

# CHAPTER 1

## DISCUSSION QUESTIONS

1. The three functions of an accounting system are to (1) analyze transactions, (2) handle routine bookkeeping tasks, and (3) structure information so it can be used to evaluate the performance and health of a business.
2. The objective of decision making is to determine an appropriate course of action. The essential elements in the decision-making process generally include the following: problem identification, accumulation and analysis of facts, consideration of alternative courses of action, formulation of a judgment, and action. Accounting assists in this process by providing and interpreting many of the facts (the financial data) to be considered in making decisions.
3. Many personal decisions involve the use of accounting data. Some examples of student-related decisions follow:
  - a. Whether to borrow money from a university or from a bank for tuition assistance.
  - b. Whether to buy or lease a car.
  - c. Whether to rent or to buy a house while going to school.
  - d. Whether to invest \$200 on an elaborate dinner date.
  - e. Whether to put a new set of tires on the car for a spring vacation trip.
  - f. Whether to invest summer earnings in certificates of deposit or in the stock market.
  - g. Whether to trade in the 10-speed bicycle on a new 21-speed model.
  - h. Whether to buy a season ski pass or pay as you go.
  - i. Whether to eat at the cafeteria or at home.
  - j. Whether to pay cash for a new stereo or to purchase it on a time contract.
  - k. Whether to purchase a laptop computer for schoolwork.
  - l. Whether to go to a private or a state school, given different tuition and other cost structures.
  - m. Whether to live in the dormitory or commute to school.

Obviously, this list is not exhaustive. Furthermore, selecting from among these alternatives—like making most decisions—involves many factors besides accounting considerations.

4. The term “business” refers to the general process of producing or distributing goods or providing services. It also may refer to an entity that has been organized to earn a profit.
5. Accounting is considered the “language of business” because it provides the means of accumulating, measuring, and recording the successes and failures of business operations. Accounting also provides a mechanism for communicating the financial results of businesses to the decision makers (e.g., investors, creditors, managers, government, labor unions, etc.).
6. Internal and external users of accounting information have similar needs in that both groups are required to make financial decisions. Managers (internal users) are required to make many day-to-day decisions in running their organizations; they generally need more detailed and timelier information. The information supplied to managers can be in any form that fits the specific questions and circumstances facing the manager. Investors and creditors, the primary external users, need summarized data to assist in making investing and lending decisions. The information supplied to external users should follow generally accepted accounting principles (GAAP) so that the information is consistent and comparable and, therefore, more useful for decision making.
7.
  - (1) IFRS refers to international financial reporting standards.
  - (2) The IFRS is issued by the International Accounting Standards Board (IASB). Currently, there are more than 100 countries in the world adopting IFRS. These countries include the European Union, Hong Kong, Australia, Canada, Taiwan, Singapore, South Korea, China, etc.

