

Fundamental

FINANCIAL ACCOUNTING

Concepts

tenth edition

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Fundamental Financial Accounting Concepts



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FUNDAMENTAL FINANCIAL ACCOUNTING CONCEPTS, TENTH EDITION

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This book is dedicated to our students, whose questions have so frequently caused us to reevaluate our method of presentation that they have, in fact, become major contributors to the development of this text.

NOTE FROM THE AUTHORS

Technology is having a profound effect on what we teach and how we teach it. The specific impacts on this text are discussed next.

- **HOW TECHNOLOGY IMPACTS WHAT WE TEACH**

Technology has changed accounting practice. Gone are the days where accountants used pens, paper, and calculators to maintain records and prepare statements. Indeed, most companies use computer software that simplifies data entry, recordkeeping, and statement preparation. Today's accountants spend less time preparing financial information and more time consulting and advising clients. To remain relevant, accounting education must move beyond the traditional preparer approach.

The first step in learning how to advise clients is to understand how business professionals incorporate accounting in the decision-making process. Business professionals tend to think about bottom-line consequences. If I do this or that, how will it affect my company's net income, total assets, cash flow, and so on. To promote bottom-line thinking, we take the student one step beyond the recording process. Specifically, we employ a ***financial statements model*** to show them how the journal entries affect financial statements. The model arranges the balance sheet, income statement, and statement of cash flows horizontally across

a single line of text as shown next:

Balance Sheet				Income Statement				Statement of Cash Flows	
Assets	=	Liab.	+	Equity	Rev.	-	Exp.	=	Net Inc.

Typically, we show the statements model immediately after each journal entry. For example, the settlement of the liability for interest would be shown as follows:

Account Title	Debit	Credit
Interest Payable	8,400	
Cash		8,400

Balance Sheet				Income Statement				Statement of Cash Flows	
Assets	=	Liab.	+	Equity	Rev.	-	Exp.	=	Net Inc.
(8,400)		(8,400)		NA	NA		NA		NA

This approach provides a direct visual connection between journal entries and financial statements and enables students to see how **each individual accounting event affects decision making**. It shifts the focus from memorizing procedures to developing real-world thinking patterns. In today's world, computers prepare statements, humans evaluate consequences.

Most textbooks, including this one, still provide coverage of debits and credits, journal entries, trial balances, and statement preparation. It can be insightful to know what the computer is doing behind the scenes. Even so, accounting education must go beyond procedure. An accountant who can prepare a journal entry but has no idea how that entry affects financial statements cannot provide the insight and counsel expected of today's practicing accountant.

● HOW TECHNOLOGY IMPACTS HOW WE TEACH

Technology has provided many teaching tools that improve the quality of education while reducing the tasks associated with course management. Some examples include algorithmic test banks and

homework management systems. The newest tool is a comprehensive set of lecture videos.

YouTube has demonstrated that videos can be a more effective medium for learning than reading. When learning almost anything, most of us reach for a video instead of the owner's manual. Even so, be aware that ***all videos are not created equal***. When you search YouTube for an instructional video, you usually have to flip through several videos to find a really good one. Similarly, you must be prepared to look through several textbook video offerings to identify a set of high-quality videos. For comparison purposes, the following is a description of the key features of the lecture videos included in this text:

- ***Our videos have been developed by members of the author team.*** These videos have the feel of a live lecture. Delivering an effective lecture requires not only knowledge but also the proper tone, inflection, emphasis, attitude, and confidence. Scripted videos presented by a professional orator cannot compete with the spontaneous delivery of an experienced teacher.
- ***We provide comprehensive instructional coverage.*** We offer a lecture video for every learning objective in our text. Indeed, we refer to our set of videos as a video textbook. You can obtain the knowledge required to accomplish all learning objectives by watching the videos or by reading the text. The content is the same. It is only the method of delivery that differs.
- ***We have assessment quizzes that accompany each lecture video.*** After watching a video, a student is required to answer 5 to 10 multiple-choice questions. These questions are graded electronically, and students and instructors are able to obtain immediate feedback. Using this feedback, instructors can identify student weaknesses and focus class time on subjects where students are experiencing difficulty, thus more effectively helping students learn from their mistakes. The faster the feedback, the more effective the learning experience. Further, including assessment quiz scores as part of the course grade will motivate students to take video assignments seriously.
- ***Our videos enable self-paced learning.*** Our videos allow students to pause for contemplation and note-taking. This permits students to replay the instructor's coverage of difficult concepts or fast-forward through content they have already

mastered. You can even set the speed at which the video plays; slowing it down to .75x or speeding it up to 2x. No longer is the lecture too fast for some and too slow for others. Now, every lecture can be further tailored to the needs of each individual student.

- **Our videos are just the right length.** The length of the video is of critical importance. If it is too long, you will lose students' interest. If too short, there is insufficient time to make your point. Our experience suggests that the average length of an effective video is approximately 10 minutes. Self-assessment questions follow the video and may take up to 20 minutes to complete. Therefore, each video assignment should require approximately 30 minutes. A typical homework assignment may cover two to three video assignments.
- **Our videos facilitate learning for students with disabilities.** Consistent with the Americans with Disabilities Act, all our videos are closed-captioned. This provides a learning tool for students who are visually and hearing impaired. Students with hearing impairment can see and read the video content, and those with visual impairment can listen to the lecture. Also, international students, who are less proficient in the English language, find videos with closed captions to be useful.

• **Implementing lecture video content**

The following are some examples of how you can use instructional videos to improve the classroom environment.

• **Supplement your traditional lecture-based course**

You do not have to change the way you teach your class to reap many of the benefits available from video instruction. Students who have to miss class or who have trouble comprehending certain concepts can benefit from watching video lectures. Also, many students who attend class will be able to build confidence by watching videos that reinforce the concepts presented in class. Because the videos are tied directly to the learning objectives, you can develop a plan for students who are struggling with specific topics. Alternatively, you may offer video instruction to enable advanced students to cover additional topics.

• Flipped courses

Instructional videos enable instructors to flip the traditional teaching model. Specifically, instead of providing a lecture in class and then assigning homework, **flipped courses** deliver the lecture at home and use the classroom as a place for students to work problems and ask questions. Video content provides an excellent venue for the delivery of at-home lectures.

• Distance learning courses

More and more students are taking classes online, but many students struggle with these courses. Generally, students prefer to learn from a live lecture, but due to timing or location are unable to attend class. Prerecorded lecture videos solve this problem by allowing students to access quality lectures on demand.

• Mass-section courses

Students often find it difficult to see and hear in large mass-section courses. Also, the lecture must be set at an average pace, which by its nature is too fast for some students and too slow for others. Prerecorded lecture videos help resolve these issues.

• Comprehensive set of technological teaching tools

Page vii

Video content is one component of a comprehensive set of technological teaching tools. Some of the other tools that accompany our text include:

- Connect
- SmartBook
- Test banks (via Connect or TestGen)
- Guided exercises
- Excel simulations

These tools can be used independently or in conjunction with one another. A detailed description of each tool is included in the following sections of the front matter.

We appreciate your interest in our text and welcome comments,

questions, and suggestions.

