bill Thomas at Bill_Thomas@baylor.edu or author Wendy Tietz at wtietz@kent.edu.

Bill Thomas
Wendy Tietz

REACH EVERY STUDENT WITH MYLAB ACCOUNTING.

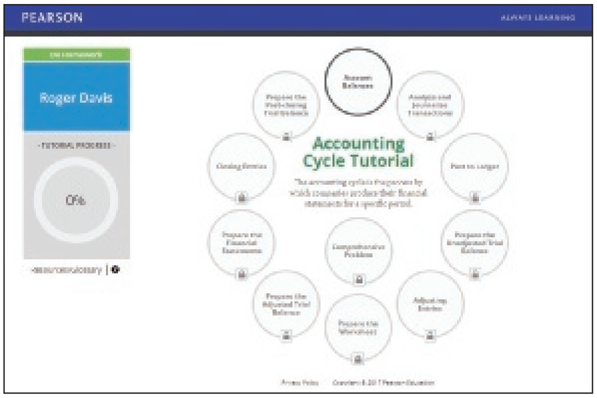
MyLab is the teaching and learning platform that empowers you to reach every student. By combining trusted author content with digital tools and a flexible platform, MyLab personalizes the learning experience and improves results for each student. Learn more about MyLab Accounting.

EMPOWER EACH LEARNER

Each student learns at a different pace. Personalized learning pinpoints the precise areas where each student needs practice, giving all students the support they need—when and where they need it—to be successful.

IMPROVE STUDENT RESULTS

When you teach with MyLab, student performance improves. That's why instructors have chosen MyLab for over 20 years, touching the lives of over 50 million students.

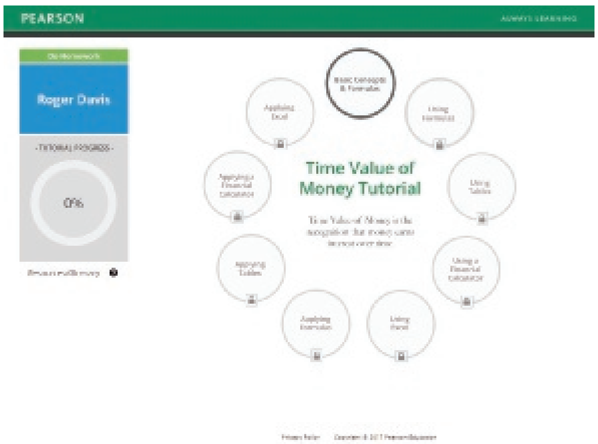


Accounting Cycle Tutorial (ACT) with Comprehensive Problem

MyLab Accounting'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 animations. Students are immediately assessed on their understanding, and their performance is recorded in the MyLab Accounting grade book. Whether the Accounting Cycle Tutorial is used as a remediation self-study tool or course assignment, students have yet-another resource within MyLab Accounting to help them be successful with the accounting cycle. This updated version includes a new comprehensive problem.

NEW—Time Value of Money Tutorial NEW!

The Time Value of Money Tutorial in MyLab ensures that students understand the basic theory and formulas of the TVM, while also helping test their ability to *apply* the TVM in the measurement of financial statement items. Students work through two sections. The first is to help them understand the theory—using whichever method the instructors choose (manually, through Excel®, with tables, or via a calculator), and the second is to give students the opportunity to apply the theory by giving them a number of scenarios regarding each financial statement.



Deliver trusted content

You deserve teaching materials that meet your own high standards for your course. That's why we partner with highly respected authors to develop interactive content and course-specific resources that you can trust—and that keep your students engaged.

Try It

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

TRY IT

(Answers are given on p. 200.)

(1) On March 15, a customer pays $3,133 for ten 4-day passes to Disney World for a vacation that will take place June 1–4. Did Disney earn the revenue on March 15?

(2) On July 1, The Walt Disney Company prepays $60,000 in rent for a Disney Store building for the next six months. Did Disney incur the expense on July 1? If not, when will the company recognize rent expense?

Try It in Excel®

You can access the most current annual report of Southwest Airlines Company in Excel format at **www.sec.gov**. Using the "FILINGS" link on the toolbar at the top of the home page, select "Company Filings Search." This will take you to the "Edgar Company Filings" page. Type "Southwest Airlines" in the company name box, and select "Search." This will produce the "EDGAR Search Results" page showing the company name. Click on the "CIK" link beside the company name. Doing so will pull up a list of the reports the company has filed with the SEC. Under the "Filing Type" box, type "10-K" and click the search box. Form 10-K is the SEC form for the company's annual report. Find the year that you wish to view. Click on the "Interactive Data" box, which takes you to the "View Filing Data" page. Find and click on the "View Excel Document" link at the top of this page. You may choose to either open or download the Excel files containing the company's most recent financial statements.

Try It in Excel®

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

Decision Guidelines

Illustrates how financial statements are used and how accounting information aids companies in decision making.

Decision Guidelines

INVESTING IN STOCK

Suppose you've saved $5,000 to invest. You visit a nearby **Edward Jones** office, where the broker probes for your risk tolerance. Are you investing mainly for dividends or for growth in the stock price? These guidelines offer suggestions for what to consider when investing in stock.

Investor Decision	Guidelines
Which category of stock to buy for:	
• A safe investment?	Preferred stock is safer than common, but for even more safety, invest in high-grade corporate bonds or government securities.
• Steady dividends?	Cumulative preferred stock. However, the company is not obligated to declare preferred dividends, and the dividends are unlikely to increase.
• Increasing dividends?	Common stock, as long as the company's net income is increasing and the company has adequate cash flow to pay a dividend after meeting all obligations and other cash demands.
• Increasing stock price?	Common stock, but again only if the company's net income and cash flow are increasing.
• How to identify a good stock to buy?	There are many ways to pick stock investments. One strategy that works reasonably well is to invest in companies that consistently earn higher rates of return on assets and on equity than competing firms in the same industry. Another, called "value investing," is to invest in companies that have high earnings but relatively low price/earnings multiples compared to other companies in the same industry. Still another is to select companies with solid earnings in industries that are expected to grow.