- (3) It is believed that adopting IFRS can help investors to compare financial statements across countries.
8. (1) Generally accepted accounting principles (GAAP) are accounting standards recognized by the accounting profession and the business community. These standards must be followed when preparing financial statements.
- (2) The purpose of GAAP is to allow comparability among firms and provides users of external reports with the foundation for sound decision making.
- (3) It is the Financial Accounting Standards Board (FASB) that develops and issues the U.S. GAAP.
9. Financial reports are prepared primarily for external users, mainly investors and creditors. It is important that the financial reports of different companies be based on the same set of generally accepted accounting principles (GAAP) so that the results are comparable. Thus, investors can choose from among several companies the ones in which they wish to invest, and lenders can select those entities that they feel are credit-worthy. If there were no general guidelines upon which financial reports were based, the reports of companies would likely be so different that comparisons and meaningful analysis of company results would be impossible.
10. In the U.S., the Securities and Exchange Commission (SEC) holds legal authority to set accounting standards. The SEC, however, delegates its authority to the Financial Accounting Standards Board (FASB). The SEC can, at any time, take over the accounting standard-setting process.
- The Internal Revenue Service (IRS) is another government agency in the U.S. that prescribes the rules and regulations that govern the collection of tax revenues. The rules and regulations, however, are often different from GAAP because they are designed for different purposes.
11. When different countries have different accounting standards, the ability to compare financial statements across countries becomes extremely difficult. Some countries prohibit certain accounting procedures, while other countries allow a wide variety of accounting alternatives. As a potential investor, these differences make the comparability of results increasingly difficult. As the president of a multinational company, you would have difficulty comparing your company's performance to the performance of foreign competitors who report using different accounting standards.
12. Accountants are responsible to the public and the companies that they work for to ensure that financial statements are in accordance with GAAP and are reported in an unbiased manner. Thus, accountants must maintain the reputation of being ethical to meet their professional responsibilities.
13. No. Although the role of accountants may change in the future, the need for judgment, which is provided by accountants, will not decrease. While technology has aided accountants in the everyday bookkeeping tasks, computers cannot analyze and interpret financial information as an accountant can. In the future, accountants could be required to perform all the financial tasks for a business. These include tax preparation, auditing, and financial planning.
14. Accounting is necessary to make wise financial decisions. Almost without exception, everyone will be faced with some type of decision requiring financial analysis. Accounting provides the needed tools to make sound decisions. Furthermore, in selecting investments, working within the business environment, and budgeting for a household, accounting concepts can prove very useful.

## EXERCISES

**Note:** Because Chapter 1 is fairly general and is intended to be a brief introduction to important accounting concepts, these exercises can be used most effectively to initiate class discussion.

**PE 1–1 (LO1)      The Role and Importance of Accounting**

Every organization, regardless of its size or purpose, should have a means of monitoring its activities and measuring how well it is accomplishing its objectives. Accounting provides such a mechanism by helping organizations to determine the optimal use of resources and to analyze the costs and benefits of decision alternatives. Accounting helps a retailer make such decisions as which lines of clothing to carry and what prices to charge. Numerous other examples are possible.

**PE 1–2 (LO1)      Bookkeeping Is Everywhere**

Bookkeeping is “the preservation of a systematic, quantitative record of an activity.” As such, bookkeeping is applied in many settings, not just in maintaining financial records. This point is illustrated with the following examples:

- a. *Your college English class.* Even though most English professors claim that the only numbers they ever look at are on the bottoms of the pages of the books they read, they must use numbers to record performance on assignments and papers in order to fairly assign final grades.
- b. *The National Basketball Association.* The NBA—and sports in general—is a record keeper’s delight. Official statisticians record every turnover, every assist, every foul, every three-point attempt, etc. In addition, with teams always struggling to sign key players and still remain under the “salary cap,” the most valuable player in the franchise is often the accountant.
- c. *A hospital emergency room.* Most emergency rooms have a status board where the status of the patient in each room is posted. This ensures that everyone can easily see where the high-risk patients are so that they can be given priority treatment. In addition, when you receive your bill from the emergency room, you realize that someone has been doing a lot of bookkeeping.
- d. *Jury selection for a major murder trial.* Juror pools typically come from lists of registered voters. That list must be maintained, a random selection must be made, and the potential jurors must be tracked as they report for jury duty. The rival lawyer teams also study all potential jurors and rank them as to how sympathetic each might be to the team’s legal arguments.

**PE 1–2 (LO1)      (Continued)**

- e. *Four college roommates on a weekend skiing trip.* Even among friends, bills must be settled up. Not every bill can be equally split at the time of payment—convenience store cashiers don't like four people coming in, each paying for one-fourth of a tank of gas. So, someone must track who pays for what during the skiing trip so that a fair settlement can be reached at the end of the trip.

**PE 1–3 (LO1)      Accounting Information and Decision Making**

The following items of information are typical of those that would help in deciding which types of computer to sell and in determining the profitability of Automated Systems, Inc.:

1. The number of computers and related equipment sold during a period (for example, a month).
2. The selling prices and costs of the items sold.
3. The number of items purchased for sale during a period and the quantity of units remaining on hand at the end of the period.
4. The amount of office supplies used during the period and their cost.
5. The amounts paid for employee wages, rent, utilities, advertising, and miscellaneous items.
6. The amount of cash or other items personally invested in the business.

