

Third Edition

ACCOUNTING

Horngren/Harrison/Robinson



Third Edition

ACCOUNTING

Charles T. Horngren

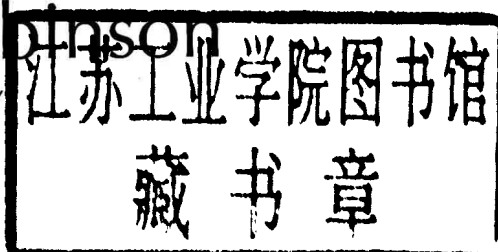
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For our wives—Joan, Nancy, and Roberta



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Preface

Accounting, third edition, provides full introductory coverage of financial and management accounting. We have written the book for use in a two-semester course. *Accounting* is in the mainstream for courses in introductory accounting. This book focuses on the most widely used accounting theory and practice.

Mission of the Book

Our mission is to present the fundamentals of financial and management accounting by challenging students to think and to make decisions. We emphasize the importance of connecting accounting to the business world and provide the student with the best support available for studying and learning accounting.

All the features of *Accounting* have been extensively tested in the market. Professor focus groups, student focus groups, reviewer conferences, dozens of reviewers, solutions checkers, an English-as-a-Second-Language student reviewer, and two development editors have critiqued all aspects of this book.

Helping Students Become Decision Makers

Beginning with page 1 we create a business context for the student. The real-world environment promotes student interest. We integrate actual companies and their data into the text narrative and assignment material. Familiar companies enliven the material and illustrate the role of accounting in business. Sometimes, however, “live” data drawn from real companies are too advanced for introductory students. In those situations, we illustrate the accounting with realistic examples to build a framework that invites students to participate in the learning process.

In this edition, we start the development of decision-making skills even before the first chapter—in a section called *Accounting’s Role in Business*. Students are challenged to develop their own plan for running a business. By piecing together a business plan, students start to see how accounting serves an organization. Students are thus motivated to integrate the details into a broad view of accounting.


Each chapter opens with an actual business situation and provides a quotation by a company manager, investor, or owner that gives insight into the chapter topic. Each chapter-opening story is illustrated with a photograph that draws students into the story. Students then revisit this story throughout the chapter, connecting accounting to a real business decision.

New or Expanded Features of the Third Edition

The third edition presents a number of new features:

- *Stop & Think* “speedbumps” ask students to do just that—stop and think about an application of accounting or an extension of the basic material—at various points in each chapter. These are not “boxes,” which typically fall outside the running text and can be bypassed. They are part of the text, complete with answers to show students “how to do it,” and they are identified by the icon you see here in the margin.
- Our *Putting Skills to Work* features illustrate how particular businesses or individuals use accounting. These features also serve as a summary of major concepts in the chapter. In Chapter 2 (page 46) Bill Neely, the founder of B. G. Graphics, discusses how accounting helps him manage his business.



- A new category of exhibits called *Concept Highlights* contains tabular or visual summaries. The Concept Highlights give students another way to review the material. Exhibit 1-7 (page 18) and Exhibit 2-6 (page 52) are examples of Concept Highlights.
- There are many *new exhibits* in this edition. Most exhibits now use diagrams to illustrate concepts and relationships, helping students visualize accounting concepts and principles. Examples include Exhibit 1-1 (page 5) and Exhibit 2-3 (page 48).
- *Highlighted photographs* with excerpts from the text emphasize accounting's role in business. In Chapter 3, for example, this feature calls attention to the role of accounting at Four Seasons Hotels and Resorts (page 91) and J.C. Penney (page 92).
- *Concept links* are margin notes that refer students to important topics studied in earlier chapters. Indicated by a red arrow in the margin  and in the accompanying text, they will help students see how the details of accounting come together.
- *Student annotations* in the margins provide a self-check or offer additional material of interest. Three types of student annotations are included. *Key Points* highlight concepts or topics that often cause students to stumble. *Short Exercises*—complete with solutions—give students immediate practice in applying new material. *Real-World Examples* illustrate the use of accounting in actual business situations.
- Each of the seven Parts of *Accounting* ends with a *Video Case* based on a real company. An accompanying video clip is available. Each Video Case includes *Case Questions* that require critical-thinking skills and a basic understanding of the concepts and principles covered in the text.
- An *all-new design* enhances learning. From the use of color to the addition of photos and exciting diagrams, the design has been thoughtfully created to bring accounting to today's visually oriented students. Different colors identify internal and external financial statements. Red corner marks identify the pages of assignment material.
- Each chapter has one or more new *Challenge Exercises*, which go beyond the ordinary coverage to develop students' critical-thinking skills and offer instructors more variety in assignment material.
- Chapters 2 through 5 include a *Serial Exercise*. A single running example builds in complexity as it illustrates the accounting cycle.
- All-new *Financial Statement Problems* are based on the financial statements of Lands' End, Inc. The Lands' End annual report appears in Appendix A.
- *Group Projects* are recommended to begin the course and are at the end of each of the seven Parts of the book, within the Comprehensive Problems. These Group Projects challenge students to develop a plan for managing a business. The intent is for students to participate in the learning process by creating a familiar context. As students move through the course, they incorporate new material to refine the plan.
- *Decision-oriented assignment materials* have been expanded in this edition.
 1. Basic exercises and problems include ratios for decision making in the context of actual business practice. For example, the classified balance sheet is accompanied by the current ratio and the debt ratio. With inventories we introduce inventory turnover and gross profit percentage.
 2. Decision Problems ask students to make decisions that go beyond mere number crunching, such as determining the price to pay to acquire an existing business or whether a company is poised for a business expansion.
 3. We want students to step back and ponder the use of accounting information for decision making. To reach this target, selected problems now include this new requirement: "How will what you learned in this problem help you manage a business (or evaluate an investment)?"
- Assignment material has been updated. This includes the *Mid-Chapter Summary Problems for Your Review*, *Summary Problems for Your Review*, *Self-Study Questions* (with Answers), *Questions*, *Exercises*, *Challenge Exercises*, *Problems* (sets A and B), and

