ELEVENTH EDITION

Financial Accounting

HARRISON | HORNGREN | THOMAS | TIETZ

ACCOUNTING in the headlines

Accounting in the Headlines.

One of the biggest challenges for accounting instructors is that students often feel disengaged from the course material, which can seem abstract and unrelated to their personal experiences. But by incorporating real-life examples, instructors can spark student interest and engagement, especially when teaching accounting at the introductory level.

Accounting in the Headlines, an award-winning blog by renowned author Wendy Tietz, does just that with stories about real companies and events that can be used in the accounting classroom to illustrate introductory financial and managerial accounting concepts.

Concise, tailorable, and updated on a weekly basis, these articles easily fit into the typical introductory accounting curriculum, whether the course is delivered in-person or online. **Accounting in the Headlines articles, along with multiple-choice and polling questions, can be assigned through MyAccountingLab and Learning Catalytics™. Instructors are also provided with discussion questions, PowerPoint slides, and handout files, to support learning initiatives.**

http://accountingintheheadlines.com

Dear Valued Colleagues,

Welcome to the Eleventh 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 Eleventh Edition of *Financial Accounting* has been improved in many respects, as explained below.

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

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

Student success. We feel we have the most advanced student learning materials in the market with MyAccountingLab. These include automatically graded homework, DemoDocs, and learning aid videos. We believe that the use of MyAccountingLab homework will greatly enhance student understanding of accounting with its instantaneous feedback. MyAccountingLab makes the study of financial accounting a more interactive and fun experience for students. In addition, we have adopted a scaffolding approach in the book and its resources. Chapter content and the end-of-chapter material builds from the basic short exercise featuring one basic 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 on 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

Bill Thomas
Wendy Tietz

Financial Accounting

ELEVENTH EDITION

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Acknowledgments of third-party content appear on the appropriate page within the text, or are as follows: Decision Guidelines and Ethical Issue icons: Micromaniac/Shutterstock. Global View and Cooking the Books icons: Pearson Education.

Library of Congress Cataloging-in-Publication Data
Names: Harrison, Walter T., author. | Horngren, Charles T., author. | Thomas, C. William, author.
Title: Financial accounting / Walter T. Harrison Jr., Baylor University, Charles T. Horngren, Stanford University, C. William (Bill) Thomas, Baylor University, Wendy M. Tietz, Kent State University.
Description: Eleventh Edition. | Boston : Pearson, 2016. | Revised edition of Financial accounting, 2015. | Includes index.
Identifiers: LCCN 2015043663 | ISBN 9780134127620
Subjects: LCSH: Accounting.
Classification: LCC HF5636 .H37 2016 | DDC 657—dc23
LC record available at http://lccn.loc.gov/2015043663
10 9 8 7 6 5 4 3 2 1

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ISBN 10: 0-13-412762-5
ISBN 13: 978-0-13-412762-0

ABOUT THE AUTHORS

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 Certified Public 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.

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, Bill 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 Certified Public Accountants, and the Texas Society of Certified Public Accountants.

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

Wendy M. Tietz is a professor in the Department of Accounting in the College of Business Administration at Kent State University, where she has taught since 2000. She teaches introductory financial and managerial accounting in a variety of formats, including large sections, small sections, and web-based sections. She has received numerous college and university teaching awards while at Kent State University. Most recently she was named the Beta Gamma Sigma Professor of the Year for the College of Business Administration.

Dr. Tietz is a certified public accountant, a certified management accountant, and a chartered global management accountant. She is a member of the American Accounting Association (AAA), the Institute of Management Accountants (IMA), and the American Institute of Certified Public Accountants (AICPA). She has published articles in such journals as *Issues in Accounting Education*, *Accounting Education: An International Journal*, and *Journal of Accounting & Public Policy*. She received the 2014 Bea Sanders/AICPA Innovation in Teaching Award for her accounting educator blog entitled "Accounting in the Headlines." She regularly presents at AAA regional and national meetings. Dr. Tietz is also the coauthor of a managerial accounting textbook, *Managerial Accounting*, with Dr. Karen Braun.

Dr. Tietz received her PhD from Kent State University. She received both her MBA and BSA from the University of Akron. 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.

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

BRIEF CONTENTS

CONTENTS

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, 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 Eleventh Edition includes updated explanations, coverage, and ratio analysis with decision-making guidelines. These time-tested methodologies with the latest technology ensures 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.

