

# Financial Accounting

Sixth Edition

## A Framework for Financial Accounting

### CHAPTER 1

Spiceland • Thomas • Herrmann

# Content

- PART A: ACCOUNTING AS A MEASUREMENT AND COMMUNICATION PROCESS  
Definition and Measures
- PART B: FINANCIAL ACCOUNTING INFORMATION  
Financial Accounting Standards and Ethics
- PART C: CAREERS IN ACCOUNTING
- APPENDIX: CONCEPTUAL FRAMEWORK

# PART A

## ACCOUNTING AS A MEASUREMENT/COMMUNICATION PROCESS



2020  
Annual Report

# Learning Objective 1

## **LO1-1** Describe the two primary functions of financial accounting.



### Dear fellow shareholder,

*Last year was marked not only by its challenges, but by how the world met them. I'm proud of the meaningful progress GE made in 2020. We have momentum and intend to build on it.*

*The path forward was not a straight one. We began 2020 with a clear game plan, strength in Aviation and Healthcare, and turnarounds well underway in Power and Renewable Energy. Then the COVID-19 pandemic changed the world, disrupting how we live and work and exacting terrible human costs. In GE's businesses, the rapid decline in air travel and disruption of global supply chains hit hard.*

*I often have witnessed our employees' battle-tested commitment and grit over the past two-plus years. Nowhere was this clearer than in the face of the pandemic, and I am profoundly thankful to them. In our mission-critical industries, GE's people served on the front lines since the beginning, from delivering hospital equipment in the first days in Wuhan, China, to maintaining the power equipment that keeps the lights on across the globe.*

# Learning Objective 1

## LO1-1 Describe the two primary functions of financial accounting.



2020  
Annual Report

### United States Securities and Exchange Commission

WASHINGTON, D.C. 20549

### FORM 10-K

☒ Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 2020

Commission file number 001-00035



### GENERAL ELECTRIC COMPANY

(Exact name of registrant as specified in its charter)

New York

or other jurisdiction of incorporation or organization)

14-0689340

(I.R.S. Employer Identification No.)

5 Necco Street, Boston MA

(Address of principal executive offices)

02210

(Zip Code)

(Registrant's telephone number, including area code) (617) 443-3000

### TABLE OF CONTENTS

	Page
Forward-Looking Statements	3
About General Electric	4
Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)	5
Consolidated Results	6
Segment Operations	9
Corporate Items and Eliminations	20
Other Consolidated Information	21
Capital Resources and Liquidity	24
Critical Accounting Estimates	31
Other Items	33
Non-GAAP Financial Measures	39
Other Financial Data	43
Risk Factors	44
Legal Proceedings	51
Management and Auditor's Reports	52
Audited Financial Statements and Notes	56
Statement of Earnings (Loss)	56
Statement of Financial Position	58
Statement of Cash Flows	60
Consolidated Statement of Comprehensive Income (Loss)	62
Consolidated Statement of Changes in Shareholders' Equity	62
Note 1 Basis of Presentation and Summary of Significant Accounting Policies	63
Note 2 Businesses Held for Sale and Discontinued Operations	68

# Illustration 1-1

## Decisions People Make About Companies



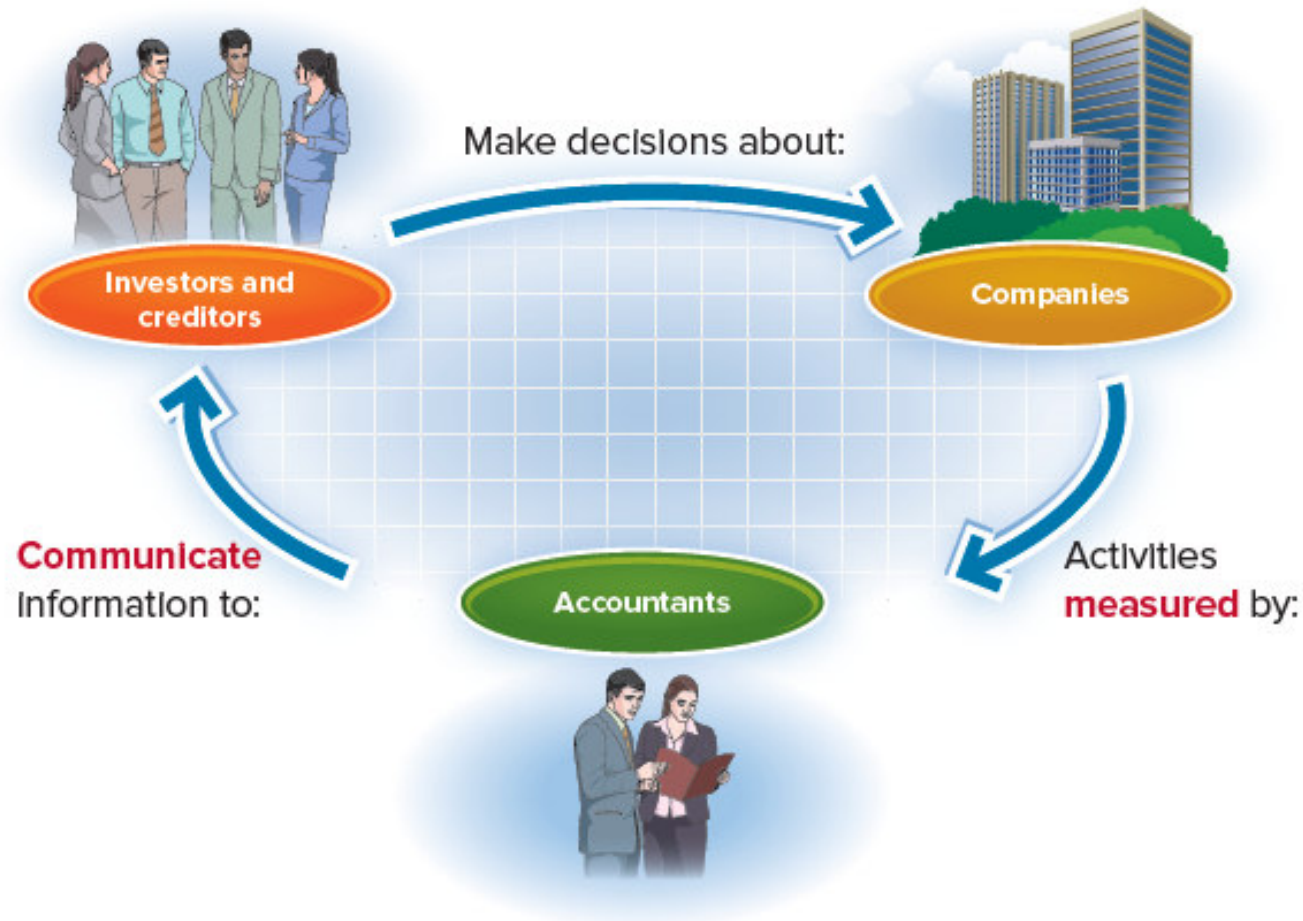
1. **Investors** decide whether to invest in stock.
2. **Creditors** decide whether to lend money.
3. **Customers** decide whether to purchase products.
4. **Suppliers** decide the customer's ability to pay for supplies.
5. **Managers** decide production and expansion.
6. **Employees** decide employment opportunities.
7. **Competitors** decide market share and profitability.
8. **Regulators** decide on social welfare.
9. **Tax authorities** decide on taxation policies.
10. **Local communities** decide on environmental issues.

