

weygandt  
kimmel  
kieso

team for success

# ACCOUNTING PRINCIPLES <sup>11e</sup>





## ACCOUNT CLASSIFICATION AND PRESENTATION

Account Title	Classification	Financial Statement	Normal Balance
<b>A</b>			
Accounts Payable	Current Liability	Balance Sheet	Credit
Accounts Receivable	Current Asset	Balance Sheet	Debit
Accumulated Depreciation—Buildings	Plant Asset—Contra	Balance Sheet	Credit
Accumulated Depreciation—Equipment	Plant Asset—Contra	Balance Sheet	Credit
Advertising Expense	Operating Expense	Income Statement	Debit
Allowance for Doubtful Accounts	Current Asset—Contra	Balance Sheet	Credit
Amortization Expense	Operating Expense	Income Statement	Debit
<b>B</b>			
Bad Debt Expense	Operating Expense	Income Statement	Debit
Bonds Payable	Long-Term Liability	Balance Sheet	Credit
Buildings	Plant Assets	Balance Sheet	Debit
<b>C</b>			
Cash	Current Asset	Balance Sheet	Debit
Common Stock	Stockholders' Equity	Balance Sheet	Credit
Copyrights	Intangible Asset	Balance Sheet	Debit
Cost of Goods Sold	Cost of Goods Sold	Income Statement	Debit
<b>D</b>			
Debt Investments	Current Asset/Long-Term Investment	Balance Sheet	Debit
Depreciation Expense	Operating Expense	Income Statement	Debit
Discount on Bonds Payable	Long-Term Liability—Contra	Balance Sheet	Debit
Dividends	Temporary account closed to Retained Earnings	Retained Earnings Statement	Debit
Dividends Payable	Current Liability	Balance Sheet	Credit
<b>E</b>			
Equipment	Plant Asset	Balance Sheet	Debit
<b>F</b>			
Freight-Out	Operating Expense	Income Statement	Debit
<b>G</b>			
Gain on Disposal of Plant Assets	Other Income	Income Statement	Credit
Goodwill	Intangible Asset	Balance Sheet	Debit
<b>I</b>			
Income Summary	Temporary account closed to Retained Earnings	Not Applicable	(1)
Income Tax Expense	Income Tax Expense	Income Statement	Debit
Income Taxes Payable	Current Liability	Balance Sheet	Credit
Insurance Expense	Operating Expense	Income Statement	Debit
Interest Expense	Other Expense	Income Statement	Debit
Interest Payable	Current Liability	Balance Sheet	Credit
Interest Receivable	Current Asset	Balance Sheet	Debit
Interest Revenue	Other Income	Income Statement	Credit
Inventory	Current Asset	Balance Sheet (2)	Debit

Account Title	Classification	Financial Statement	Normal Balance
<b>L</b>			
Land	Plant Asset	Balance Sheet	Debit
Loss on Disposal of Plant Assets	Other Expense	Income Statement	Debit
<b>M</b>			
Maintenance and Repairs Expense	Operating Expense	Income Statement	Debit
Mortgage Payable	Long-Term Liability	Balance Sheet	Credit
<b>N</b>			
Notes Payable	Current Liability/ Long-Term Liability	Balance Sheet	Credit
<b>O</b>			
Owner's Capital	Owner's Equity	Owner's Equity and Balance Sheet	Credit
Owner's Drawings	Temporary account closed to Owner's Capital	Owner's Equity	Debit
<b>P</b>			
Patents	Intangible Asset	Balance Sheet	Debit
Paid-in Capital in Excess of Par— Common Stock	Stockholders' Equity	Balance Sheet	Credit
Paid-in Capital in Excess of Par— Preferred Stock	Stockholders' Equity	Balance Sheet	Credit
Preferred Stock	Stockholders' Equity	Balance Sheet	Credit
Premium on Bonds Payable	Long-Term Liability	Balance Sheet	Credit
Prepaid Insurance	Current Asset	Balance Sheet	Debit
Prepaid Rent	Current Asset	Balance Sheet	Debit
<b>R</b>			
Rent Expense	Operating Expense	Income Statement	Debit
Retained Earnings	Stockholders' Equity	Balance Sheet and Retained Earnings Statement	Credit
<b>S</b>			
Salaries and Wages Expense	Operating Expense	Income Statement	Debit
Salaries and Wages Payable	Current Liability	Balance Sheet	Credit
Sales Discounts	Revenue—Contra	Income Statement	Debit
Sales Returns and Allowances	Revenue—Contra	Income Statement	Debit
Sales Revenue	Revenue	Income Statement	Credit
Selling Expenses	Operating Expense	Income Statement	Debit
Service Revenue	Revenue	Income Statement	Credit
Stock Investments	Current Asset/Long-Term Investment	Balance Sheet	Debit
Supplies	Current Asset	Balance Sheet	Debit
Supplies Expense	Operating Expense	Income Statement	Debit
<b>T</b>			
Treasury Stock	Stockholders' Equity—Contra	Balance Sheet	Debit
<b>U</b>			
Unearned Service Revenue	Current Liability	Balance Sheet	Credit
Utilities Expense	Operating Expense	Income Statement	Debit

- (1) The normal balance for Income Summary will be credit when there is a net income, debit when there is a net loss. The Income Summary account does not appear on any financial statement.
- (2) If a periodic system is used, Inventory also appears on the income statement in the calculation of cost of goods sold.

The following is a sample chart of accounts. It does not represent a comprehensive chart of all the accounts used in this textbook but rather those accounts that are commonly used. This sample chart of accounts is for a company that generates both service revenue as well as sales revenue. It uses the perpetual approach to inventory. If a periodic system was used, the following temporary accounts would be needed to record inventory purchases: Purchases, Freight-In, Purchase Returns and Allowances, and Purchase Discounts.

<b>CHART OF ACCOUNTS</b>				
<b>Assets</b>	<b>Liabilities</b>	<b>Owner's and Stockholders' Equity</b>	<b>Revenues</b>	<b>Expenses</b>
Cash	Notes Payable	Owner's Capital	Service Revenue	Advertising Expense
Accounts Receivable	Accounts Payable	Owner's Drawings	Sales Revenue	Amortization Expense
Allowance for Doubtful Accounts	Unearned Service Revenue	Common Stock	Sales Discounts	Bad Debt Expense
Interest Receivable	Salaries and Wages Payable	Paid-in Capital in Excess of Par—Common Stock	Sales Returns and Allowances	Cost of Goods Sold
Inventory	Unearned Rent Revenue	Preferred Stock	Interest Revenue	Depreciation Expense
Supplies	Interest Payable	Paid-in Capital in Excess of Par—Preferred Stock	Gain on Disposal of Plant Assets	Freight-Out
Prepaid Insurance	Dividends Payable	Treasury Stock		Income Tax Expense
Prepaid Rent	Income Taxes Payable	Retained Earnings		Insurance Expense
Land	Bonds Payable	Dividends		Interest Expense
Equipment	Discount on Bonds Payable	Income Summary		Loss on Disposal of Plant Assets
Accumulated Depreciation—Equipment	Premium on Bonds Payable			Maintenance and Repairs Expense
Buildings	Mortgage Payable			Rent Expense
Accumulated Depreciation—Buildings				Salaries and Wages Expense
Copyrights				Supplies Expense
Goodwill				Utilities Expense
Patents				

This page is intentionally left blank

weygandt  
kimmel  
kieso

team for success

# ACCOUNTING PRINCIPLES <sup>11e</sup>



WILEY

**Jerry J. Weygandt PhD, CPA**

University of Wisconsin—Madison  
Madison, Wisconsin

**Paul D. Kimmel PhD, CPA**

University of Wisconsin—Milwaukee  
Milwaukee, Wisconsin

**Donald E. Kieso PhD, CPA**

Northern Illinois University  
DeKalb, Illinois

*Dedicated to  
the Wiley sales representatives  
who sell our books and service our  
adopters in a professional and ethical  
manner, and to  
Enid, Merlynn, and Donna*

*Vice President & Executive Publisher  
Associate Publisher  
Editorial Operations Manager  
Content Editor  
Senior Development Editor  
Development Editor  
Senior Content Manager  
Senior Production Editor  
Associate Director of Marketing  
Marketing Manager  
Senior Product Designer  
Product Design  
Media Specialist  
Design Director  
Cover Design  
Interior Design  
Production Management Services  
Senior Photo Editor  
Editorial Assistant  
Marketing Assistant  
Cover and title page  
Brief Contents image  
Continuing Cookie Chronicle icon  
Waterways Problem Set icon  
Softbyte icon  
Pioneer Advertising Agency icon  
Caterpillar icon  
All other icons*

George Hoffman  
Christopher DeJohn  
Yana Mermel  
Ed Brislin  
Terry Ann Tatro  
Margaret Thompson  
Dorothy Sinclair  
Valerie A. Vargas  
Amy Scholz  
Karolina Zarychta Honsa  
Allison Morris  
Greg Chaput  
Daniela DiMaggio  
Harry Nolan  
Maureen Eide  
Kristine Carney  
Ingrao Associates  
Mary Ann Price  
Jaclyn MacKenzie  
Justine Kay  
© Moof/Cultura/Getty Images, Inc.  
© Cherrus/Shutterstock  
© Fekete Tibor/iStockphoto  
© Perry Kroll/Photostock  
© Cogal/iStockphoto  
© Mike Rodriguez/iStockphoto  
© Filonmar/iStockphoto  
Shutterstock

This book was set in New Aster by Aptara<sup>®</sup>, Inc. and printed and bound by Courier-Kendallville.  
The cover was printed by Courier-Kendallville.