CHANGES FOR THE ELEVENTH EDITION

1. The first three chapters of the book cover the accounting cycle and how financial statements are constructed. In previous editions of the book, we used separate companies in each of Chapters 1, 2, and 3 to illustrate various phases of the accounting cycle. In the Eleventh Edition, we switched to using *a single, very familiar* company (The Walt Disney Company) to illustrate all phases of the accounting cycle. In Chapter 1, we give an overview of the company's financial statements and explain what each contains. In Chapter 2, we cover transactions—how they impact the accounting equation and how they are journalized, posted, and summarized. In Chapter 3, we discuss the latter stages of the accounting cycle for the same company and what goes on at the end of the cycle to convert the books into financial statements—adjusting entries, closing entries, and financial statement preparation. Thus, the Eleventh Edition should have more continuity in the early chapters; tell a more integrated, unified story; and cover the accounting cycle in a chronological sequence. The hypothetical company (Alladin Travel, Inc.) that we have created in Chapter 1 and carried through Chapter 3 is a company that conceivably fits into Disney's business model.
2. A scaffolding approach has been implemented in the book and its resources. Chapter content and the end-of-chapter material builds from the basic short exercise featuring one basic concept to more advanced problems featuring multiple learning objectives. This allows the student to practice at the basic level and then build upon that success to advance to more challenging problems.
3. The ethical component of accounting has been enhanced in the Eleventh Edition by adding a section on the AICPA's Code of Professional Conduct, located at the end of Chapter 1. The principles section of the code is included, explaining CPAs' responsibilities to act in the public interest, to have integrity and objectivity, and to exercise due professional care. In each chapter, there are short exercises that demonstrate the application of these principles.
4. Short exercises, exercises, and problems are more clearly labeled by learning objective (LO). Short exercises have been shortened and simplified in this edition to cover only one LO each. They can be used better to briefly cover single concepts as illustrations or class exercises. Exercises might cover two or three LOs, and problems cover multiple LOs.
5. In Chapters 3, 5, and 11, we have updated and provided complete coverage of the revised FASB accounting standard on revenue recognition, impacting the accounting for sales returns and sales discounts. We provide the most accurate up-to-the-minute information available for this critical area. End-of-chapter short exercises, exercises, and problems have also been revised to reflect application of the new revenue recognition standard at an appropriate and understandable level for beginning students in accounting.
6. Chapter 4 contains a new hypothetical case study to introduce the concepts of fraud and how it can be prevented by internal control. This fictionalized case study is based on an actual company in Texas whose highly trusted and loyal controller and his wife systematically stole $16 million over the space of 10 years by issuing company checks to pay off their personal credit card bills. The scheme was enabled by weak internal controls. Executives of the company allowed the controller to have access to the check-signing

machine and electronic signature of the company president. Chapter 4 also contains updated illustrations of electronic bank statements.

7. In Chapter 5, using Apple Inc. as the book's Appendix A focus company, we emphasize proper revenue recognition, accounting for accounts and notes receivable, and measuring and evaluating collectability through the allowance for doubtful accounts. The coverage of the days' sales outstanding (DSO) ratio has been updated, improved, and made more consistent with the coverage of days' inventory outstanding (DIO) in Chapter 6 and days' payable outstanding (DPO) in Chapter 9. We first introduce the computation of accounts receivable turnover (net sales/average accounts receivable) and explain its meaning. We then convert the turnover to DSO by dividing the turnover by 365. In previous editions, the primary computation was average daily sales (net sales/365), followed by division of average AR by average daily sales.
8. In Chapter 6, the coverage of inventory and cost of goods sold has been updated, using Under Armour, Inc., the textbook's Appendix B focus company. The products sold by Under Armour should be highly familiar to college students, and the study of inventory is made more interesting by applying it to this fascinating and fast-growing company.
9. In Chapter 9, based on feedback we received from adopters who only have time to cover straight-line amortization for bond premium or discount, we added a new self-contained section at the beginning of the coverage for bonds payable: Accounting for Bonds Payable Using Straight-Line Amortization. We moved the coverage of amortization by the effective-interest method back one section. Thus, users who only want to cover issuance of bonds and recognition of interest expense based on straight-line amortization of bond premium or discount may use only that section. Separate problems using the straight-line method or amortization at the end of the chapter allow these users to easily skip the more complex effective-interest method altogether.
10. In every chapter, after relevant concepts are covered, a text box labeled "Try it" is introduced. This employs the following learning philosophy: 1. read it; 2. try it; 3. practice it.
11. In many cases, we add "Try It in Excel" to illustrate use of Excel and a business problem-solving tool. We feel that students should be exposed early and frequently in their business education to Excel applications. At the beginning of every chapter, we give students instructions as to how to access the most current financial statements of the chapter's focus company in Excel format from the Securities and Exchange Commission (SEC) website (**http://www.sec.gov**). Throughout the book, most exhibits and journal entries are formatted as Excel worksheets. In addition, at certain points throughout the text, we include examples that show students step-by-step how to build Excel templates to facilitate the solutions of specific accounting problems. The following provides examples of these applications by chapter:

    Chapter 1: Preparing basic financial statements (income statement, retained earnings statement, balance sheet)