Extending Your Knowledge. Many exercises and problems can be worked with a computer. Those that are coordinated with the Lotus Templates have a spreadsheet icon, and those that can be worked with the Prentice Hall Accounting Software (PHAS) are marked with a disk icon.



- Each chapter *Summary* is now organized by Chapter Objective.

Chapter-by-chapter revisions include the following:

- A new appendix to Chapter 1 discusses the accounting profession.
- Chapter 3 has a new appendix on alternate accounting treatments for prepaid expenses and unearned revenues. This material promotes the development of critical-thinking skills and illustrates that accounting is not so “cut and dried.”
- In Chapter 4, reversing entries have been moved to an appendix.
- Chapter 5 uses a modern perpetual inventory system to illustrate accounting for inventory. More intuitive to students, the perpetual system helps them learn income measurement and the matching principle. At the same time, Chapter 5 maintains the strengths of the periodic inventory system—such as the computation of cost of goods sold—and offers a chapter supplement on the periodic system.
- Chapter 6 expands the coverage of computer information systems. Also, throughout the book we discuss computer applications in context to reinforce the fact that accountants use the computer as a tool. These sections are identified in the margin by a computer terminal icon.
- Chapter 7 has a new section on ethical decision making in accounting.
- Chapter 9 shows how to convert a LIFO company's income to the FIFO basis. This material is especially helpful for investment analysis and for credit decisions when companies are using different methods and the analyst must make a comparison. New sections of the chapter briefly discuss the LIFO liquidation problem and LIFO's potential use for manipulating income.
- To make room for more decision-relevant material, Chapters 12 (The Foundation for Generally Accepted Accounting Principles) and 13 (Accounting for Partnerships) have been streamlined, and stock subscriptions have been deleted from Chapter 14.
- Chapter 16's appendix now includes future value as we introduce the present-value techniques used to value bonds and amortize bond premium or to discount by the effective-interest method. This section of the appendix can be bypassed if instructors so desire.
- Chapter 20 includes a new discussion of management's planning and control functions and managers' uses of accounting information. It combines an introduction to management accounting, manufacturing accounting, and job order costing.
- Chapter 21 is entirely devoted to process costing to help students sharpen their focus on this challenging material. Both the FIFO and weighted-average methods are presented.
- Chapter 22 derives the cost-volume-profit formula from the contribution margin income statement and includes a new section on the difference between operating income computed under absorption costing and under variable costing.
- Chapter 23 is a new chapter that discusses cost behavior in depth, contrasting committed and discretionary fixed costs and engineered and discretionary variable costs.
- Chapter 24 combines the master budget and responsibility accounting to emphasize the natural link between the two.
- Chapter 25 discusses the role of continuous improvement and perfection goals in the standard-setting process and includes a new section on three-variance overhead analysis to help students understand what causes overhead variances.
- Chapter 26 is a new chapter that places activity-based costing (ABC) in the context of activity-based *management*. It contrasts traditional production systems with just-in-time systems and demonstrates how companies use target costing and kaizen costing to improve their operations.
- Chapter 27 includes a new section on the equipment-replacement decision.