Founded in 1807, John Wiley & Sons, Inc. has been a valued source of knowledge and understanding for more than 200 years, helping people around the world meet their needs and fulfill their aspirations. Our company is built on a foundation of principles that include responsibility to the communities we serve and where we live and work. In 2008, we launched a Corporate Citizenship Initiative, a global effort to address the environmental, social, economic, and ethical challenges we face in our business. Among the issues we are addressing are carbon impact, paper specifications and procurement, ethical conduct within our business and among our vendors, and community and charitable support. For more information, please visit our website: [www.wiley.com/go/citizenship](http://www.wiley.com/go/citizenship).

Copyright © 2007, 2009, 2012, 2013 John Wiley & Sons, Inc. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning or otherwise, except as permitted under Sections 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc. 222 Rosewood Drive, Danvers, MA 01923, website [www.copyright.com](http://www.copyright.com). Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030-5774, (201)748-6011, fax (201)748-6008, website <http://www.wiley.com/go/permissions>.

Evaluation copies are provided to qualified academics and professionals for review purposes only, for use in their courses during the next academic year. These copies are licensed and may not be sold or transferred to a third party. Upon completion of the review period, please return the evaluation copy to Wiley. Return instructions and a free of charge return shipping label are available at [www.wiley.com/go/returnlabel](http://www.wiley.com/go/returnlabel). Outside of the United States, please contact your local representative.

ISBN-13 978-1-118-13003-2

Binder-Ready Version ISBN 978-1-118-18089-1

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1



A hand is shown holding a bright yellow test tube vertically. The test tube is the central focus of the left side of the page. The background is white, and the hand is positioned on the left side, gripping the test tube.

# Brief Contents

- 1 Accounting in Action 2
- 2 The Recording Process 52
- 3 Adjusting the Accounts 98
- 4 Completing the Accounting Cycle 160
- 5 Accounting for Merchandising Operations 216
- 6 Inventories 274
- 7 Accounting Information Systems 328
- 8 Fraud, Internal Control, and Cash 374
- 9 Accounting for Receivables 428
- 10 Plant Assets, Natural Resources, and Intangible Assets 470
- 11 Current Liabilities and Payroll Accounting 522
- 12 Accounting for Partnerships 566
- 13 Corporations: Organization and Capital Stock Transactions 606
- 14 Corporations: Dividends, Retained Earnings, and Income Reporting 648
- 15 Long-Term Liabilities 684
- 16 Investments 738
- 17 Statement of Cash Flows 776
- 18 Financial Statement Analysis 840
- 19 Managerial Accounting 892
- 20 Job Order Costing 938
- 21 Process Costing 982
- 22 Cost-Volume-Profit 1030
- 23 Budgetary Planning 1074
- 24 Budgetary Control and Responsibility Accounting 1122
- 25 Standard Costs and Balanced Scorecard 1176
- 26 Incremental Analysis and Capital Budgeting 1226

## APPENDICES

- A** Specimen Financial Statements: **Apple Inc.** A1
- B** Specimen Financial Statements: **PepsiCo, Inc.** B1
- C** Specimen Financial Statements: **The Coca-Cola Company** C1
- D** Specimen Financial Statements: **Amazon.com, Inc.** D1
- E** Specimen Financial Statements: **Wal-Mart Stores, Inc.** E1
- F** Specimen Financial Statements: **Zetar plc** F1
- G** Time Value of Money G1
- \*H** Using Financial Calculators H1
- \*I** Standards of Ethical Conduct for Management Accountants I1

# Student success is a team effort.

The Team for Success is focused on helping you get the most out of your accounting courses in the digital age.

Students

read it

Access the right amount of information for each course anytime, anywhere, on any device.

Students

see it

Illustrations and interactive tutorials bring the content to life and make accounting concepts easier to understand.

Students

do it

The **DO IT!** exercises throughout the textbook will help you apply your understanding of accounting. The *WileyPLUS* homework experience imitates a blank sheet of paper experience using type-ahead for account entry, and helps you catch mistakes early by providing feedback at the part level.

Students

get it

The powerful combination of quality text, visual approach to learning, and highly intuitive homework experience prepares you for class, exams, and future study.

[www.wileyteamforsuccess.com](http://www.wileyteamforsuccess.com)

WILEY



kieso  
weygandt  
kimmel  
warfield

team for success

# read it!

## REAL-WORLD CONTEXT

Real-world companies and business situations give you glimpses into how real companies use accounting.

**Feature Stories** introduce chapter topics in fun ways using real-world companies that are engaging.

**Issues** that affect today's business world are highlighted in the textbook.



Time Warner completed a spin-off of AOL after years of trying to integrate the two companies. One analyst called the failed deal "a nine-year adventure akin to a marathon through mud."

### Real-World Focus

**BYP22-4** The Coca-Cola Company hardly needs an introduction. A line taken from the cover of a recent annual report says it all: If you measured time in servings of Coca-Cola, "a billion Coca-Cola's ago was yesterday morning." On average, every U.S. citizen drinks 363 8-ounce servings of Coca-Cola products each year. Coca-Cola's primary line of business is the making and selling of syrup to bottlers. These bottlers then sell the finished bottles and cans of Coca-Cola to the consumer. In the annual report of Coca-Cola, the information shown below was provided.

#### THE COCA-COLA COMPANY Management Discussion

Our gross margin declined to 61 percent this year from 62 percent in the prior year, primarily due to costs for materials such as sweeteners and packaging. The increases [in selling expenses] in the last two years were primarily due to higher marketing expenditures in support of our Company's volume growth.

We measure and (2) unit

#### ANATOMY OF A FRAUD

Lawrence Fairbanks, the assistant vice-chancellor of communications at Aesop University, was allowed to make purchases of under \$2,500 for his department without external approval. Unfortunately, he also sometimes bought items for himself, such as expensive antiques and other collectibles. How did he do it? He replaced the vendor invoices he received with fake vendor invoices that he created. The fake invoices had descriptions that were more consistent with the communications department's purchases. He submitted these fake invoices to the accounting department as the basis for their journal entries and to the accounts payable department as the basis for payment.

Total take: \$475,000

#### THE MISSING CONTROL

**Segregation of duties.** The university had not properly segregated related purchasing activities. Lawrence was ordering items, receiving the items, and receiving the invoice. By receiving the invoice, he had control over the documents that were used to account for the purchase and thus was able to substitute a fake invoice.

Source: Adapted from Wells, *Fraud Casebook* (2007), pp. 3–15.

**Insight Boxes** frame real-world company issues through international, ethical, and other perspectives.

#### ACCOUNTING ACROSS THE ORGANIZATION

##### A Thousand Millionaires!

Traveling to space or embarking on an expedition to create hot Mayan ruins are normally the stuff of adventure novels. But for employees of Facebook, these and other tasks demand more of a reality when the world's No. 1 online social network went public through an initial public offering (IPO) that may have created at least a thousand millionaires. The IPO was the largest in Internet history, valuing Facebook at over \$100 billion.

With all these riches to be had, why did Mark Zuckerberg, the founder of Facebook, delay taking his company public? Consider that the main motivation for issuing shares to the public is to raise money so you can grow your business. However, unlike a manufacturer or even an online retailer, Facebook doesn't need major physical resources, it doesn't have inventory, and it doesn't really need much money for marketing. So in the past, the company hasn't had much need for additional cash beyond what it was already generating on its own. Ideally, in hand of a closely held, nonpublic company, Zuckerberg was subject to far fewer regulations than a public company.

Source: "Status Update: Why Facebook Remains to Be a \$100 Billionaire Among Companies and Firms," *Daily Mail Reporter* (February 1, 2012).

**?** Why did Mark Zuckerberg, the CEO and founder of Facebook, delay taking his company's shares public through an initial public offering (IPO)? (See page 42.)



## Financial Reporting and Analysis

### Financial Reporting Problem: Apple Inc.

**RVP1-1** The actual financial statements of Apple Inc. for 2011, are presented in Appendix A (at the back of the book).



#### A Look at IFRS

**LEARNING OBJECTIVE** 10 Describe the impact of international accounting standards on U.S. financial reporting.

Most agree that there is a need for one set of international accounting standards. Here is why: Multinational corporations. Today's companies view the entire world as their market. For example, Coca-Cola, Intel, and McDonald's generate more than 50% of their sales outside the United States, and many foreign companies, such as Toyota, Nestlé, and Sony, find their largest market to be the United States.

Mergers and acquisitions. The mergers between Fiat Chrysler and Volkswagen/Mercedes suggest that we will see even more such business combinations of companies from different countries in the future.