# Financial Accounting

- Accounting information provided to *external* users is referred to as **financial accounting**, which is the focus of this book.
- The two functions of financial accounting are
  - to **measure** business activities of a company, and
  - to **communicate** those measurements to *external* parties for decision-making purposes.

# Illustration 1-2

## Framework for Financial Accounting





# Key Point

The functions of financial accounting are to measure business activities of a company and to communicate information about those activities to investors and creditors and other outside users for decision-making purposes.

# Learning Objective 2

## LO1-2 Understand the business activities that financial accounting measures.

### STATEMENT OF CASH FLOWS (UNAUDITED)

(In millions)

	Three months ended March 31	
	Consolidated	
	2021	2020
Net earnings (loss)	\$ (2,798)	\$ 6,233
(Earnings) loss from discontinued operations	2,894	21
Adjustments to reconcile net earnings (loss) to cash provided from operating activities		
Depreciation and amortization of property, plant and equipment (Note 7)	452	461
Amortization of intangible assets (Note 8)	301	318
(Gains) losses on purchases and sales of business interests (Note 23)	(3)	(12,372)
(Gains) losses on equity securities (Note 23)	(296)	5,873
Principal pension plans cost (Note 14)	658	877
Principal pension plans employer contributions	(74)	(70)
Other postretirement benefit plans (net)	(289)	(254)
Provision (benefit) for income taxes	142	54
Cash recovered (paid) during the year for income taxes	(322)	(310)
Changes in operating working capital:		
Decrease (increase) in current receivables	946	(503)
Decrease (increase) in inventories, including deferred inventory costs	(722)	(1,077)
Decrease (increase) in current contract assets	(35)	145
Increase (decrease) in accounts payable and equipment project accruals	(349)	(617)
Increase (decrease) in progress collections and current deferred income	(425)	(590)
All other operating activities	(2,719)	892
<b>Cash from (used for) operating activities – continuing operations</b>	<b>(2,640)</b>	<b>(919)</b>
Cash from (used for) operating activities – discontinued operations	680	686
<b>Cash from (used for) operating activities</b>	<b>(1,959)</b>	<b>(233)</b>
<b>Cash from (used for) financing activities</b>	<b>(1,605)</b>	<b>(7,919)</b>
Effect of currency exchange rate changes on cash, cash equivalents and restricted cash	(131)	(256)
<b>Increase (decrease) in cash, cash equivalents and restricted cash</b>	<b>(3,494)</b>	<b>10,697</b>
Cash, cash equivalents and restricted cash at beginning of year	37,608	37,077
Cash, cash equivalents and restricted cash at March 31	34,115	47,774
Less cash, cash equivalents and restricted cash of discontinued operations at March 31	625	584
<b>Cash, cash equivalents and restricted cash of continuing operations at March 31</b>	<b>\$ 33,490</b>	<b>\$ 47,190</b>



2020  
Annual Report

# Business Activities

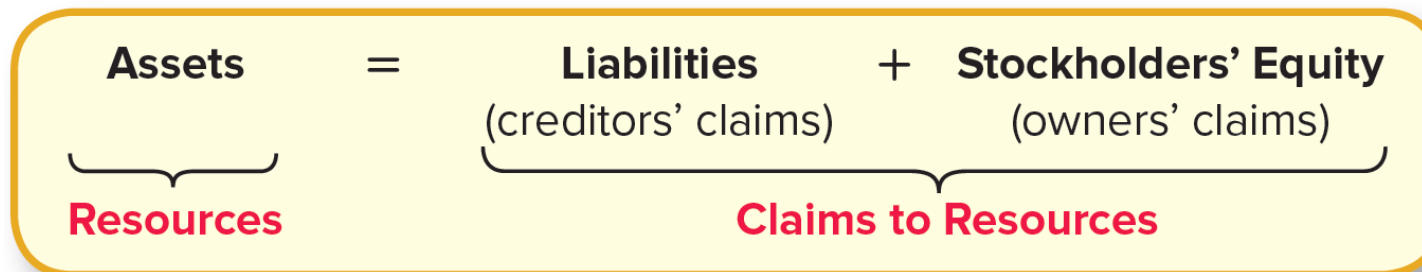
- **Financing activities:** transactions the company has with investors and creditors
- **Investing activities:** transactions involving the purchase and sale of resources that are expected to benefit the company for several years
- **Operating activities:** transactions that relate to the primary operations of the company

# Types of Business Organizations

- A **corporation** is a company that is legally separate from its owners.
  - The advantage of being legally separate is that the stockholders have *limited liability*.
- A **sole proprietorship** is a business owned by one person.
- A **partnership** is a business owned by two or more persons.
  - Neither sole proprietorships nor partnerships offer limited liability.

