16th Edition

Financial & Managerial Accounting

THE BASIS FOR BUSINESS DECISIONS

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FINANCIAL AND MANAGERIAL ACCOUNTING: THE BASIS FOR BUSINESS DECISIONS

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To Ben and Meg Wishart and Asher, Lainey, and Lucy Hunt, who have taught me the joys of being a grandfather.

—Jan R. Williams

For Cliff, Abi, and my mother, Fran.

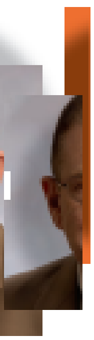
—Susan F. Haka

To my parents, Fred and Marjorie.

—Mark S. Bettner

To Terri, Stephen, Karen, and Sarah, whose sacrifices enabled me to participate in writing this book. Thank you—I love you!

—Joseph V. Carcello



Jan R. Williams is Dean of the College of Business Administration and the Stokely Foundation Leadership Chair at the University of Tennessee, where he Stoke

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versity of Arkansas. He previously served on the faculties at the University of Georgia and Texas Tech University. A CPA in Tennessee and Arkansas, Dr. Williams is also the coauthor of three books and has published over 70 articles on issues of corporate financial reporting and accounting edu

7

cation. He served as president of the American Accounting Association in cat 1999–2000 and has been actively involved in Beta Alpha Psi, the Tennessee Soci ety of CPAs, the American Institute of CPAs, and AACSB International—the Asso ciation to Advance Collegiate Schools of Business—the accrediting organization for business schools and accounting programs worldwide. He currently serves as chair elect of the Board of Directors of AACSB International.

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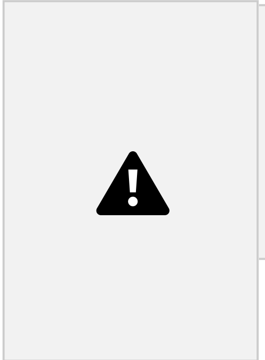

Mark S. Bettner is the Christian R. Lindback Chair of Accounting & Financial Management at Bucknell University. Dr. Bettner received his PhD in business administration from Texas Tech University and his MS in accounting from Virginia Tech University. He has received numerous teaching and research awards. In addition to his work on *Financial Accounting* and *Financial & Managerial Accounting* , he has written many ancillary materials, published in scholarly journals, and presented at academic and practitioner conferences. Professor Bettner is also on the editorial advisory boards of several academic journals, including the *International Journal of Accounting and Business Society* and the *Accounting Forum,* and has served as a reviewer for several journals, including *Advances in Public Interest Accounting* and *Hospital and Health Services Administration.*

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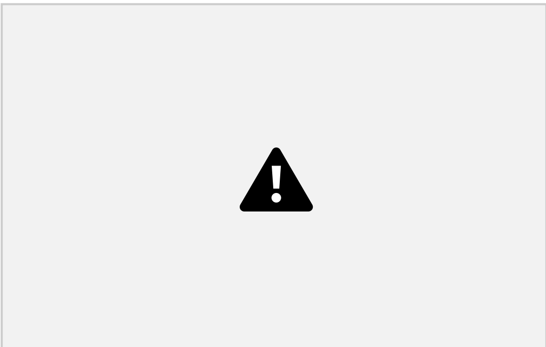

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How Does **Williams** Help Students

Step-by-Step Process for the Accounting Cycle

four steps in the process:

Analysis

A

1

Debit/Credit Rules **D**

2

its balance sheet. The revenue and expense transactions that took place on January 31 will be addressed later in the chapter.

Each transaction from January 20 through January 27 is analyzed first in terms of increases in assets, liabilities, and owners' equity. Second, we follow the debit and credit rules for entering these increases and decreases in specific accounts. Asset ledger accounts are shown on the left side of the analysis; liability and owners' equity ledger accounts are shown on the right side. For convenience in the following transactions, both the debit and credit figures for the transaction under discussion are shown in *red*. Figures relating to earlier transactions appear in *black*.

Jan. 20 Michael McBryan and family invested $80,000 cash in exchange for capital stock.

Jo

the same amount.

Owners invest cash in the business

Owners' Assets Liabilities Equity

Journal Entry

ANALYSIS The asset Cash is increased by $80,000, and ow... Stock) is increased by

T-Accounts

L

DEBIT–CREDIT RULES

Increases in owners' equity are recorded by credits; credit Capital

4

JOURNAL

Jan. 20 Cash 80,000

Capital Stock 80,000

$80,000 $80,000

Ledger

Increases in assets are recorded by debits; debit Cash $80,000.

ENTRIES IN LEDGER

COUNTS

Cash

0 80,000

Capital Stock

1/20 80,000

Jan. 21 Representing Overnight, McBryan negotiated with both the City of Santa Teresa and Metropolitan Transit Authority (MTA) to purchase an abandoned bus garage. (The city owned the land, but the MTA owned the building.) On January 21, Overnight Auto Service purchased the land from the city for $52,000 cash.

DEBIT–CREDIT RULES

JOURNAL

ENTRY

ANALYSIS

Land

Cash

1/20 80,000 1/21 52,000

ENTRIES IN LEDGER

1/21 52,000

Build a Strong Foundation?

Robust

End-of-Chapter Material

LO1

LO2

LO5

EXERCISE 3.1 E

E

The Accounting

T

Cycle

C

B

BRIEF

accounting cycle: Prepare a trial balance.
Journalize and post the closing entries.
Prepare financial statements.
Post transaction data to the ledger.
Prepare an adjusted trial balance.

Brief Exercises

accounting

Listed below in *random order* are the eight steps comprising a complete

Prepare an after-closing trial balance.

a. List these steps in the sequence in which they would normally be performed. (A detailed understanding of these eight steps is not required until Chapters 4 and 5.)

b. Describe ways in which the information produced through the accounting cycle is used by a company's management and employees.

An Alternate Problem Set

LO9

LO10

Make end-of-period adjustments.
Journalize transactions.

LO3

BRIEF
B
E

Record the following selected transactions in general journal form for Sun Orthopedic Clinic, Inc.

Problem Set B

Problem Set B

Include a brief explanation of the transaction as part of each journal entry.

EXERCISE 3.2

through

Recording
T
Transactions in
PROBLEM 21.1B
P

Oct. 1 The clinic issued 4,000 additional shares of

capital stock to Doctor Soges at $50 per Swirl Incorporated designs and manufactures fashionable women's clothing. For the coming year, the

h

LO1

through R

E through
Evaluating a Special Order through
O through

LO3

units) Total

Variable manufacturing costs $40 $2,000,000

COMPREHENSIVE PROBLEM

Comprehensive Problems,

LO5

company has scheduled production of 50,000 silk skirts. Budgeted costs for this product are as follows:

Unit Costs (50,000

Variable selling expenses . . . . 15 750,000 Fixed manufacturing costs . . . . 12 600,000 Fixed operating expenses 10 500,000

wil11048_ch03_084-137.indd 117 8/11/10 2:34 PM $ $

Utease Corporation has many production plants across the midwestern United States. A newly opened plant, the Bellingham plant, produces and sells one product. The plant is treated, for responsibility accounting purposes, as a profit center. The unit standard costs for a production unit, with overhead applied based on direct labor hours, are as follows:

Key Terms

Self-Test

Questions

The answers to these questions appear on page 137. **1.** According to the rules of debit and credit for balance sheet accounts:

a. Increases in asset, liability, and owners' equity accounts are recorded by debits.

b. Decreases in asset and liability accounts are recorded by credits.

a. Proof that no transaction was completely omitted from the ledger during the posting process.

b. Proof that the correct debit or credit balance has been computed for each account.

c at the ledger is in balance.

Demonstration Problems

4. Which of the following is provided by a trial balance in which total debits equal total credits?

c.

Discussion Questions

Increases in asset and owners'

equity accounts are

d. Proof that transactions have been correctly analyzed and

ment of cash by a business indicate that an expense has been

r Construction is a small corporation owned and managed by than Tom Baker. T mployees, few cred itors, and no investor other to creditors or inv as no obligation to issue fi nancial state ments

Critical Thinking Cases

Problems

8. What is the meaning of the term *revenue*? Does the receipt of cash by a business indicate that revenue has been earned? Explain.

9. What is the meaning of the term *expenses*? Does the pay

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is there any reason for this records? corporation to maintain account ing

incurred? Explain.

10. When do accountants consider revenue to be realized?

2. What relationship exists between the position of an account in the balance sheet equation and the rules for recording increases in that account?

What basic question about recording revenue in accounting records is answered by the *realization principle*?

Reed Mfg. Co. operates two plants that produce and sell floor tile. Shown below are the operating

3. State briefl y the rules of debit and credit as applied to asset

11. In what accounting period does the *matching principle* indi

results of both plants during the company's first quarter of operations:

d li d li bili d ' i

cate that an expense should be recognized?

~~Critical Thinking Cases~~

~~During the quarter, common fixed costs relating to both plants amounted to $500,000.~~

St. Louis Springville Plant Plant

The realization principle determines when a business should recognize revenue. Listed next are three common business situations involving revenue. After each situation, we give two alternatives

Sales . . . .

LO7

TWO

CASE 3.1
C
R

. . . . $2,000,000 $2,000,000 Variable costs . . . . 720,000 880,000 Traceable fixed costs 750,000 550,000

Select the appropriate alternative by applying the realization principle, and explain your reasoning.

Ethics Cases

Revenue Recognition LO10

as to the accounting period (or periods) in which the business might recognize this revenue.

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a. Airline ticket revenue: Most airlines sell tickets well before the scheduled date of the flight. (Period ticket sold; period of flight)

b. Sales on account: In June 2011, a San Diego–based furniture store had a big sale, featuring "No payments until 2012." (Period furniture sold; periods that payments are received from customers)

LO6
C
CASE 3.2
M
Measuring Income F

cash down payment and agreed to make annual payments equal to 40 percent of the company's net income in each of the next three years. (Such "earn-outs" are a common means of financing

Kim Morris purchased Print Shop, Inc., a printing business, from Chris Stanley. Morris made a

LO7 LO10

Fairly

c. Magazine subscriptions revenue: Most magazine publishers sell subscriptions for future delivery the purchase of a small business.) Stanley was disappointed, however, when Morris reported a first

of the magazine. (Period subscription sold; periods that magazines are mailed to customers) year's net income far below Stanley's expectations.

The agreement between Morris and Stanley did not state precisely how "net income" was to be measured. Neither Morris nor Stanley was familiar with accounting concepts. Their agreement stated only that the net income of the corporation should be measured in a "fair and reasonable manner." In measuring net income, Morris applied the following policies:

1. Revenue was recognized when cash was received from customers. Most customers paid in cash, but a few were allowed 30-day credit terms.

2. Expenditures for ink and paper, which are purchased weekly, were charged directly to Sup

2009 Home Depot
Financial Statements

LO3

EXERCISE 16.15
E

vs. Period Costs

H
Home Depot Product

Use the Home Depot 2009 financial statements in Appendix A at the end of this textbook. Read plies Expense, as were the Morris family's weekly grocery and dry cleaning bills. note 1 to the financial statements that summarizes significant accounting policies for **Home Depot**.

family members did not work in the business on a regular basis, but they did help out what basis does it distinguish between shipping or transportation costs that are period expenses and when things got busy.
those that are product costs?

4 Income taxes expense included the amount paid by the corporation (which was computed

3. Morris set her annual salary at $60,000, which Stanley had agreed was reasonable. She also Read the section titled "Cost of Sales" on page A-00. Explain how **Home Depot** classifies some paid salaries of $30,000 per year to her husband and to each of her two teenage children. transportation, shipping, and handling costs as period expenses and others as product costs. On These

Problem Set A
Problem Set A
accounting

P
PROBLEM 16.1A A
An Introduction to

LO3

Aqua-Marine manufactures fiberglass fishing boats. The manufacturing costs incurred during its first year of operations are shown as follows:

P LO4

Product Costs

e cel X

accounting

Income and Changes

d

High-profile companies frame each chapter discussion through the use of dynamic **CHAPTER OPENER** vignettes. Students learn to frame the chapter's topic in a real-world scenario.

s i b r o C / n o t e l p a t S n o

D

Retained Earnings

with ethically

in

AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:

demanding situations. They must apply what they've learned in the text to situations faced by investors, creditors, and managers in the real world.

LO1 Describe how irregular income items, such as discontinued operations and extraordinary items, are presented in the income statement.

a

LO2 C Compute earnings per share.

LO3 Distinguish between basic and diluted earnings per share.

LO4 A Account for cash dividends and stock dividends, and explain the effects of these transactions on a a company's financial statements.

LO5 Describe and prepare a statement of retained earnings.

Define *prior period adjustments,* and explain how they are presented in financial statements.

LO6 Define *comprehensive income,* and explain how it differs from net income.

Describe and prepare a statement of stockholders' equity and the stockholders' equity s section of the balance sheet.

eam Leader

ct creation team for the box design. At the initial meeting of the cross-organizational team, a serious reservation is raised by the team members from the printing firm about the confidentiality and intellectual printing firm. The reservations of the printing firm representatives are so serious that the viability of the soap box design project is threatened. What should you do?

(See our comments on the Online Learning Center Web site.)

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James Specht, Concordia College

Exhibit 18–2 PR

ODUCTION PROCESS FOR METAL PRODUCTS, INC.

key concepts in the text.

x

EXHIBITS illustrate

“Williams is a

great text overall. It provides excel

A company’s pattern of sales and net income are important factors in evaluating its financial success. Consider Procter & Gamble Company, for example. Two billion times a day, P&G products are sold around the world. The company has one of the largest and strongest portfolios of recognizable brands, including Pampers, Tide, Ariel, Always, Whisper, Pantene, Bounty, Pringles, Folgers, Charmin, Downy, Lenor, Iams, Crest, Clairol, Actonel, Dawn, and Olay. Ninety-eight thousand people work for P&G in almost 80 countries worldwide.

One of the attributes of financially successful companies like P&G is their consistent strength over time in terms of primary measures of financial performance, such as net sales and net earnings. Net sales, measuring the value of merchandise sold less returns, increased from $74,832 million in 2007 to $81,748 million in 2008 and declined to $78,029 million in 2009. This represents an approximate 9 percent increase in 2008 and a modest 3 percent decline in 2009, for a combined increase for the two years of approximately 6 percent. Net income, which starts with sales and is reduced by various expenses required to generate those sales, increased from $10,340 million in 2007 to

$12,075 million in 2008 (an approximate 17 percent increase) and to $13,436 million in 2009 (an approximate 11 percent increase), or a combined increase for the two years of approxi mately 28 percent. These figures represent impressive financial performance in terms of the company's ability to provide goods to its customers and to operate in a manner that results in a profit that benefits the company's stockholders.

lent and accurate coverage of the accounting principles curriculum. **Students like it better than any other text I have used.** A few years ago I was in a situation where I had to use a different text, since I took over a class for another teacher at the last minute. Students were getting the Williams text on their own and **I saw immediate improve ment in their understanding**

D

and grades across the board. Williams comes through again and again, where other texts fall hopelessly short."

Malcolm E White, Columbia College

Successful companies sometimes experience reductions in cash. Often these reduc tions are intentional in order to more productively use the company's cash in differ ent ways. For example, in the year ending June 30, 2009, **Microsoft Corporation** reported a *decrease* in cash in excess of $4 billion! Does this mean that the company was experiencing extreme financial difficulty? Not necessarily. That year, operations provided over $19 billion. The overall decline was due to approximately $7.5 billion being used in financing activi ties, primarily for paying cash dividends to stockholders and purchasing treasury stock. In addition, the company

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As discussed in Chapter 2, the Sarbanes-Oxley Act (SOX) substantially increases the civil and criminal penalties associated with securities fraud, including fraudulent financial reporting. The increased penalties are intended

CASE IN POINT boxes link accounting concepts in the chapter to their use in the real world. These examples often present an international scenario to expose students to accounting practices around the world.

to reduce illegal behaviors. Even prior to SOX, the penal ties available to the government and the Securities and Exchange Commission for prosecuting securities fraud were substantial. For example, Andrew Fastow, **Enron**'s former chief financial officer, and primary architect of **Enron**'s fraudulent actions, pled guilty to a number of fraud-related criminal charges and has received a 10-year prison sentence. Former chief executive officer of **Enron**, Jeffrey Skilling, also was convicted of numerous criminal charges related to his role at **Enron**. Businesspeople are sometimes told by their superiors to commit actions that are unethical and in some instances even illegal. The clear message of management is "participate in this behavior or find a job elsewhere." Management pressure and intimidation can make it difficult to resist demands to en gage in unethical behavior. Employees sometimes believe that they are insulated from responsibility and liability because "they were just following orders." As you encounter ethical dilemmas during your business

d

career, remember that obeying orders from your superiors that are unethical, and certainly those that are illegal, may expose you to serious consequences, including criminal prosecution and incarceration.

Financial statements are closely tied to time periods

© AP Photo/David J. Phillip

ETHICS, FRAUD & CORPORATE GOVERNANCE boxes discuss the accounting scandals of recent years that have sparked such comprehensive legislation as Sarbanes-Oxley. The inclusion of EFCG boxes in each chapter offers instructors the opportunity to bring complex accounting and ethical issues into the classroom.

