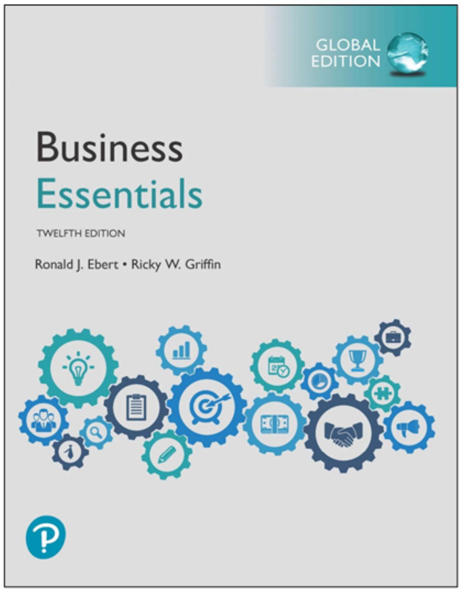
Business Essentials

Twelfth Edition, Global Edition



Chapter 15

The Role of Accountants and Accounting Information

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1) MathType Plugin
2) Math Player (free versions available)
3) NVDA Reader (free versions available)

What Is Accounting, and Who Uses Accounting Information? (1 of 4)

- **Accounting**
  - comprehensive system for collecting, analyzing, and communicating financial information
- **Bookkeeping**
  - recording of accounting transactions

Pearson

Accounting (or accountancy) is a comprehensive system for collecting, analyzing, and communicating financial information to a firm's owners and employees, to the public, and to various regulatory agencies.

To perform these functions, accountants keep records of taxes paid, income received, and expenses incurred, a process called bookkeeping, and they assess the effects of these transactions on business activities.

What Is Accounting, and Who Uses Accounting Information? (2 of 4)

- **Accounting Information System (AIS)**
  - organized procedure for
    - identifying
    - measuring
    - recording
    - retaining
  - financial information for use in accounting statements and management reports

Pearson

Accounting information systems (AIS), provide an organized procedure for identifying, measuring, recording, and retaining financial information so that it can be used in accounting statements and management reports.

What Is Accounting, and *Who Uses* Accounting Information? (3 of 4)

- **Business managers** use it to *develop* goals and plans, set *budgets*, and *evaluate* future prospects.
- **Employees and unions** use it to plan for and receive compensation benefits.
- **Investors and creditors** use it to ***estimate*** returns to stockholders, determine growth prospects, and decide whether a firm is a good credit risk.

Pearson

Users of accounting information are numerous.

What Is Accounting, and *Who Uses* Accounting Information? (4 of 4)

- **Tax authorities** use it to plan for tax inflows, determine the tax liabilities of individuals and businesses, and ensure that correct amounts are paid on time.
- **Government regulatory agencies** rely on it to fulfill their duties toward the public.

Who Are Accountants and What Do They Do?

- **Controller**
  - person who manages all of a firm's accounting activities (chief accounting officer)
- **Certified Public Accountant (CPA)**
  - Accountant licensed by the state and offering services to the public (independent)
  - **The "Big Four" Public Accounting Firms.**
    - Deloitte Touche Tohmatsu (United States),
    - Ernst & Young (United Kingdom),
    - PricewaterhouseCoopers,
    - KPMG (Netherlands)

Pearson

The controller, or chief accounting officer, manages a firm's accounting activities by ensuring that the AIS provides the reports and statements needed for planning, decision making, and other management activities. This range of activities requires different types of accounting specialists.

Public accountants offer accounting services to the public and are distinguished by their independence from the clients they serve. Certified public accountants (CPAs) are licensed by a state after passing an exam prepared by the American Institute of Certified Public Accountants (AICPA).

Financial versus Managerial Accounting

- **Financial Accounting**
  - field of accounting concerned with ***external*** users of a company's financial information
- **Managerial (Management) Accounting**
  - field of accounting that serves ***internal*** users of a company's financial information

Pearson

A firm's financial accounting system is concerned with external information users: consumer groups, unions, stockholders, suppliers, creditors, and government agencies. It prepares reports such as income statements and balance sheets that focus on the activities of the company as a whole rather than on individual departments or divisions.

Managerial (management) accounting serves internal users. Managers at all levels need information to make departmental decisions, monitor projects, and plan future activities. Other employees also need accounting information. Engineers must know certain costs. For example, before making product or operations improvements, purchasing agents use information on materials costs to negotiate terms with suppliers, and to set performance goals, salespeople need past sales data for each geographic region and for each of its products.