    Chapter 2: Processing business transactions, preparation of trial balance

    Chapter 3: Adjusting journal entries, preparation of adjusted trial balance, final financial statements

    Chapter 4: Preparation of bank reconciliation, cash budget

    Chapter 5: Accounts receivable aging analysis

    Chapter 6: Computation of cost of goods sold and gross profit

    Chapter 7: Calculation of depreciation expense and accumulated depreciation by three methods: straight-line, units-of-production, and double-declining balance

    Chapter 8: Calculation of present value

    Chapter 9: Calculation of bond discount and premium amortization tables using effective-interest method

    Chapter 13: Horizontal and vertical analysis of financial statements

12. Ethics is a vital part of accounting. Several sections of the text are dedicated to discussing potential ethical problems that can arise in dealing with that particular subject matter and how they should be properly handled.
13. In all chapters, we emphasize how accounting information covered in that chapter is analyzed and used to help managers make various kinds of business decisions. User-relevant information and key ratios that are covered in various chapters include the following:

    Chapter 3: Debt-paying ability: net working capital, current ratio, debt ratio

    Chapter 4: Internal control: importance of internal control to preserve the integrity of financial information; the significance of cash and cash flow

    Chapter 5: Liquidity: quick (acid-test) ratio, accounts receivable turnover, days' sales in receivables

    Chapter 6: Profitability: gross profit percentage, inventory turnover, days' inventory outstanding

    Chapter 7: Profitability: introduction rate of return on total assets (ROA) using Du Pont Analysis (profit margin × asset turnover)

    Chapter 8: Time value: time value of money and how it impacts investing and lending decisions

    Chapter 9: Liquidity: accounts payable turnover, days' payable outstanding, cash collection cycle (days' sales in receivables + days inventory outstanding − days' payable outstanding). Leverage: continuation of Du Pont Analysis by introducing leverage ratio (average total assets/average stockholders' equity)

    Chapter 10: Profitability: rate of return on common stockholders' equity using expanded Du Pont Analysis Model (ROA [introduced in Chapter 7] × leverage ratio [introduced in Chapter 9])

    Chapter 11: Evaluating performance: earnings quality, earnings per share, book value per share, dividend yield, capitalization of earnings from operations to estimate future profitability and stock price

    Chapter 12: Cash flow: use of cash flow information by creditors and investors; free cash flow

    Chapter 13: Statement analysis: comprehensive financial statement analysis, incorporating all of the ratios covered in the previous chapters, applying them to the book's two appendix focus companies, Under Armour, Inc. and Apple Inc.

VISUAL WALK-THROUGH

Try It in Excel

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

Try It in Excel®

Formatting comparative financial statements for horizontal analysis when the financial statements are in Excel format is quite easy. Try reconstructing Exhibit 13-2 in Excel.

1. Start with the Consolidated Statements of Operations in the opening figure of the chapter.
2. Change the labels to correspond with Exhibit 13-2. Your spreadsheet might be slightly different from Exhibit 13-2, so the cells in which you start to enter formulas might have to be modified accordingly.
3. Insert one column between the 2014 and 2013 columns and another column between the 2013 and 2012 columns. Label these "% change."
4. Compute the percentage change as follows. We start in cell C4 (blank). Change the format of the data in the cell to % by clicking on the % box in the number field in the top toolbar. In cell C4, type the following: =(B4–D4)/D4. The result of 32.3% should appear in the cell. Copy this cell formula through line 13 of the sheet to perform this computation for all other income and expenses.
5. Repeat the process in (4) using blank cell E4 and using the formula: =(D4–F4)/F4. Copy this formula through line 13.
6. Pat yourself on the back. You've just performed horizontal analysis using Excel!

A1

	A	B	C	D
1	Under Armour, Inc. Consolidated Statements of Income			
2			12 Months Ended	
3	In Thousands of $	Dec. 31, 2014	Dec. 31, 2013	Dec. 31, 2012
4	Net revenues	$ 3,084,370	$ 2,332,051	$ 1,834,921
5	Cost of goods sold	1,572,164	1,195,381	955,624
6	Gross profit	1,512,206	1,136,670	879,297
7	Selling, general and administrative expenses	1,158,251	871,572	670,602
8	Income from operations	353,955	265,098	208,695
9	Interest expense, net	(5,335)	(2,933)	(5,183)
10	Other expense, net	(6,410)	(1,172)	(73)
11	Income before income taxes	342,210	260,993	203,439
12	Provision for income taxes	134,168	98,663	74,661
13	Net income	$ 208,042	$ 162,330	$ 128,778
14				

Excel Integrated Throughout Text!

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

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

At the beginning of the month, supplies were $5,000. During the month, $7,000 of supplies were purchased. At month's end, $3,000 of supplies are still on hand. What is the

- adjusting entry?
- ending balance in the Supplies account?