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Sample

ABOUT THE AUTHORS



Courtesy of Thomas Edmonds

Thomas P. Edmonds

Thomas P. Edmonds, Ph.D., is Professor Emeritus in the Department of Accounting and Finance at the University of Alabama at Birmingham (UAB). He has been actively involved in teaching accounting principles throughout his academic career. Dr. Edmonds has coordinated the accounting principles courses at the University of Houston and UAB. He has taught introductory accounting in mass sections and in distance learning programs. He has received five prestigious teaching awards, including the Alabama Society of CPAs Outstanding Educator Award, the UAB President's Excellence in Teaching Award, and the distinguished Ellen Gregg Ingalls Award for excellence in classroom teaching. He has written numerous articles that have appeared in many publications, including *Issues in Accounting*, the *Journal of Accounting Education*, *Advances in Accounting Education*, *Accounting Education: A Journal of Theory, Practice and Research*, the

Accounting Review, *Advances in Accounting*, the *Journal of Accountancy*, *Management Accounting*, the *Journal of Commercial Bank Lending*, the *Banker's Magazine*, and the *Journal of Accounting, Auditing, and Finance*. Dr. Edmonds has served as a member of the editorial board for *Advances in Accounting: Teaching and Curriculum Innovations* and *Issues in Accounting Education*. He has published five textbooks, five practice problems (including two computerized problems), and a variety of supplemental materials including study guides, work papers, and solutions manuals. Dr. Edmonds's writing is influenced by a wide range of business experience. He is a successful entrepreneur. He has worked as a management accountant for Refrigerated Transport, a trucking company. Dr. Edmonds also worked in the not-for-profit sector as a commercial lending officer for the Federal Home Loan Bank. In addition, he has acted as a consultant to major corporations, including First City Bank of Houston (now Citi Bank), AmSouth Bank in Birmingham (now Regions Bank), Texaco, and Cortland Chemicals. Dr. Edmonds began his academic training at Young Harris Community College in Young Harris, Georgia. He received a B.B.A. degree with a major in finance from Georgia State University in Atlanta, Georgia. He obtained an M.B.A. degree with a concentration in finance from St. Mary's University in San Antonio, Texas. His Ph.D. degree with a major in accounting was awarded by Georgia State University. Dr. Edmonds's work experience and academic training have enabled him to bring a unique user perspective to this textbook.



Courtesy of Christopher Edmonds

Christopher T. Edmonds

Christopher T. Edmonds, Ph.D., is an associate professor in the Department of Accounting and Finance at the University of Alabama

at Birmingham (UAB). He coordinates the mass-section face-to-face and online principles of accounting courses. Dr. Edmonds specializes in developing flipped and online accounting courses and frequently speaks on these topics at universities and conferences. His passion for helping students learn inspired him to create hundreds of short videos teaching the fundamental concepts of accounting. Dr. Edmonds has received six prestigious teaching awards including the UAB Faculty Student Success Award, UAB Transformative Online Course Award, UAB Loudell Ellis Robinson Classroom Teaching Award, UAB Disability Support Recognition Award, and the Virginia Tech Favorite Faculty Award. He has published three textbooks where he is the lead video author and has written numerous articles that have appeared in publications including *The Accounting Review*, *Journal of Accounting and Public Policy*, *Issues in Accounting Education*, *Advances in Accounting Education*, *Advances in Accounting*, and *Review of Quantitative Finance and Accounting*. Dr. Edmonds began his academic training at Colorado State University. He obtained an M.B.A. degree from UAB. His Ph.D. degree with a major in accounting was awarded by Virginia Polytechnic Institute and State University.



Courtesy of UAB

Mark A. Edmonds

Mark A. Edmonds, Ph.D., CPA, is an assistant professor in the Department of Accounting and Finance at the University of Alabama at Birmingham. He has taught principles and advanced accounting classes in face-to-face, flipped, and online formats. Dr. Edmonds began his career providing assurance services for the internationally recognized accounting firm Ernst & Young. At the conclusion of his professional service, he obtained his Ph.D. from Southern Illinois University Carbondale. He serves as the education

adviser on the board of the Institute of Internal Auditors Birmingham Chapter. Dr. Edmonds's research focuses on alternative learning strategies and auditor decision making.



Courtesy of Francis McNair

Frances M. McNair

Frances M. McNair holds the KPMG Peat Marwick Professorship in Accounting at Mississippi State University (MSU). She has been involved in teaching principles of accounting for the past 20 years and currently serves as the coordinator for the principles of accounting courses at MSU. Dr. McNair was selected by the Mississippi Society of CPAS as outstanding educator for 2014. She joined the MSU faculty in 1987 after receiving her Ph.D. from the University of Mississippi. The author of various articles that have appeared in the *Journal of Accountancy*, *Management Accounting*, *Business and Professional Ethics Journal*, *The Practical Accountant*, *Taxes*, and other publications, she also coauthored the book *The Tax Practitioner* with Dr. Denzil Causey. Dr. McNair is currently serving on committees of the American Taxation Association, the American Accounting Association, and the Institute of Management Accountants, as well as numerous School of Accountancy and MSU committees.



Courtesy of Philip Olds

Philip R. Olds

Professor Olds is an associate professor of accounting at Virginia Commonwealth University (VCU). He serves as the coordinator of the introduction to accounting courses at VCU. Professor Olds received his A.S. degree from Brunswick Junior College in Brunswick, Georgia (now Coastal Georgia Community College). He received a B.B.A. in accounting from Georgia Southern College (now Georgia Southern University), and his M.P.A. and Ph.D. degrees are from Georgia State University. After graduating from Georgia Southern, he worked as an auditor with the U.S. Department of Labor in Atlanta, Georgia. A former CPA in Virginia, Professor Olds has published articles in various professional journals and presented papers at national and regional conferences. He also served as the faculty adviser to the VCU chapter of Beta Alpha Psi for five years. In 1989, he was recognized with an Outstanding Faculty Vice-President Award by the national Beta Alpha Psi organization. Professor Olds has received both the Distinguished Teaching Award and the Distinguished Service Award from the VCU School of Business. Most recently, he received the university's award for maintaining High Ethical and Academic Standards While Advocating for Student-Athletes and Their Quest Towards a Degree.

WHAT WE DID TO MAKE IT BETTER

As discussed in the “Note from the Authors” this text has been revised to include lecture videos that provide coverage of all of the learning objectives included in the text. These videos have been developed by a member of the author team and have the feel of a live lecture as opposed to scripted PowerPoint presentations. The videos provide unparalleled opportunities for instructional innovation, including the development of flipped and distance learning courses. The videos can also be used in traditional courses to help students who need additional instruction. For example, students who are unable to keep up in class or who have to miss class now have a video lecture that can be used to catch up. Each video is accompanied by an assessment quiz containing between 5 and 10 multiple-choice questions. The videos and assessment quizzes can be assigned to individual students or to the class as a whole through Connect. The instructor has complete control over student access to video content and the accompanying assessment quizzes.

Specific chapter changes:

Chapter 1 An Introduction to Accounting

- Revised lecture videos and assessment quizzes
- Changed learning objectives
- Changed heading for The Financial Analyst section
- Changed heading to more clearly define sections in exercises

and problems

- New “Focus on International Issues” feature
- Changed formatting to more clearly distinguish Section 1 versus Section 2 exercises and problems
- Changed formatting to highlight The Financial Analyst section
- Updated exercises, problems, and cases

Chapter 2 Accounting for Accruals and Deferrals

- Revised lecture videos and assessment quizzes
- New “Focus on International Issues” feature
- Clarified wording of learning objectives
- Revised chapter opening to provide a brief explanation of Financial Accounting Standards Board (FASB) issued Accounting Standards Codification 606 regarding revenue recognition
- Changed formatting to show learning objectives as first-level headings
- Changed formatting to more clearly distinguish Section 1 versus Section 2 exercises and problems
- Changed formatting to highlight The Financial Analyst section
- Removed all references to accrued interest revenue
- Updated exercises, problems, and cases

Chapter 3 The Double-Entry Accounting System

Page xi

- Revised lecture videos and assessment quizzes
- Revised The Curious Accountant section
- Updated exercises, problems, and cases

Chapter 4 Accounting for Merchandising Businesses

- Revised lecture videos and assessment quizzes
- Revised learning objectives to better match video lectures
- Revised The Curious Accountant section
- New Exhibit 4.6 showing trend data for Dow Jones Industrial companies
- Updated Reality Bytes
- Revised real-world data in, and corresponding text related to, Exhibit 4.10
- Updated exercises, problems, and cases

Chapter 5 Accounting for Inventories

- Revised lecture videos and assessment quizzes
- Revised learning objectives to better match video lectures
- Revised The Curious Accountant section
- New Exhibit 5.1 showing trend data for Dow Jones Industrial companies
- Updated Reality Bytes section
- Revised real-world data in, and corresponding text related to, Exhibit 5.6
- Updated exercises, problems, and cases

Chapter 6 Internal Control and Accounting for Cash

- New Curious Accountant section
- Revised learning objectives to better match video lectures
- Revised real-world data in, and corresponding text related to, Exhibit 6.1
- Updated exercises, problems, and cases