# Assets, Liabilities, and Stockholders' Equity

## Illustration 1-3 – The Accounting Equation



- **Assets** = total resources of the company.
- **Liabilities** = amounts owed to creditors.
- **Stockholders' equity** = owners' claims to resources

**The accounting equation illustrates a fundamental model of business valuation.**

# Revenues, Expenses, and Dividends

- **Revenues** are the amounts recognized when the company sells products or provides services to customers.
- **Expenses** are the costs of providing products and services and other business activities during the current period.
- **Net income** is the difference between revenues and expenses. Other common names for net income include *earnings* or *profit*.
- **Dividends** are cash payments to stockholders.
  - Dividends are not expenses.

# Illustration 1-4

## Business Activities and Their Measurement

<u>Activities Related to:</u>	<u>Measurement Category</u>	<u>Relationship</u>
<ul style="list-style-type: none"> <li>• Resources of the company</li> <li>• Amounts owed</li> <li>• Stockholders' investment</li> </ul>	<ul style="list-style-type: none"> <li>• Assets</li> <li>• Liabilities</li> <li>• Stockholders' equity</li> </ul>	<b>Accounting Equation</b> $(A = L + SE)$
<ul style="list-style-type: none"> <li>• Distributions to stockholders</li> </ul>	<ul style="list-style-type: none"> <li>• Dividends</li> </ul>	
<ul style="list-style-type: none"> <li>• Sales of products or services</li> <li>• Costs of providing sales</li> </ul>	<ul style="list-style-type: none"> <li>• Revenues</li> <li>• Expenses</li> </ul>	<b>Net Income</b> $(R - E = NI)$

# Key Point

The measurement role of accounting is to create a record of the activities of a company.

To make this possible, a company must maintain an accurate record of its assets, liabilities, stockholders' equity, revenues, expenses, and dividends.



## Concept Check 1-1

---

The total resources of a company are referred to as:

- a. Liabilities
- b. Revenues
- c. Assets
- d. Expenses

Assets are the resources of the company that will benefit future operations. They include items such as cash, supplies, inventory for sale to customers, buildings, land, and investments.

## Concept Check 1-2

---

The amounts recorded when the company sells products or provides services to customers are referred to as:

- a. Liabilities
- ☒ b. Revenues
- c. Assets
- d. Expenses

Revenues are recorded when the company sells products or provides services to customers.

## Learning Objective 3

**LO1-3** Determine how financial accounting information is communicated through financial statements.

# Communicating through Financial Statements

*Financial statements* are periodic reports published by the company for the purpose of providing information to external users.

- Primary financial statements
  - ❑ Income statement
  - ❑ Statement of stockholders' equity
  - ❑ Balance sheet
  - ❑ Statement of cash flows

# Income Statement

- Reports the company's **revenues** and **expenses** over an interval of time
  - If revenues > expenses, then **net income**
  - If revenues < expenses, then **net loss**

**Key Point:** The income statement compares revenues and expenses for the current period to assess the company's ability to earn a profit from running its operations.

## Illustration 1-5

# Income Statement for Eagle Soccer Academy

EAGLE SOCCER ACADEMY	
Income Statement	
For the month ended December 31, 2024	
<b>Revenues</b>	
Service revenue	<u>\$72,000</u>
<b>Expenses</b>	
Rent expense	5,000
Supplies expense	10,000
Salaries expense	31,000
Utilities expense	9,000
Interest expense	1,000
Other expenses	<u>2,000</u>
Total expenses	<u>58,000</u>
<b>Net income</b>	<u><u>\$14,000</u></u>

# Statement of Stockholders' Equity

Summarizes the changes in stockholders' equity over an interval of time

- Stockholders' Equity  
= Common Stock + Retained Earnings



## Illustration 1-6

# Statement of Stockholders' Equity for Eagle Soccer Academy

### EAGLE SOCCER ACADEMY Statement of Stockholders' Equity For the month ended December 31, 2024

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance (Dec. 1)	\$ -0-	\$ -0-	\$ -0-
Issuance of common stock	200,000		200,000
Add: <b>Net income for the period</b>		14,000	14,000
Less: Dividends		(4,000)	(4,000)
Ending balance (Dec. 31)	<u><u>\$200,000</u></u>	<u><u>\$ 10,000</u></u>	<u><u>\$210,000</u></u>

\*Beginning balances are zero only because this is the first month of operations for Eagle. Normally, beginning balances for Common Stock and Retained Earnings equal ending balances from the previous period.



# Common Mistake

Dividends represent the payment of cash but are not considered an expense in running the business.

Students sometimes mistakenly include the amount of dividends as an expense in the income statement, rather than as a distribution of net income in the statement of stockholders' equity.

# Key Point

The statement of stockholders' equity reports information related to changes in common stock and retained earnings each period.

