CHAPTER 1

Accounting Information and Decision Making

Learning Objectives

AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:

- **LO1** Describe the two primary functions of financial accounting.
- **LO2** Identify the three fundamental business activities that financial accounting measures.
- **LO3** Discuss how financial accounting information is communicated through financial statements.
- **LO4** Describe the role that financial accounting plays in the efficient distribution of society's resources.
- **LO5** Explain the term generally accepted accounting principles (GAAP) and describe the role of GAAP in financial accounting.
- **LO6** Identify career opportunities in accounting.

Appendix

- **LO7** Explain the nature of the conceptual framework used to develop generally accepted accounting principles.

Feature Story

DELL INCORPORATED: COMPUTING THE SUCCESS OF AN ENTREPRENEUR

Michael was not your average college student. Since age 12, when he started his first business venture selling stamps, he realized that if you have a good idea, work hard, and treat customers with special care, you can make money—and sometimes, a lot of money. After a series of small, successful business ventures through high school, at age 19 Michael came up with his next business idea. In 1984, with an initial investment of only $1,000, he started a company that custom-built personal computers for sale directly to customers. The company enjoyed immediate success. In 1988, the company offered for sale to the public 3,500,000 shares of stock for $8.50 per share and changed its name to **Dell Incorporated**.

By the age of 26, Michael Dell had become the youngest CEO of a company ever included on the prestigious **Fortune** 500 list. Better yet, Dell's stock enjoyed greater growth than any other stock during the 1990s. By December 31, 1999, each share had increased in value nearly 60,000%. If you had invested just $1,000 in Dell at its initial public offering in 1988, your investment would have increased to nearly $600,000 by the end of 1999!

What if instead of investing $1,000 in Dell in 1988, you had invested $1,000 in **Polaroid Corporation**, most famous for its instant-film cameras? You would have watched your $1,000 shrink to $0 by 2001, when the company declared bankruptcy.

How do investors decide where to invest their money? Thousands of stocks are available in the United States, and thousands more on stock exchanges around the world. How do investors separate the successful companies from the unsuccessful companies?

The key source of information investors use to identify successful and unsuccessful companies is financial accounting—the subject of this book. As you read through the chapters, you'll begin to understand the information that financial accounting provides to investors making business decisions. And as the contrast between Dell and Polaroid demonstrates, the payoffs for understanding (or failing to understand) the financial position of a company can be quite large.

PART A

ACCOUNTING AS A MEASUREMENT/ COMMUNICATION PROCESS

Welcome to accounting. A common misconception about this course is that it is a math class, much like college algebra, calculus, or business statistics. You will soon see that this is *not* a math class. Don't say to yourself, "I'm not good at math so I probably won't be good at accounting." Though it's true that we use numbers heavily throughout each chapter, accounting is far more than adding, subtracting, and solving for unknown variables. So, what exactly is accounting? We'll take a close look at this next.

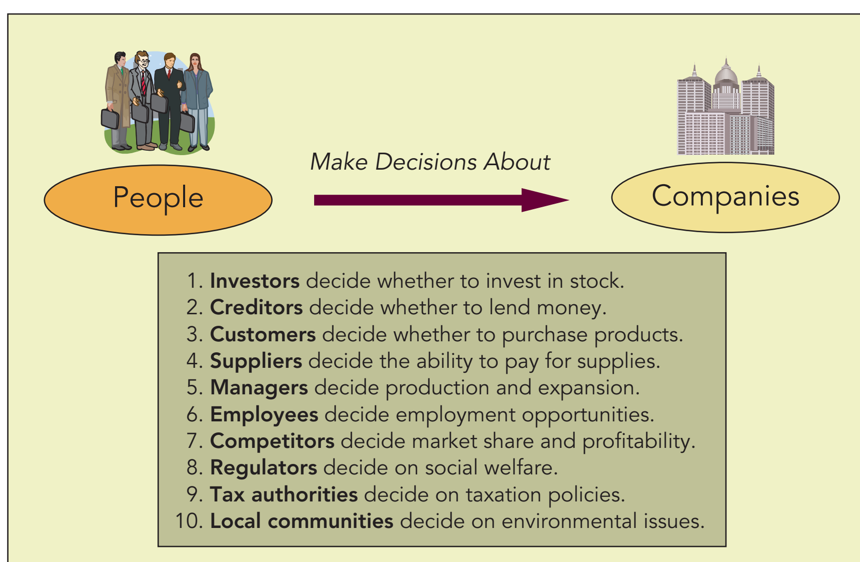
Defining Accounting

■ **LO1**
Describe the two primary functions of financial accounting.