Ethics Check

EC3-1. Identify ethical principle violated

For each of the situations listed, identify which of three principles (integrity, objectivity and independence, or due care) from the AICPA Code of Professional Conduct is violated. Assume all persons listed in the situations are members of the AICPA. (Note: Refer to the AICPA Code of Professional Conduct contained on pages 25–27 in Chapter 1 for descriptions of the principles.)

a. Drew purposely excludes a large amount of accrued salaries payable from this year's financial statements so his company's debt-to-equity ratio appears lower to investors.
b. Abbey's company determines year-end bonuses based on revenue growth. Abbey records the sales of gift cards during this month as revenue rather than as unearned revenue. None of these gift cards have been used by customers as of the end of the current month. By recording the gift card sales as revenue in the current period, revenue will be higher and Abbey's bonus will, as a result, be higher as well.
c. Debbie, a CPA, is an associate at a regional public accounting firm. Debbie's firm is auditing a local payroll company. Debbie does not disclose that her husband is a manager at the payroll company.
d. A new revenue recognition standard has been issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). John does not attend training on the new revenue recognition standard because he is busy dealing with the accounting impact of a merger.

Ethics Check

This new end-of-chapter feature presents students with several ethical business situations and asks them to identify which of the principles from the AICPA Code of Professional Conduct is violated.

Ethical Issue

This end-of-chapter feature presents students with ethical situations and has them work through the decision framework for making ethical judgments. Finally, they are asked to come to a decision and support it.

Ethical Issue

C6-85. During 2016, Coalmont, Inc., changed to the LIFO method. Suppose that during 2017, Coalmont changed back to the FIFO method. In 2018, the company switched back to LIFO again.

Requirements

1. What would you think of a company's ethics if it changed accounting methods every year?
2. What accounting principle would changing methods every year violate?
3. Who can be harmed and how when a company changes its accounting methods too often?

Serial Case

C8-53. *(Learning Objective 5: Analyze contingent liabilities of a company in the restaurant industry)*

Note: This case is part of The Cheesecake Factory serial case contained in every chapter in this textbook.

Like many other large companies, **The Cheesecake Factory Incorporated** has several legal actions pending against it at any given time. It must accrue for and/or disclose certain contingent liabilities, such as pending or possible legal actions, in its financial statements and notes to its financial statements. The necessary reporting depends on the specific circumstances of the situations and the company's attorneys' assessment of the potential outcomes.

To follow are four *hypothetical* legal situations that might face The Cheesecake Factory.

Situation A: A former restaurant employee filed a class-action lawsuit alleging that The Cheesecake Factory violated the local law when it required employees to purchase their work uniforms. Legal counsel has indicated that the case will probably be settled for $2,500.
Situation B: A customer filed a lawsuit alleging that The Cheesecake Factory was negligent when she slipped and fell on a wet floor near the bar area in a Cheesecake Factory in Topeka, Kansas. Legal counsel has indicated that the company will most likely settle this case, but counsel is unable to estimate the dollar amount of the settlement.
Situation C: A customer filed a lawsuit alleging that The Cheesecake Factory caused her severe emotional distress when her favorite dessert was out of stock for her birthday dinner at the restaurant. Legal counsel has indicated that the chance of losing this lawsuit is remote.
Situation D: A former restaurant hourly employee filed a class-action lawsuit for $200,000 alleging that The Cheesecake Factory violated the local law by failing to pay overtime. Legal counsel has stated that it is reasonably possible, but not probable, that The Cheesecake Factory could lose the lawsuit.

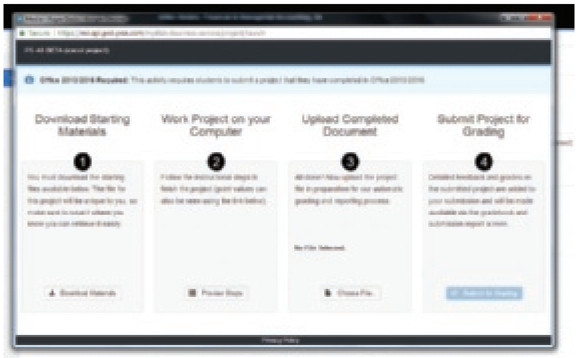
NEW Cheesecake Factory Serial Case, consisting of several smaller cases—one per chapter, focuses on the same real-world company. This continuing case is meant to inspire critical thinking and to connect the content with real life by following one company through all of the chapters in financial accounting.

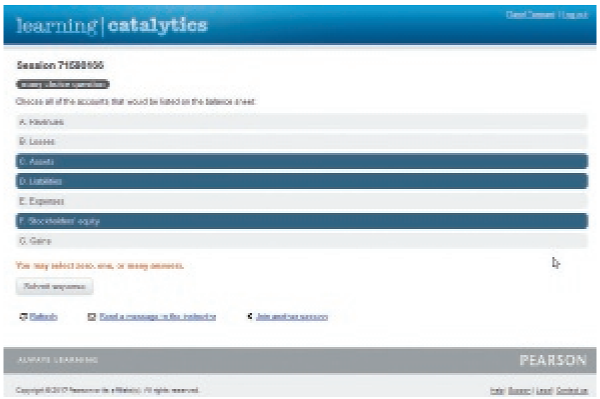
Teach your course your way

Your course is unique. So whether you'd like to build your own assignments, teach multiple sections, or set prerequisites, MyLab gives you the flexibility to easily create your course to fit your needs.

NEW Auto-Graded Excel® Projects NEW!

Using proven, field-tested technology, MyLab Accounting's new auto-graded Excel® Projects allow instructors to seamlessly integrate Excel® content into their course without having to manually grade spreadsheets. Students have the opportunity to practice important Accounting skills in Microsoft Excel®, helping them to master key concepts and gain proficiency with Excel®. Students simply download a spreadsheet, work live on an accounting problem in Excel®, and then upload that file back into MyLab Accounting, where they receive reports on their work that provide personalized, detailed feedback to pinpoint where they went wrong on any step of the problem.





Learning Catalytics

Learning Catalytics, available through MyLab Accounting, is 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 automatically graded 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.

Pearson eText

Pearson eText enhances student learning. Worked examples, videos, and interactive tutorials bring learning to life, while algorithmic practice and self-assessment opportunities test students' understanding of the material.

INSTRUCTOR TEACHING RESOURCES

This program comes with the following teaching resources.