# see! it

## CONTENT FOR ALL LEARNING STYLES

In addition to a textbook consistently reviewed as very readable, over 50% of the textbook provides visual presentations and interpretations of content.

**Equation Analysis Illustrations** visually walk you through the steps of journal transactions.

**Basic Analysis** The expense Insurance Expense is increased \$50, and the asset Prepaid Insurance is decreased \$50.

**Equation Analysis**

(2)	<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Owner's Equity</b>
	Prepaid Insurance	=			Insurance Expense
	- \$50	=			- \$50

**Debit-Credit Analysis**

Debits increase expenses: debit Insurance Expense \$50.  
Credits decrease assets: credit Prepaid Insurance \$50.


**Journal Entry**

Oct. 31	Insurance Expense	50	
	Prepaid Insurance		50
	(To record insurance expired)		

**Posting**

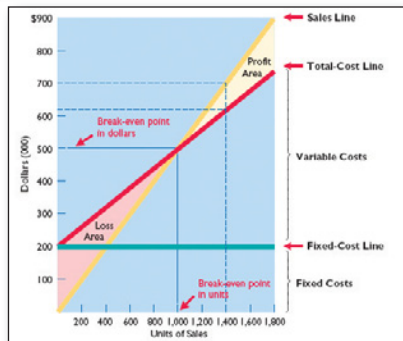
	Prepaid Insurance	130		Insurance Expense	722
Oct. 4	600	Oct. 31	Adj. 50	Oct. 31	Adj. 50
Oct. 31	Bal. 550			Oct. 31	Bal. 50

**Cash Flow Analyses** visually summarize the effects of transactions on cash flows.

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
+2,000				
-2,000				
<b>Cash Flows</b>				
+2,000 				



**Infographics** reinforce important textual concepts. All infographics were revised in the Eleventh Edition.



**Illustrations** are clearly identified and often present data in a real-world format.

HAYES COMPANY Direct Labor Budget For the Year Ending December 31, 2014									
	Quarter				Year				
	1	2	3	4					
Units to be produced (Illustration 23-5)	3,100	3,600	4,100	4,600					
Direct labor time (hours) per unit	× 2	× 2	× 2	× 2					
Total required direct labor hours	6,200	7,200	8,200	9,200					
Direct labor cost per hour	× \$10	× \$10	× \$10	× \$10					
<b>Total direct labor cost</b>	<b>\$62,000</b>	<b>\$72,000</b>	<b>\$82,000</b>	<b>\$92,000</b>	<b>\$308,000</b>				

# do! it

## KNOW THE FUNDAMENTALS

Knowing the fundamentals of accounting will help you understand what is happening in all areas of a business. **DO IT!** exercises throughout the textbook will help you practice your understanding of accounting.

**> DO IT!**

**Break-Even Analysis**

Lombardi Company has a unit selling price of \$400, variable costs per unit of \$240, and fixed costs of \$180,000. Compute the break-even point in units using (a) a mathematical equation and (b) contribution margin per unit.

**Solution**

(a) The equation is  $\$400Q - \$240Q - \$180,000 = \$0$ ;  $(\$400Q - \$240Q) = \$180,000$ . The break-even point in units is 1,125. (b) The contribution margin per unit is \$160 ( $\$400 - \$240$ ). The formula therefore is  $\$180,000 \div \$160$ , and the break-even point in units is 1,125.

**Action Plan**

- ✓ Apply the formula:  
Sales = Variable costs + Fixed costs + Net income.
- ✓ Apply the formula:  
Fixed costs + Contribution margin per unit = Break-even point in units.

Related exercise material: BE22-5, BE22-7, BE22-8, BE22-9, E22-8, E22-9, E22-10, E22-11, E22-12, E22-13, and **DO IT!** 22-3.

The Navigator

Clear **DO IT! exercises** in the textbook narrative provide step-by-step applications of a concept at the precise moment you acquire the knowledge. Each **DO IT!** in the textbook narrative includes a solution, an Action Plan, and a path of related homework exercises.

**Comprehensive DO IT!'s** at the end of each chapter apply the **DO IT!** exercises and address **multiple** topics.

**> Comprehensive DO IT!**

B.T. Hernandez Company, maker of high-quality flashlights, has experienced steady growth over the last 6 years. However, increased competition has led Mr. Hernandez, the president, to believe that an aggressive campaign is needed next year to maintain the company's present growth. The company's accountant has presented Mr. Hernandez with the data on the next page for the current year, 2014, for use in preparing next year's advertising campaign.

**> DO IT! Review**

**DO IT! 22-1** Helena Company reports the following total costs at two levels of production. *Classify types of costs.* (LO 1, 3), C

	5,000 Units	10,000 Units
Indirect labor	\$ 3,000	\$ 6,000
Property taxes	7,000	7,000
Direct labor	28,000	56,000
Direct materials	22,000	44,000
Depreciation	4,000	4,000
Utilities	5,000	7,000
Maintenance	9,000	11,000

Classify each cost as variable, fixed, or mixed.

**DO IT! 22-2** Westerville Company accumulates the following data concerning a mixed cost, using units produced as the activity level. *Compute costs using high-low method and estimate total cost.* (LO 3), AP

	Units Produced	Total Cost
March	10,000	\$18,000
April	9,000	16,650
May	10,500	18,580
June	8,800	16,200
July	9,500	17,100

(a) Compute the variable- and fixed-cost elements using the high-low method.  
 (b) Estimate the total cost if the company produces 9,200 units.

**End-of-Chapter DO IT!** exercises provide further practice with alternate versions of the in-chapter **DO IT!** exercises.

# get! it

## IMPROVE DECISION-MAKING SKILLS

As an employee, manager, or even a director of your own personal finances, you will make better decisions by learning how to analyze and solve business problems using materials provided at the end of each chapter.

**Broadening Your Perspective** questions help you pull together concepts from a particular chapter and apply them to real-world business situations. Critical thinking, communication, ethics, and other questions are included in this section at the end of each textbook chapter.

### Broadening Your Perspective

#### Financial Reporting and Analysis

##### Financial Reporting Problem: Apple Inc.

**AN** **BYP4-1** The financial statements of **Apple Inc.** are presented in Appendix A at the end of this textbook. Instructions for accessing and using the company's complete annual report, including the notes to the financial statements, are also provided in Appendix A.

#### Critical Thinking

##### Decision-Making Across the Organization

**BYP4-5** Whitegloves Janitorial Service was started 2 years ago by Lynn Sanders. Because business has been exceptionally good, Lynn decided on July 1, 2014, to expand operations by acquiring an additional truck and hiring two more assistants. To finance the expansion, Lynn obtained on

**Continuing Cookie Chronicle, Waterways Continuing Problem, and Comprehensive Problems** pull together concepts from multiple chapters and provide a macro perspective of accounting in action.

#### CONTINUING COOKIE CHRONICLE



(Note: This is a continuation of the Cookie Chronicle from Chapters 1 and 2. Use the information from the previous chapters and follow the instructions below using the general ledger accounts you have already prepared.)

**CCC3** It is the end of November and Natalie has been in touch with her grandmother. Her grandmother asked Natalie how well things went in her first month of business. Natalie, too, would like to know if she has been profitable or not during November. Natalie requests that in order to determine Cookie Creations' income, she must first make adjustments. Natalie puts together the following additional information.

- A count reveals that \$35 of baking supplies were used during November.
- Natalie estimates that all of her baking equipment will have a useful life of 5 years or 60 months. (Assume Natalie decides to record a full month's worth of depreciation regardless of when the equipment was obtained by the business.)

#### COMPREHENSIVE PROBLEM: CHAPTERS 3 TO 7

**CP7** McBride Company has the following opening account balances in its general and subsidiary ledgers on January 1 and uses the periodic inventory system. All accounts have normal debit and credit balances.

GENERAL LEDGER		
Account Number	Account Title	January 1 Opening Balance
101	Cash	\$33,750
112	Accounts Receivable	13,000

#### WATERWAYS CONTINUING PROBLEM

(Note: The Waterways Problem begins in Chapter 19 and continues in the remaining chapters. You can also find this problem at the book's companion website.)