Chapter 7 Accounting for Receivables

- Revised lecture videos and assessment quizzes
- New Curious Accountant section
- New Reality Bytes section
- New “Focus on International Issues”
- Revised real-world data in, and corresponding text related to, Exhibit 7.7
- Revised real-world data in, and corresponding text related to, Exhibit 7.8
- Added exercises for LO 7-12
- Resequenced exercises and problems so they match the order in which the learning objectives appear in the text
- Updated exercises, problems, and cases

Chapter 8 Accounting for Long-Term Operational Assets

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- Revised lecture videos and assessment quizzes
- Revised The Curious Accountant section

- New Exhibits 8.1 and 8.2 showing trend data for Dow Jones Industrial companies
- Added exercises for the Sales to Property, Plant and Equipment ratio
- Resequenced exercises and problems so they match the order in which the learning objectives appear in the text
- Revised real-world data in, and corresponding text related to, Exhibit 8.8
- Updated exercises, problems, and cases

Chapter 9 Accounting for Current Liabilities and Payroll

- Revised The Curious Accountant section
- Revised Reality Bytes section
- New Exhibits 8.1 and 8.2 showing trend data for Dow Jones Industrial companies
- Revised real-world data in, and corresponding text related to, Exhibit 9.6
- Updated exercises, problems, and cases

Chapter 10 Accounting for Long-Term Debt

- New Curious Accountant section
- New Reality Bytes section
- New Exhibit 10.3 showing trend data for Dow Jones Industrial companies
- Revised real-world data and corresponding text in The Financial Analyst section
- Updated exercises, problems, and cases

Chapter 11 Proprietorships, Partnerships, and Corporations

- Revised lecture videos and assessment quizzes
- Revised learning objectives to better match video lectures
- Revised The Curious Accountant section
- New Exhibit 11.3 showing trend data for Dow Jones Industrial companies
- Updated Reality Bytes section
- Resequenced exercises and problems so they match the order

- in which the learning objectives appear in the text
- Updated exercises, problems, and cases

Chapter 12 Statement of Cash Flows

Page xiii

- Revised The Curious Accountant section
- New Reality Bytes section
- New Exhibit 12.4 showing trend data for Dow Jones Industrial companies
- Updated exercises, problems, and cases

Chapter 13 Financial Statement Analysis

- New The Curious Accountant section
- Updated exercises, problems, and ATC cases

“The beauty is in the details. The authors cover all the steps in buying goods, dealing with freight and discounts, and they cover the sales issues.”

DON LUCY, INDIAN RIVER STATE COLLEGE CENTRAL

HOW DOES THE BOOK MOTIVATE STUDENTS?

The Curious Accountant

Jason recently purchased a new Ford automobile from a dealer near his home. When he told his friend Ryan that he was able to purchase the car for \$10,000 less than the dealer price, Ryan said Jason had gotten a heavy deal. "Everybody knows there is a huge markup on cars," Ryan said. "You need to have gotten a much lower price if you'd shopped around." Jason responded, "It didn't seem like a big profit margin on cars, why did so many of the car manufacturers get into financial trouble?" Ryan told him that he was confusing the maker of the car with the dealer. Ryan argued that although the manufacturer may not have high profit margins, the dealers do, and told him again that he had paid too much.

Endor & Partners has income statements for **AutoMoto, Inc.** and **Ford Motor Company**. Based on these statements, do you think either of these guys is correct? For example, if you pay \$20,000 for a vehicle from a dealership operated by AutoMoto, the legal seller in the United States, how much did the car cost the company? Also, how much did you pay?

Answers to The Curious Accountant

As data from the income statement for **AutoMoto** show, automobile dealers do not have big markups on the cars they sell. The new vehicles the company sold for \$1,255.8 million in 2016 cost the company \$1,212.0 to purchase, resulting in a gross margin of \$43.8, or 3.5 percent. In other words, if you bought an "average" car from AutoMoto for \$20,000, the company's gross profit on it was only \$700 (\$20,000 × 0.035), meaning it paid Ford \$19,300 (\$20,000 - \$700). Furthermore, the company still had other expenses to pay besides its cost of goods sold. In 2016, only 2.0 percent of each dollar of AutoMoto's sales were net profit (\$40 - \$21,500). Meanwhile, the amount shown for sales on AutoMoto's income statement is based on what customers actually paid for the cars the company sold, not the "dealer price."

Meanwhile, if Ford sold the car to AutoMoto for \$15,000, it earned a 10.5 percent gross margin on the sale, or \$1,591 (\$15,000 - \$14,540 = \$460; \$460/\$15,000 = 3.1% × 100 = \$1,591). Like AutoMoto, Ford still had other expenses to pay for besides the cost of goods sold. In 2016, Ford earned 3.0 percent of its profit on each dollar of sales (\$400 - \$121,000).

● REAL-WORLD EXAMPLES

The text provides a variety of real-world examples of financial accounting as an essential part of the management process. There are descriptions of accounting practices from real organizations such as Coca-Cola, Enron, General Motors, and Amazon.com. These companies are highlighted in blue in the text.

"Excellent real-world example included."

PAUL GOODCHILD,
UNIVERSITY OF CENTRAL MISSOURI

● THE CURIOUS ACCOUNTANT

Each chapter opens with a short vignette. These pose a question about a real-world accounting issue related to the topic of the chapter. The answer to the question appears in a separate sidebar a few pages further into the chapter.

FOCUS ON INTERNATIONAL ISSUES

HOW DOES IFRS DIFFER FROM U.S. GAAP?

Chapter 1 discusses the key differences between a single global IASB and the two national standard-setting bodies (FASB and IASB). The differences between IFRS and U.S. GAAP are discussed in this section. The differences between IFRS and U.S. GAAP are discussed in this section. The differences between IFRS and U.S. GAAP are discussed in this section.



● FOCUS ON INTERNATIONAL ISSUES

These boxed inserts expose students to IFRS and other International Issues in accounting.

CORPORATE GOVERNANCE

The Financial Analyst

Corporate governance is the set of relationships between the board of directors, management, shareholders, and other stakeholders that determine how a company is operated. Clearly, financial analysts are heavily involved in these relationships. This section discusses the key components of corporate governance.

● THE FINANCIAL ANALYST

Financial statement analysis is highlighted in each chapter under this heading.

CHECK YOURSELF 3.1

What are the three sources of assets? Which accounts we debited and credited when a business begins an asset?

Answer: The three sources of assets are creditors, investors, and earnings. When a company begins an asset, the asset account is debited and the source account is credited. For example, if a company starts revenue on account, the Revenue account is debited and the Revenue account is credited.

● CHECK YOURSELF

These short question/answer features occur at the end of each main topic and ask students to stop and think about the material just covered. The answer follows to provide immediate feedback before students go on to a new topic.

REALITY BYTES

Do all accounting systems require using debits and credits? The answer is a definite no. Many small businesses use a single-entry system. A checkbook is a simple, single-entry system. Many successful automated accounting systems do not require debit entry through a double-entry recording system. Double-entry is a good example of this type of system. Only one automated, the QuickBooks software program through a user-friendly computer interface that does not require knowledge of double-entry terminology. Thus, in the QuickBooks program, journal entries are recorded in a simple, single-entry system. Most people have an understanding of what is happening when a business tells them that their account is being debited or credited. It is important for you to understand the double-entry system as well as other financial reporting systems.



● REALITY BYTES

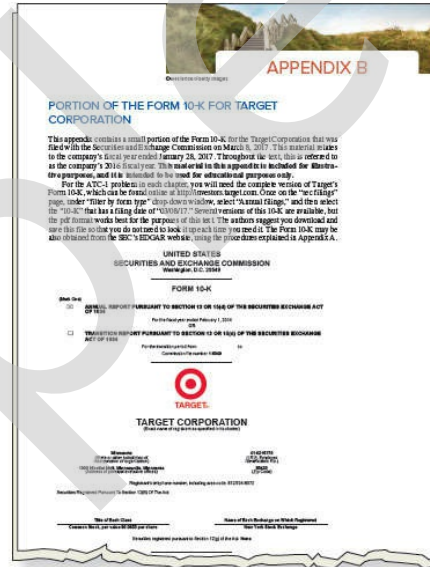
This feature expands on the topics by showing how companies use the concepts discussed in the chapter to make real-world business decisions.