Answer:

A1

	A	B	C	D	E	F
1		Supplies Expense ($5,000 + $7,000 – $3,000)	9,000			
2		Supplies		9,000		
3						
4		Ending balance of supplies = $3,000 (the supplies				
5		still on hand)				
6						

GLOBAL VIEW

In contrast to U.S. GAAP, with its mechanical, or "bright line," tests for capitalization of leases, IFRS adopts a much broader approach. Rather than rules, IFRS employs "guidance" that focuses on the overall substance of the transaction, rather than on the mechanical form, and that leaves more to the judgment of the preparer of the financial statement. If, in the judgment of the company's accountants, the lease transfers "substantially all of the risks and rewards of ownership to the lessee," IFRS says the lease should be capitalized. Otherwise, the lease should be expensed as an operating lease.

As of the date of this text, the FASB and IASB have issued a final exposure draft for a new standard on long-term leases that will, for the great majority of such agreements, require capital lease treatment. This will essentially end the practice of operating leases and off-balance-sheet financing for leased property. The new standard is expected to take effect sometime after 2016. When that happens, Southwest Airlines and many other companies with long-term operating leases for fixed assets could be forced to add billions of dollars to their long-term assets, as well as their long-term liabilities, with results as we just showed on their debt and other ratios.

Global View

Offers students an international perspective on accounting issues and integrates the International Financial Reporting Standards (IFRS) with corresponding concepts throughout the text.

Decision Guidelines

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

DECISION GUIDELINES

USING THE INCOME STATEMENT AND RELATED NOTES IN INVESTMENT ANALYSIS

Suppose you've completed your studies, taken a job, and have been fortunate to save $10,000. Now you are ready to start investing. These guidelines provide a framework for using accounting information for investment analysis.

Decision	Factors to Consider		Decision Variable or Model
Which measure of profitability should be used for investment analysis?	Are you interested in accounting income? →	Income, including all revenues, expenses, gains, and losses?	Net income (bottom line)
	→	Income that can be expected to repeat from year to year?	Income from continuing operations
	Are you interested in cash flows? →		Net cash flow from operating activities (Chapter 12)

Note: A conservative strategy may use both income and cash flows and compare the two sets of results.

Ethics Check

NEW!

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.

Ethics Check

EC10-1. 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 that 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 29–30, Chapter 1 for descriptions of the principles.)

a. Henry is the CFO for Front Street Coffee Corporation and is going to take the company public within the next six months. In an effort to make the stock look more appealing and therefore sell at a higher price, Henry overrides the system controls and records fictitious sales entries.

b. Heather is a senior auditor for Lenardi & Calwell and has worked on its client, New Iron, Inc., for the past few years. A few months ago, New Iron, Inc., offered Heather a position in its internal audit department. Heather accepted the position and works very closely with the external auditors. In fact, she often prepares the work papers for the external auditor since she knows the systems better than the new auditors.

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

Media One owns 18% of the voting stock of Web Talk, Inc. The remainder of the Web Talk stock is held by numerous investors with small holdings. Austin Cohen, president of Media One and a member of Web Talk's board of directors, heavily influences Web Talk's policies.

Under the fair value method of accounting for investments, Media One's net income increases as it receives dividend revenue from Web Talk. Media One pays President Cohen a bonus computed as a percentage of Media One's net income. Therefore, Cohen can control his personal bonus to a certain extent by influencing Web Talk's dividends.

A recession occurs in 2016, and Media One's income is low. Cohen uses his power to have Web Talk pay a large cash dividend. The action requires Web Talk to borrow in order to pay the dividend.

Requirements

1. What are the ethical issues in the Media One case?
2. Who are the stakeholders? What are the possible consequences to each?
3. What are the alternatives for Austin Cohen to consider? Analyze each alternative from the following standpoints: (a) economic, (b) legal, (c) ethical.
4. If you were Cohen, what would you do?
5. Discuss how using the equity method of accounting for the investment would decrease Cohen's potential for manipulating his bonus.

Critical Thinking Challenge Problems Increased!

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

Challenge Exercises and Problem

E5-67. ***(Learning Objective 6: Show how to speed up cash from receivables)*** Ripley Shirt Company sells on credit and manages its own receivables. Average experience for the past three years has been the following: LO 6

	Cash	Credit	Total
Sales	$350,000	$350,000	$700,000
Cost of goods sold	175,000	175,000	350,000
Uncollectible-account expense	—	20,000	20,000
Other expenses	89,000	89,000	178,000

Jack Rivers, the owner, is considering whether to accept bankcards (VISA, MasterCard). Rivers expects total sales to increase by 12% but cash sales to remain unchanged. If Rivers switches to bankcards, the business can save $10,000 on other expenses, but VISA and MasterCard charge