In addition to the above information, which is related to the general business activities of Automated Systems, Inc., you also would want to collect specific information concerning (1) comparative costs of the Apple and Windows-based personal computers, (2) expected number of sales of both products, (3) comparative sales prices of the two computers, and (4) any additional costs that may have to be paid or savings that may result in switching from one computer line to the other. Other information, such as the impact of consumer preferences, also would have to be analyzed. Accounting provides only part of the information needed for making business decisions, but it is an important part.

**PE 1–4 (LO1)      Allocation of Limited Resources**

Accounting information will tell you the financial results of your company. The following steps will help you identify and determine how to efficiently allocate the company's limited resources:

- Identify and value the limited resources in your business.
- Evaluate past performance of business activities for successes and failures.
- Prepare budgets that will express your desires and goals for the company in quantitative terms.

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## PE 1–4 (LO1) (Continued)

- Set financial goals, both short-term and long-term.
- Examine current expenses to ascertain where costs can be reduced.
- Analyze current operations to decide which business activities are most profitable.
- Determine if a different investment would be more profitable.

## PE 1–5 (LO2) Users of Financial Information

These groups or individuals would be interested in a firm's financial statements for the following reasons:

- a. Current stockholders have already invested in the firm, and with the financial statements, they can analyze the firm's performance and evaluate whether their investment has been a good one.
- b. Creditors are interested in the firm's performance because they have loaned money to the firm. They need to review the financial statements to see if the firm is performing well enough to repay the loan.
- c. Management needs to see what areas of the business the firm needs to improve upon. Management can also see if the firm has met operational goals for the last period.
- d. Prospective stockholders need to review the financial statements to determine whether they want to invest their money in the firm.
- e. The tax filings made with the Internal Revenue Service are prepared using a different set of rules from those used in preparing the financial statements. However, the IRS may make a comparison between the tax filing and the financial statements to detect unusual or extreme differences suggesting the underpayment of taxes.
- f. The SEC ensures that financial statements have been evaluated by independent external auditors. The SEC also identifies problematic accounting areas in which the SEC staff may do additional checking.
- g. The firm's major labor union would want to make sure that the employees of the firm are being treated fairly and that the company is conducting business in an appropriate manner.

**PE 1–6 (LO2)****Structuring Information for Use in Evaluation**

With some additional record-keeping procedures, the information from the convenience store cash register can be used to generate all sorts of useful data for managing the store. Some examples are as follows:

- **Product category.** If each sale were identified by the type of product sold (e.g., gasoline, food, refrigerated product), then the manager of the store could know what types of items were selling the best.
- **Timing of sale.** Each sale could also be identified by time of day and day of the week. This information could be used to determine whether the store was open for the optimal number of hours per day and whether extra staffs were needed on certain days at certain times.
- **Salesclerk.** The store manager could determine whether certain clerks were influencing sales, either positively or negatively. For example, the demeanor of some clerks may discourage customers who purchase gasoline from entering the store and making additional purchases of food and snacks.
- **Specific products.** With a more elaborate system, the convenience store could track each item sold. This information could be used to determine when inventory restocking purchases need to be made. In addition, the store manager could use this information to place the best-selling products in high-visibility locations within the store.

**PE 1–7 (LO2)****Investing in the Stock Market**

In any bookstore, you can find numerous books devoted to this very question—how to identify companies that will have high rates of return. Here are some basic accounting concepts that will help you analyze a company's future stock performance.

- Past and present stock performance
- Net earnings
- Cash flows (i.e., positive or negative)
- Total revenues
- Dividends (i.e., increasing, decreasing, nonexistent, etc.)
- Total debt outstanding and respective interest rates
- Total assets
- Price-earnings ratio (average market price of stock divided by net income per share)

As your understanding of accounting increases, you will realize that there are hundreds of ways to predict a company's stock performance, but none of them are 100% effective. Good luck in your future stock market endeavors.