● ANNUAL REPORTS

Excerpts from the 2016 annual report for Target Corporation is shown in Appendix B.

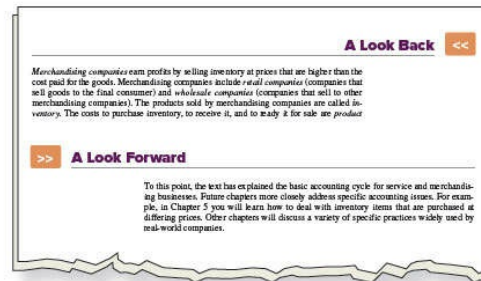
Business Application Problems related to the annual report are included at the end of each chapter.

A financial statement analysis project for the annual report is located in Appendix D. Also, a general purpose annual report project is included for instructors to assign for any company.



● A LOOK BACK / A LOOK FORWARD

Students need a roadmap to make sense of where the chapter topics fit into the “whole” picture. A Look Back reviews the chapter materials and a Look Forward introduces students to what is to come.



“Strong chapter introduction for students who may understand what a cash flow statement is and for those who may not.”

PAUL GOODCHILD,
UNIVERSITY OF CENTRAL MISSOURI

HOW ARE CHAPTER
CONCEPTS
REINFORCED?

Regardless of the instructional approach, there is no shortcut to learning accounting. Students must practice to master basic accounting concepts. The text includes a prodigious supply of practice materials and exercises and problems.

SELF-STUDY REVIEW PROBLEM

A step-by-step audio-narrated series of slides is available in Connect.

Academy Sales Company (ASC) started the Year 2 accounting period with the balances given in the financial statements model shown below. During Year 2, ASC experienced the following business events:

1. Purchased \$16,000 of merchandise inventory on account, terms 2/10, n/30.
2. The goods that were purchased in Event 1 were delivered FOB shipping point. Freight costs of \$500 were paid in cash by the responsible party.
3. Returned \$500 of goods purchased in Event 1.
- 4a. Recorded the cash discount on the goods purchased in Event 1.
- 4b. Paid the balance due on the account payable within the discount period.
- 5a. Recognized \$21,000 of cash revenue from the sale of merchandise.
- 5b. Recognized \$15,000 of cost of goods sold.
6. The merchandise in Event 5a was sold to customers FOB destination. Freight costs of \$550 were paid in cash by the responsible party.
7. Paid cash of \$4,000 for selling and administrative expenses.
8. Sold the land for \$5,000 cash.

SELF-STUDY REVIEW PROBLEM

These example problems include a detailed, worked-out solution and provide support for students before they work problems on their own. These review problems are included in an animated audio presentation in the *Connect* Library.

PROBLEMS—SERIES A

connect All applicable Problems in Series A are available in Connect.

Problem 7-17A Accounting for uncollectible accounts: two cycles using the percent of revenue allowance method LO 7-1

The following transactions apply to Jova Company for Year 1, the first year of operation:

1. Issued \$10,000 of common stock for cash.
2. Recognized \$210,000 of service revenue earned on account.
3. Collected \$160,000 from accounts receivable.
4. Paid \$125,000 cash for operating expenses.
5. Adjusted the accounts to recognize uncollectible accounts expense. Jova uses the allowance method of accounting for uncollectible accounts and estimates that uncollectible accounts expense will be 1 percent of sales on account.

CHECK FIGURES

- a. Ending Accounts Receivable, Year 1: \$40,000
- b. Net Income, Year 1: \$10,400

The following transactions apply to Jova for Year 2:

1. Recognized \$320,000 of service revenue on account.
2. Collected \$335,000 from accounts receivable.
3. Determined that \$2,150 of the accounts receivable were uncollectible and wrote them off.
4. Collected \$500 of an account that had previously been written off.
5. Paid \$205,000 cash for operating expenses.
6. Adjusted the accounts to recognize uncollectible accounts expense for Year 2. Jova estimates uncollectible accounts expense will be 0.5 percent of sales on account.

Required

Complete the following requirements for Year 1 and Year 2. Complete all requirements for Year 1 prior to beginning the requirements for Year 2.

- a. Identify the type of each transaction (asset source, asset use, asset exchange, or claims exchange).
- b. Show the effect of each transaction on the elements of the financial statements, using a horizontal statements model like the one shown here. Use + for increase, - for decrease, and NA for not

EXERCISE SERIES A & B AND PROBLEM SERIES A & B

There are two sets of problems and exercises: Series A and B. Instructors can assign one set for homework and another set for classwork.

• Check Figures

The figures provide key answers for selected problems.

• Excel

Many problems can be solved using the Excel™ templates available in the *Connect* Library. A logo appears in the margins next to these problems.

"The self-study problems and supplements on the web are very useful for students."

BARRY BUCHOFF,
TOWSON UNIVERSITY

"Good/Excellent exercises and problems at the end of chapter with Excel!"

ROBERT KACHUR,
RICHARD STOCKTON COLLEGE OF
NEW JERSEY

● ANALYZE, THINK, COMMUNICATE (ATC)

Each chapter includes an Innovative section titled Analyze, Think, Communicate (ATC). This section offers Business Applications Cases, Group Assignments, Real-World Cases, Writing Assignments, Ethical Dilemma Problems, Research Assignments, and Spreadsheet Assignments.

We use icons to help students identify the type of question being asked.

Target Corporation • Target Corp.

Group Work • Excel

Real World Company • Ethics

Research • Writing

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● COMPREHENSIVE PROBLEM

Beginning in Chapter 1, a comprehensive problem builds in each successive chapter, with the ending account balances in one chapter becoming the beginning account balances in the next chapter.

● MASTERING EXCEL AND USING EXCEL

The Excel applications are used to make students comfortable with this analytical tool and to show its use in accounting.

"I love the spreadsheet assignments and the comprehensive problems at the end of each chapter. I love the check figures that are available on some of the problems."

JANE GARVIN,
IVY TECH COMMUNITY COLLEGE

ANALYZE, THINK, COMMUNICATE

ATC 2-1 Business Applications Case Understanding real-world annual reports

Required

Obtain the **Target Corporation's** annual report at <http://www.target.com> using the instructions in Appendix B, and use it to answer the following questions:

- Which accounts on Target's balance sheet are **current** type accounts?
- Which accounts on Target's balance sheet are **deferred** type accounts?
- Compare Target's net income to its cash provided by operating activities for the fiscal year ended January 28, 2017 (2016). Which is larger?
- First, compare Target's 2015 net income to its 2016 net income. Next, compare Target's 2015 cash provided by operating activities to its 2016 cash provided by operating activities. Which changed the most from 2015 to 2016, net income or cash provided by operating activities?

ATC 2-2 Group Assignment Missing information

Verizon Communications, Inc. is one of the world's largest providers of communication services. The following information, taken from the company's annual reports, is available for the years 2016, 2015, and 2014.

	2016	2015	2014
Revenue	\$125,980	\$111,620	\$127,079
Operating expenses	98,921	98,560	107,488

In 2013, Verizon's operating income was \$11,588. Operating income is a subcategory of net income.

- Enter automatic signs in headings by placing an apostrophe in front of the sign. For example, to enter the equal sign in cell D4, enter =.
- Copy cells by positioning the mouse in the bottom right corner of the cell to copy from (such as cell O6) until a thin cross appears. Click and drag the cursor down through the desired locations to copy to (through cell O11).
- To enter the dollar sign, choose Format, Cells, and Currency.

COMPREHENSIVE PROBLEM

The following information is available for Pacific Security Services, Inc. for Year 1, its first year of operations. Pacific provides security services for local sporting events.

The following summary transactions occurred during Year 1:

- Acquired \$6,000 from the issue of common stock.
- Borrowed \$5,000 from the Small Business Government Agency. The loan is interest-free.
- Performed security services at local sporting events during the year for \$9,000 cash.
- Paid salaries expense of \$3,000 for the year.
- Purchased land for \$4,000.
- Paid other operating expenses of \$2,000 for the year.
- Paid a cash dividend to the shareholders of \$2,500.
- The market value of the land was determined to be \$4,500 at December 31, Year 1.