Supplements available to instructors at www.pearsonhighered.com/harrison	Features of the Supplement
Solutions Manual Created in collaboration with: Betsy Willis from Baylor University	Contains solutions to all end-of-chapter questions, including short exercises, exercises, problems and cases.
Instructor's Manual Created in collaboration with: Betsy Willis from Baylor University	Includes chapter outlines, suggested in-class activities, topics with which students struggle, as well as the following: • Assignment grid that outlines all end-of-chapter exercises, problems, and cases; the topic being covered in that particular exercise, problem, or case; estimated completion time; level of difficulty. • Ten-minute quizzes that quickly assess students' understanding of the chapter material.
Flipping Your Classroom Guide Created by author Wendy Tietz	Tips for each chapter on how to take your course from a traditional/in-class course to a hybrid, blended, or fully online format. Includes links to the discussion board prompts.
Discussion Board Prompts Created by author Wendy Tietz	Get the most out of online and in-class discussions and promote interaction and engagement with your financial accounting students. This supplement will aid instructors in facing the challenges of utilizing discussion prompts effectively in the online accounting classroom.
Multiple Choice Questions in MyLab Accounting for Accountingintheheadlines.com Created by author Wendy Tietz	These multiple choice questions are assignable in MyLab Accounting related to the chapter's blog post from accountingintheheadlines.com
Polling Questions in Learning Catalytics for Accountingintheheadlines.com Created by author Wendy Tietz	These Learning Catalytic polling questions related to blog posts at accountingintheheadlines.com can be used as a tool to get students actively engaged with the content during class.
Videos Created by author Wendy Tietz	• Concept videos reviewing chapter learning objectives • Step-by-step videos for selected homework problems
Directed Reading Created by author Wendy Tietz	Encourage students to actively read the textbook BEFORE coming to class and help direct them to what is important. Students should hand in these directed reading worksheets at the beginning of class before the chapter is covered in class.
Test Bank	Includes more than 2,000 questions. Both objective-based questions and computational problems are available. *Algorithmic test bank* is available in MyLab Accounting. Most computational questions are formulated with an algorithm so that the same question is available with unique values. This offers instructors a greater pool of questions to pull from and will help ensure each student has a different test. All questions include the following annotations: • Difficulty level (1 for straight recall, 2 for some analysis, 3 for complex analysis) • Type (Multiple-choice, true/false, short-answer, essay) • Learning objective • AACSB learning standard (Ethical Understanding and Reasoning; Analytical Thinking Skills; Information Technology; Diverse and Multicultural Work; Reflective Thinking; Application of Knowledge)

Continued

Computerized TestGen	TestGen allows instructors to: • Customize, save, and generate classroom tests • Edit, add, or delete questions from the Test Item Files • Analyze test results • Organize a database of tests and student results.
PowerPoint® Presentations	These presentations help facilitate classroom discussion. • Instructor PowerPoint® Presentations with lecture notes • Student PowerPoint® Presentations *Image Library* contains all image files from the text to assist instructors in modifying our supplied PowerPoint® presentations or in creating their own PowerPoint® presentations.
Working Papers	Available in both Excel® and PDF format, these documents can be used for completing end-of-chapter questions in preformatted templates

For Students

MyLab Accounting online Homework and Assessment Manager includes:

- Pearson eText
- Student PowerPoint® Presentations
- Accounting Cycle Tutorial
- Time Value of Money Tutorial
- Videos
- Demo Docs
- Flash Cards
- Dynamic Study Modules
- Excel® in Practice Data Files
- Working Papers
- Directed Reading

Student resource website: http://www.pearsonhighered.com/harrison

This website contains the following:

- The Excel® in Practice Data Files, related to select end-of-chapter problems
- Working Papers, for completing end-of-chapter questions in preformatted templates
- Directed Reading, to help direct students to what content in the chapter is important.
- Student PowerPoint® Presentations

ACKNOWLEDGMENTS

We sincerely thank the many friends and colleagues who have helped in the process of writing and revising this book. Betsy Willis deserves special mention for her dedication, feedback, and hard work throughout this project. We thank Carolyn Streuly for her amazing accuracy checking, Amy Ray for her clear, valuable feedback, and Kathy Smith for her incredible ability to manage multiple roles and people in this book revision process. We are also deeply grateful to Lacey Vitetta for her endless patience and support. Thank you to Donna Battista, Adrienne D'Ambrosio, Nayke Popovich, Tricia Murphy, Mary Kate Murray, Sarah Peterson, Martha LaChance, and Beth Geary for their continued help and support. Thanks also to Betsy Willis for preparing the *Instructor's Solutions Manual* and the *Instructor's Resource Manual*. Thank you also to the many professors and students who have used the book and provided feedback for improving it.

We would like to thank the following reviewers for the Twelfth Edition for their valuable input: Henri Akono, Maine Business School; John Babich, Kankakee Community College; Rodger Brannan, University of Minnesota Duluth; Esther Bunn, Stephen F. Austin State University; Andrew Dill, University of Southern Indiana; Caroline Falconetti, Nassau Community College; Ariana Gammel, Lake Forest College; Jane Garvin, Ivy Tech State College; Konrad Gunderson, Missouri Western State University; Frank Kane, Purdue University; Joung Yeon Kim, Indiana University Kokomo; William

Kresse, Governors State University; Jeff Paterson, Florida State University; Judy Peterson, Monmouth College; Sandra Roberson, Furman University; Chris Slinkard, Missouri State University; and Wendy Wilson, Southern Methodist University.