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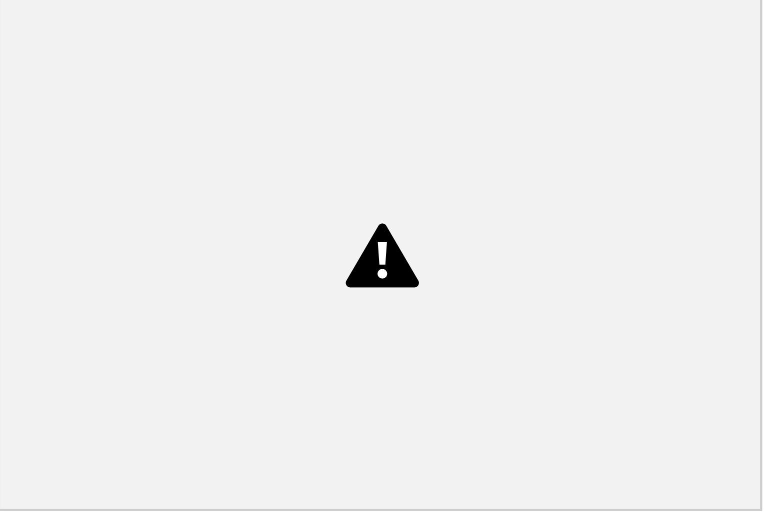

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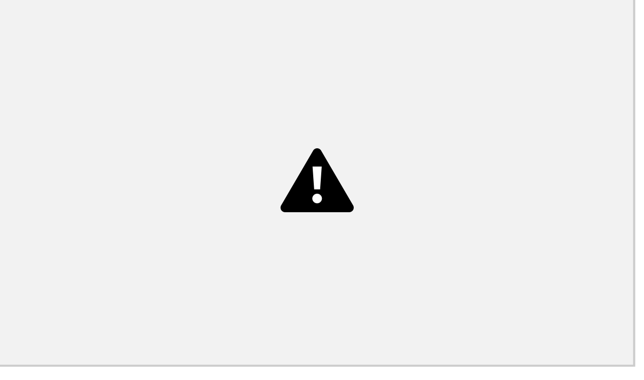

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The following list of revisions is a testament to the enthusiastic response of dozens of reviewers who contributed their considerable expertise. In doing so they have helped make the 16th edition of *Financial & Managerial Accounting* the best book of its kind.

Chapter 1

- Updated chapter-opening vignette
- Expanded coverage of support of conver gence and global accounting standards
- Updated Case in Point

Chapter 2

- Updated chapter-opening vignette

Chapter 3

- New chapter-opening vignette
- Revised Ethics, Fraud & Corporate Governance section

Chapter 4

- Updated chapter-opening vignette
- Updated Case in Point
- Revised materiality and adjusting entries section

Chapter 5

- New chapter-opening vignette
- Revised Financial Analysis and Decision Making section

Chapter 6

• New chapter-opening vignette
• Updated Case in Point
• Updated Financial Analysis and Decision Making section
• Revised Ethics, Fraud & Corporate Governance section

Chapter 7

• Updated chapter-opening vignette • Updated cash management section • Updated Case in Point
• Removed sections on petty cash funds, concentration of credit risk, internal

controls for receivables, management of accounts receivable
• Updated nature of interest section
• Updated Financial Analysis and Decision Making section
• Revised Ethics, Fraud & Corporate Governance section

Chapter 8

• Updated chapter-opening vignette
• Removed section on accounting methods affecting financial ratios
• Revised Financial Analysis and Decision Making section
• Revised Ethics, Fraud & Corporate Governance section

Chapter 9

• Updated chapter-opening vignette
• Revised differences in depreciation methods section
• Revised estimates of useful life and residual value section
• Updated Case in Point
• Revised Ethics, Fraud & Corporate Governance section

Chapter 10

• Updated chapter-opening vignette • Updated Your Turn
• Revised Ethics, Fraud & Corporate Governance section

Chapter 11

• New chapter-opening vignette
• Updated Case in Point
• Revised Financial Analysis and Decision Making section
• Revised Ethics, Fraud & Corporate Governance section

Chapter 12

• Updated chapter-opening vignette • Revised extraordinary items section
• Updated Financial Analysis and Decision Making section
• Revised Ethics, Fraud & Corporate Governance section

Chapter 13

• New chapter-opening vignette
• Revised introduction to statement of cash flows
• Updated Case in Point
• Revised Financial Analysis and Decision Making section
• Revised Ethics, Fraud & Corporate Governance section

Chapter 14

• Updated chapter-opening vignette
• Revised Ethics, Fraud & Corporate Governance section

Chapter 15

• New chapter-opening vignette
• New Exhibit 15-1 shows location of the world's top multinational companies
• New Case in Point
• Revision of Exhibit 15-5 and Exhibit 15-6
• Revised Ethics, Fraud & Corporate Governance section

Chapter 16

• Updated chapter-opening vignette • New Case in Point
• Revised Ethics, Fraud & Corporate Governance section

Chapter 18

• Updated chapter-opening vignette

Chapter 19

• Updated chapter-opening vignette • New Case in Point
• Revised Ethics, Fraud & Corporate Governance section

Chapter 20

• Revised Ethics, Fraud & Corporate Governance section

Chapter 21

• New Case in Point

Chapter 22

• Revision of Exhibit 22-1
• Revised Case in Point

Chapter 23

• New Case in Point

Chapter 24

• Two New Case in Points

Chapter 25

• Updated chapter-opening vignette • New Case in Point
• Revised Ethics, Fraud & Corporate Governance section

Chapter 26

• New chapter-opening vignette
• Revised Ethics, Fraud & Corporate Governance section

We are grateful . . .

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Jan R. Williams, Susan F. Haka, Mark S. Bettner, and Joseph V. Carcello

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Brief **Contents**

Contents

1 Accounting: Information for Decision Making

2 Basic Financial Statements

3 The Accounting Cycle: Capturing Economic Events

5 The Accounting Cycle: Reporting Financial Results

6 Merchandising Activities

4 The Accounting Cycle: Accruals and Deferrals

7 Financial Assets

8 Inventories and the Cost of Goods Sold

Guitar Universe, Inc. 381

9 Plant and Intangible Assets

10 Liabilities

11 Stockholders' Equity: Paid-In Capital

21 Incremental Analysis

22 Responsibility Accounting and Transfer Pricing

23 Operational Budgeting

24 Standard Cost Systems

Financial & Manageria l Accountin g

THE BASIS FOR BUSINESS DECISIONS

Accounting

Information for Decision Making

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AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:

Discuss accounting as the language of business and the role of accounting information in making LO1 economic decisions.
e

Discuss the significance of accounting systems in generating reliable accounting information and LO2
u
understand the five components of internal control.

E LO3
Explain the importance of financial accounting information for external parties—primarily investors and creditors—in terms of the objectives and the characteristics of that information.

E LO4
Explain the importance of accounting information for internal parties—primarily management— in terms of the objectives and the characteristics of that information.

Discuss elements of the system of external and internal financial reporting that LO5 create integrity in the reported information.
c

I LO6
Identify and discuss several professional organizations that play important roles

in preparing and I

communicating accounting information.
c

Discuss the importance of personal competence, professional judgment, and ethical behavior on

LO7 LO8

the part of accounting professionals.
t

Describe various career opportunities in accounting.

Bear Stearnswas founded in 1923 as an equity trading house. Bear Stearns grew to become one of the largest global investment banks and brokerage firms in the world. The firm grew rapidly during the early 2000s, and by 2006 the firm reported its fifth consecutive year of record net income and earnings per share. Net income topped $2 billion for the first time, an increase of 40 percent from the prior year. Bear Stearns employed approximately 14,000 people, and was recognized by *Fortune* magazine as the “most admired” securities firm in the United States. Bear Stearns ’ stock price reached $172 by January 2007, but by March 2008 the firm was forced to sell itself to JP Morgan Chasefor $10 per share in order to stave off a bankruptcy filing.

How did a firm that survived the 1929 stock market crash without laying off a single employee see its stock price collapse from $172 to $10 in approximately one year—wiping out billions of dollars of shareholder wealth— and forcing it into a distressed sale?

Bear Stearns had significant investments in subprime mortgage-related securities and had a heavily leveraged capital structure (i.e., a large amount of debt relative to investments by owners). During the latter half of 2007, investors lost confidence in the subprime mortgage market and the value of related securities plunged precipitously. Bear Stearns wrote down investments in subprime mortgage-related securities by billions of dollars, but creditors lost confidence in the firm and were no longer willing to lend it funds. The firm's lack of liquidity forced it to seek a merger partner. The only other option available to Bear Stearns was a bankruptcy filing, but if Bear Stearns had chosen that option shareholders would have received nothing for their shares. As recently as Bear Stearns' 2006 Annual Report, it touted its "dedication to risk evaluation and management that has given us the ability to expand carefully and conservatively." Bear Stearns' risk management controls failed to anticipate and/or adequately protect the firm from the dramatic decline in the value of subprime mortgage-related securities. ■

Source: Bear Stearns 2006 Annual Report, 2007 10-K, and Wikipedia.

Understanding and using accounting information is an important ingredient of any business undertaking. Terms such as sales revenue, net income, cost, expense, operating margin, and cash flow have clearly defined meanings and are commonly used in business-related commu nications. Although the precise meaning of these terms may be unfamiliar to you at this point, to become an active participant in the business world, you must gain a basic understanding of these and other accounting concepts. Our objective in this book is to provide those who both use and prepare accounting information with that basic understanding.

Information that is provided to external parties who have an interest in a company is some times referred to as financial accounting information. Information used internally by manage ment and others is commonly referred to as managerial accounting information. Whereas these two types of information have different purposes and serve different audiences, they have certain attributes in common. For example, both financial and managerial accounting require the use of judgment and information prepared for either purpose should be subject to the company's system of internal control. Financial accounting concepts are critical in order to understand the financial condition of a business enterprise. Determining a company's net income by subtracting its expenses from its revenue is a particularly important part of finan cial reporting today. This may appear to be a simple process of keeping accounting records and preparing reports from those records, but a great deal of judgment is required. For exam ple, when should the cost of acquiring a resource that is used for several years be recognized as an expense in the company's financial statements? What information is particularly useful for management, but not appropriate for public distribution because of the potential competi tive disadvantage that might result? These are among the many complex issues that business faces on a day-to-day basis and which have a critical impact on the company's responsibility to its owners, creditors, the government, and society in general.

As we begin the study of accounting, keep in mind that business does not exist solely to earn a return for its investors and creditors that supply a company's financial resources. Business also has a responsibility to operate in a socially responsible manner and to bal ance its desire for financial success within this broader social responsibility. We begin our development of these ideas in this chapter, and continue their emphasis throughout this text.

Accounting Information: A Means to an End

The primary objective of accounting is to provide information that is useful for decision making purposes. From the very start, we emphasize that accounting is *not an end,* but rather it is *a means to an end.* The final product of accounting information is the decision that is enhanced by the use of that information, whether the decision is made by owners, manage ment, creditors, governmental regulatory bodies, labor unions, or the many other groups that have an interest in the financial performance of an enterprise.

Learning Objective

e a

Discuss accounting as

D

th

Because accounting is widely used to describe all types of business activity, it is some times referred to as the *language of business.* Costs, prices, sales volume, profits, and return

LO1

the language of business and the role of accounting
a
information in making
in
economic decisions.

on investment are all accounting measurements. Investors, creditors, managers, and others who have a financial interest in an enterprise need a clear understanding of accounting terms and concepts if they are to understand and communicate about the enterprise. While our primary orientation in this text is the use of accounting information in business, from time to time we emphasize that accounting information is also used by governmental agencies, nonprofit organizations, and individuals in much the same manner as it is by business organizations.

ACCOUNTING FROM A USER'S PERSPECTIVE

Many people think of accounting as simply a highly technical field practiced only by profes sional accountants. In reality, nearly everyone uses accounting information daily. Accounting information is the means by which we measure and communicate economic events. Whether you manage a business, make investments, or monitor how you receive and use your money, you are working with accounting concepts and accounting information.

Our primary goal in this book is to develop your ability to understand and use accounting information in making economic decisions. To do this, you need to understand the following:

- The nature of economic activities that accounting information describes.
- The assumptions and measurement techniques involved in developing accounting information.
- The information that is most relevant for making various types of decisions.

Exhibit 1–1 illustrates how economic activities flow into the accounting process. The accounting process produces accounting information used by decision makers in making eco nomic decisions and taking specific actions. These decisions and actions result in economic activities that continue the cycle.

Exhibit 1–1

THE ACCOUNTING PROCESS

Economic Activities

Accounting Information

The Accounting (decisions) Makers Decision of Actions (decisions)

Reported Results

Accounting links decision makers with economic activities—and with the results of their decisions

TYPES OF ACCOUNTING INFORMATION

Just as there are many types of economic decisions, there are also many types of accounting information. The terms *financial accounting, management accounting,* and *tax accounting* often are used in describing three types of accounting information that are widely used in the business community.

Financial Accounting **Financial accounting** refers to information describing the financial resources, obligations, and activities of an economic entity (either an organization or an individual). Accountants use the term *financial position* to describe an entity's financial resources and obligations at a point in time and the term *results of operations* to describe its financial activities during the year.

In **Sony Corporation**'s

2009 financial statements to owners, financial position is pre sented as consisting of ¥12,014 trillion in assets (including cash, inventories, property, and equipment), with obligations against those assets of ¥9,049 trillion. This leaves ¥2,965 trillion as the owners' interest in those assets. In the same report, results of opera tions indicate that Sony had a net loss (expenses exceeded revenues) of ¥99 billion for the year ending March 31, 2009.

Financial accounting information is designed primarily to assist investors and creditors in deciding where to place their scarce investment resources. Such decisions are important

to society, because they determine which companies and industries will receive the financial resources necessary for growth.

Financial accounting information also is used by managers and in income tax returns. In fact, financial accounting information is used for so many different purposes that it often is called "general-purpose" accounting information.

Management Accounting **Management** (or managerial) **accounting** involves the development and interpretation of accounting information intended *specifically to assist man agement* in operating the business. Managers use this information in setting the company's overall goals, evaluating the performance of departments and individuals, deciding whether to introduce a new line of products, and making virtually all types of managerial decisions.

A company's managers and employees constantly need information to run and control daily business operations. For example, they need to know the amount of money in the company's bank accounts; the types, quantities, and dollar amounts of merchandise in the company's ware house; and the amounts owed to specific creditors. Much management accounting informa tion is financial in nature but is organized in a manner relating directly to the decision at hand.

Tax Accounting The preparation of income tax returns is a specialized field within accounting. To a great extent, tax returns are based on financial accounting information. How ever, the information often is adjusted or reorganized to conform with income tax reporting requirements. We introduce the idea of tax accounting information to contrast it with financial and management accounting information. Although tax information is important for a company's successful operations and is related to financial and management accounting information, it results from a different system and complies with specialized legal requirements that relate to a company's responsibility to pay an appropriate amount of taxes. Laws and regulations gov erning taxation are often different from those underlying the preparation of financial and man agement accounting information, so it should not be a surprise that the resulting figures and reports are different. Because the focus of this text is introductory accounting, and because tax accounting is quite complex, we defer coverage of tax accounting subjects to subsequent accounting courses.

Accounting Systems

Learning Objective

LO2

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Discuss the significance

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of accounting systems in

in generating reliable a

accounting information and understand

the five components of internal control.

An **accounting system** consists of the personnel, procedures, technology, and records used by an organization (1) to develop accounting information and (2) to communicate this information to decision makers. The design and capabilities of these systems vary greatly from one organi zation to another. In small businesses, accounting systems may consist of little more than a cash register, a checkbook, and an annual trip to an income tax preparer. In large businesses, accounting systems include computers, highly trained personnel, and accounting reports that affect the daily operations of every department. But in every case, the basic purpose of the accounting system remains the same: *to meet the organization's needs for information as effi ciently as possible.*

Many factors affect the structure of the accounting system within a particular organiza tion. Among the most important are (1) the company's *needs for accounting information* and (2) the *resources available* for operation of the system.

Describing accounting as an information system focuses attention on the information accounting provides, the users of the information, and the support for financial decisions that is provided by the information. These relationships are depicted in Exhibit 1–2 . While some of the terms may not be familiar to you at this early point in your study of business and accounting, you will be introduced to them more completely as we proceed through this text

book and as you undertake other courses in business and accounting. Observe, however, that the information system produces the information presented in the middle of the diagram— financial position, profitability, and cash flows. This information meets the needs of users of the information—investors, creditors, managers, and so on—and supports many kinds of financial decisions—performance evaluation and resource allocation, among others. These relationships are consistent with what we have already learned—namely, that accounting information is intended to be useful for decision-making purposes.

Exhibit 1–2

Financial Information

Information Users Decisions Supported Provided

ACCOUNTING AS AN INFORMATION SYSTEM

Investors • Creditors • Managers
• Owners • Customers •
Employees • Regulators

• Performance evaluations
• Stock investments
• Tax strategies • Labor relations • Resource allocations • Lending
• decisions
• Borrowing

DETERMINING INFORMATION NEEDS

The types of accounting information that a company develops vary with such factors as the size of the organization, whether it is publicly owned, and the information needs of man agement. The need for some types of accounting information may be prescribed by law. For example, income tax regulations require every business to have an accounting system that can measure the company's taxable income and explain the nature and source of every item in the company's income tax return. Federal securities laws require publicly owned companies to prepare financial statements in conformity with generally accepted accounting principles. These statements must be filed with the Securities and Exchange Commission, distributed to stockholders, and made available to the public.

Other types of accounting information are required as matters of practical necessity. For example, every business needs to know the amounts owed to it by each customer and the amounts owed by the company to each creditor. Although much accounting information clearly is essential to business operations, management still has many choices as to the types and amount of accounting information to be developed. For example, should the accounting system of a department store measure separately the sales of each department and of differ ent types of merchandise? The answer to such questions depends on *how useful* management considers the information to be and the *cost* of developing the information.

THE COST OF PRODUCING ACCOUNTING INFORMATION

Accounting systems must be *cost-effective*— that is, the value of the information produced should exceed the cost of producing it. Management has no choice but to produce the types of accounting reports required by law or contract. In other cases, however, management may use *cost-effectiveness* as a criterion for deciding whether or not to produce certain information.

In recent years, the development and installation of computer-based information systems have increased greatly the types and amount of accounting information that can be produced in a cost-effective manner.

BASIC FUNCTIONS OF AN ACCOUNTING SYSTEM

In developing information about the activities of a business, every accounting system per forms the following basic functions:

1. *Interpret and record* the effects of business transactions.
2. *Classify* the effects of similar transactions in a manner that permits determination of the various *totals* and *subtotals* useful to management and used in accounting reports.

3. *Summarize and communicate* the information contained in the system to decision makers.

The differences in accounting systems arise primarily in the manner, frequency, and speed with which these functions are performed.

In our illustrations, we often assume the use of a simple manual accounting system. Such a system is useful in illustrating basic accounting concepts, but it is too slow and cumber some to meet the needs of most business organizations. In a large business, transactions may occur at a rate of several hundred or several thousand per hour. To keep pace with such a rapid flow of information, these companies must use accounting systems that are largely computer based. The underlying principles within these systems are generally consistent with the basic manual system we frequently refer to in this text. Understanding manual systems allows users to understand the needs that must be met in a computerized system.