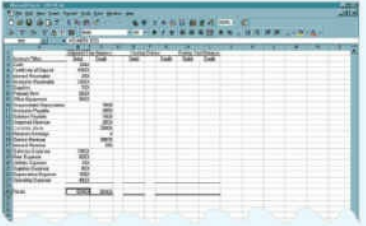
Required

- Record the above transactions in an accounting equation. Provide the appropriate account titles for the amounts shown in the Retained Earnings column.
- Prepare an income statement, statement of changes in stockholders' equity, balance sheet, and statement of cash flows for Year 1.

- Rows and columns can be inserted by positioning the mouse on the immediate row or column after the desired position. Click on the right mouse button. With the left mouse button, choose Insert and then either Entire Column or Entire Row. Use the same method to delete columns or rows.
- Enter the sequential numbering of the adjusting entries in labels rather than values by positioning an apostrophe in front of each entry. The first adjusting entry should be labeled Y1.

ATC 3-10 Spreadsheet Assignment Mastery of Excel

At the end of the accounting period, Adena Company's general ledger contained the following adjusted balances:



Source: Microsoft Office Excel 1367



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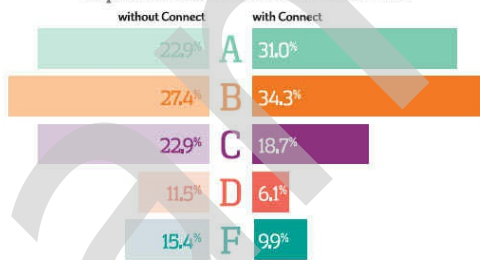
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HOW CAN TECHNOLOGY HELP IMPROVE STUDENT SUCCESS?

- **Online assignments**

Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. *Connect* grades homework automatically and gives immediate feedback on any questions students may have missed. Our assignable, gradable end-of-chapter content includes a general journal application that looks and feels like what you would find in a general ledger software package. Also, select questions have been redesigned to test students' knowledge more fully. They now include tables for students to work through rather than requiring that all calculations be done offline.

End-of-chapter content in *Connect* includes:

- Quizzes (multiple-choice questions)
- Exercises
- Problems
- Analyze, Think, Communicate
- Comprehensive Problems

Exercise 3-4A Applying debit/credit terminology to accounting events LO 3-1

Required

a. In parallel columns, list the accounts that would be debited and credited for each of the following unrelated transactions:

- (1) Acquired cash from the issue of common stock.
- (2) Provided services for cash.
- (3) Paid cash for salaries expense.
- (4) Purchased supplies for cash.
- (5) Paid in advance for two-year lease on office space.
- (6) Provided services on account.
- (7) Recognized expense for prepaid rent that had been used up by the end of the accounting period.
- (8) Recorded accrued salaries at the end of the accounting period.

b. Use a horizontal statements model to show how each event affects the balance sheet, income statement, and statement of cash flows. Indicate whether the event increases (+), decreases (-), or does not affect (NA) each element of the financial statements. Also, in the Cash Flow column, use the letters OA to designate operating activity, IA for investing activity, and FA for financing activity. The first event is shown as an example.

Complete this question by entering your answers in the tabs below.

Required A	Required B	
In parallel columns, list the accounts that would be debited and credited for each of the following unrelated transactions.		
Event	Account Debited	Account Credited
(1) Acquired cash from the issue of common stock.	Cash	Common stock
(2) Provided services for cash.	Cash	Service revenue
(3) Paid cash for salaries expense.	Salaries expense	Cash
(4) Purchased supplies for cash.		Cash
(5) Paid in advance for two-year lease on office space.		
(6) Provided services on account.		

• **Lecture videos**

One or more lecture videos are available for every learning objective introduced throughout the text. The videos have been developed by a member of the author team and have the touch and feel of a live lecture. The videos are accompanied by a set of self-assessment quizzes. Students can watch the videos and then test themselves to determine if they understand the material presented in the video. Students can repeat the process, switching back and forth between the video and self-assessment quizzes, until they are satisfied that they understand the material.

“This is the best part of the entire Connect material. I think access to these Lecture Videos would be positive, especially for online students.”

CHERYL CORKE, GENESEE COMMUNITY COLLEGE


Business Events for Year 1:

- Rustic Campsites (RCS) was formed at the beginning of Year 1 when it acquired \$120,000 cash from issuing common stock to its owners.
- RCS borrowed \$400,000 cash from a creditor.
- RCS paid \$500,000 cash to purchase land.
- RCS obtained \$85,000 cash from leasing camp sites to customers.
- RCS paid \$50,000 cash for expenses.
- RCS paid dividends of \$4,000 cash to its owners.
- The land that RCS paid \$500,000 to purchase had an appraised market value of \$525,000 at the end of Year 1.

Revenue 85,000
 - Expenses 50,000
 = Net Income 35,000

↓
 Retained Earnings

↓
 \$ Dividend



	Accounting Equation					Other Account Titles	
	Assets		=	Liab.	+		Equity
	Cash	Land		Note Payable			Com. Stk. Ret. Earn
Beg. Bal.	0	0		0		0 0	
1.	120,000					120,000	
2.	400,000			400,000			
3.	(500,000)	500,000					
4.	85,000					85,000	Revenue
5.	(50,000)					(50,000)	Expense
6.							

• Excel Simulations

Simulated Excel questions, assignable within *Connect*, allow students to practice their Excel skills—such as basic formulas and formatting—within the content of financial accounting. These questions feature animated, narrated Help and Show Me tutorials (when enabled), as well as automatic feedback and grading for both students and professors.

• Guided Examples

The **Guided Examples** in *Connect* provide a video-based, step-by-step walk-through of select exercises similar to those assigned. These short videos are available to students as hints by instructors and provide reinforcement when students need it most.

1. Compute a predetermined overhead rate.
2. Prepare schedules of cost of goods manufactured and cost of goods sold.
3. Compute underapplied or overapplied overhead cost to close the balance in Manufacturing Overhead to the appropriate accounts.

	Beginning	Ending
Raw materials (all direct)	\$ 15,000	\$ 11,375
Work in process	\$ 27,875	\$ 22,350
Finished goods	\$ 34,600	\$ 26,450

Actual manufacturing overhead cost	\$ 275,000
Predetermined overhead rate	\$11.00
Actual direct labor hours	27,760
Manufacturing overhead applied	\$277,760

• General Ledger

General Ledger Problems provide a much-improved student experience when working with accounting cycle questions, offering improved navigation and less scrolling. Students can audit their mistakes by easily linking back to their original entries and can see how the numbers flow through the various financial statements. Many General Ledger Problems include an analysis tab that allows students to demonstrate their critical thinking skills and a deeper understanding of accounting concepts.

Prepare the journal entries to record transactions (1) through (13). Then prepare the necessary adjusting entries (14) through (17) to correctly report net income for the period. Then record the closing entries (18) through (20) as of December 31, 2013. (If no entry is required for a transaction, select "No journal entry required" in the first account field.)

[View transaction list](#)

Journal entry worksheet

< 1 2 3 4 5 6 7 8 20 >

Paid the salaries payable from 2012.

Note: Enter debits before credits.

Date	General Journal	Debit	Credit
Dec 31, 2013	Salaries payable	1,200	
	Cash		
	101: Cash		

[Record entry](#) [Clear entry](#) [View general journal](#)

• Instructor Library

Page xxii

The *Connect* Instructor Library is your repository for additional resources to improve student engagement in and out of class. You can select and use any asset that enhances your lecture. The *Connect* Instructor Library includes access to:

- Solutions Manual
- Instructor's Manual
- Test Bank
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SUPPLEMENTS FOR INSTRUCTORS

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Many educational institutions today are focused on the notion of *assurance of learning*, an important element of many accreditation standards. *Fundamental Financial Accounting Concepts 10e* is designed specifically to support your assurance of learning initiatives with a simple, yet powerful, solution.