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

Past Reviewer Participants

Shawn Abbott, College of the Siskiyous
Linda Abernathy, Kirkwood Community College
Sol Ahiarah, SUNY College at Buffalo (Buffalo State)
M. J. Albin, University of Southern Mississippi
Gary Ames, Brigham Young University, Idaho
Elizabeth Ammann, Lindenwood University
Brenda Anderson, Brandeis University
Kim Anderson, Indiana University of Pennsylvania
Florence Atiase, University of Texas at Austin
Walter Austin, Mercer University, Macon
Brad Badertscher, University of Iowa
Sandra Bailey, Oregon Institute of Technology
Patrick Bauer, DeVry University, Kansas City
Barbara A. Beltrand, Metropolitan State University
Jerry Bennett, University of South Carolina–Spartanburg
Peg Beresewski, Robert Morris College
Lucille Berry, Webster University
John Bildersee, New York University, Stern School
Brenda Bindschatel, Green River Community College
Candace Blankenship, Belmont University
Charlie Bokemeier, Michigan State University
Patrick Bouker, North Seattle Community College
Amy Bourne, Oregon State University
Scott Boylan, Washington and Lee University
Robert Braun, Southeastern Louisiana University
Linda Bressler, University of Houston–Downtown
Michael Broihahn, Barry University
Rada Brooks, University of California, Berkeley
Carol Brown, Oregon State University
Elizabeth Brown, Keene State College
Helen Brubeck, San Jose State University
Scott Bryant, Baylor University
Marcus Butler, University of Rochester
Marci Butterfield, University of Utah
Mark Camma, Atlantic Cape Community College
Kay Carnes, Gonzaga University
Brian Carpenter, University of Scranton
Sandra Cereola, James Madison University
Kam Chan, Pace University
Hong Chen, Northeastern Illinois University
C. Catherine Chiang, Elon University
Freddy Choo, San Francisco State University
Charles Christy, Delaware Tech and Community College, Stanton Campus
Lawrence Chui, Opus College of Business, University of St. Thomas
Shifei Chung, Rowan University
Bryan Church, Georgia Tech at Atlanta
Carolyn Clark, Saint Joseph's University
Dr. Paul Clikeman, University of Richmond
Charles Coate, St. Bonaventure University
Dianne Conry, University of California State College Extension–Cupertino
Ellen D. Cook, University of Louisiana at Lafayette
John Coulter, Western New England College
Sue Counte, Saint Louis Community College–Meramec
Julia Creighton, American University
Sue Cullers, Buena Vista University
Donald Curfman, McHenry County College
Alan Czyzewski, Indiana State University
Laurie Dahlin, Worcester State College
Bonita Daly, University of Southern Maine
Kreag Danvers, Clarion University
Betty David, Francis Marion University
Patricia Derrick, Drexel University
Peter DiCarlo, Boston College
Charles Dick, Miami University
Barbara Doughty, New Hampshire Community Technical College
Allan Drebin, Northwestern University
Carolyn Dreher, Southern Methodist University
Emily Drogt, Grand Valley State University
Ada Duffey, University of Wisconsin-Waukesha
Carol Dutton, South Florida Community College
Reed Easton, Seton Hall University
James Emig, Villanova University
Ellen Engel, University of Chicago
Mary Ewanechko, Monroe Community College
Alan Falcon, Loyola Marymount University
Janet Farler, Pima Community College
Dr. Andrew Felo, Penn State Great Valley
Ken Ferris, Thunderbird College
Dr. Mary Fischer, The University of Texas at Tyler
Dr. Caroline Ford, Baylor University
Clayton Forester, University of Minnesota
Lou Fowler, Missouri Western State College
Timothy Gagnon, Northeastern University
Regan Garey, Lock Haven University
Terrie Gehman, Elizabethtown College
Lucille Genduso, Nova Southeastern University

Frank Gersich, Monmouth College
Bradley Gillespie, Saddleback College
Lisa Gillespie, Loyola University, Chicago
Marvin Gordon, University of Illinois at Chicago
Alesha Graves, Mount St. Joseph University
Brian Green, University of Michigan at Dearborn
Anthony Greig, Purdue University
Ronald Guidry, University of Louisiana at Monroe
Konrad Gunderson, Missouri Western State College
Dr. Geoffrey J. Gurka, Colorado Mesa University
William Hahn, Southeastern College
Jack Hall, Western Kentucky University
Gloria Halpern, Montgomery College
Penny Hanes, Mercyhurst College
Dr. Heidi Hansel, Kirkwood Community College
Kenneth Hart, Brigham Young University, Idaho
Al Hartgraves, Emory University
Michael Haselkorn, Bentley University
Thomas Hayes, University of North Texas
Larry Hegstad, Pacific Lutheran University
Candy Heino, Anoka-Ramsey Community College
Mary Hollars, Vincennes University
Anit Hope, Tarrant County College
Thomas Huse, Boston College
Fred R. Jex, Macomb Community College
Grace Johnson, Marietta College
Celina Jozsi, University of South Florida
John Karayan, Woodbury University
Beth Kern, Indiana University, South Bend
Irene Kim, The George Washington University
Hans E. Klein, Babson College
Robert Kollar, Duquesne University
Willem Koole, North Carolina State University
Emil Koren, Hillsborough Community College
Dennis Kovach, Community College of Allegheny County–North Campus
Maria U. Ku, Ohlone College & Diablo Valley College
Ellen Landgraf, Loyola University Chicago
Howard Lawrence, Christian Brothers University
Barry Leffkov, Regis College
Elliott Levy, Bentley University
Chao-Shin Liu, Notre Dame
Barbara Lougee, University of California, Irvine
Heidemarie Lundblad, California State University, Northridge
Joseph Lupino, Saint Mary's College of California
Anna Lusher, West Liberty State College
Shuai Ma, American University
Harriet Maccracken, Arizona State University
Susan Machuga, University of Hartford
Constance Malone Hylton, George Mason University
Carol Mannino, Milwaukee School of Engineering
Herb Martin, Hope College
Aziz Martinez, Harvard University, Harvard Business School
Anthony Masino, Queens University/NC Central
Lizbeth Matz, University of Pittsburgh, Bradford
Bruce Maule, College of San Mateo
Michelle McEacharn, University of Louisiana at Monroe
Molly McFadden-May, Tulsa Community College
Nick McGaughey, San Jose State University
Allison McLeod, University of North Texas
Cathleen Miller, University of Michigan–Flint
Cynthia J. Miller, Gatton College of Business & Economics, University of Kentucky
Mark Miller, University of San Francisco
Mary Miller, University of New Haven
Scott Miller, Gannon University
Frank Mioni, Madonna University
Dr. Birendra (Barry) K. Mishra, University of California, Riverside
Theodore D. Morrison III, Wingate University
Lisa Nash, Vincennes University
Rosemary Nurre, College of San Mateo
Bruce L. Oliver, Rochester Institute of Technology
Gary Olsen, Carroll University
Stephen Owen, Hamilton College
David Parker, Saint Xavier University
Charles Pedersen, Quinsigamond Community College
Richard J. Pettit, Mountain View College
George Plesko, Massachusetts Institute of Technology
David Plumlee, University of Utah
Brian Porter, Hope College
Gregory Prescott, University of South Alabama
Rama Ramamurthy, College of William and Mary
Craig Reeder, Florida A&M University
Barb Reeves, Cleary University
Bettye Rogers-Desselle, Prairie View A&M University
Darren Roulstone, University of Chicago
Brian Routh, University of Southern Indiana
Norlin Rueschhoff, Notre Dame
Anwar Salimi, California State Polytechnic University, Pomona
Philippe Sammour, Eastern Michigan University
Angela Sandberg, Jacksonville State University
George Sanders, Western Washington University
Betty Saunders, University of North Florida
Albert A. Schepanski, University of Iowa
William Schmul, Notre Dame
Arnie Schnieder, Georgia Tech at Atlanta
Randall Serrett, University of Houston—Downtown
Gim Seow, University of Connecticut
Itzhak Sharav, CUNY–Lehman Graduate School of Business
Allan Sheets, International Business College
Lily Sieux, California State University, East Bay
Alvin Gerald Smith, University of Northern Iowa
James Smith, Community College of Philadelphia
Virginia Smith, Saint Mary's College of California
Beverly Soriano, Framingham State College
Vic Stanton, Stanford University
Carolyn R. Stokes, Frances Marion University