DIGITAL WALK-THROUGH

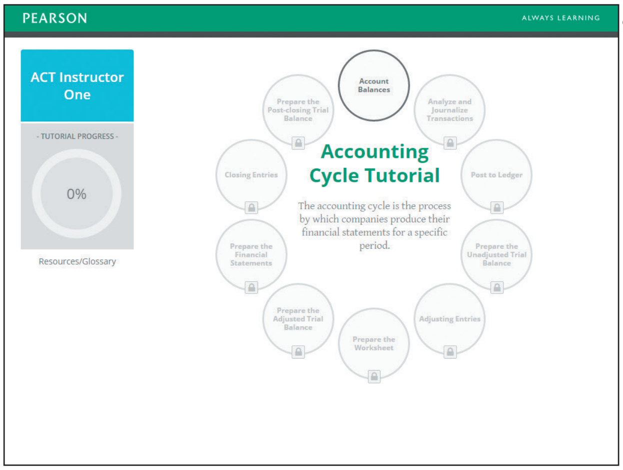
NEW!

Pearson eText

The Pearson eText, available through MyAccountingLab, gives students access to their textbook anytime, anywhere. In addition to note taking, highlighting, and bookmarking, the Pearson eText offers interactive and sharing features. Rich media options let students watch lecture and example videos as they read or do their homework. Instructors can share their comments or highlights, and students can add their own, creating a tight community of learners in your class.

The Pearson eText companion app (**http://www.pearsonhighered.com/etextmobile/**) allows existing subscribers to access their titles on an iPad or Android tablet for either online or offline viewing.

- Now available on smartphones and tablets
- Seamlessly integrated videos and other rich media
- Accessible (screen-reader ready)
- Configurable reading settings, including resizable type and night-reading mode
- Instructor and student note taking, highlighting, bookmarking, and search



Accounting Cycle Tutorial (ACT)

NEW!

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 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.

Learning Catalytics

NEW!

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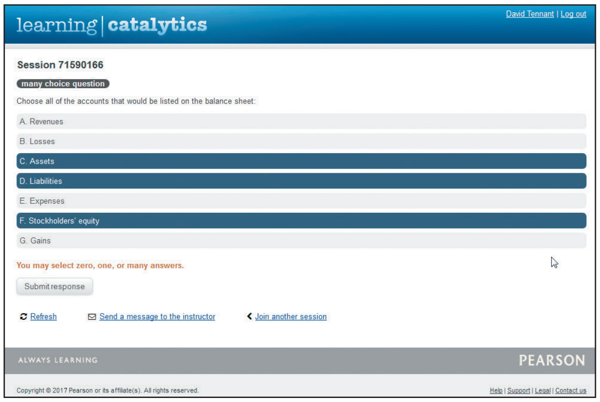

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- QuickBooks Data Files
- Excel in Practice Data Files
- Working Papers
- Directed Reading
- Questions You Should be Able to Answer

Student resource website: http://www.pearsonhighered.com/harrison
This website contains the following:

- The QuickBooks Data Files and 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, help direct students to what is content in the chapter is important.
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Instructor Resource Center: http://www.pearsonhighered.com/harrison
For the instructor's convenience, the instructor resources can be downloaded from the textbook's catalog page and MyAccountingLab. Available resources include the following:

- **NEW!** *Discussion Board Prompts*: 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 accounting classroom.

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- *Data and Solution Files*: The QuickBooks Data Files and the Excel in Practice Data Files, related to select end-of-chapter problems. Corresponding solution files are also provided.

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. We are also deeply grateful to Lacey Vitetta and Heather Pagano for their endless patience and support. Thank you to Donna Battista, Natalie Wagner, Mary Kate Murray, Sarah Peterson, Kathy Smith, and Martha LaChance for their continued help and support. Thanks also to Sheila Ammons for preparing the Test Bank, to Betsy Willis for preparing the *Instructor's Resource Manual*, and to Michelle Franz for preparing the PowerPoint presentation. 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 Eleventh Edition for their valuable input: Patricia Derrick, Drexel University; Shuai Ma, American University; Susan Machuga, University of Hartford; Dorothy Thompson, Ave Maria University; Gary Olsen, Carroll University; Reed Easton, Seton Hall University; Randall Serrett, University of Houston–Downtown; Ada Duffey, University of Wisconsin-Waukesha; Alesha Graves, Mount St. Joseph University; Brian Routh, University of Southern Indiana; Regan Garey, Lock Haven University; Michelle Watts, Boise State University; David Parker, Saint Xavier University; Brian Porter, Hope College; Rosemary Nurre, College of San Mateo.

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

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1 The Financial Statements

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 theme parks are actually only a small part of the worldwide entertainment empire that is The Walt Disney Company.