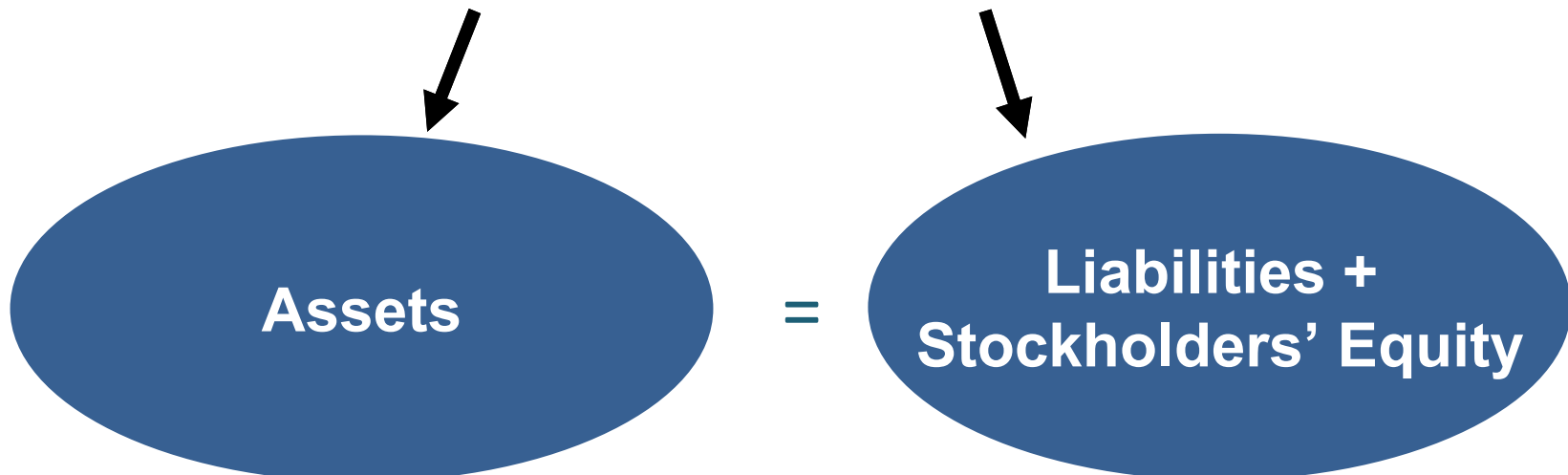
The change in retained earnings equals net income less dividends for the period.

# Balance Sheet

Presents the financial position of the company on a particular date

Financial position:

Resources = Claims to Resources



# Illustration 1-7

## Balance Sheet for Eagle Soccer Academy

EAGLE SOCCER ACADEMY Balance Sheet December 31, 2024			
<u>Assets</u>		<u>Liabilities</u>	
Cash	\$137,000	Accounts payable	\$ 23,000
Accounts receivable	27,000	Salaries payable	3,000
Supplies	13,000	Utilities payable	9,000
Equipment, net	118,000	Interest payable	1,000
Other assets	55,000	Notes payable	100,000
		Other liabilities	<u>4,000</u>
		<b>Total liabilities</b>	<b>140,000</b>
		<u>Stockholders' Equity</u>	
		Common stock	200,000
		Retained earnings	<u>10,000</u>
		<b>Total stockholders' equity</b>	<b>210,000</b>
		<b>Total liabilities and stockholders' equity</b>	<b>350,000</b>
<b>Total assets</b>	<b><u>\$350,000</u></b>		

## Concept Check 1-3

---

Which of the following accounts would appear in a company's income statement?

- a. Accounts Payable
- b. Cash
- c. Dividends
- ☒ d. Rent Expense

The income statement is a financial statement that reports the company's revenues and expenses over an interval of time. Accounts Payable (liability) and Cash (asset) would appear in the balance sheet, and Dividends would appear in the statement of stockholders' equity.

## Concept Check 1-4

---

Which relationship is reflected in the balance sheet?

- a. Revenues – Expenses = Net income
- ☒ b. Assets = Liabilities + Stockholders' Equity
- c. Assets – Liabilities = Net Income
- d. Assets = Revenues + Dividends

The balance sheet reflects the financial position of a company on a particular date. The company's financial position is summarized by showing that resources (Assets) equal claims to resources (Liabilities + Stockholders' Equity).

# Statement of Cash Flows

Measures activities involving cash receipts and cash payments over an interval of time

**Operating  
cash flows**

↓  
cash transactions  
involving revenue  
and expense  
activities

**Investing  
cash flows**

↓  
cash transactions  
for the purchase  
and sale of investments  
and long-term assets

**Financing  
cash flows**

↓  
cash transactions  
with lenders  
and stockholders

# Illustration 1-8

## Statement of Cash Flows for Eagle Soccer Academy

EAGLE SOCCER ACADEMY Statement of Cash Flows For the month ended December 31, 2024		
<b>Cash Flows from Operating Activities</b>		
Cash inflows:		
From customers	\$ 49,000	
Cash outflows:		
For salaries	(28,000)	
For rent	<u>(60,000)</u>	
Net cash flows from operating activities		<u>\$(39,000)</u>
<b>Cash Flows from Investing Activities</b>		
Purchase equipment	<u>(120,000)</u>	
Net cash flows from investing activities		<u>(120,000)</u>
<b>Cash Flows from Financing Activities</b>		
Issue common stock	200,000	
Borrow from bank	100,000	
Pay dividends	<u>(4,000)</u>	
Net cash flows from financing activities		<u>296,000</u>
Net increase in cash		<u>137,000</u>
Cash at the beginning of the period		<u>-0-</u>
Cash at the end of the period		<u><b>\$137,000</b></u>



## Concept Check 1-5

---

The cash collected from a customer would be recorded as which type of activity in the statement of cash flows?

- a. Operating Activity
- b. Business Activity
- c. Investing Activity
- d. Financing Activity

Operating activities include revenue and expense transactions. Collecting cash from customers represents activity related to revenues.

# Illustration 1-9

## Links among Financial Statements

### EAGLE SOCCER ACADEMY Income Statement

Revenues	\$72,000
Expenses	58,000
Net Income	<u>\$14,000</u>

[1]

[1] Notice that the amount of net income in the income statement appears in the statement of stockholders' equity.