CPA Services (1 of 2)

- **Audit**
  - systematic examination of a company's accounting system to determine whether its financial reports *reliably represent* its operations
  - **Generally Accepted Accounting Principles (GAAP)**
    - accounting *guidelines* that govern the content and form of financial reports

Pearson

An audit examines a company's AIS to determine whether financial reports reliably represent its operations. Organizations must provide audit reports when applying for loans, selling stock, or when going through a major restructuring.

Independent auditors who do not work for the company must ensure that clients' accounting systems follow generally accepted accounting principles (GAAP), which are formulated by the Financial Accounting Standards Board (FASB) of the AICPA and govern the content and form of financial reports.

CPA *Services* (2 of 2)

- **Tax Services**
  - assistance provided by CPAs for tax preparation and tax planning
- **Management Advisory Services**
  - assistance provided by CPA firms in areas such as financial planning, information systems design, and other areas of concern for client firms
- **CPA Vision Project - Core Competencies for Accounting**
  - the combination of skills, technology, and knowledge that will be necessary for the future CPA

Pearson

Tax services include assistance not only with tax-return preparation but also with tax planning. A CPA’s advice can help a business structure (or restructure) operations and investments and perhaps save millions of dollars in taxes.

As consultants, accounting firms provide management advisory services ranging from personal financial planning to planning corporate mergers.

The Vision Project identifies a unique combination of skills, technology, and knowledge, called core competencies for accounting, that will be necessary for the future CPA. The AICPA summarizes the project’s core purpose as follows: “CPAs . . . Making sense of a changing and complex world.”

Emerging Competencies for Success in Accounting

Table 15.1 Emerging Competencies for Success in Accounting

Skills in Strategic Thinking and Critical Problem Solving	The accountant can combine data with reasoning and professional knowledge to recognize and help solve critical problems for better strategic action.
Communications, Interpersonal Skills, and Effective Leadership	The accountant can communicate effectively in various business situations using meaningful communications skills that provide interpersonal effectiveness and leadership.
Dedication to Meeting Customer Needs	The accountant surpasses the competition in understanding each client's unique needs, in meeting those needs, and in visualizing the client's future needs.
Ability to Integrate Diverse Information	The accountant can combine financial and other kinds of information to gain new meaning that provides clients with useful insights and understanding for solving problems.
Proficiency with Information Technology	The accountant can use information technology (IT) in performing services for clients and can identify IT applications that the client can adopt for added value to the business.

Pearson

As Table 15.1 shows, those skills, which include communication, critical thinking, and leadership, go far beyond the ability to "crunch numbers." They include certain communications skills, along with skills in critical thinking and leadership.

Private Accountants and Management Accountants

- **Private Accountant**
  - salaried accountant hired by a business to carry out its day-to-day financial activities
  - **Management Accountant**
    - private accountant who provides financial services to support managers in various business activities within a firm
  - **Certified Management Accountant (CMA)**
    - professional designation awarded by the Institute of Management Accountants (IMA) in recognition of management accounting qualifications

Pearson

To ensure integrity in reporting, CPAs are always independent of the firms they audit. However, many businesses also hire their own salaried employees, private accountants, to perform day-to-day activities.

Although private accountants may be either CPAs or non-CPAs, most are management accountants who provide services to support managers in various activities (marketing, production, engineering, and so forth). Many hold the certified management accountant (CMA) designation, awarded by the Institute of Management Accountants (IMA), recognizing qualifications of professionals who have passed IMA’s experience and examination requirements.

Forensic Accountants

- **Forensic Accounting**
  - the practice of accounting for legal purposes
- **Certified Fraud Examiner (CFE)**
  - professional designation administered by the Association of Certified Fraud Examiners in recognition of qualifications for a specialty area within forensic accounting

Pearson

One of the fastest-growing areas in accounting is forensic accounting, the use of accounting for legal purposes. Forensic accountants must be good detectives. They look behind the corporate façade instead of accepting financial records at face value. In combining investigative skills with accounting, auditing, and the instincts of a bloodhound, they assist in the investigation of business and financial issues that may have application to a court of law.

One specific area within forensic accounting, the Certified Fraud Examiner (CFE) designation, is administered by the ACFE. The CFE's activities focus specifically on fraud-related issues, such as fraud detection, evaluating accounting systems for weaknesses and fraud risks, investigating white-collar crime on behalf of law enforcement agencies, evaluating internal organizational controls for fraud prevention, and expert witnessing.