**WCP19** Waterways Corporation is a private corporation formed for the purpose of providing the products and the services needed to irrigate farms, parks, commercial projects,



# Contents

## Chapter 1

### Accounting in Action 2

*Feature Story: Knowing the Numbers* 2

#### What Is Accounting? 4

Three Activities 4

Who Uses Accounting Data? 5

#### The Building Blocks of Accounting 7

Ethics in Financial Reporting 7

Generally Accepted Accounting Principles 8

Measurement Principles 9

Assumptions 10

#### The Basic Accounting Equation 12

Assets 13

Liabilities 13

Owner's Equity 13

#### Using the Accounting Equation 15

Transaction Analysis 15

Summary of Transactions 20

#### Financial Statements 21

Income Statement 23

Owner's Equity Statement 23

Balance Sheet 24

Statement of Cash Flows 24

#### APPENDIX 1A Accounting Career Opportunities 29

Public Accounting 29

Private Accounting 30

Governmental Accounting 30

Forensic Accounting 30

"Show Me the Money" 30

*A Look at IFRS* 48

## Chapter 2

### The Recording Process 52

*Feature Story: Accidents Happen* 52

#### The Account 54

Debits and Credits 54

Summary of Debit/Credit Rules 58

#### Steps in the Recording Process 58

The Journal 59

The Ledger 62

The Recording Process Illustrated 65

Summary Illustration of Journalizing and

Posting 71

#### The Trial Balance 72

Limitations of a Trial Balance 73

Locating Errors 74

Use of Dollar Signs 74

*A Look at IFRS* 96

## Chapter 3

### Adjusting the Accounts 98

*Feature Story: Keeping Track of Goupons* 98

#### Timing Issues 100

Fiscal and Calendar Years 100

Accrual- vs. Cash-Basis Accounting 100

Recognizing Revenues and Expenses 100

#### The Basics of Adjusting Entries 102

Types of Adjusting Entries 103

Adjusting Entries for Deferrals 104

Adjusting Entries for Accruals 110

Summary of Basic Relationships 116

#### The Adjusted Trial Balance and Financial Statements 119

Preparing the Adjusted Trial Balance 119

Preparing Financial Statements 119

#### APPENDIX 3A Alternative Treatment of Prepaid Expenses and Unearned Revenues 124

Prepaid Expenses 125

Unearned Revenues 126

Summary of Additional Adjustment

Relationships 127

*A Look at IFRS* 157

## Chapter 4

### Completing the Accounting Cycle 160

*Feature Story: Everyone Likes to Win* 160

#### Using a Worksheet 162

Steps in Preparing a Worksheet 163

Preparing Financial Statements from a Worksheet 165

Preparing Adjusting Entries from a Worksheet 167

#### Closing the Books 167

Preparing Closing Entries 168

Posting Closing Entries 170

Preparing a Post-Closing Trial Balance 172

#### Summary of the Accounting Cycle 174

Reversing Entries—An Optional Step 175

Correcting Entries—An Avoidable Step 176

#### The Classified Balance Sheet 177

Current Assets 178

Long-Term Investments 179

Property, Plant, and Equipment 180

Intangible Assets 180

Current Liabilities 182

Long-Term Liabilities 183

Owner's Equity 183

## APPENDIX 4A Reversing Entries 188

Reversing Entries Example 188

*A Look at IFRS 212*

## Chapter 5

### Accounting for Merchandising Operations 216

*Feature Story: Buy Now, Vote Later 216*

#### Merchandising Operations 218

Operating Cycles 218

Flow of Costs 219

#### Recording Purchases of Merchandise 221

Freight Costs 222

Purchase Returns and Allowances 223

Purchase Discounts 224

Summary of Purchasing Transactions 225

#### Recording Sales of Merchandise 226

Sales Returns and Allowances 227

Sales Discounts 228

#### Completing the Accounting Cycle 230

Adjusting Entries 230

Closing Entries 230

Summary of Merchandising Entries 231

#### Forms of Financial Statements 232

Multiple-Step Income Statement 232

Single-Step Income Statement 236

Classified Balance Sheet 236

#### APPENDIX 5A Worksheet for a Merchandising Company—Perpetual Inventory 240

Using a Worksheet 240

#### APPENDIX 5B Periodic Inventory System 241

Determining Cost of Goods Sold Under a Periodic System 242

Recording Merchandise Transactions 243

Recording Purchases of Merchandise 243

Recording Sales of Merchandise 244

Journalizing and Posting Closing Entries 245

Using a Worksheet 246

*A Look at IFRS 271*

## Chapter 6

### Inventories 274

*Feature Story: “Where Is That Spare*

*Bulldozer Blade?” 274*

#### Classifying and Determining Inventory 276

Classifying Inventory 276

Determining Inventory Quantities 277

#### Inventory Costing 280

Specific Identification 281

Cost Flow Assumptions 281

Financial Statement and Tax Effects of Cost

Flow Methods 286

Using Inventory Cost Flow Methods

Consistently 288

Lower-of-Cost-or-Market 289

#### Inventory Errors 290

Income Statement Effects 290

Balance Sheet Effects 291

#### Statement Presentation and Analysis 292

Presentation 292

Analysis 293

#### APPENDIX 6A Inventory Cost Flow Methods in Perpetual Inventory Systems 297

First-In, First-Out (FIFO) 297

Last-In, First-Out (LIFO) 298

Average-Cost 298

#### APPENDIX 6B Estimating Inventories 300

Gross Profit Method 301

Retail Inventory Method 302

*A Look at IFRS 324*

## Chapter 7

### Accounting Information Systems 328

*Feature Story: QuickBooks® Helps*

*This Retailer Sell Guitars 328*

#### Basic Concepts of Accounting Information Systems 330

Computerized Accounting Systems 330

Manual Accounting Systems 332

#### Subsidiary Ledgers 332

Subsidiary Ledger Example 333

Advantages of Subsidiary Ledgers 334

#### Special Journals 335

Sales Journal 336

Cash Receipts Journal 339

Purchases Journal 342

Cash Payments Journal 344

Effects of Special Journals on the General Journal 347

*A Look at IFRS 371*

## Chapter 8

### Fraud, Internal Control, and Cash 374

*Feature Story: Minding the Money in Moose Jaw 374*

#### Fraud and Internal Control 376

Fraud 376

The Sarbanes-Oxley Act 376

Internal Control 377

Principles of Internal Control Activities 378

Limitations of Internal Control 384

#### Cash Controls 386

Cash Receipts Controls 386

Cash Disbursements Controls 389

Petty Cash Fund 390



- Control Features: Use of a Bank 394**
  - Making Bank Deposits 394
  - Writing Checks 394
  - Bank Statements 395
  - Reconciling the Bank Account 397
  - Electronic Funds Transfer (EFT) System 401

### Reporting Cash 402

- Cash Equivalents 402
- Restricted Cash 403

*A Look at IFRS 425*

## Chapter 9

### Accounting for Receivables 428

*Feature Story: A Dose of Careful Management Keeps Receivables Healthy 428*

#### Types of Receivables 430

#### Accounts Receivable 430

- Recognizing Accounts Receivable 431
- Valuing Accounts Receivable 432
- Disposing of Accounts Receivable 438

#### Notes Receivable 441

- Determining the Maturity Date 442
- Computing Interest 443
- Recognizing Notes Receivable 443
- Valuing Notes Receivable 443
- Disposing of Notes Receivable 444

#### Statement Presentation and Analysis 447

- Presentation 447
- Analysis 447

*A Look at IFRS 468*

## Chapter 10

### Plant Assets, Natural Resources, and Intangible Assets 470

*Feature Story: How Much for a Ride to the Beach? 470*

#### Plant Assets 472

- Determining the Cost of Plant Assets 472
- Depreciation 475
- Expenditures During Useful Life 483
- Plant Assets Disposals 484

#### Natural Resources 486

- Depletion 487
- Presentation 487

#### Intangible Assets 488

- Accounting for Intangible Assets 489
- Research and Development Costs 491

#### Statement Presentation and Analysis 492

- Presentation 492
- Analysis 493

#### APPENDIX 10A Exchange of Plant Assets 497

- Loss Treatment 497
- Gain Treatment 498

*A Look at IFRS 517*

## Chapter 11

### Current Liabilities and Payroll Accounting 522

*Feature Story: Financing His Dreams 522*

#### Current Liabilities 524

- Notes Payable 524
- Sales Taxes Payable 525
- Unearned Revenues 526
- Current Maturities of Long-Term Debt 526
- Statement Presentation and Analysis 527

#### Contingent Liabilities 529

- Recording a Contingent Liability 529
- Disclosure of Contingent Liabilities 530

#### Payroll Accounting 532

- Determining the Payroll 532
- Recording the Payroll 535
- Employer Payroll Taxes 539
- Filing and Remitting Payroll Taxes 541
- Internal Control for Payroll 542

#### APPENDIX 11A Additional Fringe Benefits 545

- Paid Absences 545
- Postretirement Benefits 546

*A Look at IFRS 564*

## Chapter 12

### Accounting for Partnerships 566

*Feature Story: From Trials to the Top Ten 566*

#### Partnership Form of Organization 568

- Characteristics of Partnerships 568
- Organizations with Partnership Characteristics 569
- Advantages and Disadvantages of Partnerships 571
- The Partnership Agreement 571

#### Basic Partnership Accounting 572

- Forming a Partnership 572
- Dividing Net Income or Net Loss 574
- Partnership Financial Statements 576

#### Liquidation of a Partnership 578

- No Capital Deficiency 579
- Capital Deficiency 581

#### APPENDIX 12A Admission and Withdrawal of Partners 585

- Admission of a Partner 585
- Withdrawal of a Partner 589

## Chapter 13

### Corporations: Organization and Capital Stock Transactions 606

*Feature Story: What's Cooking? 606*

#### The Corporate Form of Organization 608

- Characteristics of a Corporation 608
- Forming a Corporation 610

Stockholder Rights 612  
Stock Issue Considerations 612  
Corporate Capital 615

**Accounting for Issues of Common Stock 617**  
Issuing Par Value Common Stock for Cash 618  
Issuing No-Par Common Stock for Cash 618  
Issuing Common Stock for Services or Noncash Assets 619