Recommendations of the Accounting Education Change Commission (AECC)

The recommendations of the AECC have inspired us in several ways.

- *Critical-Thinking Skills*—Each chapter includes Stop & Think “speedbumps” and new Challenge Exercises and places more emphasis on the Decision Problems, which require critical thinking.
- *User Perspective*—Most introductory students are not accounting majors. We motivate discussions on the basis of the experience of people who use accounting information.
- *Decision Making*—Chapter-opening stories, summaries of the material covered, and the assignment materials focus on decision making.
- *Group Learning Activities*—We propose a Group Project in *Accounting’s Role in Business*, which precedes Chapter 1. In addition, each of the seven Parts of the text includes a Group Project that asks students to devise their own business plan for financing, promoting, and operating a business.
- *Business Context for Accounting*—Students need a context for learning new material, and we have created Group Projects, chapter-opening stories, real-company examples, Putting Skills to Work, margin annotations, and company and product photographs. All of these serve to build a picture of the real business world for students. These features are especially helpful to students who have little or no previous experience in business.
- *Ethical Issues in Business*—Chapter 7 includes a new section on ethical decision making. Also, each chapter includes an *Ethical Issue* among the assignment materials.
- *International Accounting*—Chapter 9 (Merchandise Inventory) and Chapter 10 (Plant Assets, Intangible Assets, and Related Expenses) include new discussions of international accounting for these assets. The second half of Chapter 17 is devoted to accounting for international operations.
- *Communication Skills*—Each chapter includes assignment materials that require students to write business memoranda to explain the rationale for business decisions. Selected problems require students to explain how those problems will help them to, among other things, manage a business or evaluate an investment. The Group Projects can be presented orally in class.

Supplements

Supplements for the Instructor

ANNOTATED INSTRUCTOR’S EDITION The *Annotated Instructor’s Edition* includes the text plus margin notes for the instructor to use during his/her lecture. The following annotations are included:

- *Teaching Tips*, which suggest interesting new ways of presenting the material;
- *Applications*, which show how accounting is applied;
- *Class Exercises* (with full solutions), which are provided to give students immediate practice in applying concepts and implementing procedures;
- *Discussion Questions*, which introduce topics for group thinking and provide immediate feedback on how well students understand the material.

COURSE MANAGER The *Course Manager* is a three-hole-punched copy of the Annotated Instructor’s Edition in a binder. Instructors can use the Course Manager to organize their lectures by including all the necessary supplementary material for the lecture, along with the text chapter(s), in the order that the instructor prefers.

INSTRUCTOR’S MANUAL AND MEDIA GUIDE The *Instructor’s Manual and Media Guide* contains the following elements for each chapter of the text: Chapter Overview, Chapter Outline, Assignment Grid, Suggested Readings, Ten-Minute Quiz, Answer Key to the Ten-Minute Quiz, Supplement Grid, and Video Write-Ups.

SOLUTIONS MANUAL The *Solutions Manual* contains answers to all questions, exercises, and problems in the text. The pages have been designed so that they can also be used as transparency masters.

SOLUTIONS MANUAL ON DISK All numerical exercises and problems are available on disk in Lotus 2.2 format.

TRANSPARENCIES OF SOLUTIONS Every page from the *Solutions Manual* has been recreated as an acetate for use on the overhead projector.

TEST ITEM FILE Completely new for this edition of the text, this *Test Item File* contains 2,835 test items. Each chapter consists of 105 questions: 20 true/false, 70 multiple choice, 10 exercises/problems, 5 critical thinking/essay. Each chapter has been content-reviewed for clarity and solution-checked for accuracy.

TEACHING TRANSPARENCIES Approximately 80 two-color acetates have been created to provide overviews and outlines of chapter topics, summarize compare/contrast concepts, show actual exhibits such as a balance sheet, provide additional numerical examples, and give step-by-step explanations of complicated topics.

ABC News/PH Video Library for Accounting

Video is the most dynamic of all the supplements you can use to enhance your class. The quality of the video material and how well it relates to your course can make all the difference. For these reasons, Prentice Hall and ABC News are working together to bring you the best and most comprehensive video ancillaries available in the college market.