Internationalizing Accounting

- **International Accounting Standards Board (IASB)**
  - organization responsible for developing a set of global accounting standards and for gaining implementation of those standards

Pearson

Established in 2001 and housed in London, England, the International Accounting Standards Board (IASB) is an independent, nonprofit organization responsible for developing a set of global accounting standards and for gaining the support and cooperation of the world's various accounting organizations to implement those standards.

The Accounting Equation (1 of 2)

- **Accounting Equation**
  - Assets = Liabilities + Owners' Equity
  - *used by accountants to balance data for the firm's financial transactions at various points in the year*

All accountants rely on record keeping to enter and track transactions. Underlying all record-keeping procedures is the most basic tool of accounting, the accounting equation.

The Accounting Equation (2 of 2)

- **Asset**
  - any ***economic resource*** expected to benefit a firm or an individual who owns it
- **Liability**
  - *debt* owed by a firm to an *outside* organization or individual
- **Owners' Equity**
  - amount of money that ***owners would receive*** if they sold all of a firm's assets and paid all of its liabilities

An asset is any economic resource that is expected to benefit a firm or an individual who owns it. Assets for accounting purposes include land, buildings, equipment, inventories, and payments due the company (accounts receivable).

A liability is a debt that a firm owes to an outside party.

Owners' equity is the amount of money that owners would receive if they sold all of a company's assets and paid all of its liabilities.

Financial Statements

- **Financial Statement**
  - any of several types of ***reports summarizing*** a company's financial status to stakeholders and to aid in managerial decision making
    - balance sheet
    - income statement
    - statement of cash flows

Pearson

Accountants summarize the results of a firm's transactions and issue reports to help managers make informed decisions. Among the most important reports are financial statements, which fall into three broad categories: *balance sheets, income statements*, and *statements of cash flows.*

Balance Sheets (1 of 4)

- **Balance Sheet**
  - financial statement that supplies detailed information about a firm's ***assets, liabilities, and owners' equity***

Pearson

Balance sheets supply detailed information about the accounting equation items: *assets, liabilities*, and *owners' equity*. Because they also show a firm's financial condition at one point in time, they are sometimes called *statements of financial position*.

Apple's Balance Sheet

Apple, Inc.
Summary of Balance Sheet (condensed)
as of December 31, 2016
(in millions)

Assets	
Current Assets:	
Cash	$21,120
Marketable securities	20,481
Accounts receivable	16,849
Other	30,928
Total current assets	**$89,378**
Long-term marketable assets:	
Total long-term marketable assets	**$164,065**
Fixed assets:	
Property and equipment, net	$22,471
Total fixed assets	**$22,471**
Intangible assets:	
Intangible assets	$3,893
Goodwill	5,116
Total intangible assets	**$9,009**
Other assets	
Total other assets	**5,556**
Total assets	**$290,479**

Liabilities and Shareholder's Equity	
Current liabilities:	
Accounts payable	$35,490
Accrued expenses	25,181
Other	19,939
Total current liabilities	**$80,610**
Long-term liabilities:	
All long-term debts	$53,463
Other	37,051
Total long-term liabilities	**$90,514**
Total liabilities	**$171,124**
Shareholder's equity:	
Common stock and paid-in capital	$27,416
Retained earnings	91,939
Total shareholder's equity	**$119,355**
Total liabilities and shareholder's equity	**$290,479**

Apple's balance sheet for year ended December 31, 2016. As clearly indicated, Apple's total assets are equal to its total liabilities and owner's equity.

FIGURE 15.1 Apple's Balance Sheet
Source: Apple, Inc. (2017). 2016 Annual Report. Mountain View, California: Author.

Figure 15.1 is a simplified presentation of the balance sheet for Apple, Inc.

Balance Sheets (2 of 4)

- **Current Asset**
  - asset that *can or will be converted into cash within a year*
- **Liquidity**
  - *ease* with which an asset can be converted into cash
- **Fixed Asset**
  - asset with long-term use or value, such as land, buildings, and equipment
- **Depreciation**
  - accounting method for *distributing the cost* of an asset over its useful life

Pearson

Current assets include cash and assets that can be converted into cash within a year. The act of converting something into cash is called *liquidating*. Assets are normally listed in order of liquidity, the ease of converting them into cash.