**PE 1–8 (LO2) Management versus Financial Accounting**

**Management accounting** is concerned primarily with providing information to managers, those who work inside the organization and who are responsible for directing and controlling its operations. Internal reports are used in management accounting to provide management with the necessary information to run the day-to-day business operations. Since management has control over the accounting system, these internal reports are tailored to meet the specific needs of management and will vary considerably among businesses.

**Financial accounting** is concerned with developing and communicating financial information to external users (i.e., stockholders, creditors, regulatory agencies, and others outside the organization). These external users need assurance that the financial information has been prepared using a common set of ground rules. To provide this assurance to external users, financial accounting provides information in the form of external financial reports prepared according to generally accepted accounting principles.

Although management and financial accounting are two different fields of accounting, the following similarities exist between them:

1. Both rely on the accounting information system to generate information.
2. Both focus on providing information for decision making. The decision makers who receive this information are different—some being external to the firm and some being internal—but the need for information to make wise and timely decisions is the same.
3. Although management accounting and financial accounting present information in different perspectives, they ought to be consistent, which means that they should contain the same economic substance.

**PE 1–9 (LO2) IFRS**

The globalization of security markets is featured by companies cross-listed on more than one exchange with the investors coming from all over the world. Each exchange requires that its listed companies prepare financial statements in accordance with the GAAP of its country. Such a requirement leads to a company cross-listed on exchanges in different countries preparing financial statements in accordance with different sets of GAAP, which can increase the costs of preparing financial reports of companies cross-listed on exchanges. This requirement also can increase the costs of investors in interpreting financial reports prepared in accordance with different accounting standards; the need to have a set of internationally accepted accounting standards arises. The IFRS issued by the International Accounting Standards Board (IASB) is such a set of standards.

**PE 1–10 (LO2) Conflicts between Lenders and Investors**

Lenders expect payments of interest and principal, while the investors expect payment of dividends. Investors have lower priority than lenders in receiving the payment from the company. Investors may decide to distribute to themselves more dividends that potentially can hurt the lenders' interest. To protect their own interest, lenders may restrict dividend distribution in the borrowing contract. The debt contract may also have other covenants for further protecting the lenders' interest. Such covenants are often based on accounting numbers. Financial ratios like current ratio or debt ratio are examples (to be covered in the later chapters of this book). While lenders want to protect their own interest by requesting a lower debt ratio, such an action may be disadvantageous to investors because investors are not willing to invest in projects with the expected return on investment lower than the rate of return prevailing in the market.

**PE 1–11 (LO2) Conflicts between Management and Investors (Shareholders)**

Managers are being compensated for their contribution. Most of the time, their contribution are measured by accounting numbers. Therefore, managers may be tempted to pick accounting methods that suit their own interest, or they might even window dress the financial statements. Such an action may hurt investors in two aspects. One is that managers receive more than they deserve that lowers the investors' interest. The other is that investors may be misled by the financial statements when making decisions. To protect their interest, auditors are hired to make reasonable assurance that the information management provided is free of material misstatement.

**PE 1–12 (LO3) Ethics in Accounting**

This exercise should provide the basis for discussing several aspects of ethics. Students likely will have different points of view.

The authors believe that ethics can be "taught," although probably not in the same way that we teach history or math. A student's sense of ethics develops over time. The way people approach and deal with ethical issues seems to be affected by life experiences, including formal education.

The authors have tried to expose students to some ethical considerations in accounting by incorporating ethical issues in several of the end-of-chapter cases throughout the textbook. Hopefully, these materials, and the discussion of them, will increase students' awareness of the ethical dimensions of accounting.

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**PE 1–13 (LO3) Challenges to the Accounting Profession**

The accounting profession faces several challenges. Among them are (1) increased competition for clients, (2) increased number of malpractice lawsuits, (3) escalating costs of insurance, (4) greater difficulty in recruiting bright young talent to the profession, (5) the possibility of increased government regulation of accounting, (6) problems associated with international operations, (7) ethical considerations of business decisions, and (8) significant information technology advances. While it is clear that the environment in which accounting operates is complex and dynamic, and that these challenges are real, many within the profession still feel that the future is bright.