Through its award-winning programs—*Nightline*, *Business World*, *On Business*, *This Week with David Brinkley*, and *World News Tonight*—ABC offers a resource for feature and documentary-style videos related to text concepts and applications. The programs have extremely high production quality, present substantial content, and are hosted by well-versed, well-known anchors. Prentice Hall, its authors, and its editors provide the benefit of having selected videos on topics that will work well with this course and give the instructor teaching notes on how to use them in the classroom.

The ABC News/PH Video Library offers video material for selected topics in the text. A video guide is provided to integrate the videos into your lecture. Some of the topics covered include PepsiCo's use of bar coding in processing accounts receivable transactions; the introduction of Frito Lay's automated accounting information system to track sales, inventory, and the development of new markets; and frequent-flier miles as current liabilities.

Supplements for Students

STUDY GUIDE Each *Study Guide* chapter contains the following parts: Chapter Overview, Chapter Review, and Test Yourself (with Matching, Multiple-Choice, and Completion Exercises and Critical-Thinking and Demonstration Problems).

WORKING PAPERS *Working Papers* is a set of tear-out forms that students can use to solve all exercises and problems in the text. Because T-accounts, general journals, cash receipts journals, purchases journals, and so on are already set up, students can focus on accounting concepts by filling in the necessary calculations to solve their assignments.

The forms are numbered in the same way as the textbook exercises and problems and are arranged in the same order.

PRACTICE SETS The *Runners Corporation Practice Set* is a merchandising corporation practice set for a complete, one-year accounting cycle. It includes narrative of transactions and is available in both manual and computerized formats.

The *Galleria Leathergoods, Inc., Practice Set* is a merchandising corporation practice set with payroll, in business paper format. It is available only in a manual format.

THE NEW YORK TIMES SUPPLEMENTS FOR FINANCIAL AND MANAGEMENT ACCOUNTING *The New York Times* and Prentice Hall are sponsoring “A Contemporary View,” a program designed to enhance student access to current information of relevance to the classroom. Through this program, the core subject matter provided in the text is supplemented by a collection of time-sensitive articles from one of the world’s most distinguished newspapers, *The New York Times*. These articles demonstrate the connection between what is learned in the classroom and what is happening in the world around us.

Prentice Hall and *The New York Times* are proud to co-sponsor “A Contemporary View.” We hope it will make the reading of both textbooks and newspapers a dynamic learning process.

Software Supplements

PRENTICE HALL ACCOUNTING SOFTWARE (PHAS)—GENERAL LEDGER PACKAGE *Prentice Hall Accounting Software* is a user-friendly general ledger package covering the accounting cycle. The student will be able to use existing exercises or problems from the textbook, create new problems or companies, enter journal entries, change or delete journal entries, print journal and other reports, post journal entries in batch mode, backup data files, and close the period. PHAS is available in both DOS and Windows versions.

COMPACT d/SEC ACADEMIC EDITION *Compact d/SEC* is a financial disclosure package that can be used in various accounting courses. It contains complete financial information for either 30 or 100 companies. Financial information for Lands’ End, Inc., the company whose annual report is included in *Accounting*, can be found on this software as well.

PH RE-ENFORCER An interactive *Tutorial* consists of multiple-choice questions, problems, and case problems for each chapter of the text.

PH PROFESSOR The *Classroom Presentation Package* on PowerPoint 3.0 can be used to present chapter material using graphics and innovative ways of explaining concepts from the text. Other publishers provide this type of software but call it electronic transparencies.

LOTUS TEMPLATES *Lotus Templates* can be used to solve selected exercises and problems in the text. The documentation includes a short tutorial on how to use Lotus, and a “walk-through” for each template is provided. Students are not required to have an in-depth knowledge of Lotus programming techniques. Instead, the templates are designed to focus on the accounting concepts presented in each template.

TEST MANAGER Prentice Hall’s *Test Manager* 2.0 can be used to generate tests of up to 200 questions. Instructors can select the questions they want to use or allow questions to be randomly selected by chapter section, level of difficulty, or question type. The existing question bank can be edited on-screen, and instructors can create and insert their own questions as well.

Entire tests can be previewed on-screen before printing. Tests can be saved to one of three word processing file formats: WordPerfect, Microsoft Word, or ASCII. Test Manager can print multiple variations of the same test, scrambling the order of questions and multiple-choice answers. A comprehensive, fully indexed desktop reference guide is included.