WHO DESIGNS AND INSTALLS ACCOUNTING SYSTEMS?

The design and installation of large accounting systems is a specialized field. It involves not just accounting, but expertise in management, information systems, marketing, and—in many cases—computer programming. Thus accounting systems generally are designed and installed by a team of people with many specialized talents.

Large businesses have a staff of systems analysts, internal auditors, and other professionals who work full-time in designing and improving the accounting system. Medium-size compa nies often hire a CPA firm to design or update their systems. Small businesses with limited resources often purchase one of the many packaged accounting systems designed for small companies in their line of business. These packaged systems are available through office sup ply stores, computer stores, and software manufacturers.

COMPONENTS OF INTERNAL CONTROL [1]

In developing its accounting system, an organization also needs to be concerned with devel oping a sound system of internal control. **Internal control** is a process designed to provide reasonable assurance that the organization produces reliable financial reports, complies with applicable laws and regulations, and conducts its operations in an efficient and effective man ner. A company's board of directors, its management, and other personnel are charged with developing and monitoring internal control. The five components of internal control, as dis cussed in *Internal Control–Integrated Framework* (Committee of Sponsoring Organizations of the Treadway Commission), are the *control environment, risk assessment, control activi ties, information and communication,* and *monitoring.*

An organization's **control environment** is the foundation for all the other elements of internal control, setting the overall tone for the organization. Factors that affect a company's control environment are: (1) the integrity, ethical values, and competence of the company's personnel, (2) management's philosophy and operating style, (3) management's assignment of authority and responsibility, (4) procedures for the hiring and training of personnel, and (5) oversight by the board of directors. The control environment is particularly important because fraudulent financial reporting often results from an ineffective control environment.

Risk assessment involves identifying, analyzing, and managing those risks that pose a threat to the achievement of the organization's objectives. For example, a company should assess the risks that might prevent it from preparing reliable financial reports and then take steps to minimize those risks. The situation described in the chapter opener involving Bear

Stearns provides an example of where that firm's risk assessment procedures failed.

Control activities are the policies and procedures that management puts in place to address the risks identified during the risk assessment process. Examples of control activities include approvals, authorizations, verifications, reconciliations, reviews of operating performance, physical safeguarding of assets, and segregation of duties.

Information and communication involves developing information systems to capture and communicate operational, financial, and compliance-related information necessary to run

[1] The information in this section is taken from *Internal Control–Integrated Framework,* Committee of Sponsoring Organizations of the Treadway Commission, September 1992.

the business. Effective information systems capture both internal and external information. In addition, an effective control system is designed to facilitate the flow of information downstream (from management to employees), upstream (from employees to management), and across the organization. Employees must receive the message that top management views internal control as important, and they must understand their role in the internal control system and the roles of others.

All internal control systems need to be monitored. **Monitoring** enables the company to evaluate the effectiveness of its system of internal control over time. Monitoring is generally accomplished through ongoing management and supervisory activities, as well as by periodic separate evaluations of the internal control system. Most large organizations have an internal audit function, and the activities of internal audit represent separate evaluations of internal control.

As a result of the large financial frauds at **Enron** and **WorldCom**, the U.S. Congress passed, and President George W. Bush signed, the **Sarbanes-Oxley Act** (SOX) of 2002. SOX has been described as the most far-reaching securities law since the 1930s. One of the SOX requirements is that public companies issue a yearly report indicating whether they have an effective system of internal control over financial reporting. In essence, management must indicate whether the entity's internal control system provides reasonable assurance that financial statements will be prepared in accordance with laws and regulations governing financial reporting. In addition, the company's external auditor must issue its own report as to whether the auditor believes that the company's internal control system is effective. These requirements are contained in Section 404 of SOX; therefore, many businesspeople describe the above process as the 404 certification and the audit under Section 404. This certification process has been extremely expensive and time-consuming, and some businesspeople believe that the costs associated with this certification requirement exceed the benefits.

Financial Accounting Information

Learning Objective **Explain the importance of financial accounting information for external parties—primarily investors and creditors—in terms of the objectives and the characteristics of that information.**

Financial accounting is an important subject for students who need only an introduction to the field of accounting, as well as for students who will pursue accounting as a major and take many additional accounting courses. Financial accounting provides information about the financial resources, obligations, and activities of an enterprise that is intended for use primarily by external decision makers—investors and creditors.

EXTERNAL USERS OF ACCOUNTING INFORMATION

What do we mean by *external users* and who are they? **External users** of accounting information are individuals and other enterprises that have a current or potential financial interest in the reporting enterprise, but that are not involved in the day-to-day operations of that enterprise. External users of financial information may include the following:

- Owners • Suppliers
- Creditors • Customers
- Potential investors • Trade associations
- Labor unions • General public
- Governmental agencies

Each of these groups of external decision makers requires unique information to be able to make decisions about the reporting enterprise. For example, customers who purchase from the enterprise need information to allow them to assess the quality of the products they buy and the faithfulness of the enterprise in fulfilling warranty obligations. Governmental agencies such as the Federal Trade Commission may have an interest in whether the enterprise meets certain governmental regulations that apply. The general public may be interested in the extent to which the reporting enterprise is socially responsible (for example, does not pollute the environment).

Providing information that meets the needs of such a large set of diverse users is difficult, if not impossible, in a single set of financial information. Therefore, external financial reporting is primarily used by two groups—investors and creditors. As you will soon see, investors

LO3

are individuals and other enterprises that own the reporting enterprise. Creditors, on the other hand, are individuals and other enterprises to whom the reporting entity owes money, goods, or services. For example, a commercial bank may have loaned money to the reporting enterprise, or a supplier may have permitted the reporting enterprise to purchase goods and to pay for those goods later. Our assumption is that by meeting the financial information needs of investors and creditors, we provide information that is also useful to many other users of financial information.

For these reasons, we sometimes refer to investors and creditors as the primary external financial information users. When you see references like these, keep in mind that we are talking about both current investors and creditors and those individuals and other enterprises that may become investors and creditors in the future.

OBJECTIVES OF EXTERNAL FINANCIAL REPORTING

If you had invested in a company, or if you had loaned money to a company, what would be your primary financial interest in the company? You probably would be interested in two things, both of which make up the company's **cash flow prospects.** You would be interested in the return to you at some future date of the amount you had invested or loaned. We refer to this as the **return *of* your investment.** In addition, you would expect the company to pay you something for the use of your funds, either as an owner or a creditor. We refer to this as the **return *on* your investment.** Information that is useful to you in making judgments about the company's ability to provide you with what you expect in terms of the return *of* your funds as well as a return *on* your funds while you do not have use of them is what we mean by information about *cash flow prospects.*

Assume that you have a friend who wants to start a business and needs some help getting the money required to rent space and acquire the needed assets to operate the business (for

You as a Creditor

You are a loan officer at a bank that makes small loans to individuals to help finance purchases such as automobiles and appliances. You are considering an application from a young woman who needs to purchase a new car. She is requesting a loan of $10,000 which, when combined with the trade-in value of her old car, will allow her to meet her needs. What are your expectations with regard to repayment of the loan, and what information would help you decide whether she is a good credit risk for your bank?

(See our comments on the Online Learning Center Web site.)

example, delivery truck, display fixtures) and pay employees for their work before the doors open and customers begin paying for the products the company plans to sell. You are in a financially strong position and agree to loan your friend $100,000. Your intent is not to be a long-term investor or co-owner of the business, but rather to help your friend start his company and at the same time earn a return on the funds you have loaned him. Assume further that you agree to let your friend have the use of your $100,000 for one year and, if you had not loaned this amount to him, you could have earned an 8 percent return by placing your money in another investment.

In addition to wanting to help a friend, you are interested in knowing how much risk you are taking with regard to your $100,000. You expect your friend to pay that $100,000 back, and to also pay you an additional amount of $8,000 ($100,000 8%) for his use of your money. The total return of your investment ($100,000) back to you one year later, added to the amount you expect to receive for his having used your money for a year ($8,000), is shown in Exhibit 1–3 .

Providing information for you to assess your friend's ability to meet his cash flow commit ment to you is essentially what financial reporting is about. You need information to assess the risk you are taking and the prospects that your friend will be able to deliver $108,000 to you one year from the time you loan him the $100,000. While this is a relatively simple example,

Exhibit 1–3

INVESTMENT ANALYSIS

Cash flow from your original investment

$100,000

Cash flow from a return for allowing another's use of your funds ($100,000 3 8%)

$8,000

Total cash flow expected to be received in one year

$108,000

it sets the stage for your understanding of the kinds of information that will help you make this important investment decision.

The accounting profession has identified certain objectives of external financial reporting to guide its efforts to refine and improve the reporting of information to external decision makers. These general objectives are displayed in Exhibit 1–4 and are best understood if stud ied from the bottom up—from general to specific. [2]

The first objective is the most general and is to provide information that is useful in making investment and credit decisions. As we indicated earlier, investors and creditors are the pri mary focus of external financial reporting. We believe that, by meeting the information needs of investors and creditors, we provide general information that is also useful to many other important financial statement users.

The second objective, which is more specific than the first, is to provide information that is useful in assessing the amount, timing, and uncertainty of future cash flows. As we discussed earlier, investors and creditors are interested in future cash flows to them, so an important objective of financial reporting is to provide general information that permits that kind of analysis.

The most specific objective of external financial reporting is to provide information about esources, and how both the resources and claims to resources change over time. An enterprise's resources are often referred to as *assets,* and the primary claims to those resources are the claims of creditors and owners, known as liabilities and owners equity.

One of the primary ways investors and creditors assess whether an enterprise will be able to make future cash payments is to examine and analyze the enterprise's financial statements.

[2] FASB *Statement of Financial Accounting Concepts No. 1,* "Objectives of Financial Reporting by Business Enterprises" (Norwalk, Conn.: 1978), p. 4.

Exhibit 1–4

OBJECTIVES OF FINANCIAL REPORTING: BUILDING FROM THE GENERAL TO THE SPECIFIC

Provide specific information about economic resources, claims to resources, and changes in resources and claims.

Provide information useful in assessing the amount, timing, and uncertainty of future cash flows.

Provide general information useful in making investment and credit decisions.

In the general sense of the word, a statement is simply a declaration of something believed to be true. A **financial statement,** therefore, is simply a monetary declaration of what is believed to be true about an enterprise. When accountants prepare financial statements, they are describing in financial terms certain attributes of the enterprise that they believe fairly represent its financial activities.

Financial statements prepared for periods of time shorter than one year (for example, for three months or one month) are referred to as *interim financial statements.* Throughout this text, we use both annual and interim financial statements. As you approach a company's finan cial statements—either as a user or as a preparer—it is important to establish the time period those statements are intended to cover.

The primary financial statements are the following:

- *Statement of financial position (balance sheet).* The **balance sheet** is a position statement that shows where the company stands in financial terms at a specific date.
- *Income statement.* The **income statement** is an activity statement that shows details and results of the company's profit-related activities for a period of time (for example, a month, quarter [three months], or year).
- *Statement of cash flows.* The **statement of cash flows** is an activity statement that shows the details of the company's activities involving cash during a period of time.

The names of the three primary financial statements are descriptive of the information you find in each. The **statement of financial position,** or balance sheet, for example, is sometimes described as a snapshot of the business in financial or dollar terms (that is, what the enterprise looks like at a specific date). An income statement is an activity statement that depicts the profitability of an enterprise for a designated period of time. The statement of cash flows is particularly important in understanding an enterprise for purposes of investment and credit decisions. As its name implies, the statement of cash flows depicts the ways cash has changed during a designated period. While the interest of investors and creditors is in cash flows to themselves rather than to the enterprise, information about cash activity of the enterprise is considered to be an important signal to investors and creditors.

At this early stage in your study of accounting, you are not expected to understand these financial statements or how they precisely help you assess the cash flow prospects of a com pany. The statement of financial position (balance sheet), income statement, and statement of cash flows are introduced more fully to you in the next chapter. Thereafter, you will learn a great deal about how these statements are prepared and how the information contained in them can be used to help you understand the underlying business activities they represent.

CHARACTERISTICS OF EXTERNALLY REPORTED INFORMATION

Financial information that is reported to investors, creditors, and others external to the report ing enterprise has certain qualities that must be understood for the information to have maxi mum usefulness. Some of these qualities are discussed in the following paragraphs.

Financial Reporting—A Means As we learned in the introduction to this chapter, financial information is a means to an end, not an end in and of itself. The ultimate out come of providing financial information is to improve the quality of decision making by external parties. Financial statements themselves are simply a means by which that end is achieved.

Financial Reporting versus Financial Statements Financial reporting is broader than financial statements. Stated another way, financial statements are a subset of the total information encompassed by financial reporting. Investors, creditors, and other external users of financial information learn about an enterprise in a variety of ways in addition to its formal financial statements (for example, press releases sent directly to investors and creditors, articles in *The Wall Street Journal,* and more recently, open communications via the Internet). Serious investors, creditors, and other external users take advantage of many sources of infor mation that are available to support their economic decisions about an enterprise.

Historical in Nature Externally reported financial information is generally histori cal in nature. It looks back in time and reports the results of events and transactions that already have occurred. While historical information is very useful in assessing the future, the information itself is more about the past than it is about the future. However, in recent years, accounting standard setters are requiring greater use of fair values, rather than historical costs, in measuring assets and liabilities.

Inexact and Approximate Measures Externally reported financial information may have a look of great precision, but in fact much of it is based on estimates, judgments, and assumptions that must be made about both the past and the future. For example, assume a company purchases a piece of equipment for use in its business. To account for that asset and to incorporate the impact of it into the company's externally reported financial informa tion, some assumptions must be made about how long it will be used by the company—how many years it will be used, how many machine-hours it will provide, and so on. The fact that a great deal of judgment underlies most accounting information is a limitation that is sometimes misunderstood.

General-Purpose Assumption As we have already mentioned, we assume that, by providing information that meets the needs of investors and creditors, we also meet the infor mation needs of other external parties. We might be able to provide superior information if we were to treat each potential group of external users separately and prepare different informa tion for each group. This approach is impractical, however, and we instead opt for preparing what is referred to as **general-purpose information** that we believe is useful to multiple user groups (that is, "one size fits all").

Usefulness Enhanced via Explanation The accounting profession believes that the value of externally reported financial information is enhanced by including explanations from management. This information is often nonquantitative and helps to interpret the finan cial numbers that are presented. For this reason, financial information, including financial statements, is accompanied by a number of notes and other explanations that help explain and interpret the numerical information.

Management Accounting Information

Learning Objective LO4

Explain the importance of accounting information for internal parties— primarily management— in terms of the objectives and the characteristics of that information.

Internal decision makers employed by the enterprise, often referred to as management, create and use internal accounting information not only for exclusive use inside the organization but also to share with external decision makers. For example, in order to meet a production sched ule, a producer may design an accounting information system for suppliers detailing its produc tion plans. The producer shares this information with its supplier companies so that they can help the producer meet its objectives. Thus, although the creator and distributor of the account ing information is an internal decision maker, the recipient of the information is, in this case, an external decision maker. Other types of accounting information, however, are not made availa ble to external decision makers. Long-range plans, research and development results, capital budget details, and competitive strategies typically are closely guarded corporate secrets.

USERS OF INTERNAL ACCOUNTING INFORMATION

Every employee of the enterprise uses internal accounting information. From basic labor cat egories to the chief executive officer (CEO), all employees are paid, and their paychecks are generated by the accounting information system. However, the amount of use and, in par ticular, the involvement in the design of accounting information systems vary considerably. Examples of **internal users** of accounting information systems are as follows:

- Board of directors
- Chief executive officer (CEO)
- Chief financial officer (CFO)
- Vice-presidents (information services, human resources, ethics, and so forth)
- Business unit managers
- Plant managers
- Store managers
- Line supervisors

Employees have different specific goals and objectives that are designed to help the enter prise achieve its overall strategies and mission. Looking at the typical, simple organization chart in Exhibit 1–5, you can see that the information created and used by various employees

Exhibit 1–5 TYPICAL SIMPLE ORGANIZATION CHART

will differ widely. All enterprises follow rules about the design of their accounting informa tion systems to ensure the integrity of accounting information and to protect the enterprise's assets. There are no rules, however, about the type of internal reports or the kind of account ing information that can be generated. A snapshot look inside a firm will demonstrate the diversity of accounting information generated and used in the decision-making processes of employees.

Many enterprises use a database warehousing approach for the creation of accounting information systems. This approach, coupled with user-friendly software, allows manage ment and other designated employees access to information to create a variety of accounting reports, including required external financial reports. For example, detailed cost information about a production process is used by the production line supervisor to help control produc tion costs. A process design engineer, when considering the best configuration of equipment and employees, uses the same information to reduce costs or to increase efficiency. Finally, production-related cost information appears in the external financial statements used by inves tors and creditors.

OBJECTIVES OF MANAGEMENT ACCOUNTING INFORMATION

Each enterprise has implicit and explicit goals and objectives. Many enterprises have a mission statement that describes their goals. These goals can vary widely among enterprises ranging from nonprofit organizations, where goals are aimed at serving specified constituents, to for profit organizations, where goals are directed toward maximizing the owners' objectives. For example, the **American Cancer Society**, a nonprofit organization, has the following mission:

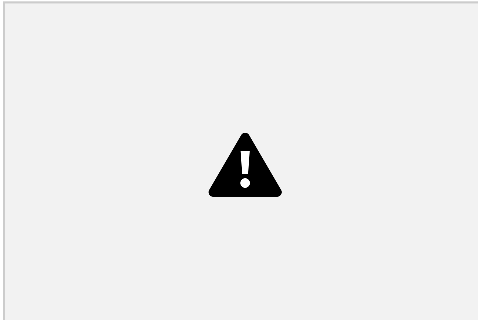
> The American Cancer Society is the nationwide community-based voluntary health organization dedicated to eliminating cancer as a major health problem by preventing cancer, saving lives, and diminishing suffering from cancer, through research, education, advocacy, and service.[3]

Procter & Gamble, a for-profit, global producer of consumer products, has the following purpose:

> We will provide branded products and services of superior quality and value that improve the lives of the world's consumers, now and for generations to come.[4]

Procter & Gamble's annual report to shareholders provides more detail on how the company will achieve its mission. Procter & Gamble's design for growth was explained in P&G's annual letter to its shareholders and includes:

- Clear strategies.
- The core strengths required to win in our industry.
- Rigorous cash and cost discipline.
- The most diverse and experienced management team in P&G history.[5]



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The constituents of these organizations receive external financial information that helps them assess the progress being made in achieving these goals and objectives. In the case of Procter & Gamble, quarterly and annual information is provided to shareholders. The American Cancer Society is required to report its activities and financial condition to regulators. Providing constituents evaluative information is only one objective of accounting systems.