From rather humble beginnings in the American Midwest, Walt Disney first began to display his extraordinary talents as an animation artist in the 1920s. Walt and his brother Roy pooled their resources and set up a cartoon studio in Hollywood, California, in 1923. Their early work focused on animated short cartoon films featuring animal characters. The best known of these is Mickey Mouse, invented in the early 1930s. Mickey became an instant success in the first cartoon "short" with sound called *Steamboat Willie*, earning Disney his first Academy Award in 1932. The studio soon launched spin-offs for supporting characters: Mickey's friends Donald Duck and Goofy, and Mickey's beloved hound Pluto.

Martin Beddall/Alamy

Thankfully, Walt Disney's dreams didn't end with the short animated cartoon. In 1937, the studio released its first-ever full-length feature animated film, *Snow White and the Seven Dwarfs*. Considered quite a risky venture at the time, the film became the most successful motion picture of 1938, earning over $8 million on its initial release, the equivalent of over $134 million today. This led to numerous other animated features such as *Pinocchio*, *Fantasia, Bambi, Cinderella, Peter Pan,* and *Dumbo.*

Fueled by imagination, the empire continued to grow. The opening of Disneyland in 1955 signaled a new era in development for the Disney name, which has become synonymous with family entertainment worldwide. Sixty years later, among The Walt Disney Company's assets are sole ownership or interests in 5 vacation resorts, 11 theme parks, 2 water parks, 39 hotels, 8 motion picture studios, 6 record labels, and 11 cable television networks (including ESPN and ABC). The company also sells billions of dollars of branded merchandise through its retail, online, and wholesale distribution channels (Disney Stores and DisneyStore.com). As shown in The

	A	B	C	D	E
1	**The Walt Disney Company Consolidated Statements of Income**	**12 Months Ended**			
2	**Adapted, in millions of $**	**Sep. 27, 2014**	**Sep. 28, 2013**		
3	Services revenue	$ 40,246	$ 37,280		
4	Products revenue	8,567	7,761		
5	Total revenues	48,813	45,041		
6	Cost of services (exclusive of depreciation and amortization)	(21,356)	(20,090)		
7	Cost of products (exclusive of depreciation and amortization)	(5,064)	(4,944)		
8	Selling, general, administrative, and other	(8,565)	(8,365)		
9	Depreciation and amortization	(2,288)	(2,192)		
10	Total costs and expenses	(37,273)	(35,591)		
11	Income from operations	11,540	9,450		
12	Other income (expense), net	706	170		
13	Income before income taxes	12,246	9,620		
14	Income taxes	(4,242)	(2,984)		
15	Net income	8,004	6,636		
16	Less: Net income attributable to noncontrolling interests	(503)	(500)		
17	Net income attributable to The Walt Disney Company (Disney)	$ 7,501	$ 6,136		
18					

Walt Disney Company Consolidated Statement of Income for the year ended September 27, 2014, the company had annual revenues of $48.8 billion (line 5) and net income attributable to The Walt Disney Company of $7.5 billion (line 17). The Walt Disney Company today stands as an example of just how far a dream and a little imagination can take you!

The terms *revenue* and *net income* may be unfamiliar to you now, but after you read this chapter, you'll be able to use these and other business terms. Welcome to the world of accounting!

Most chapters of this book begin with an actual financial statement. In Chapters 1–3, our reference is the Consolidated Financial Statements of The Walt Disney Company, for the two years ended September 27, 2014, and September 28, 2013. The core of financial accounting revolves around these basic financial statements:

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

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

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

LEARNING OBJECTIVES

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

Try It in Excel®

You can access the most current annual report of The Walt Disney Company in Excel® format at **http://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 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, 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 ideas will bring about a new feature film? How can those ideas be incorporated into new features in the company's theme parks? Should the company acquire another television network or sell a radio network? Which character dolls are the hottest sellers—Mickey, Pluto, Donald, or Elsa from *Frozen*? 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 on page 2. Focus on Net income attributable to The Walt Disney Company (line 17). Net income (profit) is the excess of revenues (net sales) over expenses. You can see that The Walt Disney Company earned $7,501 million of net income in the year ended September 27, 2014. That's good news because it means that The Walt Disney Company had $7.5 billion more revenues than expenses for the year.

The Walt Disney Company's Consolidated Statements of Income present more interesting news. Total revenue (line 5) increased by about 8.4% during the period compared with the previous year (from $45,041 million to $48,813 million). Furthermore, net income attributable to The Walt Disney Company increased by 22.2% (from $6,136 million to $7,501 million).

Suppose you have $10,000 to invest. What information would you need before deciding to invest that money in stock of The Walt Disney Company? Let's see how accounting works.

EXPLAIN WHY ACCOUNTING IS THE LANGUAGE OF BUSINESS

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

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

Accounting produces financial statements, which report information about a business. The financial statements measure performance and communicate where a business stands in financial terms. In this chapter, as well as Chapters 2 and 3, we focus on The Walt Disney Company. After completing this chapter, you'll begin to understand the nature of 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**.