Each chapter in the book begins with a list of numbered learning objectives, which appear throughout the chapter, as well as in the end-of-chapter assignments. Every Test Bank question for *Fundamental Financial Accounting Concepts* maps to a specific chapter learning objective in the textbook. Each Test Bank question also identifies topic area, level of difficulty, Bloom's Taxonomy level, and AICPA and AACSB skill area. You can use our Test Bank software, *EZ Test Online*, or *Connect Plus Accounting* to easily search for learning objectives that directly relate to the learning objectives for your course. You can then use the reporting features of *EZ Test* to aggregate student results in a similar fashion, making the collection and presentation of Assurance of Learning data simple and easy.


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McGraw-Hill Education is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *Fundamental Financial Accounting Concepts 10e* recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected

questions in the text and the Test Bank to the general knowledge and skill guidelines in the revised AACSB standards.

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CHAPTER 1

An Introduction to Accounting

LEARNING OBJECTIVES

After you have mastered the material in this chapter, you will be able to:

SECTION 1: COLLECTING AND ORGANIZING INFORMATION

LO 1-1 Identify the ways accounting benefits society.

LO 1-2 Identify reporting entities.

LO 1-3 Identify the components of the accounting equation.

LO 1-4 Show how business events affect the accounting equation.

LO 1-5 Interpret information shown in an accounting equation.

LO 1-6 Classify business events as asset source, use, or exchange transactions.

SECTION 2: REPORTING INFORMATION

LO 1-7 Prepare an income statement, a

statement of changes in stockholders' equity, and a balance sheet.

LO 1-8 Prepare a statement of cash flows.

LO 1-9 Close revenue, expense, and dividend accounts.

LO 1-10 Record business events using a horizontal financial statements model.



Video lectures and accompanying self-assessment quizzes are available in Connect for all learning objectives.

The Curious Accountant

Who owns **Starbucks**? Who owns the **American Cancer Society** (ACS)? Many people and organizations other than owners are interested in the operations of Starbucks and the ACS. These parties are called **stakeholders**. Among others, they include lenders, employees, suppliers, customers, benefactors, research institutions, local governments, cancer patients, lawyers, bankers, financial analysts, and government agencies such as the Internal Revenue Service and the Securities and Exchange Commission. Organizations communicate information to stakeholders through **financial reports**.

How do you think the financial reports of Starbucks differ from those of the ACS? (Answers on page 11.)



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SECTION 1:

COLLECTING AND ORGANIZING INFORMATION

Why should you study accounting? Because it can help you succeed in business. Businesses use accounting to keep score. Imagine trying to play football without knowing how many points a touchdown is worth. Like sports, business is competitive. If you do not know how to keep score, you likely will not succeed.

Accounting is an information system that reports on the economic activities and financial condition of a business or other organization. The importance of accounting information is paramount. It helps predict business success, and could make

you a wealthy Wall Street investor. Indeed, it is so important that accounting is frequently called the *language of business*.

THE ROLE OF ACCOUNTING IN SOCIETY

LO 1-1



Identify the ways accounting benefits society.

How should society allocate its resources? Should we spend more to harvest food or cure disease? Should we build computers or cars? Should we invest money in IBM or General Motors? Accounting provides information that helps answer such questions.

Using Free Markets to Set Resource Priorities

Suppose you want to start a business. You may have heard “you need to have money to make money.” In fact, you will need more than just money to start and operate a business. You will likely need such resources as equipment, land, materials, and employees. If you do not have these resources, how can you get them? In the United States, you compete for resources in open markets.

A **market** is a group of people or entities organized to exchange items of value. The market for business resources involves three distinct participants: consumers, conversion agents, and resource owners. *Consumers* use resources. Resources are frequently not in a form consumers want. For example, nature provides trees but consumers want houses. *Conversion agents* (businesses) transform resources such as trees into desirable products such as houses. *Resource owners* control the distribution of resources to conversion agents. Thus, resource owners provide resources (inputs) to conversion agents, who provide goods and services (outputs) to consumers.

For example, a home builder (conversion agent) transforms labor and

materials (inputs) into houses (output) that consumers use. The transformation adds value to the inputs, creating outputs worth more than the sum of the inputs. For example, a house that required \$220,000 of materials and labor to build could have a market value of \$250,000.

Common terms for the added value created in the transformation process include **profit**, **income**, or **earnings**. Accountants measure the added value as the difference between the cost of a product or service and the selling price of that product or service. The profit on the house described above is \$30,000, the difference between its \$220,000 cost and \$250,000 market value.



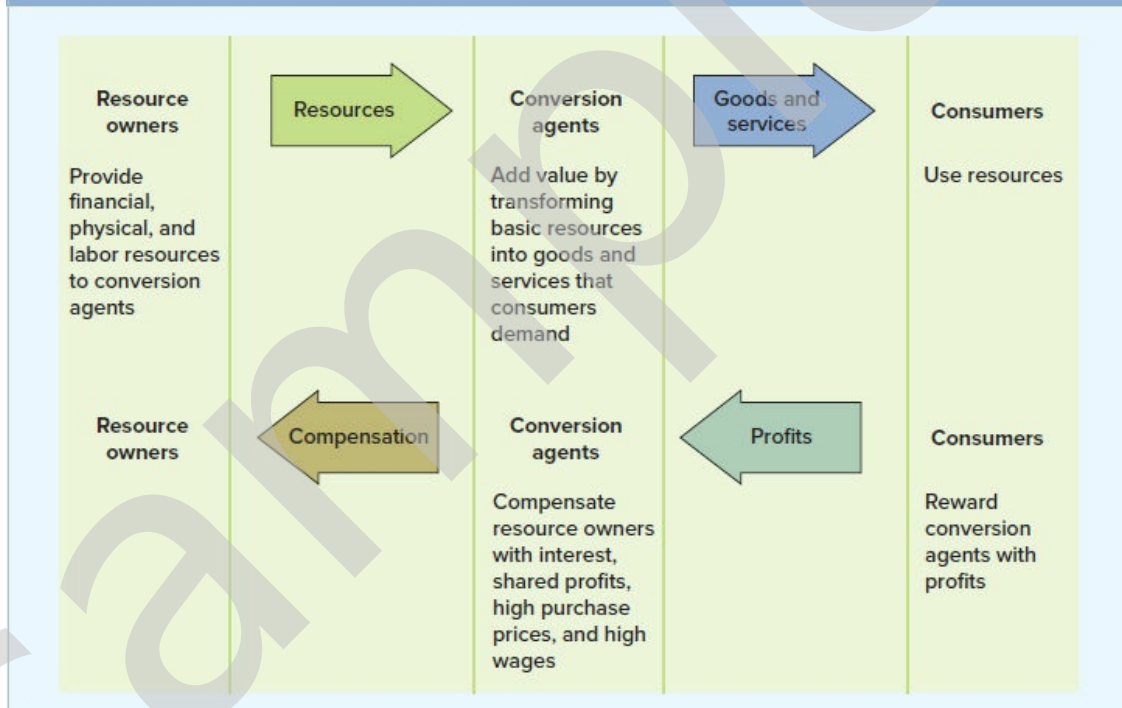
©David Buffington/Getty Images RF

Conversion agents who successfully and efficiently (at low cost) satisfy consumer preferences are rewarded with high earnings. These earnings are shared with resource owners, so conversion agents who exhibit high earnings potential are more likely to compete successfully for resources.

Return to the original question. How can you get the resources you need to start a business? You must go to open markets and convince resource owners that you can produce profits. [Exhibit 1.1](#) illustrates the market trilogy involved in resource allocation.

EXHIBIT 1.1

Market Trilogy in Resource Allocation



The specific resources businesses commonly use to satisfy consumer demand are financial resources, physical resources, and labor resources.

Financial Resources

Businesses (conversion agents) need **financial resources** (money) to get started and to operate. *Investors* and *creditors* provide financial resources.

- **Investors** provide financial resources in exchange for ownership interests in businesses. Owners expect businesses to return to them a share of the business, including a portion of earned income.
- **Creditors** lend financial resources to businesses. Instead of a share of the business, creditors expect the businesses to repay borrowed resources plus a specified fee called **interest**.

Investors and creditors prefer to provide financial resources to businesses with high earnings potential because such companies are better able to share profits and make interest payments. Profitable businesses are also less likely to experience bankruptcy.