[2] Notice that the ending balance in the statement of stockholders' equity reappears in the balance sheet.

### EAGLE SOCCER ACADEMY Statement of Stockholders' Equity

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance (Dec. 1)	\$ -0-	\$ -0-	\$ -0-
Issuances	200,000		200,000
Add: Net income		14,000	14,000
Less: Dividends		(4,000)	(4,000)
Ending balance (Dec. 31)	<u>\$200,000</u>	<u>\$10,000</u>	<u>\$210,000</u>

[2]

### EAGLE SOCCER ACADEMY Balance Sheet

Cash	<u>\$137,000</u>	Liabilities	\$140,000
Other assets	213,000	Stockholders' equity	<u>210,000</u>
<b>Total assets</b>	<b><u>\$350,000</u></b>	<b>Total liabilities and stockholders' equity</b>	<b><u>\$350,000</u></b>

[3]

[3] Notice that the amount of cash in the balance sheet reappears as the ending cash balance in the statement of cash flows.

### EAGLE SOCCER ACADEMY Statement of Cash Flows

Cash flows from operating activities	\$ (39,000)
Cash flows from investing activities	(120,000)
Cash flows from financing activities	<u>296,000</u>
Net increase in cash	137,000
Cash at the beginning of the year	-0-
Cash at the end of the year	<u>\$137,000</u>

## Key Point

All transactions that affect revenues or expenses reported in the income statement ultimately affect the balance sheet through the balance in retained earnings.

# Other Information Reported to Outsiders

- The financial statements are a key component of a company's *annual report*.
- Two other important components of the annual report are (1) management's discussion and analysis and (2) note disclosures to the financial statements.
  - The **management discussion and analysis** (MD&A) section typically includes management's views on significant events, trends, and uncertainties pertaining to the company's operations and resources.
  - **Note disclosures** offer additional information either to explain the information presented in the financial statements or to provide information not included in the financial statements.

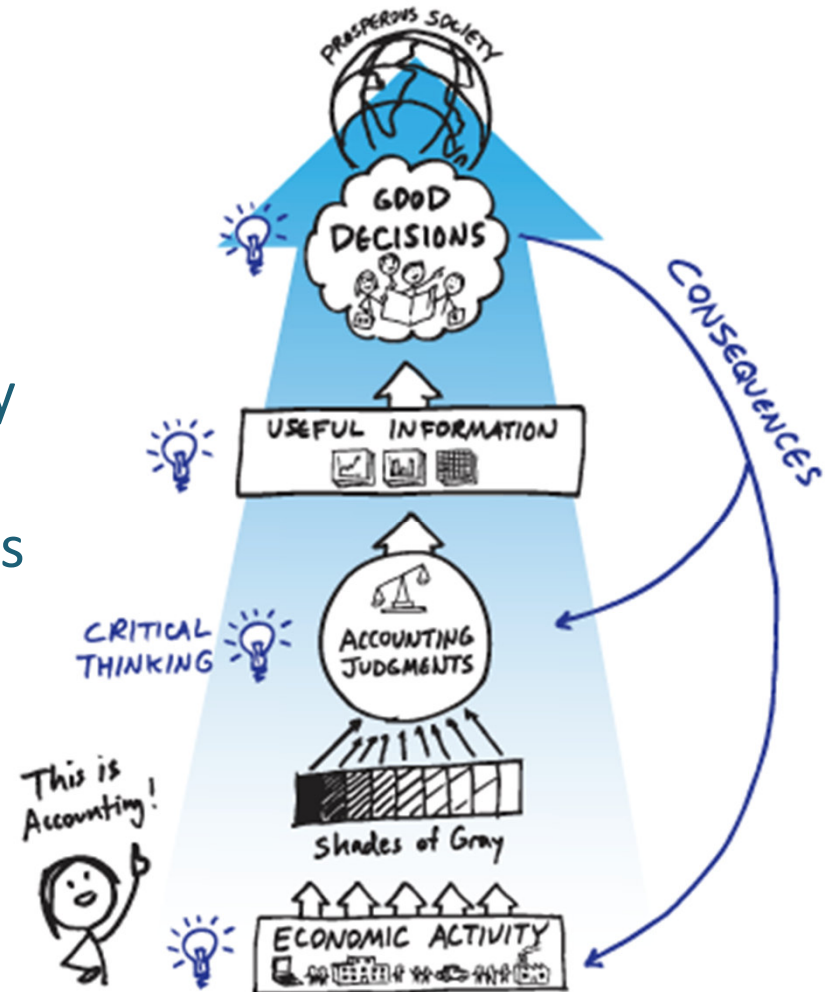
## Learning Objective 4

**LO1-4** Describe the role that financial accounting plays in the decision-making process.

# Illustration 1-10

## Pathways Commission Visualization: "THIS is Accounting!"

- Accounting serves an important role in a prosperous society by measuring economic activity and communicating useful information to help investors and creditors make good decisions.
- The practice of accounting requires judgment and critical thinking skills.