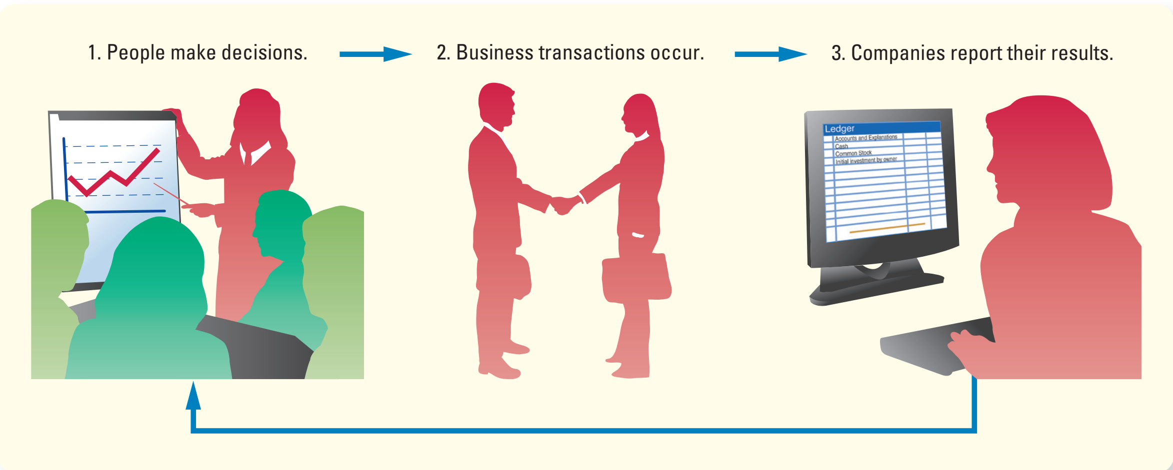
Don't confuse bookkeeping and accounting. Bookkeeping is a mechanical part of accounting, just as arithmetic is a part of mathematics. Exhibit 1-1 below illustrates the flow of accounting information and helps illustrate accounting's role in business. The accounting process begins and ends with people making decisions.

Who Uses Accounting Information?

Decision makers use many types of information; a banker needs information to decide who gets a loan or The Walt Disney Company uses accounting information, along with designs and plans from its "imagineers" (designers and engineers) to decide the size and location of a new theme park attraction. Let's see how decision makers use accounting information.

- *Individuals.* People like you manage their personal bank accounts, decide whether to rent an apartment or buy a house, and budget the monthly income and expenditures of their businesses. Accounting provides the necessary information to allow individuals to make these decisions.
- *Investors and creditors.* Investors and creditors provide the money to finance The 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 Walt Disney 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,

Exhibit 1-1 | The Flow of Accounting Information



and other taxes. The 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.* Nonprofit organizations—churches, hospitals, and charities such as Habitat for Humanity and the Red Cross—base many of their operating decisions on accounting data. In addition, these organizations have to file periodic reports of their activities with the IRS and state governments, even though they may owe no taxes.

Two Kinds of Accounting: Financial Accounting and Management Accounting

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

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

Management accounting provides information for managers of The Walt Disney Company. Examples of management accounting information include budgets, forecasts, and projections that are used in making the strategic decisions of the entity. Internal information must still be accurate and relevant for the decision needs of managers. Management accounting is covered in a separate course that usually follows this one.

Organizing a Business

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

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

Exhibit 1-2 compares 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, called the proprietor. Walt Disney started his work as a sole-proprietor animator working out of his home. Proprietorships tend to be small retail stores or solo providers of professional services—physicians, attorneys, artists, or accountants. Legally, the business *is* the proprietor, and the proprietor is personally liable for all the business's debts. But for accounting purposes, a proprietorship is a distinct entity, separate from its proprietor. Thus, the business records should not include the proprietor's personal finances.

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

A *limited-liability partnership* is one in which a wayward partner cannot create a large liability for the other partners. In LLPs, each partner is liable for partnership debts only up to the extent of his or her investment in the partnership. Each LLP, however, must have one general partner with unlimited liability for all 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 do *not* have unlimited liability for the LLC's debts. An LLC pays no business income tax. Instead, the LLC's income "flows through" to the members, and they pay income tax at their own tax rates, just as they would if they were partners. Today, many multiple-owner businesses are organized as LLCs, because members of an LLC effectively enjoy limited liability while still being taxed like members of a partnership.