**Accounting for Treasury Stock 620**  
Purchase of Treasury Stock 621  
Disposal of Treasury Stock 622

**Accounting for Preferred Stock 624**  
Dividend Preferences 625  
Liquidation Preference 625

**Statement Presentation 626**  
*A Look at IFRS 644*

## Chapter 14

### Corporations: Dividends, Retained Earnings, and Income Reporting 648

*Feature Story: Owning a Piece of the Action 648*

**Dividends 650**  
Cash Dividends 650  
Stock Dividends 654  
Stock Splits 656

**Retained Earnings 658**  
Retained Earnings Restrictions 658  
Prior Period Adjustments 659  
Retained Earnings Statement 660

**Statement Presentation and Analysis 661**  
Presentation 661  
Analysis 662  
Income Statement Presentation 663  
Income Statement Analysis 663

*A Look at IFRS 682*

## Chapter 15

### Long-Term Liabilities 684

*Feature Story: And Then There Were Two 684*

**Bond Basics 686**  
Types of Bonds 687  
Issuing Procedures 687  
Determining the Market Price of a Bond 688

**Accounting for Bond Issues 690**  
Issuing Bonds at Face Value 690  
Discount or Premium on Bonds 691  
Issuing Bonds at a Discount 692  
Issuing Bonds at a Premium 693

**Accounting for Bond Redemptions 694**  
Redeeming Bonds at Maturity 695  
Redeeming Bonds before Maturity 695  
Converting Bonds into Common Stock 695

**Accounting for Other Long-Term Liabilities 696**  
Long-Term Notes Payable 696  
Lease Liabilities 699

**Statement Presentation and Analysis 700**  
Presentation 700  
Analysis 701

### APPENDIX 15A Present Value Concepts Related to Bond Pricing 705

Present Value of a Single Amount 706  
Present Value of Interest Payments (Annuities) 707  
Time Periods and Discounting 709  
Computing the Present Value of a Bond 709

### APPENDIX 15B Effective-Interest Method of Bond Amortization 711

Amortizing Bond Discount 711  
Amortizing Bond Premium 713

### APPENDIX 15C Straight-Line Amortization 715

Amortizing Bond Discount 715  
Amortizing Bond Premium 716

*A Look at IFRS 735*

## Chapter 16

### Investments 738

*Feature Story: "Is There Anything Else We Can Buy?" 738*

**Why Corporations Invest 740**

**Accounting for Debt Investments 741**  
Recording Acquisition of Bonds 741  
Recording Bond Interest 741  
Recording Sale of Bonds 742

**Accounting for Stock Investments 743**  
Holdings of Less than 20% 743  
Holdings Between 20% and 50% 743  
Holdings of More than 50% 743

**Valuing and Reporting Investments 748**  
Categories of Securities 748  
Balance Sheet Presentation 752  
Presentation of Realized and Unrealized Gain or Loss 753  
Classified Balance Sheet 754

*A Look at IFRS 773*

## Chapter 17

### Statement of Cash Flows 776

*Feature Story: Got Cash? 776*

**The Statement of Cash Flows: Usefulness and Format 778**

Usefulness of the Statement of Cash Flows 778  
Classification of Cash Flows 778  
Significant Noncash Activities 780  
Format of the Statement of Cash Flows 780  
Preparing the Statement of Cash Flows 782  
Indirect and Direct Methods 782

## Preparing the Statement of Cash Flows—Indirect Method 783

- Step 1: Operating Activities 784
- Summary of Conversion to Net Cash Provided by Operating Activities—Indirect Method 788
- Step 2: Investing and Financing Activities 789
- Step 3: Net Change in Cash 790

## Using Cash Flows to Evaluate a Company 793

- Free Cash Flow 793

## APPENDIX 17A Statement of Cash Flows—Direct Method 798

- Step 1: Operating Activities 799
- Step 2: Investing and Financing Activities 803
- Step 3: Net Change in Cash 805

## APPENDIX 17B Using a Worksheet to Prepare the Statement of Cash Flows—Indirect Method 806

- Preparing the Worksheet 807

*A Look at IFRS 837*

## Chapter 18

### Financial Statement Analysis 840

*Feature Story: It Pays to Be Patient 840*

#### Basics of Financial Statement Analysis 842

- Need for Comparative Analysis 842
- Tools of Analysis 842

#### Horizontal Analysis 843

- Balance Sheet 844
- Income Statement 844
- Retained Earnings Statement 845

#### Vertical Analysis 846

- Balance Sheet 846
- Income Statement 847

#### Ratio Analysis 848

- Liquidity Ratios 850
- Profitability Ratios 853
- Solvency Ratios 857
- Summary of Ratios 858

#### Earning Power and Irregular Items 861

- Discontinued Operations 861
- Extraordinary Items 862
- Changes in Accounting Principle 863
- Comprehensive Income 864

#### Quality of Earnings 865

- Alternative Accounting Methods 865
- Pro Forma Income 865
- Improper Recognition 866

*A Look at IFRS 889*

## Chapter 19

### Managerial Accounting 892

*Feature Story: Just Add Water . . . and Paddle 892*

#### Managerial Accounting Basics 894

- Comparing Managerial and Financial Accounting 894

Management Functions 894

Organizational Structure 896

Business Ethics 897

#### Managerial Cost Concepts 899

Manufacturing Costs 899

Product versus Period Costs 901

#### Manufacturing Costs in Financial Statements 902

Income Statement 902

Cost of Goods Manufactured 903

Cost of Goods Manufactured Schedule 904

Balance Sheet 905

Cost Concepts—A Review 906

Product Costing for Service Industries 908

#### Managerial Accounting Today 909

Focus on the Value Chain 909

Balanced Scorecard 910

Corporate Social Responsibility 911

## Chapter 20

### Job Order Costing 938

*Feature Story: She Succeeds Where Others Have Failed 938*

#### Cost Accounting Systems 940

Job Order Cost System 940

Process Cost System 940

#### Job Order Cost Flow 941

Accumulating Manufacturing Costs 942

Assigning Manufacturing Costs to Work in Process 944

Manufacturing Overhead Costs 948

Assigning Costs to Finished Goods 952

Assigning Costs to Cost of Goods Sold 953

Summary of Job Order Cost Flows 954

Job Order Costing for Service Companies 955

Advantages and Disadvantages of Job Order Costing 957

#### Reporting Job Cost Data 958

Under- or Overapplied Manufacturing Overhead 958

## Chapter 21

### Process Costing 982

*Feature Story: Ben & Jerry's Tracks Its Mix-Ups 982*

#### The Nature of Process Cost Systems 984

Uses of Process Cost Systems 984

Process Costing for Service Companies 985

Similarities and Differences Between Job Order Cost and Process Cost Systems 985

Process Cost Flow 987

Assigning Manufacturing Costs—Journal Entries 987

#### Equivalent Units 990

Weighted-Average Method 990

Refinements on the Weighted-Average Method 991

## **Production Cost Report 993**

- Compute the Physical Unit Flow (Step 1) 994
- Compute Equivalent Units of Production (Step 2) 994
- Compute Unit Production Costs (Step 3) 995
- Prepare a Cost Reconciliation Schedule (Step 4) 995
- Preparing the Production Cost Report 996
- Costing Systems—Final Comments 998

## **Contemporary Developments 998**

- Just-in-Time Processing 998
- Activity-Based Costing 1000

## **APPENDIX 21A Example of Traditional Costing versus Activity-Based Costing 1006**

- Production and Cost Data 1006
- Unit Costs Under Traditional Costing 1006
- Unit Costs Under ABC 1006
- Comparing Unit Costs 1007
- Benefits of ABC 1008
- Limitations of ABC 1008

## **Chapter 22**

### **Cost-Volume-Profit 1030**

*Feature Story: Don't Worry—Just Get Big 1030*

#### **Cost Behavior Analysis 1032**

- Variable Costs 1032
- Fixed Costs 1033
- Relevant Range 1034
- Mixed Costs 1035
- Importance of Identifying Variable and Fixed Costs 1039

#### **Cost-Volume-Profit Analysis 1040**

- Basic Components 1040
- CVP Income Statement 1040
- Break-Even Analysis 1043
- Target Net Income 1047
- Margin of Safety 1048
- CVP and Changes in the Business Environment 1050
- CVP Income Statement Revisited 1052

## **APPENDIX 22A Variable Costing 1055**

- Example Comparing Absorption Costing with Variable Costing 1055
- Absorption Costing Example 1056
- Variable Costing Example 1056
- Rationale for Variable Costing 1058

## **Chapter 23**

### **Budgetary Planning 1074**

*Feature Story: Was This the Next Amazon.com? Not Quite 1074*

#### **Budgeting Basics 1076**

- Budgeting and Accounting 1076
- The Benefits of Budgeting 1076
- Essentials of Effective Budgeting 1076