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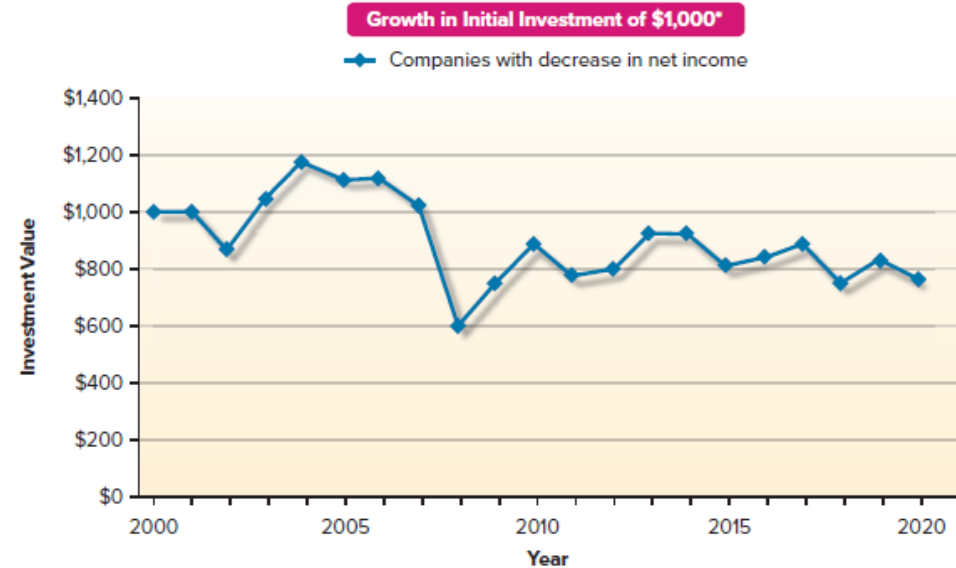
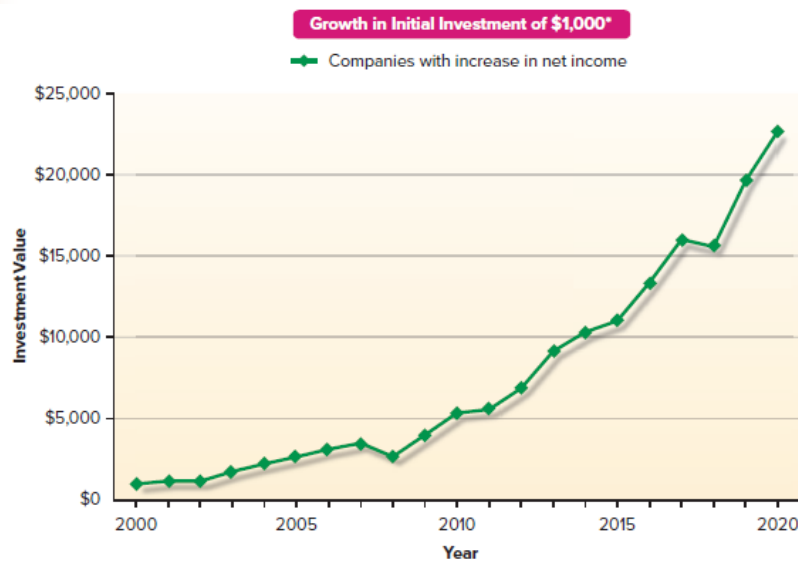
Reprinted with permission from the American Accounting Association.

# Key Point

Financial accounting serves an important role by providing information useful in investment and lending decisions.

# Illustration 1-11

## Relationship between Changes in Stock Prices and Changes in Net Income over a 20-Year Period



\*Amounts in this chart represent the investment growth based on the median stock return of each group each year. Companies included in this analysis are all U.S. companies with listed stocks, which averages about 6,000 companies per year.



## Key Point

No single piece of company information better explains companies' stock price performance than does financial accounting net income.

A company's debt level is an important indicator of management's ability to respond to business situations and the possibility of bankruptcy.



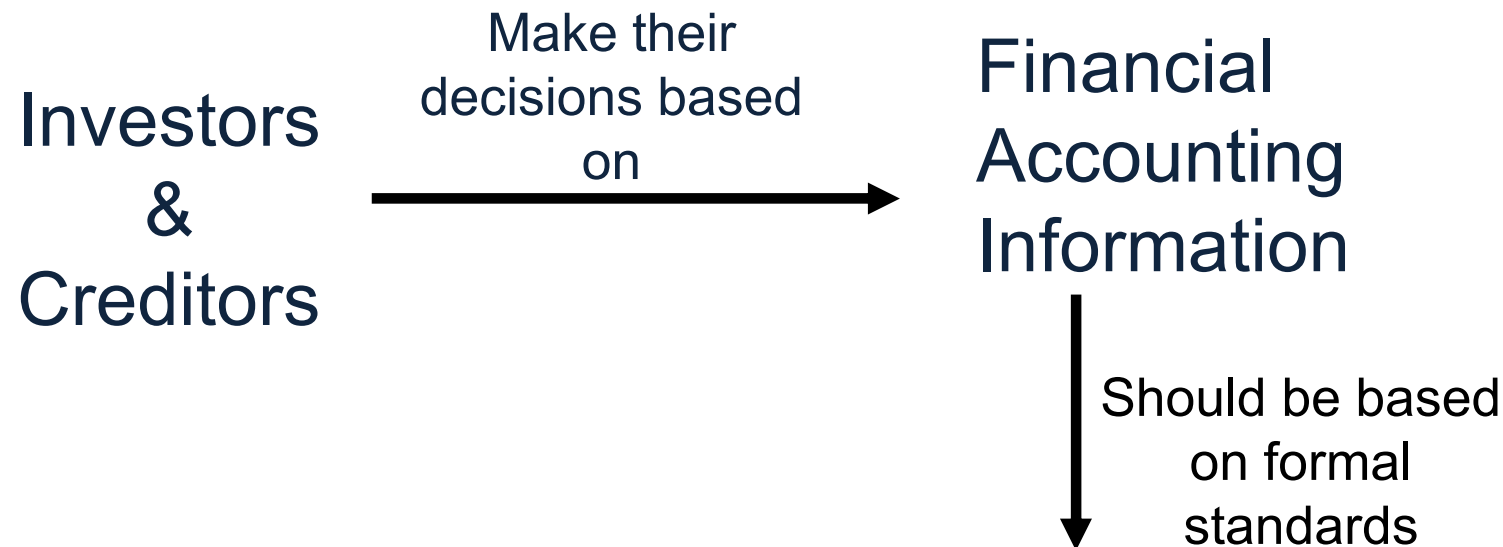
# PART B

## FINANCIAL ACCOUNTING INFORMATION

## Learning Objective 5

**LO1-5** Explain the term generally accepted accounting principles (GAAP) and describe the role of GAAP in financial accounting.