Enterprises design and use their internal accounting information systems to help them achieve their stated goals and missions. Multiple reports, some as part of the normal reporting process and some that are specially constructed and designed, are produced and distributed regularly. To motivate managers to achieve organizational goals, the internal accounting system is also used to evaluate and reward decision-making performance. When the accounting system compares the plan or budget to the actual outcomes for a period, it creates a signal about the performance of the employee responsible for that part of the budget. In many enterprises management creates a reward system linked to performance as measured by the accounting system.

Thus the objectives of accounting systems begin at the most general level with the objectives and mission of the enterprise. These general organizational goals create a need for information. The enterprise gathers historical and future information from both inside the enterprise and external sources. This information is used by the decision makers who have authority over the firm's resources and who will be evaluated and rewarded based on their decision outcomes.

CHARACTERISTICS OF MANAGEMENT ACCOUNTING INFORMATION

The accounting information created and used by management is intended primarily for planning and control decisions. Because the goal of creating and using management accounting information differs from the reasons for producing externally reported financial information, its characteristics are different.

Both the processes used to create financial accounting reports and the structure of those reports significantly impact management strategy. For example, because external financial reporting standards require companies to include pension-related obligations on their financial statements, management monitors those obligations closely. These pension-related obligations impact labor negotiations and labor-related corporate strategies.

Another example is that the processes necessary to create required external financial reports have historically determined the type of accounting information available inside of companies for internal decision making. Most plants within companies are organized as profit centers where plant-related financial statements mirror those necessary for external reporting purposes.

[3] www.cancer.org

[4] www.pg.com

[5] Procter & Gamble, 2009 Annual Report, Letter to Shareholders.

As you read the chapters of this book, we will remind you about how financial reporting has an impact on and is impacted by management strategies. The following paragraphs iden tify internal accounting information characteristics.

Importance of Timeliness In order to plan for and control ongoing business pro cesses, accounting information needs to be timely. The competitive environment faced by many enterprises demands immediate access to information. Enterprises are responding to this demand by creating computerized databases that link to external forecasts of industry associations, to their suppliers and buyers, and to their constituents. Time lines for the devel opment and launch of new products and services are becoming shorter and shorter, making quick access to information a priority.

In addition to needing timely information for planning purposes, enterprises are constantly monitoring and controlling ongoing activities. If a process or activity goes out of control, the enterprise can incur significant costs. For example, recalls of products can be very expensive for a company. If the company can monitor processes and prevent low-quality or defective products from reaching its customers, it can experience significant savings.

Identity of Decision Maker Information that is produced to monitor and control processes needs to be provided to those who have decision-making authority to correct prob lems. Reporting scrap and rework information to line workers without providing them the responsibility for fixing the process is counterproductive. However, a self-directed work team that has been assigned decision-making responsibility over equipment and work-related activ ities can have a significant impact on rework and scrap if team members control the process causing the problems.

Oriented toward the Future Although some accounting information, like finan cial accounting information, is historical in nature, the purpose in creating and generating it is to affect the future. The objective is to motivate management to make future decisions that are in the best interest of the enterprise, consistent with its goals, objectives, and mission.

Measures of Efficiency and Effectiveness Accounting information measures the efficiency and effectiveness of resource usage. By comparing the enterprise's resource inputs and outputs with measures of competitors' effectiveness and efficiency, an assessment can be made of how effective management is in achieving the organization's mission. The accounting system uses money as a common unit to achieve these types of comparisons.

Management Accounting Information—A Means As with financial account ing information, management accounting information is a means to an end, not an end in and of itself. The ultimate objective is to design and use an accounting system that helps manage ment achieve the goals and objectives of the enterprise.

Integrity of Accounting Information

What enables investors and creditors to rely on financial accounting information without fear that the management of the reporting enterprise has altered the information to make the company's performance look better than it actually was? How can management be sure that internally generated information is free from bias that might favor one outcome over another? The word **integrity** refers to the following qualities: complete, unbroken, unimpaired, sound, honest, and sincere. Accounting information must have these qualities because of the sig nificance of the information to individuals who rely on it in making important financial decisions.

Learning Objective

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Discuss elements of the

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The integrity of accounting information is enhanced in three primary ways. First, certain institutional features add significantly to the integrity of accounting information. These

LO5

system of external and internal financial reporting in

that create integrity in the th reported information.

features include standards for the preparation of accounting information, an internal control structure, and audits of financial statements. Second, several professional accounting organizations play unique roles in adding to the integrity of accounting information. Finally, and perhaps most important, is the personal competence, judgment, and ethical behavior of

professional accountants. These three elements of the accounting profession come together to ensure that users of accounting information—investors, creditors, managers, and others—can rely on the information to be a fair representation of what it purports to represent.

INSTITUTIONAL FEATURES

Standards for the Preparation of Accounting Information Accounting information that is communicated externally to investors, creditors, and other users must be prepared in accordance with standards that are understood by both the preparers and users of that information. We call these standards **generally accepted accounting principles,** often shortened to GAAP. These principles provide the general framework for determining what information is included in financial statements and how this information is to be prepared and presented. GAAP includes broad principles of measurement and presentation, as well as detailed rules that are used by professional accountants in preparing accounting information and reports.

Accounting principles are not like physical laws; they do not exist in nature waiting to be discovered. Rather, they are developed by people, in light of what we consider to be the most important objectives of financial reporting. In many ways, accounting principles are similar to the rules established for an organized sport, such as baseball or basketball. For example, accounting principles, like sports rules:

- Originate from a combination of tradition, experience, and official decree.
- Require authoritative support and some means of enforcement.
- Are sometimes arbitrary.
- May change over time as shortcomings in the existing rules come to light.
- Must be clearly understood and observed by all participants in the process.

Accounting principles vary somewhat from country to country. The phrase "generally accepted accounting principles (GAAP)" refers to the accounting concepts in use in the United States. The International Accounting Standards Board (IASB) is currently attempting to establish greater uniformity among the accounting principles in use around the world in order to facilitate business activity that increasingly is carried out in more than one country.

In the United States, three organizations are particularly important in establishing account ing principles—the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), and the International Accounting Standards Board (IASB).

Securities and Exchange Commission The **Securities and Exchange Commis sion** is a governmental agency with the *legal power* to establish accounting principles and financial reporting requirements for publicly owned corporations. In the past, the SEC has generally adopted the recommendations of the FASB (discussed below), rather than develop its own set of accounting principles. Thus, accounting principles continue to be developed in the private sector but are given the *force of law* when they are adopted by the SEC.

To ensure widespread acceptance of new accounting standards, the FASB *needs the sup port* of the SEC. Therefore, the two organizations work closely together in developing new accounting standards. The SEC also reviews the financial statements of publicly owned cor porations to ensure compliance with its reporting requirements. In the event that a publicly owned corporation fails to comply with these requirements, the SEC may initiate legal action against the company and the responsible individuals. Thus the SEC enforces compliance with generally accepted accounting principles that are established primarily by the FASB.

Financial Accounting Standards Board Today, the most authoritative source of generally accepted accounting principles is the **Financial Accounting Standards Board.** The FASB is an independent rule-making body, consisting of seven members from the accounting profession, industry, financial statement users, and accounting education. Lending support to these members are an advisory council and a large research staff.

The FASB has compiled all of its standards, and those of its predecessors, in an Accounting Standards Codification. The FASB periodically issues updates to its codification. The codifi cation represents official expressions of generally accepted accounting principles.

In addition to maintaining the Accounting Standards Codification, the FASB has com pleted a project describing a *conceptual framework* for financial reporting. This conceptual framework sets forth the FASB's views as to the:

- Objectives of financial reporting.
- Desired characteristics of accounting information (such as relevance, reliability, and understandability).
- Elements of financial statements.
- Criteria for deciding what information to include in financial statements.
- Valuation concepts relating to financial statement amounts.

The primary purpose of the conceptual framework is to provide guidance to the FASB in developing new accounting standards, which are issued as updates to the codification. By mak ing each new standard consistent with this framework, the FASB believes that the Accounting Standards Codification resolves accounting problems in a logical and consistent manner.

The FASB is part of the private sector of the economy— *it is not a governmental agency.* The development of accounting principles in the United States traditionally has been carried out in the private sector, although the government, acting through the SEC, exercises consid erable influence.

International Accounting Standards Board When an enterprise operates beyond the borders of its own country, differences in financial reporting practices between countries can pose significant problems. For example, when a company buys or sells products in another country, the lack of comparability of accounting information can create uncertain ties. Similarly, cross-border financing, where companies sell their securities in the capital markets of another country, is increasingly popular. Business activities that cross borders cre ate the need for more comparable information between companies that reside in different countries.

As a result of increasing cross-border activities, efforts are under way to harmonize accounting standards around the world. The **International Accounting Standards Board (IASB)** is playing a leading role in the harmonization process. The London-based IASB is an elite panel of professionals with deep knowledge of accounting methods used in the most vibrant capital markets.

The IASB issues *International Financial Reporting Standards (IFRSs).* The European Union requires listed companies in its member states to follow IASB standards. In addition, many other countries either require the use of IASB standards or have plans to require their use in the future, including Australia and Canada. Most important, the SEC accepts financial statements prepared using IASB standards from foreign companies that are cross-listed on a U.S. stock exchange, and is considering allowing U.S. companies to prepare their financial statements using either U.S. GAAP (based on FASB standards) or IASB standards. In addi tion, the AICPA, which essentially has jurisdiction over private company reporting, accepts either FASB standards or IASB standards as authoritative sources of accounting principles.

In early 2010, the SEC issued a Statement in Support of Convergence and Global Account ing Standards. This SEC statement reaffirms the SEC's belief that a single set of high-quality, global accounting standards is in the best interests of investors, and also reaffirms the SEC's belief that IFRS as issued by the IASB is the set of standards best positioned to fill this role. However, the SEC indicates that there remain obstacles to the adoption of IFRS in the United States and until these obstacles are addressed the SEC is reserving its judgment as to whether to require U.S. public companies to prepare their financial statements using IFRS. If the SEC decides to require U.S. public companies to use IFRS, this would be a major development because IASB standards are less detailed and prescriptive than existing FASB standards. The SEC has indicated that if IFRS were to be required in the United States any such change would not occur before 2015.

A movement to IFRS is likely to require significant changes to accounting systems, con
trols, and procedures. For example, IFRS requires that an entity account for similar trans
actions in an identical manner regardless of where the transaction occurs in the entity, a
requirement that does not exist under U.S. GAAP. Therefore, if IFRS becomes mandatory
for U.S. public companies, companies would have to inventory all of their transactions and how they are accounted for throughout the entity.

Public Company Accounting Oversight Board The **Public Company Accounting Oversight Board (PCAOB)** is a quasi-governmental body charged with over sight of the public accounting profession. The Board was created as a result of the Sarbanes Oxley Act of 2002 and began operations in the spring of 2003.

The PCAOB has extensive powers in overseeing the accounting profession. Any account ing firm wishing to audit a public company must register with the PCAOB. The PCAOB sets auditing standards for audits of publicly traded companies, an activity that previously was performed by the accounting profession. The Board also inspects the quality of audits performed by public accounting firms and conducts investigations and administers penalties when substandard audit work is alleged.

The PCAOB is headquartered in Washington, D.C., and has regional offices in major cit ies throughout the United States. The PCAOB has five members who serve a five-year term and are eligible to be reappointed once. No more than two members of the Board can be certified public accountants. The Board also maintains a large and well-qualified staff. The PCAOB is funded by a mandatory assessment on publicly traded companies. The assessment is a function of the company's market value relative to overall stock market value in the United States.

Audits of Financial Statements What assurance do outsiders have that the finan cial statements issued by management provide a complete and reliable picture of the com pany's financial position and operating results? In large part, this assurance is provided by an *audit* of the company's financial statements, performed by a firm of *certified public accoun tants (CPAs).* These auditors are experts in the field of financial reporting and are *independent* of the company issuing the financial statements.

An **audit** is an *investigation* of a company's financial statements, designed to determine the fairness of these statements. Accountants and auditors use the term *fair* in describing financial statements that are reliable and complete, conform to generally accepted accounting princi ples, and are *not misleading.*

In the auditing of financial statements, generally accepted accounting principles are the standard by which those statements are judged. For the auditor to reach the conclusion that the financial statements are fair representations of a company's financial position, results of operations, and cash flows, the statements must comply in all important ways with generally accepted accounting principles.

Legislation As discussed previously, Congress passed the Sarbanes-Oxley Act in 2002. Among the more important provisions of Sarbanes-Oxley is the creation of the Public Com pany Accounting Oversight Board described earlier in this chapter. Another important provi sion of the Act is to ban auditors from providing many nonaudit services for their audit clients on the assumption that those services interfere with the objectivity required of auditors in rendering opinions regarding financial statements upon which investors and creditors rely. Sarbanes-Oxley also places additional responsibilities on corporate boards of directors and audit committees with regard to their oversight of external auditors, and it places responsibil ity on chief executive officers and chief financial officers of companies to certify the fairness of the company's financial statements.

PROFESSIONAL ORGANIZATIONS

Learning Objective

LO6

Identify and discuss several professional organizations that play important roles in preparing and communicating accounting information.

Several professional accounting organizations play an active role in improving the quality of accounting information that is used by investors, creditors, management, and others. In addition to the Securities and Exchange Commission, Financial Accounting Standards Board, and International Accounting Standards Board discussed earlier, the American Institute of CPAs, the Institute of Management Accountants, the Institute of Internal Auditors, the American Accounting Association, and the Committee of Sponsoring Organizations of the Treadway Commission are particularly important.

American Institute of CPAs (AICPA) The **American Institute of CPAs** is a professional association of certified public accountants. Its mission is to provide members with the resources, information, and leadership to enable them to provide valuable services in the highest professional manner to benefit the public, employers, and clients. The AICPA participates in many aspects of the accounting profession. The AICPA conducts accounting research and works closely with the FASB in the establishment and interpretation of generally accepted accounting principles. In fact, prior to the establishment of the FASB, the AICPA had primary responsibility for the establishment of accounting principles. The AICPA's Auditing Standards Board has developed the standards by which audits of private companies are conducted, and the PCAOB has accepted many of these standards for audits of public companies. The AICPA also issues standards for the conduct of other professional services. Finally, the AICPA is responsible for the preparation and grading of the CPA examination, which is discussed later in this chapter.

Institute of Management Accountants (IMA) The mission of the **Institute of Management Accountants** is to provide members personal and professional development opportunities through education, association with business professionals, and certification. The IMA is recognized by the financial community as a respected organization that influences the concepts and ethical practice of management accounting and financial management. The IMA sponsors a number of educational activities for its members, including national seminars and conferences, regional and local programs, self-study courses, and in-house and online programs. The IMA offers a certification program—the Certified Management Accountant (CMA). This designation testifies to the individual's competence and expertise in management accounting and financial management.

Institute of Internal Auditors (IIA) With more than 170,000 members in over 100 countries, the **Institute of Internal Auditors** is the primary international professional association dedicated to the promotion and development of the practice of internal auditing. It provides professional development through the Certified Internal Auditor® Program and leading edge conferences and seminars; research through the IIA Research Foundation on trends, best practices, and other internal auditing issues; guidance through the *Standards for the Professional Practice of Internal Auditing;* and educational products on virtually all aspects of the profession. The IIA also provides audit specialty services and industry-specific auditing programs, as well as quality assurance reviews and benchmarking services.

American Accounting Association (AAA) Membership in the **American Accounting Association** is made up primarily of accounting educators, although many practicing accountants are members as well. The mission of the AAA includes advancing accounting education and research, as well as influencing accounting practice. The focus of many of the AAA's activities is on improving accounting education by better preparing accounting professors and on advancing knowledge in the accounting discipline through research and publication. An important contribution of the AAA to the integrity of accounting information is its impact through accounting faculty on the many students who study accounting in college and subsequently become professional accountants.

Committee of Sponsoring Organizations of the Treadway Commission (COSO) **COSO** is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, organizational governance, and enterprise risk management. COSO was originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting (chaired by former SEC

Commissioner James C. Treadway, Jr.). The National Commission on Fraudulent Financial Reporting studied the causal factors that lead to fraudulent financial reporting and made a series of recommendations for improving financial reporting, auditing, and accounting education. The original sponsors of the National Commission on Fraudulent Financial Reporting, and the current sponsors of COSO, are the AAA, the AICPA, Financial Executives International, the IIA, and the IMA.

COSO is best known for its work in developing the standards for evaluating internal control—particularly internal control over financial reporting. As a result of the Sarbanes-Oxley Act, public companies now need to evaluate the effectiveness of their internal control over financial reporting on a yearly basis, as well as have their auditors separately report on the auditors' evaluation of the effectiveness of internal control over financial reporting. The standard for evaluating the effectiveness of internal control over financial reporting is contained in COSO's 1992 publication, *Internal Control – Integrated Framework.* COSO has also issued a document, *Guidance for Smaller Public Companies Reporting on Internal Control over*

Financial Reporting, that seeks to provide implementation guidance to smaller businesses in applying the original COSO internal control framework.

COMPETENCE, JUDGMENT, AND ETHICAL BEHAVIOR

Learning Objective LO7 **Discuss the importance of personal competence, professional judgment, and ethical behavior on the part of accounting professionals.**

Preparing and presenting accounting information is not a mechanical task that can be per formed entirely by a computer or even by well-trained clerical personnel. A characteristic common to all recognized professions, including medicine, law, and accounting, is the need for competent individual practitioners to solve problems using their professional judgment and applying strong ethical standards. The problems encountered in the practice of a profes sion are often complex, and the specific circumstances unique. In many cases, the well-being of others is directly affected by the work of a professional.