J. B. Stroud, Nicholls State University
Gloria J. Stuart, Georgia Southern University
Al Taccone, Cuyamaca College
Diane Tanner, University of North Florida
Martin Taylor, University of Texas at Arlington
Dorothy Thompson, Ave Maria University
Howard Toole, San Diego State University
Vincent Turner, California State Polytechnic University, Pomona
Sue Van Boven, Paradise Valley Community College
Marcia Veit, University of Central Florida
Bruce Wampler, Louisiana State University, Shreveport
Suzanne Ward, University of Louisiana at Lafayette
Michelle Watts, Boise State University
Craig Weaver, University of California, Riverside
Frederick Weis, Claremont McKenna College
Frederick Weiss, Virginia Wesleyan College
Betsy Willis, Baylor University
Ronald Woan, Indiana University of Pennsylvania
Allen Wright, Hillsborough Community College
Dr. Jia Wu, University of Massachusetts, Dartmouth
Yanfeng Xue, George Washington University
Barbara Yahvah, University of Montana–Helena
Myung Yoon, Northeastern Illinois University
Lin Zeng, Northeastern Illinois University
Tony Zordan, University of St. Francis

This page intentionally left blank

1 The Financial Statements

LEARNING OBJECTIVES

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

SPOTLIGHT

The Walt Disney Company

Where is the happiest place on earth? Walt Disney World or Disneyland, of course! The Disney theme parks in Orlando, Florida, and Anaheim, California, are famous for providing the ultimate family entertainment experience. However, these two parks are only a small part of **The Walt Disney Company**'s worldwide entertainment empire. The company owns vacation resorts, theme and water parks, hotels, motion-picture and recording studios, and cable TV networks throughout the world. Disney also sells billions of dollars of branded merchandise through retail, online, and wholesale distribution channels. How does Disney decide what to invest in and how to operate its businesses so as to maximize its profits? One way to find out is by studying its financial accounting information. ●

Most chapters of this book begin with an actual financial statement. **Financial statements** are the business documents companies use to report the results of their activities to people and groups that can include managers, investors, creditors, and regulatory agencies. These parties then use the reported information to make a variety of decisions, such as whether to invest in or loan money to the companies. The following four basic financial statements are used for these purposes:


Martin Beddall/Alamy Stock Photo

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

In Chapters 1–3, we will look at the contents of these statements using The Walt Disney Company as an example. For instance, the following financial statement is Disney's income statement for the year ended October 1, 2016.

Chapter 1 also explains generally accepted accounting principles, their underlying assumptions and concepts, and the bodies responsible for issuing accounting standards. Last, but not least, we examine the judgment process needed to make good accounting decisions.

	A	B	C	D	E
1	**The Walt Disney Company Consolidated Statements of Income**	**Fiscal 2016**	**Fiscal 2015**		
2		**12 Months Ended**			
3	**Adapted, in millions of $**	**Oct. 01, 2016**	**Oct. 03, 2015**		
4	Services revenue	$ 47,130	$ 43,894		
5	Products revenue	8,502	8,571		
6	Total revenues	55,632	52,465		
7	Cost of services	24,653	23,191		
8	Cost of products	5,340	5,173		
9	Selling, general, administrative and other	8,754	8,523		
10	Depreciation and amortization	2,527	2,354		
11	Total costs and expenses	41,274	39,241		
12	Income from operations	14,358	13,224		
13	Other items of income (expense), net	111	174		
14	Income before income taxes	14,469	13,398		
15	Income taxes	5,078	5,016		
16	Net income	$ 9,391	$ 8,382		
17					

Data from the U.S. Securities and Exchange Commission EDGAR Company Filings, www.sec.gov

Later chapters explain financial statements in more detail, as well as how the information contained in them is used to make business decisions.

Try It in Excel®

You can access the most current annual report of The Walt Disney Company in Excel® format at **www.sec.gov**. Using the "FILINGS" link on the toolbar at the top of the home page, select "Company Filings Search." This will take you to the "EDGAR Company Filings" page. Type "Walt Disney" in the company name box, and select "Search." This will produce the "EDGAR Search Results" page showing the company name. Click on the "CIK" link beside the company name. This will pull up a list of the reports the company has filed with the Securities and Exchange Commission (SEC). Under the "Filing Type" box, type "10-K," and click the "Search" box. Form 10-K is the SEC form for the company's annual report. Find the year you wish to view. Click on the "Interactive Data" box, which takes you to the "View Filing Data" page. Find and click on the "View Excel Document" link at the top of this page, and download the Excel file containing the selected 10-K report. Alternatively, you can click the listed section of the 10-K you would like to open.

The Walt Disney Company's managers make lots of decisions. What new films should be produced, and how should they be incorporated into new features in the company's theme parks? Should the company acquire another TV network? Which character dolls are the hottest sellers—Mickey, Donald, Elsa from *Frozen,* or Han Solo from *Star Wars*? Which theme parks are most and least profitable? Accounting information helps companies make these decisions.

Take a look at The Walt Disney Company's Consolidated Statements of Income. In accounting, the word *net* refers to an amount after a subtraction. Focus on Net income (line 16). Net income (profit) is the excess of revenues (net sales) over expenses. You can see that The Walt Disney Company earned $9,391 million of net income in the year ended October 1, 2016. That's good news because it means that the company had almost $9.4 billion more revenues than expenses for the year. Total revenues (line 6) increased by about 6% during the period compared to the previous year (from $52,465 million to $55,632 million). Net income increased by about 12% (from $8,382 million to $9,391 million).

Suppose you have $10,000 to invest. What information would you need before deciding to invest it in The Walt Disney Company? You can find some of that information in the company's financial statements, and to understand it, you must study accounting.