- Length of the Budget Period 1077
- The Budgeting Process 1077
- Budgeting and Human Behavior 1078
- Budgeting and Long-Range Planning 1079
- The Master Budget 1079

#### **Preparing the Operating Budgets 1081**

- Sales Budget 1081
- Production Budget 1082
- Direct Materials Budget 1084
- Direct Labor Budget 1086
- Manufacturing Overhead Budget 1087
- Selling and Administrative Expense Budget 1087
- Budgeted Income Statement 1089

#### **Preparing the Financial Budgets 1090**

- Cash Budget 1090
- Budgeted Balance Sheet 1093

#### **Budgeting in Nonmanufacturing**

##### **Companies 1095**

- Merchandisers 1095
- Service Enterprises 1096
- Not-for-Profit Organizations 1096

## **Chapter 24**

### **Budgetary Control and Responsibility Accounting 1122**

*Feature Story: Turning Trash into Treasure 1122*

#### **Budgetary Control 1124**

##### **Static Budget Reports 1125**

- Examples 1125
- Uses and Limitations 1126

##### **Flexible Budgets 1126**

- Why Flexible Budgets? 1127
- Developing the Flexible Budget 1128
- Flexible Budget—A Case Study 1130
- Flexible Budget Reports 1133

##### **Responsibility Accounting 1135**

- Controllable versus Noncontrollable Revenues and Costs 1137
- Principles of Performance Evaluation 1137
- Responsibility Reporting System 1139

##### **Types of Responsibility Centers 1142**

- Responsibility Accounting for Cost Centers 1143
- Responsibility Accounting for Profit Centers 1143
- Responsibility Accounting for Investment Centers 1145

## **Chapter 25**

### **Standard Costs and Balanced Scorecard 1176**

*Feature Story: 80,000 Different Caffeinated Combinations 1176*

#### **The Need for Standards 1178**

- Distinguishing Between Standards and Budgets 1178
- Why Standard Costs? 1178

## Setting Standard Costs 1178

Ideal versus Normal Standards 1179

A Case Study 1180

## Analyzing and Reporting Variances from Standards 1184

Direct Materials Variances 1185

Direct Labor Variances 1188

Manufacturing Overhead Variances 1190

Reporting Variances 1193

Statement Presentation of Variances 1193

## Balanced Scorecard 1194

## APPENDIX 25A Standard Cost Accounting System 1200

Journal Entries 1200

Ledger Accounts 1202

## APPENDIX 25B A Closer Look at Overhead Variances 1203

Overhead Controllable Variance 1203

Overhead Volume Variance 1204

## Chapter 26

## Incremental Analysis and Capital Budgeting 1226

*Feature Story: Make It or Buy It? 1226*

### Incremental Analysis 1228

Management's Decision-Making Process 1228

Incremental Analysis Approach 1228

How Incremental Analysis Works 1229

Accept an Order at a Special Price 1230

Make or Buy 1232

Sell or Process Further 1234

Repair, Retain, or Replace Equipment 1235

Eliminate an Unprofitable Segment  
or Product 1236

Allocate Limited Resources 1239

### Capital Budgeting 1240

Evaluation Process 1240

Annual Rate of Return 1241

Cash Payback 1243

Discounted Cash Flow 1245

Comparing Discounted Cash Flow Methods 1249

## Appendix A

Specimen Financial Statements:  
Apple Inc. A1

## Appendix B

Specimen Financial Statements:  
PepsiCo, Inc. B1

## Appendix C

Specimen Financial Statements:  
The Coca-Cola Company C1

## Appendix D

Specimen Financial Statements:  
Amazon.com, Inc. D1

## Appendix E

Specimen Financial Statements:  
Wal-Mart Stores, Inc. E1

## Appendix F

Specimen Financial Statements:  
Zetar plc F1

## Appendix G

Time Value of Money G1

Nature of Interest G1

Simple Interest G1

Compound Interest G2

Present Value Variables G3

Present Value of a Single Amount G3

Present Value of an Annuity G5

Time Periods and Discounting G7

Computing the Present Value of a  
Long-Term Note or Bond G7

Appendix H (available online at  
[www.wiley.com/college/wegandt](http://www.wiley.com/college/wegandt))

Using Financial Calculators H1

Present Value of a Single Sum H1

Plus and Minus H2

Compounding Periods H2

Rounding H2

Present Value of an Annuity H2

Useful Applications of the Financial  
Calculator H3

Auto Loan H3

Mortgage Loan Amount H3

Appendix I (available online at  
[www.wiley.com/college/wegandt](http://www.wiley.com/college/wegandt))

Standards of Ethical Conduct for  
Management Accountants I1

IMA Statement of Ethical Professional Practice I1

Principles I1

Standards I1

Resolution of Ethical Conflict I2

company index IN-1

subject index IN-3

## Feature Story

*The Feature Story helps you picture how the chapter topic relates to the real world of accounting and business. You will find references to the story throughout the chapter.*



## Knowing the Numbers

Many students who take this course do not plan to be accountants. If you are in that group, you might be thinking, “If I’m not going to be an accountant, why do I need to know accounting?” Well, consider this quote from Harold Geneen, the former chairman of IT&T: “To be good at your business, you have to know the numbers—cold.” In business, accounting and financial statements are the means for communicating the numbers. If you don’t know how to read financial statements, you can’t really know your business.

Many businesses agree with this view. They see the value of their employees being able to read financial statements and understand how their actions affect the company’s financial results. For example, consider **Clif Bar & Company**. The original Clif Bar® energy bar was created in 1990 after six months of experimentation by Gary Erickson and his mother in her kitchen. Today, the company has almost 300 employees and is considered one of the leading Landor’s Breakaway Brands®.

Clif Bar is guided by what it calls its Five Aspirations—Sustaining Our Business, Our Brands, Our People, Our

Community, and the Planet. Its website documents its efforts and accomplishments in these five areas. Just a few examples include the company’s use of organic products to protect soil, water, and biodiversity; the “smart” solar array (the largest in North America), which provides nearly all the electrical needs for its 115,000-square foot building; and the incentives Clif Bar provides to employees to reduce their personal environmental impact, such as \$6,500 toward the purchase of an efficient car or \$1,000 per year for eco-friendly improvements toward their homes.

One of the company’s proudest moments was the creation of an employee stock ownership plan (ESOP) in 2010. This plan gives its employees 20% ownership of the company (Gary and his wife Kit own the other 80%). The ESOP also resulted in Clif Bar enacting an open-book management program, including the commitment to educate all employee-owners about its finances. Armed with this basic financial knowledge, employees are more aware of the financial impact of their actions, which leads to better decisions.


Many other companies have adopted this open-book management approach. Even in companies that do not practice

*The Navigator is a learning system designed to prompt you to use the learning aids in the chapter and set priorities as you study.*



The Navigator

*Learning Objectives give you a framework for learning the specific concepts covered in the chapter.*

- Scan Learning Objectives
- Read Feature Story
- Read Preview
- Read text and answer **DO IT!** p. 11
  - p. 14
  - p. 21
  - p. 25
- Work Comprehensive **DO IT!** p. 26
- Review Summary of Learning Objectives
- Answer Self-Test Questions
- Complete Assignments
- Go to **WileyPLUS** for practice and tutorials
-  **Read A Look at IFRS** p. 48

## Learning Objectives



The Navigator

*After studying this chapter, you should be able to:*

- [1]** Explain what accounting is.
- [2]** Identify the users and uses of accounting.
- [3]** Understand why ethics is a fundamental business concept.
- [4]** Explain generally accepted accounting principles.
- [5]** Explain the monetary unit assumption and the economic entity assumption.
- [6]** State the accounting equation, and define its components.
- [7]** Analyze the effects of business transactions on the accounting equation.
- [8]** Understand the four financial statements and how they are prepared.



© Dan Moore/iStockphoto

open-book management, employers generally assume that managers in all areas of the company are “financially literate.”

Taking this course will go a long way to making you financially literate. In this textbook, you will learn how to read and prepare financial statements, and

how to use basic tools to evaluate financial results. Throughout this textbook, we attempt to increase your familiarity with financial reporting by providing numerous references, questions, and exercises that encourage you to explore the financial statements of well-known companies.

## Preview of Chapter 1

✓ The Navigator

The opening story about **Clif Bar & Company** highlights the importance of having good financial information and knowing how to use it to make effective business decisions. Whatever your pursuits or occupation, the need for financial information is inescapable. You cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or dispensing financial information. Good decision-making depends on good information.

The purpose of this chapter is to show you that accounting is the system used to provide useful financial information. The content and organization of Chapter 1 are as follows.