To illustrate the importance of competence, professional judgment, and ethical behavior in the preparation of financial statements, consider the following complex issues that must be addressed by the accountant:

- At what point should an enterprise account for transactions that continue over a long period of time, such as a long-term contract to construct an interstate highway?
- What constitutes adequate disclosure of information that would be expected by a reasonably informed user of financial statements?
- At what point are a company's financial problems sufficient to question whether it will be able to remain in business for the foreseeable future, and when should that information be communicated to users of its financial statements?
- When have efforts by management to improve (that is, "window dress") its financial statements crossed a line that is inappropriate, making the financial statements actually misleading to investors and creditors?

Judgment always involves some risk of error. Some errors in judgment result from care lessness or inexperience on the part of the preparer of financial information or the decision maker who uses that information. Others occur simply because future events are uncertain and do not work out as expected when the information was prepared.

If the public is to have confidence in the judgment of professional accountants, these accountants first must demonstrate that they possess the characteristic of *competence.* Both the accounting profession and state governments have taken steps to assure the public of the technical competence of **certified public accountants** (CPAs). CPAs are licensed by the states, in much the same manner as states license physicians and attorneys. The licensing requirements vary somewhat from state to state, but in general, an individual must be of good character, have completed 150 semester hours of college work with a major in accounting, pass a rigorous examination, and have accounting experience. In addition, most states require all CPAs to spend at least 40 hours per year in continuing professional education throughout their careers.

Management accountants are not required to be licensed as CPAs. However, they voluntar ily may earn a **Certified Management Accountant** (CMA) or a **Certified Internal Auditor** (CIA) as evidence of their professional competence. These certifications are issued by the

IMA and the IIA, and signify competence in management accounting and internal auditing, respectively. The requirements for becoming a CMA and CIA are similar to those for becom ing a CPA.

Integrity in accounting requires honesty and a strong commitment to ethical conduct—doing the right thing. For a professional accountant, ethical behavior is just as important as competence. However, it is far more difficult to test or enforce.

Many professional organizations have codes of ethics or professional conduct that direct the activities of their members. The AICPA, for example, has a code of professional conduct that expresses the accounting profession's recognition of its responsibilities to the public, to clients, and to colleagues. The principles included in the code guide AICPA members in the performance of their professional responsibilities. This code expresses the basic tenets of ethi cal and professional behavior and is enforced in conjunction with state professional societies of CPAs, although state regulatory boards take precedence in regulating the CPA license.

Exhibit 1–6 contains excerpts from the AICPA code of professional conduct. One of the principles expressed in the AICPA's code of professional conduct is the commitment of CPAs

You as a Professional Accountant

on our goal of finishing our work by the end of the month."
What would you do?
(See our comments on the Online Learning Center Web site.)

to the public interest, shown in Article II. The public interest is defined as the collective well being of the community of people and institutions the profession serves. Other principles emphasize the importance of integrity, objectivity, independence, and due care in the perform ance of one's duties.

Expectations of ethical conduct are also important for other accountants. The IMA has a code of conduct for management accountants, as does the IIA for internal auditors. Users of accounting information—both external and internal—recognize that the reliabil ity of the information is affected by the competence, professional judgment, and ethical stand ards of accountants. While the institutional features and professional organizations that were discussed earlier are important parts of the financial reporting system, the personal attributes of competence, professional judgment, and ethical behavior ultimately ensure the quality and reliability of accounting information.

In this text, we address the topic of ethical conduct primarily through questions, exercises, problems, and cases that emphasize the general concepts of honesty, fairness, and adequate disclosure. Most chapters include assignment material in which you are asked to make judg ment calls in applying these concepts. (These assignments are identified by the scales of justice logo appearing in the margin.)

Careers in Accounting

Accounting—along with such fields as architecture, engineering, law, medicine, and theology— is recognized as a profession. What distinguishes a profession from other disciplines? There is no single recognized definition of a profession, but all of these fields have several charac teristics in common.

Learning Objective
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Describe various career opportunities in a accounting.

LO8

You are a professional accountant working for a public accounting firm and find yourself in a difficult situation. You have discovered some irregularities in the financial records of your firm's client. You are uncertain whether these irregularities are the result of careless ness on the part of the company's employees or represent intentional steps taken to cover up questionable activities. You approach your superior about this and she indicates that you should ignore it. Her response is, "These things happen all of the time and usually are pretty minor. We are on a very tight time schedule to complete this engagement, so let's just keep our eyes

Exhibit 1–6

EXCERPTS FROM THE AICPA CODE OF PROFESSIONAL CONDUCT

Preamble

These Principles of the Code of Professional Conduct of the American Institute of Certified Public Accountants express the profession's recognition of its responsibilities to the public, to clients, and to colleagues. They guide members in the performance of their professional responsibilities and express the basic tenets of ethical and professional conduct. The Principles call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage.

Articles

I. Responsibilities

In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.

II. The Public Interest

Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

III. Integrity

To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

IV. Objectivity and Independence

A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

V. Due Care

A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of service, and discharge professional responsibility to the best of the member's ability.

VI. Scope and Nature of Services

A member in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

First, all professions involve a complex and evolving body of knowledge. In account ing, the complexity and the ever-changing nature of the business world, financial reporting requirements, management's demands for increasingly complex information, and income tax laws certainly meet this criterion.

Second, in all professions, practitioners must use their professional judgment to resolve problems and dilemmas. Throughout this text, we will point out situations requiring account ants to exercise professional judgment.

Of greatest importance, however, is the unique responsibility of professionals *to serve the public's best interest, even at the sacrifice of personal advantage.* This responsibility stems from the fact that the public has little technical knowledge in the professions, yet fair and competent performance by professionals is vital to the public's health, safety, or well-being. The practice of medicine, for example, directly affects public health, while engineering affects public safety. Accounting affects the public's well-being in many ways, because accounting information is used in the allocation of economic resources throughout society. Thus, account ants have a basic social contract to avoid being associated with misleading information. Accountants tend to specialize in specific fields, as do the members of other professions. Career opportunities in accounting may be divided into four broad areas: (1) public account ing, (2) management accounting, (3) governmental accounting, and (4) accounting education.

PUBLIC ACCOUNTING

Certified public accountants offer a variety of accounting services to the public. These indi viduals may work in a CPA firm or as sole practitioners.

The work of public accountants consists primarily of auditing financial statements, income tax work, and management advisory services (management consulting). Management advisory services extend well beyond tax planning and accounting matters; CPAs advise management on such diverse issues as international mergers, manufacturing processes, and the introduction of new products. CPAs assist management because *financial considerations enter into almost every business decision.*

A great many CPAs move from public accounting into managerial positions with organiza tions. These "alumni" from public accounting often move directly into such top management positions as controller, treasurer, or chief financial officer.

The CPA Examination To become a CPA, a person must meet several criteria, includ ing an extensive university education requirement, passing the CPA examination, and meet ing a practice experience requirement. CPA certificates are granted by 55 legal jurisdictions (50 U.S. states, Guam, Puerto Rico, the Virgin Islands, Washington, D.C., and the Mariana Islands). The CPA examination is a rigorous examination that covers a variety of accounting and business subjects that allow candidates to demonstrate their knowledge and skills in areas believed important for protecting the public. The exam is computer based and is offered at many testing centers throughout the United States.

MANAGEMENT ACCOUNTING

In contrast to the public accountant who serves many clients, the management accountant works for one enterprise. Management accountants develop and interpret accounting informa tion designed specifically to meet the various needs of management.

The chief accounting officer of an organization usually is called the *chief accounting officer (CAO)* or *controller*. The term *controller* has been used to emphasize the fact that one basic purpose of accounting data is to aid in controlling business operations. The CAO or controller is part of the top management team, which is responsible for running the business, setting its objectives, and seeing that these objectives are met.

In addition to developing information to assist managers, management accountants are responsible for operating the company's accounting system, including the recording of trans actions and the preparation of financial statements, tax returns, and other accounting reports. Because the responsibilities of management accountants are so broad, many areas of speciali zation have developed. Among the more important are financial forecasting, cost accounting, and internal auditing.

GOVERNMENTAL ACCOUNTING

Governmental agencies use accounting information in allocating their resources and in con trolling their operations. Therefore, the need for management accountants in governmental agencies is similar to that in business organizations.

The GAO: Who Audits the Government? The **Government Accountability Office** (GAO) audits many agencies of the federal government, as well as some private orga nizations doing business with the government. The GAO reports its findings directly to Con gress, which, in turn, often discloses these findings to the public.

GAO investigations may be designed either to evaluate the efficiency of an entity's opera tions or to determine the fairness of accounting information reported to the government.

The IRS: Audits of Income Tax Returns Another governmental agency that per forms extensive auditing work is the **Internal Revenue Service** (IRS). The IRS handles the millions of income tax returns filed annually by individuals and business organizations and frequently performs auditing functions to verify data contained in these returns.

The SEC: The "Watchdog" of Financial Reporting The SEC works closely with the FASB in establishing generally accepted accounting principles. Most publicly owned corporations must file audited financial statements with the SEC each year. If the SEC believes that a company's financial statements are deficient in any way, it conducts an investigation. If the SEC concludes that federal securities laws have been violated, it initiates legal action against the reporting entity and responsible individuals.

Many other governmental agencies, including the FBI, the Treasury Department, and the FDIC (Federal Deposit Insurance Corporation), use accountants to audit compliance with governmental regulations and to investigate suspected criminal activity. People beginning their careers in governmental accounting often move into top administrative positions.

ACCOUNTING EDUCATION

Some accountants, including your instructor and the authors of this textbook, have chosen to pursue careers in accounting education. A position as an accounting faculty member offers opportunities for teaching, research, consulting, and an unusual degree of freedom in developing individual skills. Accounting educators contribute to the accounting profession in many ways. One, of course, lies in effective teaching; second, in publishing significant research findings; and third, in influencing top students to pursue careers in accounting.

WHAT ABOUT BOOKKEEPING?

Some people think that the work of professional accountants consists primarily of bookkeeping. Actually, it doesn't. In fact, many professional accountants do *little or no* bookkeeping.

Bookkeeping is the clerical side of accounting—the recording of routine transactions and day-to-day record keeping. Today such tasks are performed primarily by computers and skilled clerical personnel, not by accountants.

Professional accountants are involved more with the *interpretation and use* of accounting information than with its actual preparation. Their work includes evaluating the efficiency of operations, resolving complex financial reporting issues, forecasting the results of future operations, auditing, tax planning, and designing efficient accounting systems. There is very little that is "routine" about the work of a professional accountant.

A person might become a proficient bookkeeper in a few weeks or months. To become a professional accountant, however, is a far greater challenge because this requires more than understanding the bookkeeping systems. It requires years of study, experience, and an ongoing commitment to keeping current.

We will illustrate and explain a number of bookkeeping procedures in this text, particularly in the next several chapters. But teaching bookkeeping skills is *not* our goal; the primary purpose of this text is to develop your abilities to *understand and use* accounting information in today's business world.

ACCOUNTING AS A STEPPING-STONE

We have mentioned that many professional accountants leave their accounting careers for key positions in management or administration. An accounting background is invaluable in such positions, because top management works continuously with issues defined and described in accounting terms and concepts.

An especially useful stepping-stone is experience in public accounting. Public accountants have the unusual opportunity of getting an inside look at many different business organizations, which makes them particularly well suited for top management positions in other organizations.

BUT WHAT ABOUT ME? I'M NOT AN ACCOUNTING MAJOR

Most students who use this book are not accounting majors. However, the study of accounting is still important to you. You need to understand accounting concepts, both for your professional careers and for many aspects of your personal life. Finance students need to understand accounting concepts if they seek positions in investment banking, consulting, or in corporate America as a financial analyst. Approximately 50 percent of the chief financial officers of large U.S. corporations have a background in accounting. A management student seeking a career as a management trainee—with the ultimate goal of running a corporation or a corporate division—needs to understand accounting in order to be able to run, control, and evaluate the performance of a business unit. Accounting is the language of business, and trying to run a business without understanding accounting information is analogous to trying to play sports without understanding the rules. Marketing students often take positions in sales. It is imperative that marketing students understand the principles of revenue recognition, as well as the obligations of a public company under the U.S. securities laws. A lack of this understanding has led many a marketing/sales executive to become involved in improper revenue recognition schemes. Many of these executives have been subject to civil and criminal prosecution.

financial reporting that include corporations that have now become household names—**Enron**, **WorldCom**, **HealthSouth**, **Adelphia Communications**, **Tyco**, and **Qwest**, among others. These problems are not exclusively a problem with financial reporting in the United States, as evidenced by fraud allegations at **Parmalat**, a large Italian company.

Fraud typically is perpetrated by senior management; for example, a 2010 study indicates that the company's chief executive officer and/or chief financial officer is involved in 89% of the fraud-related enforcement actions brought by the Securities and Exchange Commission. Committing fraud, an illegal act, obviously suggests a serious lack of ethical awareness and ethical sensitivity on the part of the perpetrators. Another feature of many frauds is that the company where the fraud occurred had a weak corporate governance environment. **Corporate governance** entails corporate structures and processes for overseeing the company's affairs, including oversight by the board of directors of the actions of top management to ensure that the company is being managed with the best interests of shareholders in mind.

Dennis Kozlowski, the former CEO of Tyco, leaves court upon his conviction for conspiracy, securities fraud, and falsifying records. Kozlowski was sentenced to 8⅓ to 25 years in prison. A failure to under stand and apply securities laws exposes management to great personal and pro fessional risk.

In each chapter, we will discuss common fraud-related schemes relevant to the material covered in that chapter, ethi cal quandaries and challenges faced by businesspeople, or ef forts to improve corporate governance and by extension the quality of accounting information in the United States.

The early 2000s was a time of unprecedented business failures amid allegations of fraudulent

Finally, accounting knowledge is helpful in many aspects of your personal lives. Account ing concepts are integral to such everyday decisions as personal budgeting, retirement and college planning, lease versus buy decisions, evaluation of loan terms, and evaluation of investment opportunities. Since accounting skills are designed to help you make better eco nomic decisions, you will be using these skills for the rest of your life. The only question is the degree of skill with which you will apply these concepts.

Concluding Remarks

Concluding Remarks

In this chapter, we have established a framework for your study of accounting. You have I thi h t h t bli h d f k f t d f ti Y h learned how financial accounting provides information for external users, primarily investors and creditors, and how accounting provides information for internal management. We have established the importance of integrity in accounting information and have learned about sev eral things that build integrity. Looking ahead, in Chapter 2 we begin to look in greater depth at financial accounting and, more specifically, financial statements. You will be introduced to the details of the three primary financial statements that provide information for investors and creditors. As the text progresses, you will learn more about the important information that these financial statements provide and how that information is used to make important financial decisions.

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thus, is sometimes called the language of business. Many different users have need for accounting information in order to make important decisions. These users include investors, creditors, management, governmental agencies, labor unions, and others. Because the primary role of accounting information is to provide useful information for decision-making purposes, it is sometimes referred to as a means to an end, with the end being the decision that is helped by the availability of accounting information.

LO2

generating reliable accounting

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quality accounting information on a timely basis and the communication of that information to decision makers. While there are different types of information systems, they all have one characteristic in common—to meet the organization's needs for accounting information as efficiently as possible. Per the COSO framework, the five elements of internal control are: (1) control environment, (2) risk assessment, (3) control activities,

(4) information and communication, and (5) monitoring.

reporting

reporting is important because of the reliance that is placed on financial information by users both outside and inside the reporting organization. Important dimensions of financial reporting that work together to ensure integrity in information are institutional features (accounting principles, internal structure, audits, and legislation); professional organizations (the AICPA, IMA, IIA, AAA); and the competence, judgment, and ethical behavior of individual accountants.

Identify and discuss several professional

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organizations that play important roles in

LO6

Discuss the significance of accounting systems in

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preparing and communicating accounting

information. The FASB, IASB, PCAOB, and SEC are important organizations in terms of standard setting in the United States. The FASB and IASB are private-sector organizations that establish accounting standards for public and private companies. The PCAOB sets auditing standards. The SEC is a governmental entity that oversees U.S. public companies and the capital markets.

Discuss the importance of personal competence,

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LO7

professional judgment, and ethical behavior on t

the part of accounting professionals. Personal

LO3

information for external parties—primarily in investors and creditors—in terms of the objectives in

Explain the importance of financial accounting

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competen

and the characteristics of that information. The primary

and the

objectives of financial accounting are to provide information that is useful in making investment and credit decisions; in assessing the amount, timing, and uncertainty of future cash flows; and in learning about the enterprise's economic resources, claims to resources, and changes in claims to resources. Some of the most important characteristics of financial accounting information are:

competence and professional judgment are, perhaps, the most important factors in ensuring the integrity of financial information. Competence is demonstrated by one's education and professional certification (CPA, CMA, CIA). Professional judgment is important because accounting information is often based on inexact measurements, and assumptions are required. Ethical behavior refers to the quality of accountants being motivated to "do the right thing."

LO8

it is a means to an end, it is historical in nature, it results from inexact and approximate measures of business activity, and it is based on a general-purpose assumption.

accounting. Accounting opens the door to many career opportunities. Public accounting is the segment of the

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Explain the importance of accounting information

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profession where professionals offer audit, tax, and consulting

profession

services. Management, or managerial, accounting refers to that segment of the accounting profession where professional accountants work for individual companies in a wide variety of

Describe various career opportunities in

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management—in terms of the objectives and the characteristics of

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capacities. Many accountants work for governmental agencies. Some accountants choose education as a career and work to

LO4

for internal parties—primarily

that info

that information. Accounting information is useful to the enterprise in achieving its goals, objectives, and mission; assessing past performance and future directions; and evaluating and rewarding decision-making performance. Some of the important characteristics of internal accounting information are its timeliness, its relationship to decision-making authority, its future orientation, its relationship to measuring efficiency and effectiveness, and the fact that it is a means to an end.

prepare students for future careers in one of the other segments of the accounting profession. While keeping detailed records (that is, bookkeeping) is a part of accounting, it is not a distinguishing characteristic of a career in accounting; in fact, many accounting careers involve little or no bookkeeping. Accounting skills are important to nonaccounting majors and to all students in their personal lives.