Fixed assets (such as land, buildings, and equipment) have long-term use or value, but as buildings and equipment wear out or become obsolete, their value decreases. Accountants use depreciation to spread the cost of an asset over the years of its useful life.

Balance Sheets (3 of 4)

- **Current Liability**
  - debt that must be paid within one year
- **Accounts Payable (Payables)**
  - current liability consisting of bills owed to suppliers
- **Long-Term Liability**
  - debt that is not due for at least one year
- **Retained Earnings**
  - earnings retained by a firm for its use rather than paid out as dividends

Balance Sheets (4 of 4)

- **Intangible Asset**
  - nonphysical asset, such as a patent or trademark, that has economic value in the form of expected benefit
- **Goodwill**
  - amount paid for an existing business above the value of its other assets

Pearson

Although their worth is hard to set, intangible assets have monetary value in the form of expected benefits, which may include fees paid by others for obtaining rights or privileges—including patents, trademarks, copyrights, and franchises—to your products. Goodwill is the amount paid for an existing business beyond the value of its other assets.

Income Statements (1 of 3)

- **Income Statement (Profit-and-Loss Statement)**
  - financial statement listing a firm's annual ***revenues and expenses*** so that a bottom line shows annual profit or loss
  - revenues, cost of revenues, operating expenses, and net income

Profit (or Loss) = Revenues − Expenses

Pearson

The income statement is sometimes called a profit-and-loss statement because its description of revenues and expenses results in a figure showing the firm's annual profit or loss.

Apple's Income Statement

Apple, Inc.
Summary of Income Statement (condensed)
January 1, 2016–December 31, 2016
(in millions)

Revenues (gross sales)		**$233,715**
Cost of revenues	**140,089**	
Gross profit		**$93,626**
Operating expenses:		
Research development	8,067	
Selling, administrative and general	13,044	
Total operating expenses		**$21,111**
Operating income (before taxes)		$72,515
Income taxes*		19,121
Net income		**$53,394**

*approximate

FIGURE 15.2 Apple's Income Statement
Source: Apple, Inc. (2017). 2016 Annual Report. Mountain View, California: Author.

Popularly known as the *bottom line*, profit or loss is probably the most important figure in any business enterprise. Figure 15.2 shows the 2012 income statement for Apple, whose bottom line was $53,394 million.

Income Statements (2 of 3)

- **Revenues**
  - funds that flow into a business from the sale of goods or services
- **Cost of Goods Sold**
  - costs of obtaining materials for making the products sold by a firm during the year
- **Operating Expenses**
  - costs, other than the cost of revenues, incurred in producing a good or service

Income Statements (3 of 3)

- **Gross Profit**
  - preliminary, quick-to-calculate profit figure calculated from the firm's revenues minus its cost of revenues (the direct costs of getting the revenues)
- **Operating Income**
  - gross profit minus operating expenses
- **Net Income (Net Profit, Net Earnings)**
  - gross profit minus operating expenses and income taxes

Pearson

Managers are often interested in gross profit, a preliminary, quick-to-calculate profit figure that considers just two pieces of data—revenues and cost of revenues (the direct costs of getting those revenues)—from the income statement. To calculate gross profit, subtract cost of revenues from revenues obtained by selling the firm's products.

Statements of Cash Flows

- **Statement of Cash Flows**
  - financial statement describing a firm's yearly cash receipts and cash payments

The SEC requires all firms whose stock is publicly traded to issue a third report, the statement of cash flows, which describes yearly cash receipts and cash payments. Because it provides the most detail about how the company generates and uses cash, some investors and creditors consider it one of the most important statements of all. It shows the effects on cash of three aspects of a business: *operating activities, investing activities*, and *financing activities*.

Apple's Statement of Cash Flows

Apple, Inc.
Summary of Cash-flow (condensed)
January 1, 2016–December 31, 2016
(in millions)

Net cash/cash equivalents at beginning of year		**$13,844**
Net cash provided by operating activities		**$53,394**
Net cash provided from other sources		
Proceeds from sales of marketable securities	$5,541	
Proceeds from issuance of common stock	543	
Other	289	
Total	**$6,373**	**$73,611**
Net cash expended		
Payments for marketable securities	$12,897	
Payments for intangible assets	9,450	
Payments for repurchase of common stock	24,756	
Other	5,388	
Total		**$52,491**
Net case/cash equivalents at end of year		**$21,120**

FIGURE 15.3 Google's Statement of Cash Flows
Source: Google, Inc. (2015). 2014 Annual Report. Mountain View, California: Author.