EXPLAIN WHY ACCOUNTING IS CRITICAL TO BUSINESSES

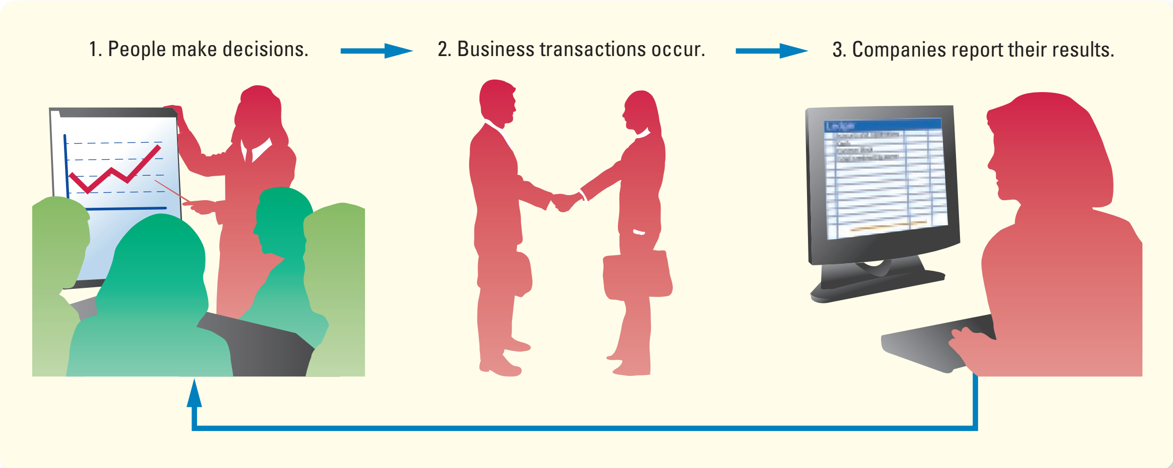
1 Explain why accounting is critical to businesses

Accounting is an information system that measures business activities, processes data into financial statements and reports, and communicates results to decision makers. Why study accounting? Accounting is the "language of business." You wouldn't think of moving to a foreign country without planning to learn the language(s) spoken there. Likewise, you shouldn't spend your career not knowing the language needed to measure and communicate business information. The better you understand the language of accounting, the better you can manage your own finances, as well as those of your business.

After you have completed this chapter, you'll begin to understand the nature of accounting, financial statements, and the relationships between them. By the end of Chapter 3, you'll understand the process by which a company's financial statements are prepared, called the **accounting cycle**.

Don't confuse bookkeeping and accounting. Bookkeeping is a mechanical part of accounting, just as arithmetic is a part of mathematics. Exhibit 1-1 below illustrates the flow of accounting information and its role in making business decisions.

Exhibit 1-1 | The Flow of Accounting Information



Describe the Decision Makers Who Use Accounting

Decision makers use many types of information. For example, a banker needs financial information from an applicant to decide whether to grant a loan request. Managers at Disney use revenue forecasts along with design-and-engineering plans to decide where to locate new theme parks and how large they will be. Let's explore how decision makers use accounting information.

- *Individuals.* People like you manage their personal bank accounts, decide whether to rent an apartment or buy a house, and calculate the monthly income and expenditures of their businesses. Accounting provides the information people need to make these decisions.
- *Investors and creditors.* Investors and creditors provide the money to finance The Walt Disney Company. Investors want to know how much income they can expect to earn on an investment. Creditors want to know when and how the company is going to pay them back. These decisions also require accounting information.
- *Regulatory bodies.* All kinds of regulatory bodies use accounting information. For example, the Internal Revenue Service (IRS) and various state and local governments require businesses, individuals, and other types of organizations to pay income, property, excise, and other taxes. The Securities and Exchange Commission (SEC) requires companies with

publicly-traded stock to provide it with many kinds of periodic financial reports. All of these reports contain accounting information.

- *Nonprofit organizations.* Churches, hospitals, and charities such as Habitat for Humanity and the Red Cross base many of their operating decisions on accounting data. These nonprofit organizations also have to file periodic financial reports with the IRS and state governments, even though they will owe no income taxes.

Describe the Two Types of Accounting and Who Uses Each Type

People inside *and* outside of an organization use accounting information. As a result, accounting has evolved into two branches: financial accounting and managerial accounting. **Financial accounting** provides relevant and accurate financial information to decision makers *outside* of an organization, such as investors, creditors, government agencies, and the public. This textbook focuses on financial accounting. **Managerial accounting** provides accurate and relevant information to people *inside* the organization, such as the managers of The Walt Disney Company. Examples of managerial accounting information include budgets, forecasts, and projections used to make strategic decisions. Managerial accounting is covered in a separate course that usually follows this one.

Explain How Businesses Are Organized

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

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

Exhibit 1-2 compares different ways to organize a business.

Exhibit 1-2 The Various Forms of Business Organization

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

Proprietorship. A **proprietorship** has a single owner. Proprietorships tend to be small retail stores or solo providers of services—physicians, attorneys, artists, electricians, or accountants. Legally, the business *is* the proprietor, and the proprietor is personally liable for all the business's debts. But for accounting purposes, a proprietorship is a distinct entity, separate from its proprietor. Thus, the business records should be kept separate from the proprietor's personal finances.

Partnership. A **partnership** has two or more parties as co-owners, and each owner is a partner. Individuals, corporations, partnerships, or other types of entities can be partners. Income and losses of the partnership "flow through" to the partners, and they recognize them based on their agreed-upon percentage interest in the business. The partnership does not pay taxes. Instead, each partner pays taxes based on that partner's individual or corporate rate. Many retail establishments, professional service firms (law, accounting, etc.), real estate, and oil and gas exploration companies operate as partnerships. Many partnerships are small or medium-sized, but some are gigantic, with thousands of partners.

Partnerships are governed by agreement, usually spelled out in writing in the form of a contract between the partners. In most partnerships, each partner can conduct business on behalf of the organization and can make agreements that legally bind all partners. Partnerships such as these are called *general partnerships.* They are risky because an irresponsible partner can create large debts for the other general partners without their knowledge or permission. This feature of general partnerships has led to the creation of limited-liability partnerships (LLPs). A *limited-liability partnership* is one in which a single partner cannot create a large liability for the other partners. In LLPs, each partner is liable for the partnership's debts only up to the extent of his or her investment in the partnership. However, each LLP must have one general partner with unlimited liability for all of the partnership debts.

Limited-Liability Company. A **limited-liability company (LLC)** is one in which the business (and not the owner) is liable for the company's debts. An LLC may have one owner or many owners, called *members.* Unlike a proprietorship or a general partnership, the members of an LLC have limited liability for the LLC's debts only up to the extent of their investment in the LLC. Similar to a partnership, the LLC's income "flows through" to the members, and they pay income taxes at their own tax rates. Because of these favorable features, many multiple-owner businesses are organized as LLCs.