Key Terms Introduced or Emphasized in Chapter 1

accounting system (p. 6) The personnel, procedures, devices, and records used by an organization to develop accounting information and communicate that information to decision makers.

American Accounting Association (p. 20) A professional accounting organization consisting primarily of accounting educators that is dedicated to improving accounting education, research, and practice.

American Institute of CPAs (p. 20) A professional accounting organization of certified public accountants that engages in a variety of professional activities, including establishing auditing standards for private companies, conducting research, and establishing industry-specific financial reporting standards.

audit (p. 19) An investigation of financial statements designed to determine their fairness in relation to generally accepted accounting principles.

balance sheet (p. 12) A position statement that shows where the company stands in financial terms at a specific date. (Also called the statement of financial position.)

bookkeeping (p. 25) The clerical dimension of accounting that includes recording the routine transactions and day-to-day record keeping of an enterprise.

cash flow prospects (p. 10) The likelihood that an enterprise will be able to provide an investor with both a return on the investor's investment and the return of that investment.

Certified Internal Auditor (p. 21) A professional designation issued by the Institute of Internal Auditors signifying expertise in internal auditing.

Certified Management Accountant (p. 21) A professional designation issued by the Institute of Management Accountants signifying expertise in management accounting.

Certified Public Accountant (p. 21) An accountant who is licensed by a state after meeting rigorous education, experience, and examination requirements.

Committee of Sponsoring Organizations of the Treadway Commission (COSO) (p. 20) A voluntary private-sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, organizational governance, and enterprise risk management.

control activities (p. 8) Policies and procedures that management puts in place to address the risks identified during the risk assessment process.

control environment (p. 8) The foundation for all the other elements of internal control, setting the overall tone for the organization.

corporate governance (p. 26) Includes the corporate structures and processes for overseeing a company's affairs, for example, the board of directors and the company's internal control processes.

external users (p. 9) Individuals and other enterprises that have a financial interest in the reporting enterprise but that are not involved in the day-to-day operations of that enterprise (e.g., owners, creditors, labor unions, suppliers, customers).

financial accounting (p. 5) Providing information about the financial resources, obligations, and activities of an economic entity that is intended for use primarily by external decision makers—investors and creditors.

Financial Accounting Standards Board (FASB) (p. 17) A private-sector organization that is responsible for determining generally accepted accounting principles in the United States.

financial statement (p. 12) A monetary declaration of what is believed to be true about an enterprise.

general-purpose information (p. 13) Information that is intended to meet the needs of multiple users that have an interest in the financial activities of an enterprise rather than tailored to the specific information needs of one user.

generally accepted accounting principles (GAAP) (p. 17) Principles that provide the framework for determining what information is to be included in financial statements and how that information is to be presented.

Government Accountability Office (p. 24) A federal government agency that audits many other agencies of the federal government and other organizations that do business with the federal government and reports its findings to Congress.

income statement (p. 12) An activity statement that shows details and results of the company's profit-related activities for a period of time.

information and communication (p. 8) The organization's process for capturing operational, financial, and compliance related information necessary to run the business, and communicating that information downstream (from management to employees), upstream (from employees to management), and across the organization.

Institute of Internal Auditors (p. 20) A professional accounting organization that is dedicated to the promotion and development of the practice of internal auditing.

Institute of Management Accountants (p. 20) A professional accounting organization that intends to influence the concepts and ethical practice of management accounting and financial management.

integrity (p. 16) The qualities of being complete, unbroken, unimpaired, sound, honest, and sincere.

internal control (p. 8) A process designed to provide reasonable assurance that the organization produces reliable financial reports, complies with applicable laws and regulations, and conducts its operations in an efficient and effective manner.

Internal Revenue Service (p. 24) A government organization that handles millions of income tax returns filed by individuals and businesses and performs audit functions to verify the data contained in those returns.

internal users (p. 13) Individuals who use accounting information from within an organization (for example, board of directors, chief financial officer, plant managers, store managers).

International Accounting Standards Board (IASB) (p. 18) The group responsible for creating and promoting *International Financial Reporting Standards (IFRSs).*

management accounting (p. 6) Providing information that is intended primarily for use by internal management in decision making required to run the business.

monitoring (p. 9) The process of evaluating the effectiveness of an organization's system of internal control over time, including both ongoing management and supervisory activities and periodic separate evaluations.

Public Company Accounting Oversight Board (PCAOB) (p. 19) A quasi-governmental body charged with oversight of the public accounting profession. The PCAOB sets auditing standards for audits of publicly traded companies.

return of investment (p. 10) The repayment to an investor of the amount originally invested in another enterprise.

return on investment (p. 10) The payment of an amount (interest, dividends) for using another's money.

risk assessment (p. 8) A process of identifying, analyzing, and managing those risks that pose a threat to the achievement of the organization's objectives.

Sarbanes-Oxley Act (p. 9) A landmark piece of securities law, designed to improve the effectiveness of corporate financial reporting through enhanced accountability of auditors, boards of directors, and management.

Securities and Exchange Commission (SEC) (p. 17) A governmental organization that has the legal power to establish accounting principles and financial reporting requirements for publicly held companies in the United States.

statement of cash flows (p. 12) An activity statement that shows the details of the company's activities involving cash during a period of time.

statement of financial position (p. 12) Also called the balance sheet.

Find the **Intel Corporation** annual 10-K report from 2009 at the following Internet address (**http:// www.intc.com/secfiling.cfm?filingID = 950123-10-15237**) to answer the following questions: **a.** Name the titles of the financial reports in the **Intel Corp**. annual report that provide specific

information about economic resources, claims to resources, and changes in resources and claims. **b.** Name three other sections from **Intel** 's 2009 annual report that provide information useful in assessing the amount, timing, and uncertainty of future cash flows.

c. Which main categories of other general information are useful in making investment and credit decisions?

Solution to the Demonstration Problem

a. • **Intel Corporation**

Consolidated Balance Sheets

• **Intel Corporation**

Consolidated Statements of Stockholders' Equity

• **Intel Corporation**

Consolidated Statements of Operations

• **Intel Corporation**

Consolidated Statements of Cash Flows

b. • Management's Discussion and Analysis of Financial Condition and Results of Operations • Quantitative and Qualitative Disclosures about Market Risk

• Notes to the Consolidated Financial Statements

c. • Business Discussion

• Management's Discussion and Analysis of Financial Condition and Results of Operations that contains general discussions about strategy, results of operations, business outlook, and liquidity and capital resources

• Report of the Independent Registered Public Accounting Firm

The answers to these questions appear on page 35. **1.** Which of the following does *not* describe accounting? **a.** Language of business.

b. Is an end rather than a means to an end.

c. Useful for decision making.

d. Used by business, government, nonprofi t organizations, and individuals.

2. To understand and use accounting information in making economic decisions, you must understand:

a. The nature of economic activities that accounting infor mation describes.

b. The assumptions and measurement techniques involved in developing accounting information.

c. Which information is relevant for a particular type of decision that is being made.

d. All of the above.

3. Purposes of an accounting system include all of the follow ing *except:*

a. Interpret and record the effects of business transactions.

b. Classify the effects of transactions to facilitate the prep aration of reports.

c. Summarize and communicate information to decision makers.

d. Dictate the specifi c types of business transactions that the enterprise may engage in.

4. External users of fi nancial accounting information include all of the following *except:*

a. Investors. **c.** Line managers.

b. Labor unions. **d.** General public.

5. Objectives of fi nancial reporting to external investors and creditors include preparing information about all of the fol lowing *except:*

a. Information used to determine which products to produce.

b. Information about economic resources, claims to those resources, and changes in both resources and claims.

c. Information that is useful in assessing the amount, tim ing, and uncertainty of future cash fl ows.

d. Information that is useful in making investment and credit decisions.

6. Financial accounting information is characterized by all of the following *except:*

a. It is historical in nature.

b. It sometimes results from inexact and approximate measures.

c. It is factual, so it does not require judgment to prepare. **d.** It is enhanced by management's explanation. **7.** Which of the following is *not* a user of internal accounting information?

a. Store manager.

b. Chief executive offi cer.

c. Creditor.

d. Chief fi nancial offi cer.

8. Characteristics of internal accounting information include all of the following *except:*

a. It is audited by a CPA.

b. It must be timely.

c. It is oriented toward the future.

d. It measures effi ciency and effectiveness. **9.** Which of the following are important factors in ensuring the integrity of accounting information?

a. Institutional factors, such as standards for preparing information.

b. Professional organizations, such as the American Insti tute of CPAs.

c. Competence, judgment, and ethical behavior of individ ual accountants.

d. All of the above.

10. The code of conduct of the American Institute of Certifi ed Public Accountants includes requirements in which of the following areas?

a. The Public Interest. **c.** Independence. **b.** Objectivity. **d.** All of the above.

1. Accounting is sometimes described as the language of busi ness. What is meant by this description?

2. When you invest your savings in a company, what is the dif ference between the return *on* your investment and the return *of* your investment?

3. Going from general to specific, what are the three primary objectives of financial accounting information?

4. What are the three primary financial statements with which we communicate financial accounting information? **5.** Is externally reported financial information always precise and accurate?

6. Is internal accounting information primarily historical or future-oriented? How does that compare with financial accounting information?

7. What is meant by *generally accepted accounting principles,* and how do these principles add to the integrity of financial accounting information?

8. What is the definition of *internal control,* and what are the five components of COSO's internal control framework? **9.** What is an *audit,* and how does it add to the integrity of accounting information?

10. What is meant by the professional designations *CPA, CMA,* and *CIA,* and how do these designations add to the integrity of accounting information?

11. Why was the Sarbanes-Oxley legislation passed in 2002, and what are its implications for the accounting profession? **12.** What is the Financial Accounting Standards Board (FASB), and what is its role in external financial reporting?

13. What is the Securities and Exchange Commission (SEC), and what is its role in external financial reporting? **14.** What is the role of the Public Company Accounting Over sight Board in the audit of financial statements?

15. What is the International Accounting Standards Board (IASB), and what are its objectives?

Brief Exercises

accounting

Brief

Exercises

accounting

BRIEF EXERCISE 1.1 Users of Information

List four external users of accounting information.

BRIEF EXERCISE 1.2 Components of Internal Control

Match the terms on the left with the descriptions on the right. Each description should be used only once.

Term

Control environment

Risk assessment

Control activities

Information and communication

Monitoring

Description

a. Identifying, analyzing, and managing those risks that pose a threat to the achievement of the organization's objectives.

b. A process, involving both ongoing activities and separate evaluations, that enables an organization to evaluate the effectiveness of its system of internal control over time.

c. The process of capturing and communicating operational, financial, and compliance-related information.

d. The foundation for all the other elements of internal control, setting the overall tone for the organization.

e. Policies and procedures put in place by management to address the risks identified during the risk assessment process.

BRIEF EXERCISE 1.3 Inexact or Approximate Measures

Why does accounting rely on inexact or approximate measures?

BRIEF EXERCISE 1.4 Standards for the Preparation of Accounting Information

What are the two primary organizations in the U.S. that are responsible for setting standards related to the preparation of accounting information?

BRIEF EXERCISE 1.5 FASB Conceptual Framework

The FASB's conceptual framework sets forth the Board's views on which topics?

BRIEF EXERCISE 1.6 Public Company Accounting Oversight Board (PCAOB)

Use the Web to find the home page of the PCAOB. What are the four primary activities of the PCAOB?

BRIEF EXERCISE 1.7 Committee of Sponsoring Organizations (COSO)

Who are the sponsoring organizations of COSO, and what is COSO best known for doing?

BRIEF EXERCISE 1.8 Professional Certifications in Accounting

List three professional certifications offered in accounting and the organizations that offer them.

BRIEF EXERCISE 1.9 AICPA Code of Professional Conduct

Match the terms on the left with the descriptions on the right. Each description should be used only once.

Term

Responsibilities

The Public Interest

Integrity

Objectivity and Independence

Due Care

Scope and Nature of Services

Description

a. A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of service, and discharge professional responsibility to the best of the member's ability.

b. In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.

c. A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

d. A member in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

e. Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

f. To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

BRIEF EXERCISE 1.10 List three accounting-related skills that are useful to many people in their personal lives.

Personal Benefits of Accounting Skills

Exercises

accounting

Exercises

accounting

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SE 1.1

You as a User of

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Accounting Information

Identify several ways in which *you* currently use accounting information in your life as a student.

Also identify several situations in which, while you are still a student, you might be required to supply financial information about yourself to others.

E LO3

EXERCISE 1.2

U

Users of Accounting In

Information

Boeing Company is the largest manufacturer of commercial aircraft in the United States and is a major employer in Seattle, Washington. Explain why each of the following individuals or organiza tions would be interested in financial information about the company.

LO4

LO3

LO6

E

EXERCISE 1.3

What Is Financial

W

Reporting?

E

EXERCISE 1.4

Generally Accepted

G

Accounting Principles

a. California Public Employees Retirement System, one of the world's largest pension funds. **b. China Airlines**, a rapidly growing airline serving the Pacific

Rim.

c. Henry James, a real estate investor considering building apartments in the Seattle area. **d.** **Boeing** 's management.

e. **International Aerospace Machinists**, a labor union representing many **Boeing** employees.

A major focus of this course is the process of financial reporting.

a. What is meant by the term *financial reporting*?

b. What are the principal accounting reports involved in the financial reporting process? In gen eral terms, what is the purpose of these reports?

c. Do all business entities engage in financial reporting? Explain.

d. How does society benefit from the financial reporting process?

Generally accepted accounting principles play an important role in financial reporting.

a. What is meant by the phrase *generally accepted accounting principles*? **b.** What are the major sources of these principles?

c. Is there a single comprehensive list of generally accepted accounting principles? Explain. **d.** What types of accounting reports are prepared in conformity with generally accepted account ing principles?

LO6 LO3

E

EXERCISE 1.5 A

Accounting Organizations

E

EXERCISE 1.6 In

Investment Return

Describe the roles of the following organizations in establishing generally accepted accounting principles:

a. The FASB **b.** The AICPA **c.** The SEC

From which of these organizations can you most easily obtain financial information about publicly owned companies?

You recently invested $12,000 of your savings in a security issued by a large company. The secu rity agreement pays you 7 percent per year and has a maturity two years from the day you pur chased it. What is the total cash flow you expect to receive from this investment, separated into the return on your investment and the return of your investment?

LO3

E

EXERCISE 1.7 Accounting

A

Match the terms on the left with the descriptions on the right. Each description should be used only once.

through T through

Terminology

LO5

LO7

Term

Financial accounting

_Management accounting

Financial reporting

_Financial statements _General-purpose assumption

_Integrity

_Internal control

Public accounting

Bookkeeping

Description

a. The procedural aspect of accounting that involves keeping detailed records of business transactions, much of which is done today by computers.

b. A broad term that describes all information provided to external users, including but not limited to financial statements.

c. An important quality of accounting information that allows investors, creditors, management, and other users to rely on the information.

d. The segment of the accounting profession that relates to providing audit, tax, and consulting services to clients. e. Procedures and processes within an organization that ensure the integrity of accounting information.

f. Statement of financial position (balance sheet), income statement, statement of cash flows.

g. The fact that the same information is provided to various external users, including investors and creditors. h. The area of accounting that refers to providing information to support internal management decisions.

i. The area of

accounting that refers to providing information to support external investment and credit decisions.

LO6

E

EXERCISE 1.8 Accounting

A

Organizations

Match the organizations on the left with the functions on the right. Each function should be used only once.

Organization

_Institute of Internal Auditors

_Securities and Exchange Commission

_American Institute of CPAs

_Institute of Management Accountants

_Financial Accounting Standards Board

_American Accounting Association

_Public Company Accounting Oversight Board

_International Accounting Standards Board

Function

a. Government agency responsible for financial reporting by publicly held companies.

b. International organization dedicated to the advancement of internal auditing.

c. Organization dedicated to providing members personal and professional development opportunities in the area of management accounting.

d. The body charged with setting auditing standards for audits of public companies.

e. Organization consisting primarily of accounting educators that encourages improvements in teaching and research.

f. The group that creates and promotes International Financial Reporting Standards (IFRSs).

g. Professional association of Certified Public Accountants.

h. Private-sector organization that establishes accounting standards.

LO3 **E**

EXERCISE 1.9

F

Financial and

M

The major focus of accounting information is to facilitate decision making. **a.** As an investor in a company, what would be your primary objective?

LO4

Management A

Accounting

b. As a manager of a company, what would be your primary objective?

c. Is the same accounting information likely to be equally useful to you in these two different roles?

LO4 LO6 LO5

LO5 LO7

LO8

LO1

E
EXERCISE 1.10

M
Management Accounting Information

E
EXERCISE 1.11

A
Accounting Organizations

E
EXERCISE 1.12

P
Purpose of an Audit

E
EXERCISE 1.13

A
Audits of Financial Statements

E
EXERCISE 1.14

E
Ethics and Professional Judgment

E
EXERCISE 1.15

Careers in Accounting C

E
EXERCISE 1.16

H
Home Depot, Inc.

H

Internal accounting information is used primarily for internal decision making by an enterprise's management.

a. What are the three primary purposes of internal accounting information? **b.** Which of these is the most general and which is the most specific?

c. Give several examples of the kinds of decisions that internal accounting information supports.

Describe which professional organization(s) would most likely be of greatest value to you if your position involved each of the following independent roles:

a. Accounting educator.

b. Management accountant.

c. Certified public accountant.

Audits of financial statements are an important part of the accounting process to ensure integrity in financial reporting.

a. What is the purpose of an audit?

b. As an external user of accounting information, what meaning would you attach to an audit that concludes that the financial statements are fairly presented in conformity with generally accepted accounting principles?

c. Would your interest in investing in this same company be affected by an auditor's report that concluded the financial statements were *not* fairly presented? Why or why not?

The annual financial statements of all large, publicly owned corporations are audited. **a.** What is an audit of financial statements?

b. Who performs audits?

c. What is the purpose of an audit?