Page 5

Physical Resources

In their most primitive form, **physical resources** are natural resources.

Physical resources often move through numerous stages of transformation. For example, standing timber may be successively transformed into harvested logs, raw lumber, and finished houses. Owners of physical resources seek to sell those resources to businesses with high earnings potential because profitable businesses are able to pay higher prices and make repeat purchases.

Labor Resources

Labor resources include both intellectual and physical labor. Like other resource providers, workers prefer businesses that have high income potential because these businesses are able to pay higher wages and offer continued employment.

Accounting Provides Information

How do providers of financial, physical, and labor resources identify conversion agents (businesses) with high profit potential? Investors, creditors, and workers rely heavily on accounting information to evaluate which businesses are worthy of receiving resources. In addition, other people and organizations have an interest in accounting information about businesses. The many **users** of accounting information are commonly called **stakeholders**. Stakeholders include resource providers, financial analysts, brokers, attorneys, government regulators, and news reporters.

The link between conversion agents (businesses) and those stakeholders who provide resources is direct: Businesses pay resource providers. Resource providers use accounting information to identify companies with high earnings potential because those companies are more likely to return higher profits, make interest payments, repay debt, pay higher prices, and provide stable, high-paying employment.

The link between conversion agents and other stakeholders is indirect. Financial analysts, brokers, and attorneys may use accounting information when advising their clients. Government agencies may use accounting information to assess companies' compliance with income tax laws and other regulations. Reporters may use accounting information in news reports.

Types of Accounting Information

Stakeholders such as investors, creditors, lawyers, and financial analysts

exist outside of and separate from the businesses in which they are interested. The accounting information these *external users* need is provided by **financial accounting**. In contrast, the accounting information needed by *internal users*, stakeholders such as managers and employees who work within a business, is provided by **managerial accounting**.

The information needs of external and internal users frequently overlap. For example, external and internal users are both interested in the amount of income a business earns. Managerial accounting information, however, is usually more detailed than financial accounting reports. For example, investors are concerned about the overall profitability of **Wendy's** versus **Burger King**; whereas a Wendy's regional manager is interested in the profits of individual Wendy's restaurants. In fact, a regional manager is also interested in nonfinancial measures, such as the number of employees needed to operate a restaurant, the times at which customer demand is high versus low, and measures of cleanliness and customer satisfaction.

Nonbusiness Resource Usage

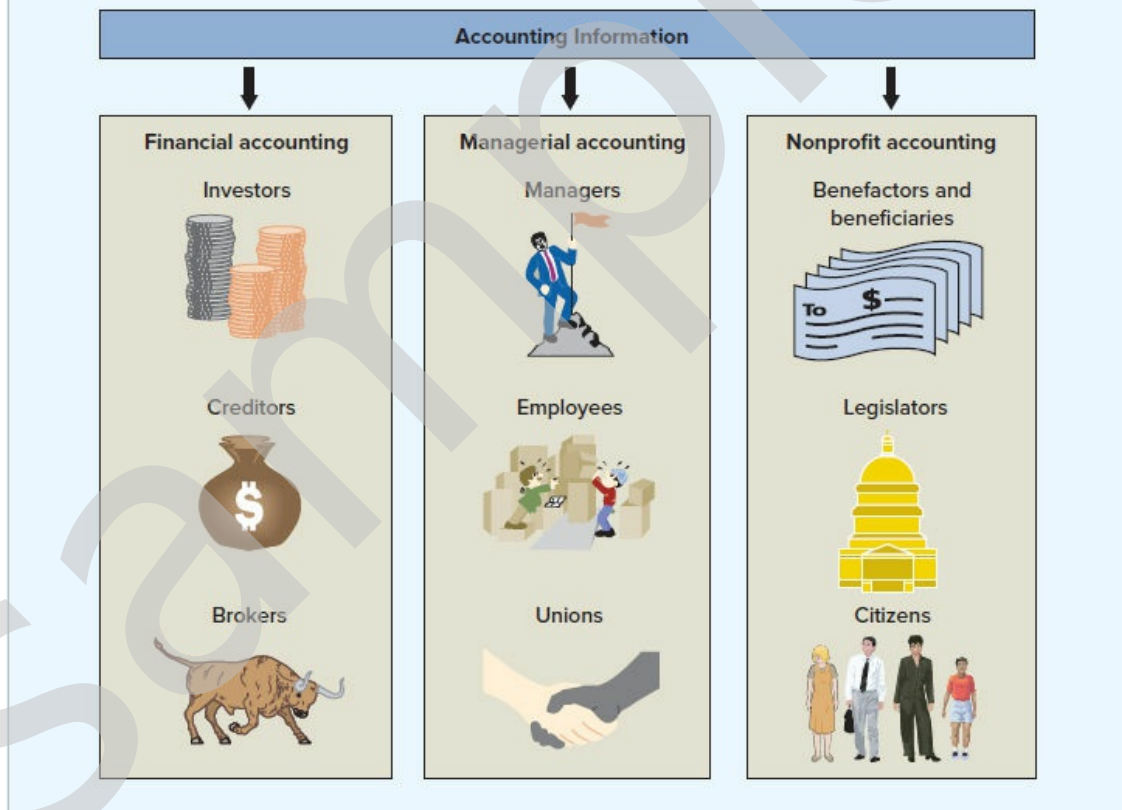
The U.S. economy is not purely market-based. Factors other than profitability often influence resource allocation priorities. For example, governments allocate resources for national defense, to redistribute wealth, or to protect the environment. Foundations, religious groups, the Peace Corps, and other benevolent organizations prioritize resource usage based on humanitarian concerns.

Organizations that are not motivated by profit are called **not-for-profit entities** (also called *nonprofit* or *nonbusiness organizations*). Stakeholders interested in nonprofit organizations also need accounting information. Accounting systems measure the cost of the goods and services not-for-profit organizations provide, the efficiency and effectiveness of the organizations' operations, and the ability of the organizations to continue to provide goods and services. This information serves a host of stakeholders, including taxpayers, contributors, lenders, suppliers, employees, managers, financial analysts, attorneys, and beneficiaries.

The focus of accounting, therefore, is to provide information that is useful to a variety of business and nonbusiness user groups for decision making. The different types of accounting information and the stakeholders that commonly use the information are summarized in [Exhibit 1.2](#).

EXHIBIT 1.2

Accounting as Information Provider



Careers in Accounting

An accounting career can take you to the top of the business world. In a recent *Forbes* article, Jeffery Sanders reveals that a significantly higher percentage of Fortune 500 CEOs advance from financial backgrounds than any other discipline. Sanders notes that large companies prefer CEOs who understand the financial ramifications of business decisions.

What do accountants do? Accountants identify, record, analyze, and communicate information about the economic events that affect organizations. They may work in either public accounting or private accounting.

Public Accounting

You are probably familiar with the acronym CPA. CPA stands for certified *public* accountant. Public accountants provide services to various clients. They are usually paid a fee that varies depending on the service provided. Services typically offered by public accountants include (1) audit services, (2) tax services, and (3) consulting

services.

- *Audit services* involve examining a company's accounting records in order to issue an opinion about whether the company's financial statements conform to generally accepted accounting principles. The auditor's opinion adds credibility to the statements, which are prepared by the company's management.
- *Tax services* include both determining the amount of tax due and tax planning to help companies minimize tax expense.
- *Consulting services* cover a wide range of activities that include everything from installing sophisticated computerized accounting systems to providing personal financial advice.

All public accountants are not certified. Each state government, as well as Washington, DC, and four U.S. territories, establish certification requirements applicable in that jurisdiction. Although the requirements vary from jurisdiction to jurisdiction, CPA candidates normally must have a college education, pass a demanding technical examination, and obtain work experience relevant to practicing public accounting.

Private Accounting

Accountants employed in the private sector usually work for a specific company or nonprofit organization. Private sector accountants perform a wide variety of functions for their employers. Their duties include classifying and recording transactions, billing customers and collecting amounts due, ordering merchandise, paying suppliers, preparing and analyzing financial statements, developing budgets, measuring costs, assessing performance, and making decisions.