Corporation. A **corporation** is a business owned by **stockholders**, or **shareholders**, who own **stock** representing shares of ownership in the corporation. Being able to raise large sums of capital by issuing shares of stock to the public is a major advantage of forming a corporation. All types of entities (individuals, partnerships, corporations, or other types) may be shareholders in a corporation. Even though proprietorships and partnerships are more numerous, corporations tend to be larger in terms of their assets, income, and number of employees. Most well-known companies, such as The Walt Disney Company, **Amazon.com, Inc.**, **Alphabet, Inc.** (parent company of **Google, Inc.**), **General Motors Company**, and **Apple Inc.**, are corporations. Unlike proprietorships and partnerships, a corporation must be formed under state law and is legally distinct from its owners. The corporation is like an artificial person and possesses many of the same rights that a person has. The stockholders have no personal obligation for the corporation's debts. So, stockholders of a corporation have limited liability, as do limited partners and members of an LLC. However, unlike partnerships or LLCs, a corporation pays a business income tax as well as many other types of taxes. So, the shareholders of a corporation are effectively taxed twice on distributions received from the corporation (called dividends): (1) when the corporation pays income taxes, and (2) when the shareholders pay taxes on the income distributed to them by the corporation. Thus, one of the major disadvantages of the corporate form of business is *double taxation of distributed profits*. The unique attributes of a corporation are covered in more detail in Chapter 10.

EXPLAIN AND APPLY UNDERLYING ACCOUNTING CONCEPTS, ASSUMPTIONS, AND PRINCIPLES

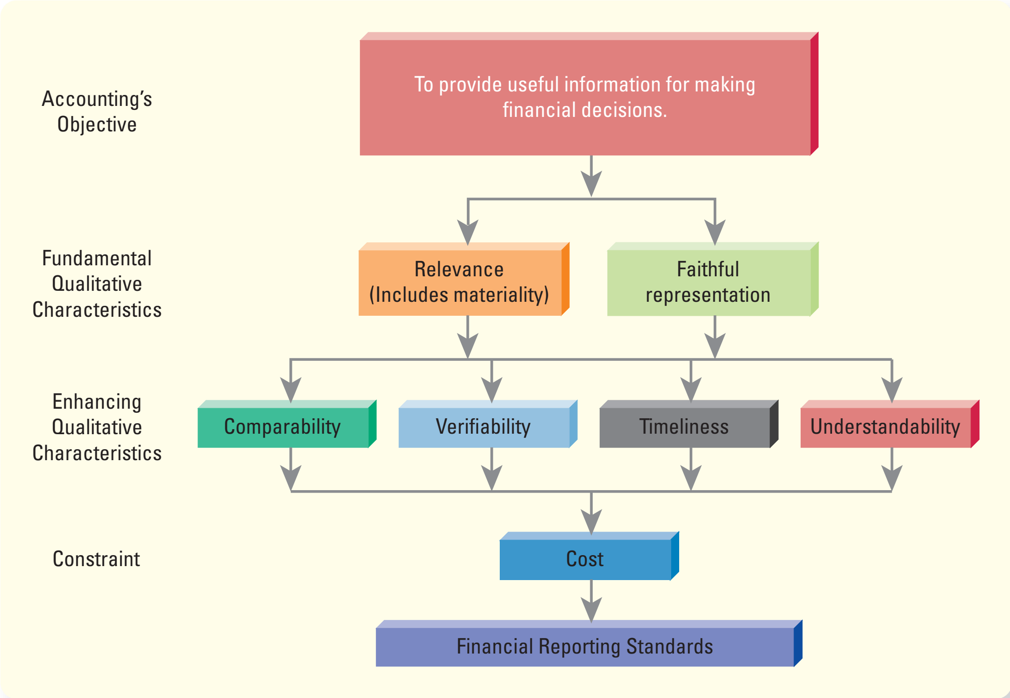
2 Explain and apply underlying accounting concepts, assumptions, and principles

Accountants follow professional standards for measuring and disclosing financial information. The most common set of standards are called **Generally Accepted Accounting Principles (GAAP)**. In the United States, the **Financial Accounting Standards Board (FASB)** formulates the standards for U.S. GAAP. The **International Accounting Standards Board (IASB)** sets **International Financial Reporting Standards (IFRS)**, as discussed later in this section.

Exhibit 1-3 gives an overview of the joint conceptual framework of accounting developed by the FASB and the IASB. Financial reporting standards (whether U.S. or international), at the bottom, follow this conceptual framework. The top frame shows that the overall *objective* of accounting is to provide financial information about the reporting entity that existing and potential investors, lenders, and other creditors can use to make decisions. The second level in the exhibit indicates that to be useful, the information must have two fundamental qualitative characteristics:

- relevance, and
- faithful representation.

Exhibit 1-3 Conceptual Foundation of Accounting



To be relevant, the information must be useful to decision makers in terms of helping them predict or confirm an organization's value. In addition, the information must be *material*, which means it must be important enough that, if it were omitted or incorrect, it would affect a user's decision. Only information that is material needs to be separately *disclosed* (listed or discussed) in financial statements. If it's not material, it can be combined with other information and not separately disclosed. To make a faithful representation, the information must be complete, neutral (free from bias), and free from error (accurate). Faithful representation makes the information *reliable* to users.

The third level in the exhibit indicates that accounting information must also have a number of *enhancing qualitative characteristics.* These include

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

Comparability means that accounting information must be prepared in a way that allows it to be compared with information from other companies in the same period; the information should also be *consistent* with similar information for that company in previous periods. For example, the methods used to compute sales revenue should be consistent for each year presented in financial statements. *Verifiability* means that it must be possible to check the information for accuracy, completeness, and reliability. Verifiability enhances the reliability of information and thus makes the information more representative of economic reality. *Timeliness* means that the information must be made available to users early enough to help them make decisions. *Understandability* means the information must be transparent, or clear, enough so that it makes sense to reasonably informed users of the information (investors, creditors, regulatory agencies, and managers).

Cost is the fourth level in the exhibit. Because accounting information is costly to produce, the cost of disclosing it should not exceed its expected benefits to users. Managers must carefully decide what accounting costs the organization must incur to give users a good understanding of its financial situation and what accounting information is too costly to provide.

This course will expose you to U.S. GAAP as well as to relevant IFRS. We summarize U.S. GAAP in Appendix C and IFRS in Appendix D. In the following section, we briefly summarize some of the basic assumptions and principles that underlie these standards.

The Entity Assumption

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

Consider Robert A. Iger, Chairman and CEO of The Walt Disney Company. Iger likely owns several homes, automobiles, and other personal assets. In addition, he may owe money on some personal loans. All these assets and liabilities belong to Iger and have nothing to do with The Walt Disney Company. Likewise, Disney's cash, computers, and inventories belong to the company and not to Iger. Why? The entity assumption draws a sharp boundary around each entity. In this case, The Walt Disney Company is one entity, and Robert Iger is a second, separate entity.