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

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

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

EXPLAIN AND APPLY UNDERLYING ACCOUNTING CONCEPTS, ASSUMPTIONS, AND PRINCIPLES

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

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

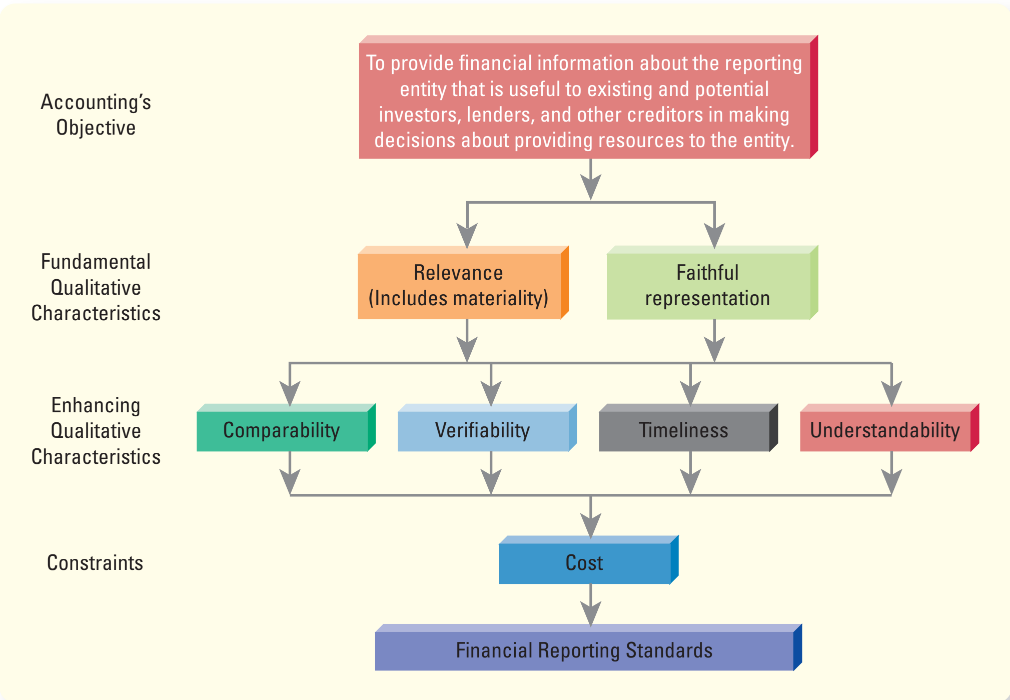
Exhibit 1-3 gives an overview of the joint conceptual framework of accounting developed by the FASB and the IASB. Financial reporting standards (whether U.S. or international), at the bottom, follow this conceptual framework. The overall *objective* of accounting is to provide financial information about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

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

- relevance, and
- faithful representation.

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

Exhibit 1-3 | Conceptual Foundation of Accounting



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

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

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

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

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

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

The Entity Assumption

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

Consider 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, The Walt Disney Company's cash, computers, and inventories belong to the company and not to Iger. Why? Because the entity assumption draws a sharp boundary around each entity; in this case, The Walt Disney Company is one entity, and Robert A. 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, 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 Walt Disney 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). Thus, each type of business and each region keeps its own records in order to be evaluated separately.

The Continuity (Going-Concern) Assumption

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

The Historical Cost Principle

The **historical cost principle** states that assets should be recorded at their *actual cost*, measured on the date of purchase as the amount of cash paid plus the fair market value of all noncash considerations (other assets, privileges, or rights) also given in exchange. For example, suppose The Walt Disney Company purchases a building for a new Disney Store. The building's current owner is asking $6,000,000 for the building. The management of The Walt Disney Company believes the building is worth $5,850,000 and offers the present owner that amount. Two real estate professionals appraise the building at $6,100,000. The buyer and seller compromise and agree on a price of $5,900,000 for the building. The historical cost principle requires The Walt Disney Company 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. At the point of purchase, $5,900,000 is both the *relevant* amount for the building's worth and the amount that *faithfully represents* a reliable figure for the price the company paid for it.

The *historical cost principle* and the *continuity assumption* (discussed previously) also maintain that The Walt Disney Company's accounting records should continue to use historical cost to value the asset for as long as the business holds it. Why? Because cost is a *verifiable* measure that is relatively *free from bias*. Suppose that The Walt Disney Company owns the building for six years. Real estate prices increase during this period. As a result, at the end of the period, the building can be sold for $6,500,000. Should The Walt Disney Company increase the carrying value of the building on the company's books to $6,500,000? 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, The Walt Disney Company intends to stay in business and use the building, not to sell it, so its historical cost is the most relevant and the most faithful representation of its carrying value. It is also the most easily verifiable (auditable) amount. Should the company decide to sell the building later at a price above or below its carrying value, it will record the cash received, remove the carrying value of the building from the books, and record a gain or a loss for the difference at that time.

Although the historical cost principle is used widely in the United States to value certain 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" GAAP with IFRS. IFRS generally allow for broader measurement of different types of assets with fair values than GAAP, which may cause more assets to be revalued periodically to fair market values. We will discuss the trend toward globalization of accounting standards on the next page, and we will illustrate it in later chapters throughout the book.

The Stable-Monetary-Unit Assumption

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

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