Ethical conduct and professional judgment each play important roles in the accounting process. **a.** In general terms, explain why it is important to society that people who prepare accounting information act in an ethical manner.

b. Identify at least three areas in which accountants must exercise *professional judgment,* rather than merely relying on written rules.

Four accounting majors, Maria Acosta, Kenzo Nakao, Helen Martin, and Anthony Mandella, recently graduated from Central University and began professional accounting careers. Acosta entered public accounting, Nakao became a management accountant, Martin joined a governmental agency, and Mandella (who had completed a graduate program) became an accounting faculty member.

Assume that each of the four graduates was successful in his or her chosen career. Identify the types of accounting *activities* in which each of these graduates might find themselves specializing several years after graduation.

Locate the **Home Depot, Inc.**, 2009 financial statements in Appendix A of this text. Briefly peruse the financial statements and answer the following questions:

G LO3

G
General and Specific Information

In

LO5

a. Name the titles of each of **Home Depot** 's financial statements that provide specific information about economic resources, claims to resources, and changes in resources and claims. **b.** Name three other sections from **Home Depot** 's 2009 financial statements that might be useful to a potential investor or creditor.

Due to the introductory nature of this chapter and the conceptual nature of its contents, no items labeled ***Problems*** *are included. In all future chapters, you will find two problem sets, A and B, that generally include computations, are more complex, and generally require more time to complete than the Exercises.*

Critical Thinking Cases

LO5 LO3 LO2 LO7 LO6 LO7

CASE 1.1
Reliability of Financial Statements

In the mid-2000s, **Fannie Mae** was in severe financial difficulty and desperately needed additional capital for the company to survive. What factors prevented **Fannie Mae** from simply providing potential lenders with misleading financial statements to make the company look like a risk-free investment?

CASE 1.2
Objectives of Financial Accounting

Divide into groups as instructed by your professor and discuss the following: **a.** How does the description of accounting as the "language of business" relate to accounting as being useful for investors and creditors?

b. Explain how the decisions you would make might differ if you were an external investor or a member of an enterprise's management team.

CASE 1.3
Accounting Systems

You are employed by a business consulting firm as an information systems specialist. You have just begun an assignment with a startup company and are discussing with the owner her need for an accounting system. How would you respond to the following questions from the owner? **a.** What is the meaning of the term *accounting system*? **b.** What is the purpose of an accounting system and what are its basic functions? **c.** Who is responsible for designing and implementing an accounting system?

CASE 1.4
Codes of Ethics

Assume you have recently completed your college degree with a major in accounting and have accepted a position on the accounting staff of a large corporation. Your supervisor suggests that in preparing for your first day on the job, you become familiar with the basic principles included in the code of ethics of the Institute of Management Accountants. Briefly explain what you learn as you study the code and how it might affect your behavior on your new job. (Use the IMA's Web site to obtain access to the IMA's Code of Ethics.)

INTERNET CASE 1.5
Accessing Information on the Internet

The Internet is a good place to get information that is useful to you in your study of accounting. For example, you can find information about accounting firms, standard setters, and regulators.

Instructions

a. The largest U.S. accounting firms are referred to as the Big 4—Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers. Find the Internet sites of these four firms and learn what you can about the types of services provided by the firm.

b. The Public Company Accounting Oversight Board (PCAOB) was created by the Sarbanes Oxley Act to oversee auditors of public companies. Find the PCAOB's Internet site and learn what you can about the PCAOB's four major activities.

c. The Financial Accounting Standards Board (FASB) is the designated accounting standard setter in the U.S. Find the FASB's Internet site and identify the FASB's board members including a brief description of their backgrounds.

d. The International Accounting Standards Board (IASB) is the body that issues International Financial Reporting Standards. Find the IASB's Internet site and identify the IASB's board members including a brief description of the backgrounds of five board members.

Internet sites are time and date sensitive. It is the purpose of these exercises to have you explore the Internet. You may need to use the Yahoo! search engine **http://www.yahoo.com** *(or another favorite search engine) to find a company's current Web address.*

Answers to Self-Test Questions

1. b **2.** d **3.** d **4.** c **5.** a **6.** c **7.** c **8.** a **9.** d **10.** d

Basic Financial Statements

AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:

LO1 E

Explain the nature and general purpose of financial statements.

Explain certain accounting principles that are important for an understanding of financial statements E

E

LO2

and how professional judgment by accountants may affect the application of those principles.

a

Demonstrate how certain business transactions affect the elements of the accounting equation:

A LO3

Assets Liabilities Owners ' Equity.

Explain how the statement of financial position, often referred to as the balance sheet, is an E

LO4

LO5

LO6

LO7

LO8

LO9

E

expansion of the basic E

Explain how the income statement reports an enterprise's financial performance for a period of E

E

time in terms of the relationship of revenues and expenses.

t

Explain how the statement of cash flows presents the change in cash for a period of time in E

E

t

terms of the company's operating, investing, and financing activities.

w the statement of sition (balance me statement, and

statement

E

o

of cash flows relate to each other.

Explain common forms of business ownership—sole proprietorship, partnership, and corporation— E

E

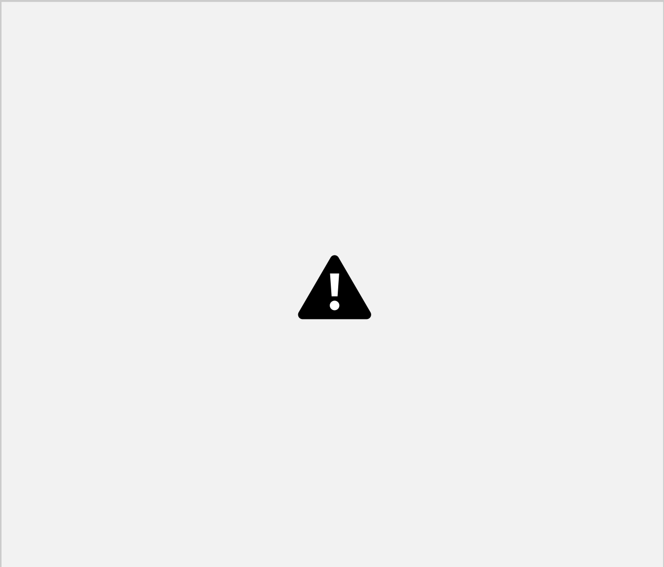
and demonstrate how they differ in terms of their presentation in the statement of financial position.

a

Discuss the importance of financial statements to a company and its investors and creditors and why management may take steps to improve the appearance of the company in its financial statements.

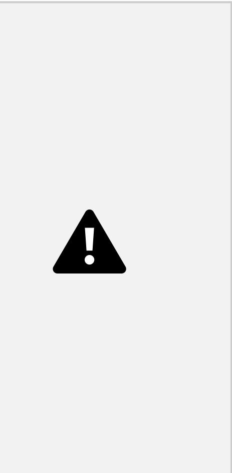
Intel supplies the computing and communications industries with chips, boards, and systems building blocks that are the ingredients of computers and servers as well as networking and communications products. These industries use Intel's products to create advanced computing and communications systems. Intel states that its mission is to be the preeminent building block supplier in the worldwide Internet economy.

Technology-based companies like Intel operate in highly competitive markets and continuously introduce new products. Intel's management discusses the company's business strategy in a recent corporate information communication on the company's Web site by explaining the importance of meeting the needs of customers: "Our goal is to be the preeminent provider of semiconductor chips and platforms for the worldwide digital economy. . . We offer products at

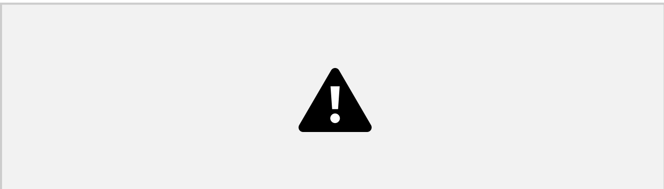


various levels of integration, to allow our customers flexibility in creating computing and communications systems. The substantial majority of our revenue is from the sale of microprocessors and chipsets."

Modern-day historians indicate that we are rapidly moving from the industrial age, with an emphasis on heavy manufacturing, to the information age. Companies like Intel, Microsoft, Cisco Systems, and others are major players in this transformation of business. For information-age companies the factors of success are quite different than for industrial-age companies. Information-age companies rely more heavily on intellectual capital, research and development, and other intangibles that were less important for



companies whose focus was heavy manufacturing or, even earlier in our history, primarily agricultural.



If you were a person with considerable wealth who wanted to invest in a forward-looking company in today's information age, how would you know whether **Intel** or any other com pany is a wise investment? What information would you seek out to help you decide where to place your investment dollars? A primary source of financial information is a company's financial statements. These statements, which are prepared at least once a year and in many cases more frequently, provide insight into the current financial status of the company and how successful the company has been in meeting its financial goals. In this chapter, you are introduced to the three primary financial statements—the statement of financial position (often referred to as the balance sheet), the income statement, and the statement of cash flows. Combined with information presented in notes and other accompanying presentations, these financial statements provide for investors, creditors, and other interested parties a wealth of useful information. In fact, financial information is what this entire textbook is about, and in this chapter you receive your initial introduction to how financial statements come about and how they may be used to better understand a company.

Introduction to Financial Statements

In Chapter 1, we learned that investors and creditors are particularly interested in cash flows that they expect to receive in the future. Creditors, for example, are interested in the ability of an enterprise, to which they have made loans or sold merchandise on credit, to meet its pay ment obligations, which may include payment of interest. Similarly, investors are interested in the market value of their stock holdings, as well as dividends that the enterprise will pay while they own the stock.

One of the primary ways investors and creditors assess the probability that an enterprise will be able to make future cash payments is to study, analyze, and understand the enterprise's financial statements. As discussed in Chapter 1, a **financial statement** is simply a declara tion of what is believed to be true about an enterprise, communicated in terms of a monetary unit, such as the dollar. When accountants prepare financial statements, they are describing in financial terms certain attributes of the enterprise that they believe fairly represent its financial activities.

In this chapter, we introduce three primary financial statements:

- Statement of financial position (commonly referred to as the balance sheet).
- Income statement.
- Statement of cash flows.

In introducing these statements, we use the form of business ownership referred to as a *corpo ration* . The corporation is a unique form of organization that allows many owners to combine their resources into a business enterprise that is larger than would be possible based on the financial resources of a single or a small number of owners. While businesses of any size may be organized as corporations, most large businesses are corporations because of their need for a large amount of capital that the corporate form of business organization makes possible. Later in this chapter we introduce two other forms of business organization—the sole propri etorship and the partnership—which are alternatives to the corporate form for some business enterprises.

Learning Objective

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Explain the nature and

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general purpose of financial statements.

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The names of the three primary financial statements describe the information you find in each. The **statement of financial position** , or **balance sheet** , is a financial statement that describes where the enterprise stands at a specific date. It is sometimes described as a snap shot of the business in financial or dollar terms (that is, what the enterprise "looks like" at a specific date).

As businesses operate, they engage in transactions that create revenues and incur expenses that are necessary to earn those revenues. An **income statement** is an activity statement that shows the revenues and expenses for a designated period of time. Revenues already have resulted in positive cash flows, or are expected to do so in the near future, as a result of trans actions with customers. For example, a company might sell a product for $100. This revenue transaction results in an immediate positive cash flow into the enterprise if the customer pays

cash at the time of the transaction. An expected future cash flow results if it is a credit transac tion in which payment is to be received later. Expenses have the opposite effect in that they result in an immediate cash flow *out* of the enterprise (if a cash transaction) or an expected future flow of cash out of the enterprise (if a credit transaction). For example, if a company incurs a certain expense of $75 and pays it at that time, an immediate cash outflow takes place. If payment is delayed until some future date, the transaction represents an expected future cash outflow. Revenues result in **positive cash flows** —either past, present, or future—while expenses result in **negative cash flows** —either past, present, or future. *Positive* and *negative* indicate the directional impact on cash. The term *net income* (or *net loss*) is simply the dif ference between all of an enterprise's revenues and expenses for a designated period of time.

The **statement of cash flows** is particularly important in understanding an enterprise for purposes of investment and credit decisions. As its name implies, the statement of cash flows shows the ways cash changed during a designated period—the cash received from revenues and other transactions as well as the cash paid for certain expenses and other acquisitions during the period. While the primary focus of investors and creditors is on cash flows to themselves rather than to the enterprise, information about cash activity of the enterprise is an important signal to investors and creditors about the prospects of future cash flows to them.

A Starting Point: Statement of Financial Position

All three financial statements contain important information, but each includes different infor mation. For that reason, it is important to understand all three financial statements and how they relate to each other. The way they relate is sometimes referred to as **articulation ,** a term we will say more about later in this chapter.

A logical starting point for understanding financial statements is the statement of financial position, also called the balance sheet. The purpose of this financial statement is to demon strate where the company stands, in financial terms, at a specific point in time. As we will see later in this chapter, the other financial statements relate to the statement of financial position and show how important aspects of a company's financial position change over time. Beginning with the statement of financial position also allows us to understand certain basic accounting principles and terminologies that are important for understanding all financial statements.

Every business prepares a balance sheet at the end of the year, and many companies pre pare one at the end of each month, week, or even day. It consists of a listing of the assets, the liabilities, and the owners' equity of the business. The *date* is important, as the financial posi tion of a business may change quickly. Exhibit 2–1 shows the financial position of Vagabond Travel Agency at December 31, 2011.

Notes Receivable . . . . . 10,000 Notes Payable . . . . . . $ 41,000 Accounts Receivable . . . 60,500 Accounts Payable . . . 36,000 Supplies . . . . 2,000 Salaries Payable . . . . 3,000 $ 80,000 Land . . . . 100,000 Owners' equity:
Building . . . . 90,000 Capital Stock . . . . $150,000 Office Equipment . . . . . . 15,000 Retained Earnings . . . 70,000 220,000 Total . . . . $300,000 Total $300,000

Exhibit 2–1

STATEMENT OF FINANCIAL POSITION

A balance sheet shows financial position at a specific date

Assets Liabilities & Owners' Equity

Cash . . . . $ 22,500 Liabilities:

Let us briefly describe several features of the statement of financial position, using Exhibit 2–1 as an example. First, the heading communicates three things: (1) the name of the business, (2) the name of the financial statement, and (3) the date. The body of the balance sheet consists of three distinct sections: *assets, liabilities,* and *owners' equity.*

Notice that cash is listed first among the assets, followed by notes receivable, accounts receivable, supplies, and any other assets that will *soon be converted into cash or used up in business operations* . Following these assets are the more permanent assets, such as land, buildings, and equipment.

Moving to the right side of the balance sheet, liabilities are shown before owners' equity. Each major type of liability (such as notes payable, accounts payable, and salaries payable) is listed separately, followed by a figure for total liabilities.

Owners' equity is separated into two parts—capital stock and retained earnings. Capi tal stock represents the amount that owners originally paid into the company to become owners. It consists of individual shares and each owner has a set number of shares. Notice in this illustration that capital stock totals $150,000. This means that the assigned value of the shares held by owners, multiplied by the number of shares, equals $150,000. For example, assuming an assigned value of $10 per share, there would be 15,000 shares ($10   15,000 $150,000). Alternatively, the assigned value might be $5 per share, in which case there would be 30,000 shares ($5   30,000 $150,000). The retained earnings part of owners' equity is simply the accumulated earnings of previous years that remain within the enterprise. Retained earnings is considered part of the equity of the owners and serves to enhance their investment in the business.

Finally, notice that the amount of total assets ($300,000) is *equal* to the total amount of liabilities and owners' equity (also $300,000). This relationship *always exists* —in fact, the *equality of these totals* is why this financial statement is frequently called a *balance* sheet.

The Concept of the Business Entity

Generally accepted accounting principles require that financial statements describe the affairs of a specific economic entity. This con cept is called the *entity principle.*

Learning Objective
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Explain certain accounting
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principles that are important fo
for an understanding of fi
financial statements and how professional judgment by accountants may affect the application of those principles.

A **business entity** is an economic unit that engages in identifiable business activities. For accounting purposes, the business entity is regarded as *separate from the personal activities of its owners*. For example, Vagabond is a business organization operating as a travel agency. Its owners may have personal bank accounts, homes, cars, and even other businesses. These items are not involved in the operation of the travel agency and do not appear in Vagabond's financial statements.

If the owners were to commingle their personal activities with the transactions of the busi ness, the resulting financial statements would fail to describe clearly the financial activities of the business organization. Distinguishing business from personal activities of the owners may require judgment by the accountant.

ASSETS

Assets are economic resources that are owned by a business and are expected to benefit future operations. In most cases, the benefit to future operations comes in the form of posi tive future cash flows. The positive future cash flows may come directly as the asset is con verted into cash (collection of a receivable) or indirectly as the asset is used in operating the business to create other assets that result in positive future cash flows (buildings and land used to manufacture a product for sale). Assets may have definite physical characteristics such as buildings, machinery, or an inventory of merchandise. On the other hand, some assets exist not in physical or tangible form, but in the form of valuable legal claims or rights; examples are amounts due from customers, investments in government bonds, and patent rights.

One of the most basic and at the same time most controversial problems in accounting is determining the correct dollar amount for the various assets of a business. At present, gener ally accepted accounting principles call for the valuation of some assets in a balance sheet at *cost,* rather than at their current value. The specific accounting principles supporting cost as the basis for asset valuation are discussed below.

The Cost Principle

Assets such as land, buildings, merchandise, and equipment are typical of the many economic resources that are required in producing revenue for the busi ness. The prevailing accounting view is that such assets should be presented at their cost. When we say that an asset is shown in the balance sheet at its *historical cost,* we mean the original amount the business entity paid to acquire the asset. This amount may be different from what it would cost to purchase the same asset today.

For example, let us assume that a business buys a tract of land for use as a building site, pay ing $100,000 in cash. The amount to be entered in the accounting records for the asset will be the cost of $100,000. If we assume a booming real estate market, a fair estimate of the market value of the land 10 years later might be $250,000. Although the market price or economic value of the land has risen greatly, the amount shown in the company's accounting records and in its balance sheet would continue unchanged at the cost of $100,000. This policy of account ing for many assets at their cost is often referred to as the **cost principle** of accounting.