**PE 1–14 (LO3) Environment of Accounting**

- GAAP: Generally Accepted Accounting Principles. Authoritative guidelines that define accounting practice at a particular time.
- IASB: International Accounting Standards Board. The committee formed in 1973 to develop worldwide accounting standards.
- IFRS: International Financial Reporting Standards. The accounting standards produced by the IASB and envisioned to be a set of standards that can be used by all companies regardless of where the company is based.
- FASB: Financial Accounting Standards Board. The private organization responsible for establishing the standards for financial accounting and reporting in the United States.
- SEC: Securities and Exchange Commission. The government body responsible for regulating the financial reporting practices of most publicly owned corporations in connection with the buying and selling of stocks and bonds.
- CPA: Certified Public Accountant. A special designation given to an accountant who has passed a national uniform examination and has met other certifying requirements.
- AICPA: American Institute of Certified Public Accountants. The national organization of CPAs in the United States.
- IRS: Internal Revenue Service. A government agency that prescribes the rules and regulations that govern the collection of tax revenues in the United States.

**PE 1–15 (LO4) Why Do I Need to Know Accounting?**

Your friend will find that he needs accounting sooner than he thinks. He will need knowledge of accounting to complete his tax returns. He will be required to have a complete financial history should he ever elect to expand his business and need to borrow funds. He will need accounting information to determine if he is covering his costs and providing to himself a fair return. Your friend will certainly

need knowledge of revenues and expenses to measure his success. In addition, he will need a record of his obligations and the amounts owed to him. Every business manager finds out rather quickly that accounting information is very valuable.

#### PE 1–16 (LO4)      Career Opportunities in Accounting

Since accounting is the “language of business,” your mother should take comfort in knowing that you know how to speak another language. With knowledge of accounting, you are prepared to seek employment in many different areas within the business world. Since all aspects of business have some cost or profit elements, your knowledge of how these costs or profits are accounted for will provide you with an advantage. In addition to working in for-profit organizations, accountants are in demand in government and nonprofit organizations as well.

In addition, tell your mom that not all those who graduate with a degree in accounting seek employment as accountants. Many use their degree in accounting as background for a master’s or PhD degree. Examples of areas of graduate study include an MBA degree, a law degree, and a master’s degree in accounting.

## ANALYTICAL ASSIGNMENTS

### AA 1–1 To Lend or Not To Lend—That Is the Question

#### Discussion

Sam needs several pieces of information to determine whether to give Bill the loan. First, he would need to see a listing of Bill's assets and liabilities. Examples of these would include a list of all of Bill's property and equipment needed to run the ranch, the cash that he has, money other people owe him, the debts he owes, and any investments that he has made. Second, Sam would want to see evidence of Bill's income from the Mountain Meadow Ranch. Bill would need to bring his receipts and tax returns to show evidence of income. Third, Sam would want to see documentation of the inflows and outflows of Bill's bank accounts and the monthly payments that Bill has to make. These records would give Sam an idea of where Bill's money is coming from, where it is going, and whether he will have enough money in the future to repay the loan.

Bill should compile the pieces of information listed above and determine if he has been successful in his business thus far. Bill should see if he is operating at a profit or at a loss. If he is operating at a loss, he should determine how he plans to turn things around and therefore be able to repay the loan. Bill should anticipate the questions Sam are sure to ask and be prepared with data to support his answers to those questions.

### AA 1–2 Information Needs to Remain Competitive

#### Discussion

Family Mart would want to look at the financial statements of other convenient store companies, such as PCSC, to see what they are doing differently. An analysis of competitors' statements may show Family Mart that certain areas of this industry are more successful than others. Family Mart would also want to look at its own financial statements and identify the areas that are most successful, as well as those that are less successful. Family Mart may want to consider focusing its energy on the most successful segments.