# Financial Accounting Standards



***Generally Accepted Accounting Principles (GAAP)***

# Standard Setting Today

## United States

Financial Accounting  
Standards Board (**FASB**)

↓  
Governed by the  
Securities and Exchange  
Commission (**SEC**)

## Global

International Accounting  
Standards Board (**IASB**)

# Key Point

The rules of financial accounting are called Generally Accepted Accounting Principles (GAAP).

The Financial Accounting Standards Board (FASB) is an independent, private body that has primary responsibility for the establishment of GAAP in the United States.

# Importance of Auditors

Trained individuals hired by a company as an independent party to express a professional opinion of the extent to which financial statements are prepared in compliance with GAAP and are free of material misstatement.

## Role of auditors



```
graph TD; A[Role of auditors] --> B[Help ensure that management has in fact appropriately applied GAAP in preparing the company's financial statements.]; A --> C[Play a major role in investors' and creditors' decisions by adding credibility to the financial statements.]
```

Help ensure that management has in fact appropriately applied GAAP in preparing the company's financial statements.

Play a major role in investors' and creditors' decisions by adding credibility to the financial statements.

## Illustration 1-12

# Excerpts from the Independent Auditor's Report of Dick's Sporting Goods, Inc.

### **DICK'S SPORTING GOODS, INC. Report of Independent Auditors**

To the Board of Directors and Stockholders of  
Dick's Sporting Goods, Inc.  
Pittsburgh, Pennsylvania

We have audited the accompanying consolidated balance sheets of Dick's Sporting Goods, Inc., and subsidiaries (the "Company") as of February 1, 2020, and February 2, 2019, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for each of the three years in the period ended February 1, 2020 and the related notes (collectively referred to as the "financial statements").

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of February 1, 2020, and February 2, 2019, and the results of their operations and their cash flows for each of the three years in the period ended February 1, 2020, in conformity with accounting principles generally accepted in the United States of America.



## Illustration 1-13

# Objectives of Financial Accounting

**Financial accounting should provide information that:**

1. Is useful to investors and creditors in making decisions.
2. Helps to predict cash flows.
3. Tells about economic resources, claims to resources, and changes in resources and claims.

# Key Point

The primary objective of financial accounting is to provide useful information to investors and creditors in making decisions.

## Concept Check 1-6

---

Auditors are independent parties that help:

- a. To establish accounting rules in the U.S.
- b. To ensure management has appropriately prepared the company's financial statements
- c. Investors and creditors in their decisions by adding credibility to the financial statements
- d. Both b. and c. are correct

Auditors are hired by a company as an independent party to express a professional opinion of the extent to which financial statements are prepared in compliance with GAAP.



# PART C

## CAREERS IN ACCOUNTING

## Learning Objective 6

**LO1-6** Identify career opportunities in accounting.

# Illustration 1- 14 Some of the Career Options in Accounting

	Public Accounting (Big 4 and Non-Big 4)	Private Accounting
<b>Who are the clients?</b>	Corporations Governments Nonprofit organizations Individuals	Your particular employer
<b>What are the traditional career opportunities?</b>	Auditors Tax preparers/planners Business consultants	Financial accountants Managerial accountants Internal auditors Tax preparers Payroll managers
<b>What other career opportunities are available?</b>	Financial planners Information technology developers Financial analysts Forensic accountants Information risk managers Investment bankers Environmental accountants Financial advisors Tax lawyers	Information managers Management advisors Tax planners Acquisition specialists FBI agents Sports agents

# Learning Objective 7

**LO1-7** Explain the nature of the conceptual framework used to develop generally accepted accounting principles.

# APPENDIX

## CONCEPTUAL FRAMEWORK



# Conceptual Framework

The conceptual framework:

- Is established by the FASB.
- Provides standard setters with a benchmark for creating a consistent set of financial reporting rules now and in the future.
- Provides others with a written framework so that everyone understands the underlying concepts that accountants are to consider in preparing and interpreting financial accounting information.