Let's consider the various types of businesses that make up The Walt Disney Company. The company operates five types of businesses, called **segments**: media networks, parks and resorts, studio entertainment, consumer products, and interactive media (games and online services). Top managers evaluate the results of the parks and resorts businesses separately from those of media networks. If theme park revenues were falling, the company should identify the reason. But if revenue figures from all the businesses were combined in a single total, managers couldn't tell how differently each business segment was performing. To correct the problem, managers need accounting information for each business segment (entity) in the company. They also need separate information for each geographic region (such as country). To accomplish this, each type of business and each region keeps its own records so it can be evaluated separately.

The Continuity (Going-Concern) Assumption

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

Consider the alternative to the **going-concern assumption**: the *quitting concern*, or going out of business assumption. An entity going out of business would have to sell all of its assets in the process. In that case, the most *relevant* measure of the value of the assets would be their liquidating values (or the amount the company can receive for the assets when sold in order to go out of business). But going out of business is the exception rather than the rule. Therefore, the continuity assumption says that a business should stay in business long enough to convert its inventories and receivables to cash and pay off its obligations in the ordinary course of business, and to continue this process of operating into the future.

The Historical Cost Principle

The **historical cost principle** states that assets should be recorded at their actual cost, measured on the date of purchase as the amount of cash paid plus noncash types of compensation given in exchange. For example, suppose The Walt Disney Company wants to purchase a building for a new Disney Store. The building's current owner is asking $6,000,000 for the building. Disney's managers believe the building is worth $5,850,000 and offer that amount. Two real estate professionals appraise the building at $6,100,000. The buyer and seller then compromise and agree on a price of $5,900,000. The historical cost principle requires Disney to initially record the building at its actual cost of $5,900,000—not at $5,850,000, $6,000,000, or $6,100,000, even though those amounts were what some people believed the building was worth. The $5,900,000 cost is both the *relevant* amount of the building's worth and the amount that *faithfully represents* a reliable figure for the price the company paid for it.

Based on the historical cost principle and the continuity assumption, The Walt Disney Company should continue to use historical cost to value the asset for as long as the business owns it. Why? Because cost is a *verifiable* measure that is relatively *free from bias*. Suppose that after the company has owned the building for six years, it can be sold for $6,500,000 because real estate prices have gone up. Should Disney increase the value of the building on the company's books to $6,500,000 at this point? No. According to the historical cost principle, the building remains on The Walt Disney Company's books at its historical cost of $5,900,000, less accumulated depreciation. According to the continuity assumption, Disney intends to stay in business and use the building—not sell it—so its historical cost is the most relevant and the most faithful representation of its value. It is also the most easily verifiable amount. Should the company decide to sell the building later at a price above or below its value, it will record the cash received, remove the value of the building from the books, and record a gain or a loss for the difference at that time.

Although the historical cost principle is used widely in the United States to value assets, accounting is moving in the direction of reporting more assets and liabilities at their fair values. **Fair value** is the amount that the business could sell the asset for, or the amount that the business could pay to settle the liability. The FASB has issued guidance for companies to report many assets and liabilities at fair values.[1] Moreover, in recent years, the FASB has agreed to "harmonize" U.S. GAAP with IFRS. IFRS generally allow more types of assets to be periodically adjusted to their fair values than U.S. GAAP. We will discuss the trend toward globalization of accounting standards in the following Global View feature, and we will illustrate it in later chapters throughout the book.

The Stable-Monetary-Unit Assumption

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

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

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

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

GLOBAL VIEW

International Financial Reporting Standards We live in a global economy: Investors in the United States can easily trade stocks on the Hong Kong, London, and Brussels stock exchanges over the Internet. Each year, American companies such as **Starbucks**, **The Gap**, **McDonald's**, **Microsoft**, and Disney conduct billions of dollars of business around the globe. Conversely, foreign companies such as **Nokia**, **Samsung**, **Toyota**, and **Nestlé** conduct billions of dollars of business in the United States. American companies have merged with foreign companies to create international conglomerates such as **Pearson** (the publisher of this textbook) and **Anheuser-Busch InBev** (producers of alcoholic beverages). No matter where your career starts, it is very likely that it will involve global markets.

At one time, the major developed countries in the world (the United States, the United Kingdom, Japan, Germany, etc.) all had their own versions of GAAP. This made it difficult and expensive for users to compare financial results across entities from different countries. Why? It compelled users to restate and convert accounting data from one country to the next in order to make them comparable.

This problem has been largely solved by the IASB, which has developed International Financial Reporting Standards (IFRS) that are now being used by most countries around the world. IFRS have not been adopted in the United States because existing U.S. GAAP have long been considered the strongest single set of accounting standards in the world. In addition, the application of U.S. GAAP for public companies in the United States has been overseen carefully by the SEC, a body that at present has no global counterpart. Although it has taken measures to permit some types of U.S. companies that operate globally to use IFRS, the SEC has stopped short of requiring it. Thus, it appears that the FASB and IASB will continue to co-exist in the future. The FASB and IFRS have ongoing projects to converge their standards. The goal is to adopt a rather uniform set of high-quality global accounting standards, although some major differences remain.

In chapters that cover concepts where major differences between U.S. GAAP and IFRS exist, we will briefly discuss those differences. Appendix D includes a table, cross-referenced by chapter, that summarizes all of these differences, as well as their impact on financial statements.

APPLY THE ACCOUNTING EQUATION TO BUSINESS ORGANIZATIONS

3 **Apply** the accounting equation to business organizations

The Walt Disney Company's financial statements tell us how the business is performing and where it stands. But how do we arrive at the financial statements? Let's examine the elements of financial statements, which are the building blocks from which statements are made.

Assets and Liabilities

The financial statements are based on the accounting equation. This equation presents the resources of a company and the claims to those resources.

- **Assets** are economic resources that are expected to produce a benefit in the future. The Walt Disney Company's cash, receivables, inventory, attractions, buildings, and equipment are examples of assets.

Claims on assets come from two sources:

- **Liabilities** are "outsider claims." They are debts owed to people and organizations outside of the business (creditors). For example, a creditor who has loaned money to The Walt Disney Company has a claim—a legal right—to a part of the company's assets until the company repays the debt.
- **Equity** (also called **capital, owners' equity,** or **stockholders' equity** for a corporation) represents the "insider claims" of a business. Equity means ownership, so The Walt Disney Company's equity is the stockholders' interest in the assets of the corporation. Throughout most of this book we will be discussing corporations, so the term stockholders' equity is most likely to be used.