*The Preview describes and outlines the major topics and subtopics you will see in the chapter.*

ACCOUNTING IN ACTION				
What Is Accounting?	The Building Blocks of Accounting	The Basic Accounting Equation	Using the Accounting Equation	Financial Statements
<ul style="list-style-type: none"> <li>• Three activities</li> <li>• Who uses accounting data</li> </ul>	<ul style="list-style-type: none"> <li>• Ethics in financial reporting</li> <li>• Generally accepted accounting principles</li> <li>• Measurement principles</li> <li>• Assumptions</li> </ul>	<ul style="list-style-type: none"> <li>• Assets</li> <li>• Liabilities</li> <li>• Owner's equity</li> </ul>	<ul style="list-style-type: none"> <li>• Transaction analysis</li> <li>• Summary of transactions</li> </ul>	<ul style="list-style-type: none"> <li>• Income statement</li> <li>• Owner's equity statement</li> <li>• Balance sheet</li> <li>• Statement of cash flows</li> </ul>

## What Is Accounting?

### LEARNING OBJECTIVE

1

Explain what accounting is.

What consistently ranks as one of the top career opportunities in business? What frequently rates among the most popular majors on campus? What was the undergraduate degree chosen by Nike founder Phil Knight, Home Depot co-founder Arthur Blank, former acting director of the Federal Bureau of Investigation (FBI) Thomas Pickard, and numerous members of Congress? Accounting.<sup>1</sup> Why did these people choose accounting? They wanted to understand what was happening financially to their organizations. Accounting is the financial information system that provides these insights. In short, to understand your organization, you have to know the numbers.

**Accounting** consists of three basic activities—it **identifies**, **records**, and **communicates** the economic events of an organization to interested users. Let's take a closer look at these three activities.

### Three Activities

As a starting point to the accounting process, a company **identifies** the **economic events relevant to its business**. Examples of economic events are the sale of snack chips by PepsiCo, the provision of telephone services by AT&T, and the payment of wages by Ford Motor Company.

Once a company like PepsiCo identifies economic events, it **records** those events in order to provide a history of its financial activities. Recording consists of keeping a **systematic, chronological diary of events**, measured in dollars and cents. In recording, PepsiCo also classifies and summarizes economic events.

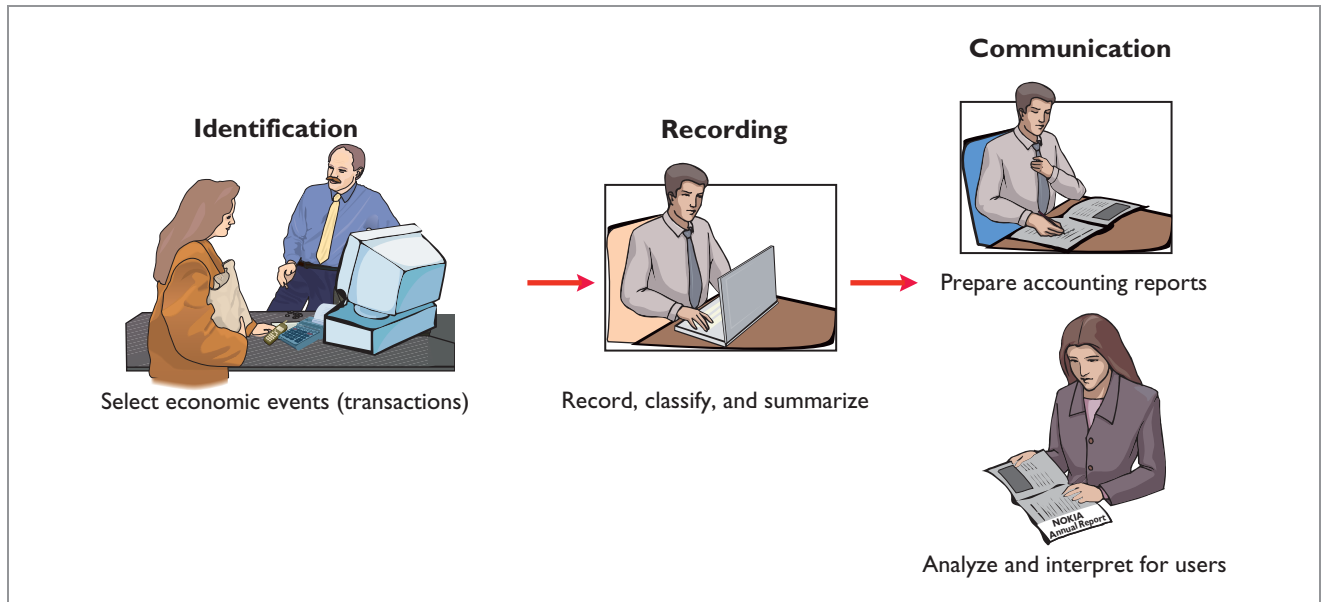
Finally, PepsiCo **communicates** the collected information to interested users by means of **accounting reports**. The most common of these reports are called **financial statements**. To make the reported financial information meaningful, PepsiCo reports the recorded data in a standardized way. It accumulates information resulting from similar transactions. For example, PepsiCo accumulates all sales transactions over a certain period of time and reports the data as one amount in the company's financial statements. Such data are said to be reported **in the aggregate**. By presenting the recorded data in the aggregate, the accounting process simplifies a multitude of transactions and makes a series of activities understandable and meaningful.

A vital element in communicating economic events is the accountant's ability to **analyze and interpret** the reported information. Analysis involves use of ratios, percentages, graphs, and charts to highlight significant financial trends and relationships. Interpretation involves **explaining the uses, meaning, and limitations of reported data**. Appendices A–E show the financial statements of Apple Inc., PepsiCo Inc., The Coca-Cola Company, Amazon.com, Inc., and Walmart Stores, Inc., respectively. (In addition, in the *A Look at IFRS* section at the end of each chapter, the U.K. company Zetar plc is analyzed.) We refer to these statements at various places throughout the textbook. At this point, these financial statements probably strike you as complex and confusing. By the end of this course, you'll be surprised at your ability to understand, analyze, and interpret them.

Illustration 1-1 summarizes the activities of the accounting process.

<sup>1</sup>The appendix to this chapter describes job opportunities for accounting majors and explains why accounting is such a popular major.





**Illustration 1-1**  
The activities of the accounting process

You should understand that the accounting process **includes** the bookkeeping function. **Bookkeeping** usually involves **only** the recording of economic events. It is therefore just one part of the accounting process. In total, accounting involves **the entire process of identifying, recording, and communicating economic events.**<sup>2</sup>

*Essential terms are printed in blue when they first appear, and are defined in the end-of-chapter glossary.*

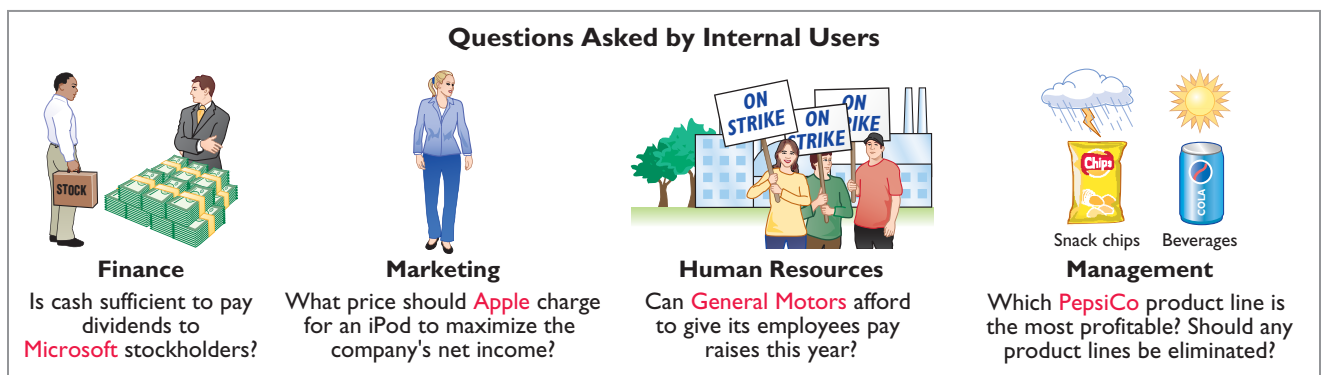
### Who Uses Accounting Data

The financial information that users need depends upon the kinds of decisions they make. There are two broad groups of users of financial information: internal users and external users.

**LEARNING OBJECTIVE 2**  
Identify the users and uses of accounting.

#### INTERNAL USERS

**Internal users** of accounting information are managers who plan, organize, and run the business. These include marketing managers, production supervisors, finance directors, and company officers. In running a business, internal users must answer many important questions, as shown in Illustration 1-2.



**Illustration 1-2**  
Questions that internal users ask

<sup>2</sup>The origins of accounting are generally attributed to the work of Luca Pacioli, an Italian Renaissance mathematician. Pacioli was a close friend and tutor to Leonardo da Vinci and a contemporary of Christopher Columbus. In his 1494 text *Summa de Arithmetica, Geometria, Proportione et Proportionalitate*, Pacioli described a system to ensure that financial information was recorded efficiently and accurately.

To answer these and other questions, internal users need detailed information on a timely basis. **Managerial accounting** provides internal reports to help users make decisions about their companies. Examples are financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year.