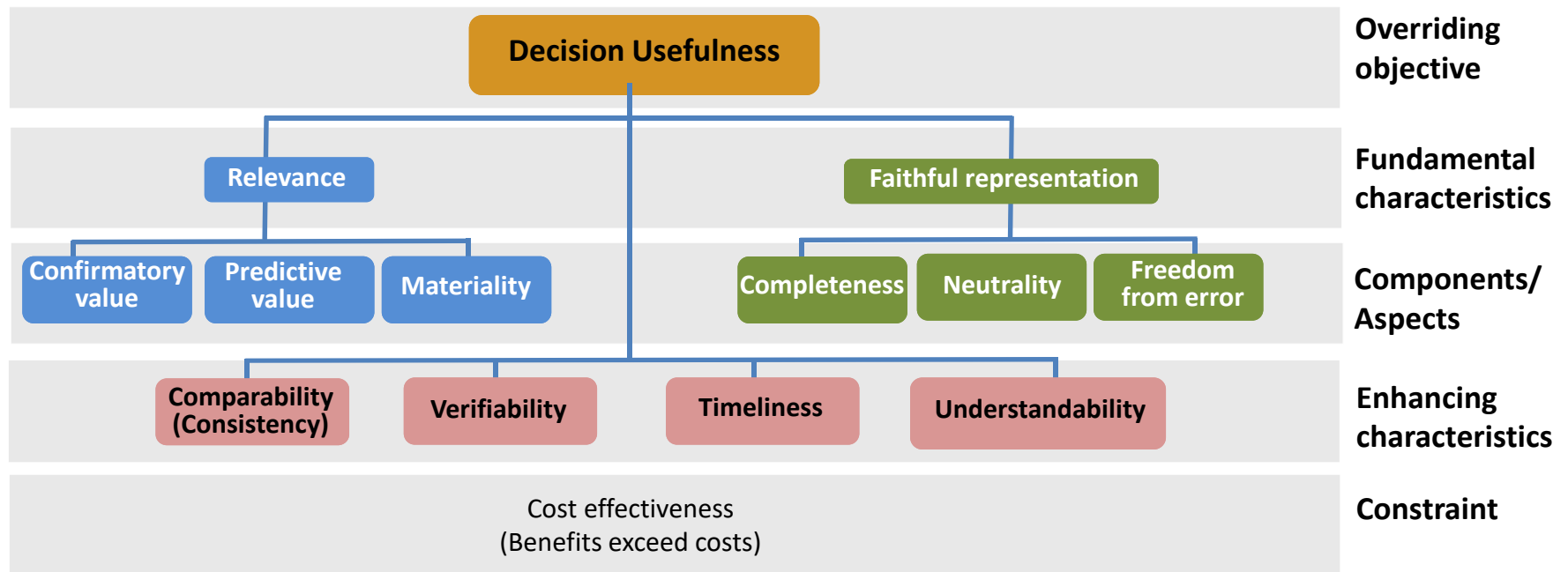
# Key Point

The conceptual framework provides an underlying foundation for the development of accounting standards and interpretation of accounting information.

## Illustration 1-15

# Qualitative Characteristics of Useful Financial Information

### QUALITATIVE CHARACTERISTICS



# Key Point (Fundamental Characteristics)

To be useful for decision making, accounting information should have relevance and faithful representation.

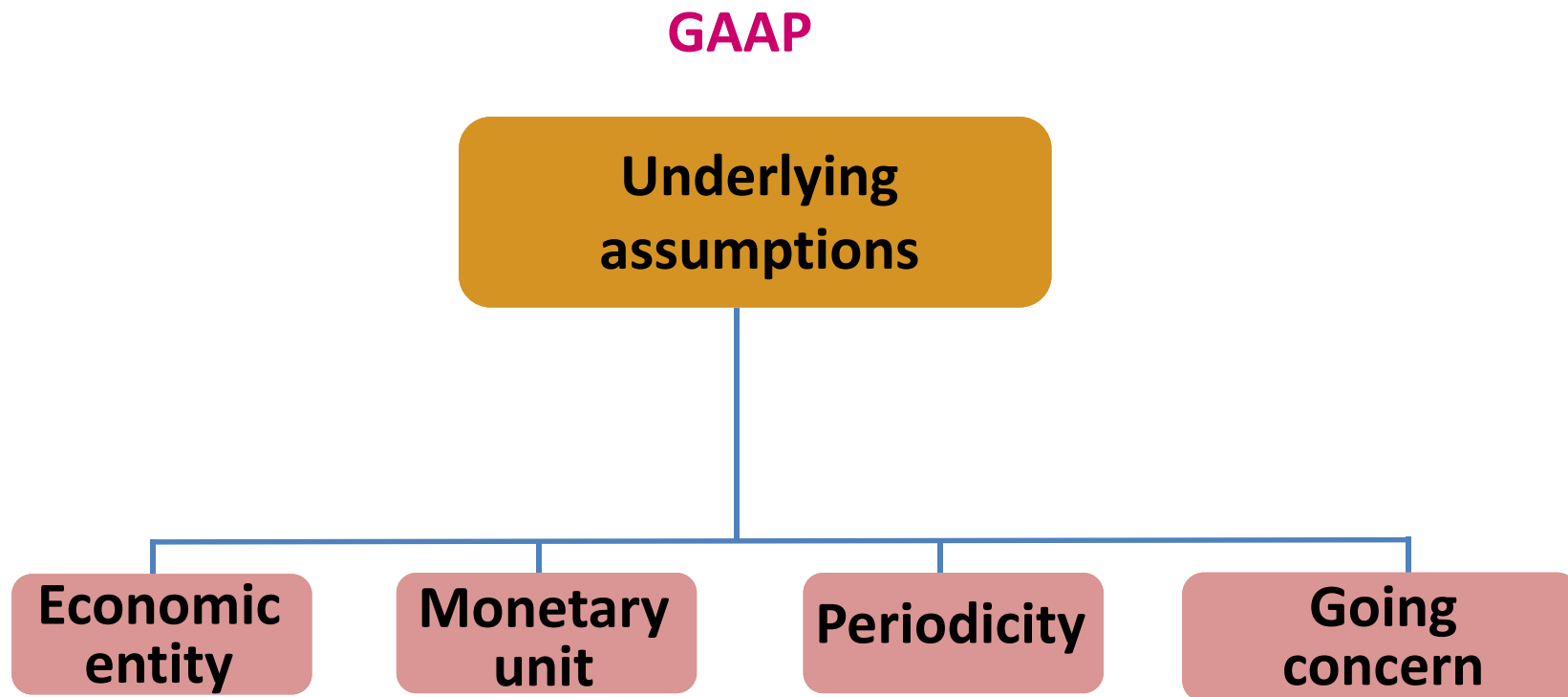
# Key Point (Enhancing Characteristics)

Four characteristics of financial reporting enhance its usefulness.

These characteristics include comparability, verifiability, timeliness, and understandability.

## Illustration 1-16

# Assumptions That Underlie GAAP



## Concept Check 1-7

---

Which of the following assumptions indicates that the life of a company can be divided into artificial time periods for periodic reporting?

- a. Economic Entity
- ☒ b. Periodicity
- c. Going Concern
- d. Monetary Unit

The periodicity assumption states that the economic life of an enterprise (presumed to be indefinite) can be divided into artificial time periods for periodic financial reporting.

# End of Chapter 1