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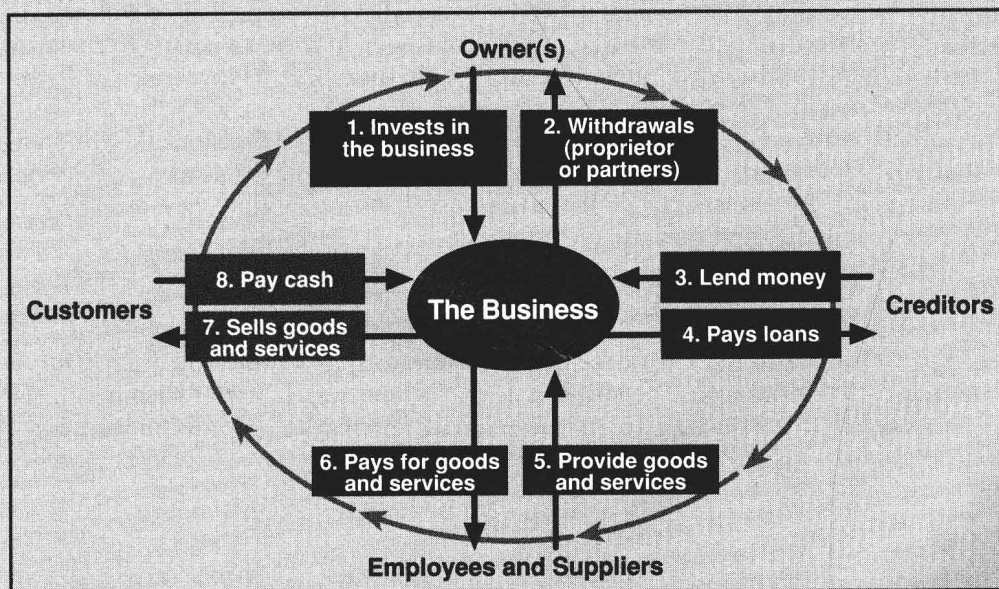
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Accounting's Role in Business

The Primary Mission of Business

Every organization has a primary mission. Hospitals provide health care. Law firms advise clients on legal matters. Automobile manufacturers produce cars. Auto dealers sell cars.

Consider a Ford automobile dealership, Pearson Ford. Most car dealerships are complex organizations that bring together the activities of a diverse group of people. The owners operate the business to earn a profit. They probably have to borrow money from the bank and other creditors. The Pearson dealership purchases automobiles from Ford Motor Company and sells the cars to customers such as you. Along the way, the business hires employees, buys and uses supplies, and pays bills for its building, insurance, and electric power. The following diagram shows these relationships, with the business at the center interacting with various parties.



The primary mission of the Ford dealership is to sell cars to customers. For the Ford Motor Company, headquartered in Dearborn, Michigan, the mission is to manufacture the cars. But let's return to Pearson Ford. It must buy the cars that the public wants. It must hire productive employees and pay its bills to stay in business.

A dealership needs support services to accomplish its primary mission. For example, Pearson needs employees—salespersons, mechanics, and accountants. The dealership's personnel officer hires these employees. Someone else or some group must manage the overall business. We call this support function *administration* or

management. The managers need information to make wise business decisions. Accountants produce much of this information. If the dealership borrows money (and most do), the lenders demand reports on how well the business is doing. Accountants supply much of this information, too. Virtually all businesses have an accounting function. Depending on the size and complexity of the organization, it may need additional support services. For now, however, let's focus on a business that has the functions we have mentioned.

Primary Mission of the Business—to Provide a Product or a Service

Functions directly related to the primary mission:

- Production (or purchasing)
- Sales

Support functions:

- Personnel
- Administration
- Accounting

Accounting as a Business Function

Accounting is a support function in business. Unlike the sale of automobiles, which brings in money to the dealership, accounting by itself generates no cash. To earn its way, accounting must provide more benefit for the organization than the cost of operating the accounting department. What benefits does an accounting department bring to a car dealership? Simply, better decisions. For example, the owner must decide how many salespersons to hire and how to pay them: straight salary, commission, or salary plus commission. Accounting information aids these and many other decisions. Operating without an accounting department would be like driving blind from Los Angeles to a remote village.

Business activity is complex. Suppose that Ford sales have been down for the past five years. Pearson is considering adding a Nissan dealership. If you were Pearson, how would you decide whether to invest? You probably would seek the advice of other people in the organization. The salespersons have valuable opinions about their ability to sell Nissans. The mechanics can predict the training they will need in order to work on foreign cars. The general manager may be reluctant to make so drastic a change. The accountant can answer the question, "How much will this changeover cost us?"