The Budget: An Internal Financial Statement

- **Budget**
  - detailed statement of ***estimated*** receipts and expenditures for a future period of time

Pearson

For planning, controlling, and decision making, the most important internal financial statement is the budget, a detailed report on estimated receipts and expenditures for a future period of time. Although that period is usually one year, some companies also prepare three- or five-year budgets, especially when considering major capital expenditures. The budget differs from the other statements we have discussed in that budgets are not shared outside the company; hence the “internal financial statement” title.

Perfect Posters' Sales Budget

Perfect Posters, Inc.
555 RIVERVIEW, CHICAGO, IL 60606

Perfect Posters, Inc.
Sales Budget
First Quarter, 2018

	January	February	March	Quarter
Budgeted sales (units)	7,500	6,000	6,500	20,000
Budgeted selling price per unit	$3.50	$3.50	$3.50	$3.50
Budgeted sales revenue	**$26,250**	**$21,000**	**$22,750**	**$70,000**
Expected cash receipts:				
From December sales	$26,210			$26,210
From January sales	17,500	$8,750		26,250
From February sales		14,000	$7,000	21,000
From March sales			15,200	15,200
Total cash receipts:	**$43,710**	**$22,750**	**$22,200**	**$88,660**

FIGURE 15.4 Perfect Posters' Sales Budget

Pearson

Figure 15.4 is a sales budget for a hypothetical wholesaler, Perfect Posters.

Analyzing Financial Statements

- **Solvency Ratio**
  - financial ratio, either short- or long-term, for estimating the borrower's ability to repay debt
- **Profitability Ratio**
  - financial ratio for measuring a firm's potential earnings
- **Activity Ratio**
  - financial ratio for evaluating management's efficiency in using a firm's assets

What are the chances that a borrower will be able to repay a loan and the interest due? This question is first and foremost in the minds of bank lending officers, managers of pension funds and other investors, suppliers, and the borrowing company's own financial managers. Solvency ratios provide measures of a firm's ability to meet its debt obligations.

It's important to know whether a company is solvent in both the long and the short term, but risk alone is not an adequate basis for investment decisions. Investors also want some indication of the returns they can expect. Evidence of earnings power is available from profitability ratios, such as *earnings per share*.

The efficiency with which a firm uses resources is linked to profitability. As a potential investor, you want to know which company gets more mileage from its resources. Information obtained from financial statements can be used for *activity ratios* to measure this efficiency.

Solvency Ratios: Borrower’s Ability to Repay Debt

- **Short-Term Solvency Ratio**
  - financial ratio for measuring a company’s ability to pay immediate debts
  - **Current Ratio**
    - financial ratio for measuring a company’s ability to pay current debts out of current assets
    - current assets / current liabilities

Pearson

Short-term solvency ratios measure a company’s liquidity and its ability to pay immediate debts. The most commonly used of these is the current ratio, or “banker’s ratio.”

This ratio measures a firm’s ability to generate cash to meet current obligations through the normal, orderly process of selling inventories and collecting revenues from customers. It is calculated by dividing current assets by current liabilities. The higher a firm’s current ratio, the lower the risk to investors.

Long-Term Solvency

- **Debt**
  - company's total liabilities
- **Leverage**
  - ability to finance an investment through borrowed funds

Liabilities / Owner's Equity

Pearson

Long-term solvency is calculated by dividing debt (total liabilities) by owners' equity. The lower a firm's debt, the lower the risk to investors and creditors.

Companies with more debt may find themselves owing so much that they lack the income needed to meet interest payments or to repay borrowed money.

Sometimes, high debt can be not only acceptable but also desirable. Borrowing funds gives a firm leverage, the ability to make otherwise unaffordable investments.

In *leveraged buyouts*, firms have willingly taken on sometimes huge debts to buy out other companies.

Profitability Ratios: Earnings Power for Owners

- **Earnings Per Share**
  - profitability ratio measuring the net profit that the company earns for each share of outstanding stock

- **Activity Ratios**
  - how efficiently is the firm using its resources?
  - annual sales revenues can increase without an increase in operating costs

Pearson

It’s important to know whether a company is solvent in both the long and the short term, but risk alone is not an adequate basis for investment decisions. Investors also want some indication of the returns they can expect. Evidence of earnings power is available from profitability ratios, such as *earnings per share*. Defined as net income divided by the number of shares of common stock outstanding, earnings per share determines the size of the dividend that a firm can pay shareholders.