Exceptions to the cost principle are found in some of the most liquid assets (that is, assets that are expected to soon become cash). Amounts receivable from customers are generally included in the balance sheet at their *net realizable value,* which is an amount that approxi mates the cash that is expected to be received when the receivable is collected. Similarly, cer tain investments in other enterprises are included in the balance sheet at their current market value if management's plan includes conversion into cash in the near future.

In reading a balance sheet, it is important to keep in mind that the dollar amounts listed for many assets do not indicate the prices at which the assets could be sold or the prices at which they could be replaced. A frequently misunderstood feature of a balance sheet is that it *does not* show how much the business currently is worth, although it contains valuable information in being able to calculate such a value.

The Going-Concern Assumption *Why* don't accountants change the recorded amounts of assets to correspond with changing market prices for these properties? One reason is that assets like land and buildings are being used to house the business and were acquired for *use* and not for resale; in fact, these assets usually could not be sold without disrupting the business. The balance sheet of a business is prepared on the assumption that the business is a continuing enterprise, or a **going concern .** Consequently, the present estimated prices at which assets like land and buildings could be sold are of less importance than if these properties were intended for sale. These are frequently among the largest dollar amounts of a company's assets. Determining that an enterprise is a going concern may require judgment by the accountant.

The Objectivity Principle Another reason for using cost rather than current market values in accounting for many assets is the need for a definite, factual basis for valuation. The cost of land, buildings, and many other assets that have been purchased can be definitely determined. Accountants use the term *objective* to describe asset valuations that are factual and can be verified by independent experts. For example, if land is shown on the balance sheet at cost, any CPA who performed an audit of the business would be able to find objective evidence that the land was actually measured at the cost incurred in acquiring it. On the other hand, estimated market values for assets such as buildings and specialized machinery are not factual and objective. Market values are constantly changing, and estimates of the prices at which assets could be sold are largely a matter of judgment.

You as a Home Owner

First, assume you have owned your home for 10 years and need to report the value of your home to the city assessor for real estate tax assessment purposes. What information would you provide? Second, assume you are planning to sell your home. What type of information would you provide to potential buyers? What ethical issues arise in these two situations that the objectivity principle helps address? (See our comments on the Online Learning Center Web site.)

At the time an asset is acquired, the cost and market value are usually the same. With the passage of time, however, the current market value of assets is likely to differ considerably from its historical cost. As you will learn, for some assets we adjust the amount in the balance sheet as the value changes. For other assets, we retain historical cost as the basis of the asset in the balance sheet.

The Stable-Dollar Assumption A limitation of measuring assets at historical cost is that the value of the monetary unit or dollar is not always stable. **Inflation** is a term used to describe the situation where the value of the monetary unit decreases, meaning that it will purchase less than it did previously. **Deflation ,** on the other hand, is the opposite situation in which the value of the monetary unit increases, meaning that it will purchase more than it did previously. Typically, countries like the United States have experienced inflation rather than deflation. When inflation becomes severe, historical cost amounts for assets lose their relevance as a basis for making business decisions.

Accountants in the United States prepare financial statements under an assumption that the dollar is a stable unit of measurement, as is the gallon, the acre, or the mile. The cost principle and the **stable-dollar assumption** work well in periods of stable prices but are less satisfac tory under conditions of rapid inflation. For example, if a company bought land 20 years ago for $100,000 and purchased a second similar tract of land today for $500,000, the total cost of land shown by the accounting records would be $600,000 following the historical cost principle. This treatment ignores the fact that dollars spent 20 years ago had greater purchas ing power than today's dollar. Thus the $600,000 total for the cost of land is a mixture of two "sizes" of dollars with different purchasing power.

CASE IN POINT

Many countries experience prolonged and serious inflation. Inflation can undermine the
dermine the
stable-currency assumption. Accounting rules have been designed in some foreign coun tries to address the impact of inflation on a company's financial position. For example, Mexican corporate law requires Mexican companies to adjust their balance sheets to cur rent purchasing power by using indexes provided by the government. Because inflation is significant, the indexes are used to devalue the Mexican currency (pesos) to provide a more transparent representation of the company's financial condition.

After much research into this problem, at one time the FASB required on a trial basis that large corporations annually disclose financial data adjusted for the effects of inflation. At the present time, this disclosure is optional, as judged appropriate by the accountant who prepares the financial statements.

LIABILITIES

Liabilities are financial obligations or debts. They represent negative future cash flows for the enterprise. The person or organization to whom the debt is owed is called a **creditor .**

All businesses have liabilities; even the largest and most successful companies often pur chase merchandise, supplies, and services "on account." The liabilities arising from such pur chases are called *accounts payable.* Many businesses borrow money to finance expansion or the purchase of high-cost assets and pay for them over time. When obtaining a loan, the bor rower usually must sign a formal note payable. A *note payable* is a written promise to repay the amount owed by a particular date and usually calls for the payment of interest as well.

Accounts payable, in contrast to notes payable, involve no written promises and generally do not call for interest payments. In essence, a note payable is a *more formal* arrangement than an account payable, but they are similar in that they require the company to make pay ment in the future.

Liabilities are usually listed in the order in which they are expected to be repaid. [1] Liabili ties that are similar may be combined to avoid unnecessary detail in the financial statement. For example, if a company had several expenses payable at the end of the year (for example, wages, interest, taxes), it might combine these into a single line called *accrued expenses.* The word *accrued* is an accounting term communicating that the payment of certain expenses has been delayed or deferred.

Liabilities represent claims against the borrower's assets. As we shall see, the owners of a business *also* have claims on the company's assets. But in the eyes of the law, creditors' claims *take priority* over those of the owners. This means that creditors are entitled to be *paid in full,* even if such payment would exhaust the assets of the business and leave nothing for its owners.

OWNERS' EQUITY

Owners' equity represents the *owners' claims* on the assets of the business. Because lia bilities or creditors' claims have legal priority over those of the owners, owners' equity is a *residual amount.* If you are the owner of a business, you are entitled to assets that are left after the claims of creditors have been satisfied in full. Therefore, owners' equity is always equal to *total assets minus total liabilities.* For example, using the data from the illustrated balance sheet of Vagabond Travel Agency (Exhibit 2–1):

Vagabond has total assets of $300,000

And total liabilities of . . . . (80,000)

Therefore, the owners' equity must be $220,000

Owners' equity does *not* represent a specific claim to cash or any other particular asset. Rather, it is the owners' overall financial interest in the entire company.

Increases in Owners' Equity The owners' equity in a business comes from two primary sources:

1. *Investments of cash or other assets* by owners.
2. *Earnings* from profitable operation of the business.

Decreases in Owners' Equity Decreases in owners' equity also are caused in two ways:

1. *Payments of cash or transfers of other assets* to owners.
2. *Losses* from unprofitable operation of the business.

Accounting for payments to owners and net losses are addressed in later chapters.

THE ACCOUNTING EQUATION

A fundamental characteristic of every statement of financial position is that the total for assets always equals the total of liabilities plus owners' equity. This agreement or balance of total assets with the total of liabilities and owners' equity is the reason for calling this financial statement a *balance sheet.* But *why* do total assets equal the total of liabilities and owners' equity?

The dollar totals on the two sides of the balance sheet are always equal because they repre sent *two views of the same business.* The listing of assets shows us what things the business owns; the listing of liabilities and owners' equity tells us who supplied these resources to the business and how much each group supplied. Everything that a business owns has been sup plied to it either by creditors or by the owners. Therefore, the total claims of the creditors plus the claims of the owners always equal the total assets of the business.

Learning Objective

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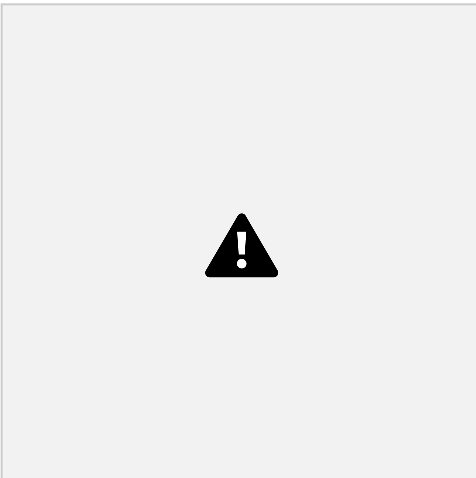
Demonstrate how certain business transactions affect the elements of the accounting equation: Assets Liabilities Owners' Equity.

Long-term liabilities are shown separately in the balance sheet, after the listing of all short-term liabilities. Long-term liabilities are addressed in Chapter 10.

[1] Short-term liabilities generally are those due within one year.

The equality of the assets on the one hand and the claims of the creditors and the owners on the other hand is expressed in the following **accounting equation :**

The accounting equation



© Getty Images/Stockbyte/DAL

Assets	Liabilities	Owners' Equity
$300,000	$80,000	$220,000

The amounts listed in the equation were taken from the balance sheet illustrated in Exhibit 2–1 . The balance sheet is simply a detailed statement of this equation. To illustrate this rela tionship, compare the balance sheet of Vagabond Travel Agency with the above equation.

Every business transaction, no matter how simple or how complex, can be expressed in terms of its effect on the accounting equation. A thorough understanding of the equation and some practice in using it are essential to the student of accounting.

Regardless of whether a business grows or contracts, the equality between the assets and the claims on the assets is always maintained. Any increase in the amount of total assets is necessarily accompanied by an equal increase on the other side of the equation—that is, by an increase in either the liabilities or the owners' equity. Any decrease in total assets is necessarily accompanied by a corresponding decrease in liabilities or owners' equity. The continuing equality of the two sides of the accounting equation can best be illustrated by taking a new business as an example and observing the effects of various transactions.

THE EFFECTS OF BUSINESS TRANSACTIONS: AN ILLUSTRATION

How does a statement of financial position come about? What has occurred in the past for it to exist at any point in time? The statement of financial position is a picture of the results of past business transactions that has been captured by the company's information system and
organized into a concise financial description of where the company stands at a point in time. The specific items and dollar amounts are the direct results of the transactions in which the company has engaged. The balance sheets of two separate companies would almost always be different due to the unique nature, timing, and dollar amounts of each company's business transactions.

To illustrate how a balance sheet comes about, and later to show how the income statement and statement of cash flows relate to the balance sheet, we use an example of a small auto repair business, Overnight Auto Service.

The Business Entity Assume that Michael McBryan, an experienced auto mechanic, opens his own automotive repair business, Overnight Auto Service. A distinctive feature of Overnight's operations is that all repair work is done at night. This strategy offers customers the convenience of dropping off their cars in the evening and picking them up the following morning.

Operating at night also enables Overnight to minimize labor costs. Instead of hiring full-time employees, Overnight offers part-time work to mechanics who already have day jobs at major automobile dealerships. This eliminates the need for costly employee training programs and for such payroll fringe benefits as group health insur ance and employees' pension plans, benefits usually associated with full-time employment.

Overnight's Accounting Policies McBryan has taken several courses in account ing and maintains Overnight's accounting records himself. He knows that small businesses such as his are not required to prepare formal financial statements, but he prepares them any way. He believes they will be useful to him in running the business. In addition, if Overnight is successful, McBryan plans to open more locations. He anticipates needing to raise substantial amounts of capital from investors and creditors. He believes that the financial history provided by a series of monthly financial statements will be helpful in obtaining investment capital.

The Company's First Transaction McBryan officially started Overnight on January 20, 2011. On that day, he received a charter from the state to begin a small, closely held corpora tion whose owners consisted of himself and several family members. Capital stock issued to

these investors included 8,000 shares at $10 per share. McBryan opened a bank account in the name of Overnight Auto Service, into which he deposited the $80,000 received from the issuance of the capital stock.

This transaction provided Overnight with its first asset—Cash—and also created the initial owners' equity in the business entity. See the balance sheet showing the company's financial position after this initial transaction in Exhibit 2–2.

Assets		Owners' Equity	
Cash	$80,000	Capital Stock	$80,000

Assets		Liabilities & Owners' Equity	
Cash	$ 22,000	Liabilities:	
Land	52,000	Notes Payable	$ 30,000
Building	36,000	Owners' equity:	
		Capital Stock	80,000
Total.	$110,000	Total	$110,000

Exhibit 2–2

BALANCE SHEET, JAN. 20

Beginning balance sheet of a new business

Overnight's next two transactions involved the acquisition of a suitable site for its business operations.

Purchase of an Asset for Cash Representing the business, McBryan negotiated with both the City of Santa Teresa and the Metropolitan Transit Authority (MTA) to purchase an abandoned bus garage. (The MTA owned the garage, but the city owned the land.)

On January 21, Overnight purchased the land from the city for *$52,000 cash.* This transac tion had two immediate effects on the company's financial position: first, Overnight's cash was reduced by $52,000; and second, the company acquired a new asset—Land. We show the company's financial position after this transaction in Exhibit 2–3.

Exhibit 2–3

BALANCE SHEET, JAN. 21

Assets		Owners' Equity	
Cash	$28,000	Capital Stock	$80,000
Land	52,000		
Total.	$80,000	Total	$80,000

Balance sheet totals unchanged by purchase of land for cash

Purchase of an Asset and Financing Part of the Cost On January 22, Over night purchased the old garage building from Metropolitan Transit Authority for *$36,000.* Overnight made a cash down payment of *$6,000* and issued a 90-day non-interest-bearing note payable for the *$30,000* balance owed.

As a result of this transaction, Overnight had (1) $6,000 less cash; (2) a new asset, Build ing, which cost $36,000; and (3) a new liability, Notes Payable, in the amount of $30,000. This transaction is reflected in Exhibit 2–4 .

BALANCE SHEET, JAN. 22

Totals increased equally by debt incurred in acquiring assets

Exhibit 2–4

Purchase of an Asset on Account On January 23, Overnight purchased tools and automotive repair equipment from Snappy Tools. The purchase price was *$13,800,* due within 60 days. After this purchase, Overnight's financial position is depicted in Exhibit 2–5.

Exhibit 2–5

BALANCE SHEET, JAN. 23

Totals increased equally by debt incurred in acquiring assets

Assets Liabilities & Owners' Equity

Cash . . . . $ 22,000 Liabilities:

Land . . . . 52,000 Notes Payable . . . . $ 30,000 Building . . . . 36,000 Accounts Payable . . . . 13,800 Tools and Equipment. . . . . 13,800 Total liabilities . . . . $ 43,800 Owners' equity:

Capital Stock . . . . 80,000 Total. . . . . $123,800 Total $123,800

Exhibit 2–6

BALANCE SHEET, JAN. 24

No change in totals by sale of assets at cost

Sale of an Asset After taking delivery of the new tools and equipment, Overnight found that it had purchased more than it needed. Ace Towing, a neighboring business, offered to buy the excess items. On January 24, Overnight sold some of its new tools to Ace for *$1,800,* a price equal to Overnight's cost.[2] Ace made no down payment but agreed to pay the amount due within 45 days. This transaction reduced Overnight's tools and equipment by $1,800 and created a new asset, Accounts Receivable, for that same amount. A balance sheet as of January 24 appears in Exhibit 2–6 .

Assets Liabilities & Owners' Equity

Cash . . . . $ 22,000 Liabilities:
Accounts Receivable . . . . 1,800 Notes Payable . . . .
. . . $ 30,000 Land . . . . 52,000 Accounts
Payable . . . . 13,800 Building . . . .
36,000 Total liabilities . . . . $ 43,800 Tools and
Equipment. . . . . 12,000 Owners' equity:
Capital Stock . . . . 80,000 Total. . . . .
. . . . $123,800 Total $123,800

Collection of an Account Receivable On January 26, Overnight received $600 from Ace Towing as partial settlement of its account receivable from Ace. This transaction caused an increase in Overnight's cash but a decrease of the same amount in accounts receiv able. This transaction converts one asset into another of equal value; there is no change in the

[2] Sales of assets at prices above or below cost result in gains or losses. Such transactions are discussed in later chapters.

amount of total assets. After this transaction, Overnight's financial position is summarized in Exhibit 2–7.

Snappy Tools. This transaction reduced Overnight's cash and accounts payable by the same amount, leaving total assets and the total of liabilities plus own ers' equity in balance. Overnight's balance sheet at January 27 appears in Exhibit 2–8.

Assets Liabilities & Owners' Equity

Cash . . . . $ 22,600 Liabilities:
Accounts Receivable . . . . 1,200 Notes Payable . . . .
. $ 30,000 Land . . . . 52,000 Accounts
Payable . . . . 13,800 Building 36,000
Total liabilities . . . . $ 43,800 Tools and Equipment. . . . . .
. 12,000 Owners' equity:
Capital Stock 80,000
Total. $123,800 Total . . . .
. . . . . $123,800

Assets Liabilities & Owners' Equity

Cash . . . . $ 15,800 Liabilities:
Accounts Receivable . . . . 1,200 Notes Payable . . . .
. $ 30,000 Land . . . . 52,000 Accounts
Payable . . . . 7,000 Building 36,000
Total liabilities . . . . $ 37,000 Tools and Equipment. . . . . .
. 12,000 Owners' equity:
Capital Stock 80,000

Exhibit 2–7

Payment of a Liability On January 27, Overnight made a partial payment of $6,800 on its account payable to

BALANCE SHEET, JAN. 26 **BALANCE SHEET, JAN. 27**

Totals unchanged by collection of a receivable

Exhibit 2–8

Total.	$117,000	Total	$117,000

Both totals decreased by paying a liability

Earning of Revenue By the last week in January, McBryan had acquired the assets Overnight needed to start operating, and he began to provide repair services for customers. Rather than recording each individual sale of repair services, he decided to accumulate them and record them at the end of the month. Sales of repair services for the last week of January were $2,200, all of which was received in cash.

Earning of revenue represents the creation of value by Overnight. It also represents an increase in the financial interest of the owners in the company. As a result, cash is increased by $2,200 and owners' equity is increased by the same amount. To distinguish owners' equity that is earned from that which was originally invested by the owners, the account *Retained Earnings* is used in the owners' equity section of the balance sheet. The balance sheet in Exhibit 2–9, as of January 31, reflects the increase in assets (cash) and owners' equity (retained earnings) from the revenue earned and received in cash during the last week of January, but before the payment of expenses (see next section).