There is abundant evidence that groups can make better decisions than an individual can. "Two heads are better than one." That is why most business activity occurs in groups. In fact, more people fail in business because they cannot get along with others than because they are incompetent.

Innovations in Accounting Education

Over the past several years, an organization known as the Accounting Education Change Commission (AECC) has suggested innovations in the way accounting is taught at the college level. The authors, one of whom was a charter member of the AECC, believe that some key changes can enrich the teaching—and the learning—of accounting. This book incorporates several innovations that are a direct result of the work of the AECC.

Accounting in Context

The key innovation of this book is that accounting is presented in its business context. Throughout, we set the context before we launch into how to do accounting procedures. We want you to know *why* the accounting is done. In this way you will learn the subject better.

Accounting and Decision Making

Another innovation is that we present accounting as a tool for *decision making*. Every chapter has exercises and problems that ask you to make decisions. You will learn how accounting generates information for decision making. You will also learn to

use the information to make business decisions. We ask questions that lead you to think about what you will do with accounting information. As you progress through the book—specifically, as you finish each exercise and each problem in the assignment material—we encourage you to answer these questions:

1. What did you learn from working this exercise or problem?
2. How will what you learned help you manage a business?

To illustrate what we mean, consider Exercise 1-7. That exercise asks you to account for the transactions of Dr. Allison LaChappelle, a physician who is starting a pediatric medical practice. The exercise determines the amount of cash, medical supplies, and so on that LaChappelle's medical practice has at the end of the first month. For this exercise, let's address our two key questions.

1. What did you learn from working this exercise or problem? Possible answers (there can be many):
 - a. A business should account for its affairs separately from those of its owners.
 - b. A business begins by raising money from its owners.
 - c. To know where it stands, the business must account for its buying and selling transactions.
 - d. Each business transaction, such as the purchase of land, has at least two effects.
2. How will what you learned help you manage a business?
 - a. By keeping my personal affairs separate from those of my business, I am better able to evaluate the business. If I mix my personal finances with those of my business, I will not be able to tell how well the business is doing.
 - b. If I go into business, I will probably have to invest some of my own money. Therefore, I should save. I will probably have to borrow, so I will need a good credit record.
 - c. Accounting is necessary if I want to know how my business is doing.
 - d. It makes sense that buying and selling have two effects on an organization because it takes two parties—a buyer and a seller—to complete a business transaction, such as the purchase of land.

To Instructors—A Group Project

To emphasize that accounting is best learned in the context of business decision making, the authors recommend that you begin the course with the following group activity (or some similar project). Divide the class into groups of four or five students. Allow 15 to 30 minutes for each group to list the decisions they must make to plan, promote, and present a **rock concert**. Each group's goal is to earn a profit. Instruct them to be as specific and as detailed as they can in describing the decisions for this business endeavor. At the end of the allotted time, have them report their business plan to the class. Your class can engage in this project at any time. It works particularly well as a structure builder at the beginning of the course. At the end of the term, you can revisit the exercise to summarize what the students have learned.¹ There are several benefits from beginning the study of accounting with the students' own business plan:

1. Starting a business is a stimulating endeavor that should capture student interest.
2. This strategy provides a context for illustrating the relevance of accounting.
3. The broad exercise helps students to think critically—beyond the details of accounting.
4. Student goals form the structure of learning.

¹The authors thank J. R. Dietrich for suggesting this Group Project.

5. The project develops group skills and communication skills—both oral and written.
6. Students become active participants in the learning process. The project is student-centered and learning-centered rather than instructor-centered and teaching-centered.
7. The exercise is decision-oriented.

We hope students will understand why accountants rise to leadership positions in their organizations in greater numbers than businesspersons trained in any other field.

The possibilities for implementation are virtually endless. Instructors may wish to have students refine their business plans as they cover new material in each chapter. The book includes a Comprehensive Problem at the end of each Part (after Chapters 6, 12, 17, 19, 21, 25, and 27) to challenge students to incorporate and synthesize the material they learned in the preceding chapters. Students can write short memoranda or formal reports, as desired. Either individuals or groups can make class presentations. The authors encourage instructors to relay to us your experiences with this project. If you prefer to use e-mail, you can contact us at the following addresses:

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PART 1 The Basic Structure of Accounting

PART 2 Accounting for Assets and Liabilities

PART 3 Accounting for Partnerships and Corporate Transactions

PART 4 Analysis of Accounting Information

PART 5 Management Accounting and Product Costing

PART 6 Internal Decision Making, Planning, and Control

PART 7 Strategy and Long-Term Decision Making