Family Mart could also conduct market research to see why more consumers are shopping in PCSC. From this research, it could determine what improvements should be made.

### AA 1–3 We Don't Have Time for Good Accounting!

#### Discussion

Your sister is correct in recognizing the importance of continuing to develop the most important part of her business, which are new products and new people. However, one of those new people should be a trustworthy accountant. New, successful businesses often make the mistake of assuming that the initial period when they are swimming in cash and profits will last forever. It won't. As the business expands, there will be a greater need for managing the payroll, systematically paying the bills, preparing forecasts and budgets, and generating performance evaluations. Only by carefully laying the groundwork for a useful accounting system can a successful new business mature into a successful old business.

**AA 1–4      You Decide: How much education is necessary for an accountant?****Judgment Call**

Issues to be discussed with this question are:

1. Certainly, computers and technology have replaced much of the procedural work that accountants used to do—preparing manual tax returns, making journal entries, posting to ledgers, etc.
2. No matter how much technology develops, there will always be a need for individuals who can design systems, interpret results, provide financial insight into decision making, perform planning, audit systems, and do other tasks requiring analytical skills. Today, accountants are an integral part of management teams. With knowledge of financial data, better management decisions can be made.
3. The skills needed for today's accountants are expanding rapidly. Instead of being a preparer of information, today's accountants must have good analytical skills, communication skills, technology skills, and other knowledge and skills. Being an accountant is being a professional, and five years is one of the lowest levels of education required to enter a professional field.
4. QuickBooks can help, but it will never replace one who understands what QuickBooks can do and who can make intelligent decisions based on the data.

**AA 1–5      TSMC****Real Company Analysis**

TSMC's annual report is divided into 8 sections. These are letter to shareholders, company profile, corporate governance, capital and shares, operational highlights, financial highlights and analysis, corporate social responsibility, and subsidiary information and other special notes. Each of these sections can be accessed online

([http://www.tsmc.com/download/ir/annualReports/2015/english/pdf/e\\_11.pdf](http://www.tsmc.com/download/ir/annualReports/2015/english/pdf/e_11.pdf)). More than half of the report is devoted to financial information. Within the financial information, there are condensed financial statements, financial analysis, audit committee's review report, auditor's opinions, financial statements, and notes to financial statements. In the section of corporate social responsibility, TSMC talks about its effort on environmental protection, and safety and health management. Also, it introduces its education and culture foundation, and its volunteer program.

**AA 1–6      Should the SEC Choose the FASB or the IASB?****International**

The SEC has been charged by Congress to make sure that all investors trading in U.S. securities markets have access to sufficient financial disclosures to allow them to make informed trades. If the SEC were to allow U.S. companies to adopt IASB accounting standards, the SEC would be ceding its accounting standard-setting responsibilities to a group over which they, the SEC, have no direct jurisdiction.

However, it seems only a matter of time before U.S. companies argue that requiring one set of accounting standards for one group of companies and allowing another set of standards for another set of companies' results in an unlevel playing field.

It seems likely that the SEC will push for a convergence of IASB and FASB accounting standards. Allowing non-U.S. companies access to U.S. capital markets seems a first step in that direction.

**Chapter 1****AA 1–7 Disagreement with the Boss****Ethics**

In instances like the one presented in this case, students should realize that if they knowingly process an item that is outside corporate guidelines, without the written approval from someone who is authorized, they are jeopardizing their job. If your boss has the authority to deviate from established guidelines, then written approval from him or her should be obtained. If your boss is not authorized to go outside guidelines, yet insists on being reimbursed for the expenditures, you should realize that auditors will eventually audit the expense reports, and you will be asked to account for the deviations from the norm. Without written approval from your boss, you will be in trouble.

**SOLUTIONS TO “STOP & THINK”**

***Stop & Think (p. 14): Why is it important for the FASB to remain completely independent?***

Independence enables the FASB to make decisions for the good of the entire business community rather than giving special advantages to select firms or other constituents. Independence also enhances the FASB's credibility as a policy-making body.