## ACCOUNTING ACROSS THE ORGANIZATION



### The Scoop on Accounting

Accounting can serve as a useful recruiting tool even for the human resources department. **Rhino Foods**, located in Burlington, Vermont, is a manufacturer of specialty ice cream. Its corporate website includes the following:

“Wouldn’t it be great to work where you were part of a team? Where your input and hard work made a difference? Where you weren’t kept in the dark about what management was thinking? . . . Well—it’s not a dream! It’s the way we do business . . . Rhino Foods believes in family, honesty and open communication—we really care about and appreciate our employees—and it shows. Operating results are posted and monthly group meetings inform all employees about what’s happening in the Company. Employees also share in the Company’s profits, in addition to having an excellent comprehensive benefits package.”

Source: [www.rhinofoods.com/workforus/workforus.html](http://www.rhinofoods.com/workforus/workforus.html).



What are the benefits to the company and to the employees of making the financial statements available to all employees? (See page 47.)

© Agnieszka Pastuszek-Maksim/  
iStockphoto

*Accounting Across the Organization boxes demonstrate applications of accounting information in various business functions.*

### EXTERNAL USERS

**External users** are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors. **Investors** (owners) use accounting information to decide whether to buy, hold, or sell ownership shares of a company. **Creditors** (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money. Illustration 1-3 shows some questions that investors and creditors may ask.

**Questions Asked by External Users**

**Investors**

Is **General Electric** earning satisfactory income?

**Investors**

How does **Disney** compare in size and profitability with **Time Warner**?

**Creditors**

Will **United Airlines** be able to pay its debts as they come due?

**Illustration 1-3**  
Questions that external users ask

**Financial accounting** answers these questions. It provides economic and financial information for investors, creditors, and other external users. The information

needs of external users vary considerably. **Taxing authorities**, such as the Internal Revenue Service, want to know whether the company complies with tax laws. **Regulatory agencies**, such as the Securities and Exchange Commission or the Federal Trade Commission, want to know whether the company is operating within prescribed rules. **Customers** are interested in whether a company like **General Motors** will continue to honor product warranties and support its product lines. **Labor unions** such as the **Major League Baseball Players Association** want to know whether the owners have the ability to pay increased wages and benefits.

## The Building Blocks of Accounting

A doctor follows certain standards in treating a patient's illness. An architect follows certain standards in designing a building. An accountant follows certain standards in reporting financial information. For these standards to work, a fundamental business concept must be at work—ethical behavior.

### LEARNING OBJECTIVE 3

Understand why ethics is a fundamental business concept.

## Ethics in Financial Reporting

People won't gamble in a casino if they think it is "rigged." Similarly, people won't play the stock market if they think stock prices are rigged. In recent years, the financial press has been full of articles about financial scandals at **Enron**, **WorldCom**, **HealthSouth**, **AIG**, and other companies. As the scandals came to light, mistrust of financial reporting in general grew. One article in the *Wall Street Journal* noted that "repeated disclosures about questionable accounting practices have bruised investors' faith in the reliability of earnings reports, which in turn has sent stock prices tumbling." Imagine trying to carry on a business or invest money if you could not depend on the financial statements to be honestly prepared. Information would have no credibility. There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

United States regulators and lawmakers were very concerned that the economy would suffer if investors lost confidence in corporate accounting because of unethical financial reporting. In response, Congress passed the **Sarbanes-Oxley Act (SOX)**. Its intent is to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals. As a result of SOX, top management must now certify the accuracy of financial information. In addition, penalties for fraudulent financial activity are much more severe. Also, SOX increased the independence requirements of the outside auditors who review the accuracy of corporate financial statements and increased the oversight role of boards of directors.

The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair, are **ethics**. Effective financial reporting depends on sound ethical behavior. To sensitize you to ethical situations in business and to give you practice at solving ethical dilemmas, we address ethics in a number of ways in this textbook:

1. A number of the *Feature Stories* and other parts of the textbook discuss the central importance of ethical behavior to financial reporting.


### Ethics Note

Circus-founder P.T. Barnum is alleged to have said, "Trust everyone, but cut the deck." What Sarbanes-Oxley does is to provide measures that (like cutting the deck of playing cards) help ensure that fraud will not occur.

*Ethics Notes help sensitize you to some of the ethical issues in accounting.*

2. *Ethics Insight* boxes and marginal *Ethics Notes* highlight ethics situations and issues in actual business settings.
3. Many of the *People, Planet, and Profit Insight* boxes focus on ethical issues that companies face in measuring and reporting social and environmental issues.
4. At the end of the chapter, an *Ethics Case* simulates a business situation and asks you to put yourself in the position of a decision-maker in that case.

When analyzing these various ethics cases, as well as experiences in your own life, it is useful to apply the three steps outlined in Illustration 1-4.



1. **Recognize an ethical situation and the ethical issues involved.**  
Use your personal ethics to identify ethical situations and issues. Some businesses and professional organizations provide written codes of ethics for guidance in some business situations.
2. **Identify and analyze the principal elements in the situation.**  
Identify the **stakeholders**—persons or groups who may be harmed or benefited. Ask the question: What are the responsibilities and obligations of the parties involved?
3. **Identify the alternatives, and weigh the impact of each alternative on various stakeholders.**  
Select the most ethical alternative, considering all the consequences. Sometimes there will be one right answer. Other situations involve more than one right solution; these situations require an evaluation of each and a selection of the best alternative.

**Illustration 1-4**

Steps in analyzing ethics cases and situations

*Insight boxes provide examples of business situations from various perspectives—ethics, investor, international, and corporate social responsibility. Guideline answers are provided near the end of the chapter.*



Gemunu Amarasinghe/AP Photo

## ETHICS INSIGHT

### The Numbers Behind Not-for-Profit Organizations



Accounting plays an important role for a wide range of business organizations worldwide. Just as the integrity of the numbers matters for business, it matters at least as much at not-for-profit organizations. Proper control and reporting help ensure that money is used the way donors intended. Donors are less inclined to give to an organization if they think the organization is subject to waste or theft. The accounting challenges of some large international not-for-profits rival those of the world's largest businesses. For example, after the Haitian earthquake, the Haitian-born musician Wyclef Jean was criticized for the poor accounting controls in a relief fund that he founded. In response, he hired a new accountant and improved the transparency regarding money raised and spent.



What benefits does a sound accounting system provide to a not-for-profit organization? (See page 47.)

## Generally Accepted Accounting Principles

### LEARNING OBJECTIVE

4

Explain generally accepted accounting principles.

The accounting profession has developed standards that are generally accepted and universally practiced. This common set of standards is called **generally accepted accounting principles (GAAP)**. These standards indicate how to report economic events.

The primary accounting standard-setting body in the United States is the **Financial Accounting Standards Board (FASB)**. The **Securities and Exchange Commission (SEC)** is the agency of the U.S. government that oversees U.S. financial markets and accounting standard-setting bodies. The SEC relies on the FASB to develop accounting standards, which public companies must follow. Many countries outside of the United States have adopted the accounting standards issued by the **International Accounting Standards Board (IASB)**. These standards are called **International Financial Reporting Standards (IFRS)**.

As markets become more global, it is often desirable to compare the results of companies from different countries that report using different accounting standards. In order to increase comparability, in recent years the two standard-setting bodies have made efforts to reduce the differences between U.S. GAAP and IFRS. This process is referred to as **convergence**. As a result of these convergence efforts, it is likely that someday there will be a single set of high-quality accounting standards that are used by companies around the world. Because convergence is such an important issue, we highlight any major differences between GAAP and IFRS in *International Notes* (as shown in the margin here) and provide a more in-depth discussion in the *A Look at IFRS* section at the end of each chapter.

## International Note



Over 100 countries use International Financial Reporting Standards (called IFRS). For example, all companies in the European Union follow international standards. The differences between U.S. and international standards are not generally significant.

*International Notes highlight differences between U.S. and international accounting standards.*

## Measurement Principles

GAAP generally uses one of two measurement principles, the historical cost principle or the fair value principle. Selection of which principle to follow generally relates to trade-offs between relevance and faithful representation. **Relevance** means that financial information is capable of making a difference in a decision. **Faithful representation** means that the numbers and descriptions match what really existed or happened—they are factual.

**Helpful Hint** *Relevance and faithful representation are two primary qualities that make accounting information useful for decision-making.*

### HISTORICAL COST PRINCIPLE

The **historical cost principle** (or cost principle) dictates that companies record assets at their cost. This is true not only at the time the asset is purchased, but also over the time the asset is held. For example, if **Best Buy** purchases land for \$300,000, the company initially reports it in its accounting records at \$300,000. But what does Best Buy do if, by the end of the next year, the fair value of the land has increased to \$400,000? Under the historical cost principle, it continues to report the land at \$300,000.

**Helpful Hints** *further clarify concepts being discussed.*

### FAIR VALUE PRINCIPLE

The **fair value principle** states that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability). Fair value information may be more useful than historical cost for certain types of assets and liabilities. For example, certain investment securities are reported at fair value because market price information is usually readily available for these types of assets. In determining which measurement principle to use, companies weigh the factual nature of cost figures versus the relevance of fair value. In general, most companies choose to use cost. Only in situations where assets are actively traded, such as investment securities, do companies apply the fair value principle extensively.