Private accountants may earn any of several professional certifications. For example, the Institute of Management Accountants issues the *Certified Management Accounting (CMA)* designation. The Institute of Internal Auditors issues the *Certified Internal Auditor (CIA)* designation. These designations are widely recognized indicators of technical competence and integrity on the part of individuals who hold them. All professional accounting certifications call for meeting education requirements, passing a technical examination, and obtaining relevant work experience.

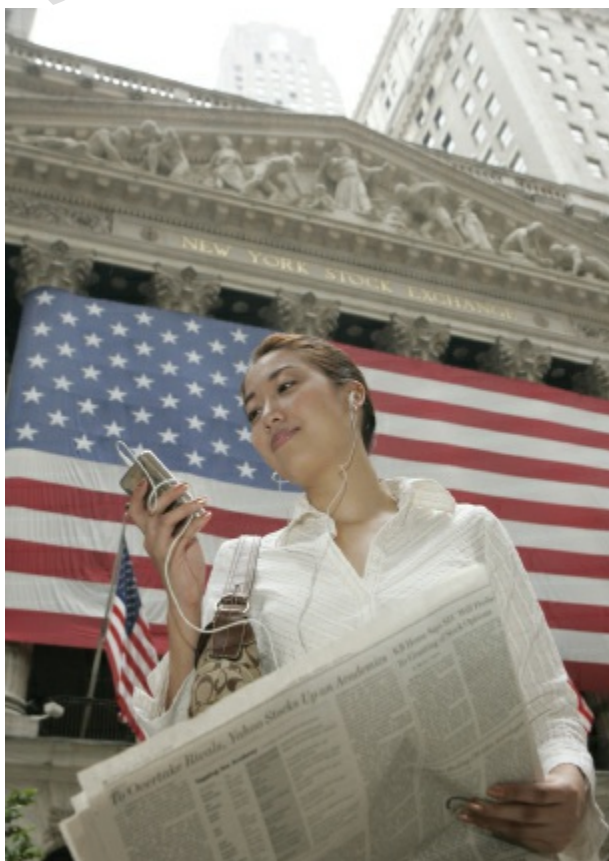
Measurement Rules

Suppose a store sells an MP3 player in December to a customer who

agrees to pay for it in January. Should the business *recognize* (report) the sale as a December transaction or as a January transaction? It really does not matter as long as the storeowner discloses the rule the decision is based on and applies it consistently to other transactions. Because businesses may use different reporting rules, however, clear communication also requires full and fair disclosure of the accounting rules chosen.

Communicating business results would be simpler if each type of business activity were reported using only one measurement method. World economies and financial reporting practices, however, have not evolved uniformly. Even in highly sophisticated countries such as the United States, companies exhibit significant diversity in reporting methods. Providers of financial reports assume that users are educated about accounting practices.

The [Financial Accounting Standards Board \(FASB\)](#)¹ is a privately funded organization with the primary authority for establishing accounting standards in the United States. The measurement rules established by the FASB are called [generally accepted accounting principles \(GAAP\)](#). Financial reports issued to the public must follow GAAP. This textbook introduces these principles so you will be able to understand business activity reported by companies in the United States.



Companies are not required to follow GAAP when preparing *management accounting* reports. Although there is considerable overlap between financial and managerial accounting, managers are free to construct internal reports in whatever fashion best suits the effective operation of their companies.

REPORTING ENTITIES

LO 1-2



Identify reporting entities.

Think of accountants in the same way you would think of news reporters. A news reporter gathers and discloses information about some person, place, or thing. Likewise, an accountant gathers and discloses financial information about specific people or businesses. The people or businesses accountants report on are called **reporting entities**. When studying accounting, you should think of yourself as the accountant. Your first step is to identify the person or business on which you are reporting. This is not always as easy as it may seem. To illustrate, consider the following scenario.

FOCUS ON INTERNATIONAL ISSUES

IS THERE GLOBAL GAAP?

As explained in this chapter, accounting is a _____ measurement and communication discipline based _____ on rules referred to as generally accepted _____ accounting principles (GAAP). The rules described in this

text are based on GAAP used in the United States, but what rules do the rest of the world use? Is there a global GAAP, or does each country establish its own unique GAAP?

Until recently, each country developed its own unique GAAP. Global companies were required to prepare multiple sets of financial statements to satisfy each country's GAAP. The use of multiple accounting standards across the globe made comparing company performance difficult and expensive. To address the need for a common set of financial standards, the International Accounting Standards Committee was formed in 1973. The committee was reorganized as the **International Accounting Standards Board (IASB)** in 2001. The IASB issues **International Financial Reporting Standards (IFRS)**, which are rapidly gaining support worldwide. In 2005, companies in the countries who were members of the European Union were required to use the IFRS as established by the IASB, which is headquartered in London. Today, over 100 countries require or permit companies to prepare their financial statements using IFRS.



©Mark Wilson/Getty Images

As of 2018, most of the major economic countries have switched from their local GAAP to IFRS. One notable exception is the United States, but even here, there is an active process in place to reduce the differences between

IFRS and U.S. GAAP.

There are many similarities between the IASB and the FASB. Both the FASB and the IASB are required to include members with a variety of backgrounds, including auditors, users of financial information, academics, and so forth. Also, both groups primarily require that their members work full-time for their respective boards; they cannot serve on the board while being compensated by another organization. (The IASB does allow up to three of its members to be part-time.) Members of each board serve five-year terms and can be reappointed once. The funds to support both boards, and the large organizations that support them, are obtained from a variety of sources, including selling publications and private contributions. To help maintain independence of the board's members, fund-raising is performed by separate sets of trustees.

Despite their similarities, there are significant differences between the IASB and the FASB. One of these relates to size and geographic diversity. The FASB has only seven members, all from the United States. The IASB has 16 members, and these must include at least 4 from Asia, 4 from Europe, 4 from North America, 1 from Africa, and 1 from South America.

Not only is the structure of the standards-setting boards different, but the standards and principles they establish may also differ significantly. In this chapter, you will learn that GAAP employs the historical cost concept. This means that the assets of most U.S. companies are shown on the balance sheet at the amount for which they were purchased. For example, land that has a market value of millions of dollars may be shown on **Ford's** financial statements with a value of only a few hundred thousand dollars. This occurs because GAAP requires Ford to show the land at its cost rather than its market value. In contrast, IFRS permits companies to show market values on their financial statements. This means that the exact same assets may show radically different values if the statements are prepared under IFRS rather than GAAP.

Throughout this text, where appropriate, we will note the differences between U.S. GAAP and IFRS. However, by the

time you graduate, it is likely that among the major industrialized nations, there will be a global GAAP.

Jason Winston recently started a business. During the first few days of operation, Mr. Winston transferred cash from his personal account into a business account for a company he named Winston Enterprises. Mr. Winston's brother, George, invested cash in Winston Enterprises, for which he received an ownership interest in the company. Winston Enterprises borrowed cash from First Federal Bank. Winston Enterprises paid cash to purchase a building from Commercial Properties, Inc. Winston Enterprises earned cash revenues from its customers and paid its employees cash for salaries expense.

How many reporting entities are described in this scenario? Assuming all of the customers are counted as a single entity and all of the employees are counted as a single entity, there are a total of seven entities named in the scenario. These entities include: (1) Jason Winston, (2) Winston Enterprises, (3) George Winston, (4) First Federal Bank, (5) Commercial Properties, Inc., (6) the customers, and (7) the employees. A separate set of accounting records would be maintained for each entity.

Your ability to learn accounting will be greatly influenced by how you approach the entity concept. Based on your everyday experiences, you likely think from the perspective of a customer. In contrast, this text is written from the perspective of a business entity. These opposing perspectives dramatically affect how you view business events. For example, as a customer, you consider a sales discount a great bargain. The view is different from the perspective of the business granting the discount. A sales discount means an item did not sell at the expected price. To move the item, the business had to accept less money than it originally planned to receive. From this perspective, a sales discount is not a good thing. To understand accounting, train yourself to interpret transactions from the perspective of a business rather than a consumer. Each time you encounter an accounting event, ask yourself, "How does this affect the business?"



CHECK YOURSELF 1.1

In a recent business transaction, land was exchanged for cash. Did the amount of cash increase or decrease?