Accounting is "the language of business." More precisely, **accounting** is a system of maintaining records of a company's operations and communicating that information to decision makers. Perhaps the earliest use of such systematic recordkeeping dates back thousands of years to ancient Mesopotamia (present-day Iraq), where records were kept of delivered agricultural products. Using accounting to maintain a record of multiple transactions allowed for better exchange among individuals and aided in the development of more complex societies.[1] In this class, you'll learn how to read, interpret, and communicate using the language of business.

Today, many millions of people every day must make informed decisions about companies. While investors and creditors (lenders) are the primary users of financial accounting information, there are many others. Illustration 1–1 identifies some of those people and examples of decisions they make about the companies.

ILLUSTRATION 1–1
Decisions People Make About Companies



People and organizations need useful information in order to make good decisions. This is where accounting plays a key role. As Illustration 1–2 shows, **the functions of accounting are to *measure* the activities of the company and *communicate* those measurements to people.**

We classify accounting into two broad categories: managerial accounting and financial accounting. **Managerial accounting** deals with the methods accountants use to provide information to an organization's *internal* users—that is, its own managers. These are the subjects of another course.

[1]S. Basu and G. Waymire. 2006. Recordkeeping and Human Evolution. *Accounting Horizons* 20(3): 201–229.

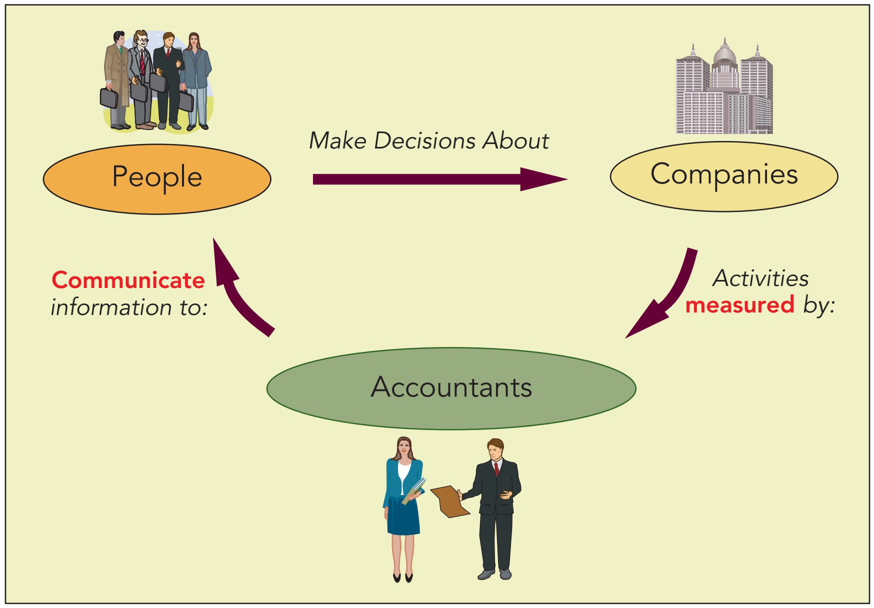


ILLUSTRATION 1–2
Functions of Accounting

In this class, we focus on financial accounting. The two primary functions of **financial accounting** are to measure business activities of a company and to communicate those measurements to *external* parties for decision-making purposes. The two primary external users of financial accounting information (users outside the firm) are investors and creditors. **Investors** make decisions related to buying and selling the company's stock (shares of ownership): Is the company profitable? Will the company's stock increase in value? **Creditors** make decisions related to lending money to the company: Will the company be able to repay its debt when it comes due? Will it be able to pay interest in the meantime?

User's Guide For learning objectives throughout the book, you will see boxed sections, like this one, titled *Key Point.* These boxed items will highlight the central focus of the learning objectives.

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.

Business Activities to Measure

LO2
Identify the three fundamental business activities that financial accounting measures.

The first of financial accounting's functions is to measure business activities. A business engages in three fundamental activities—financing, investing, and operating.

- **Financing activities** are transactions involving external sources of funding. There are two basic sources of this external funding—the owners of the company who invest their own funds in the business, and creditors who lend money to the company. With this financing, the company engages in investing activities.
- **Investing activities** include the purchase and sale of (1) long-term resources such as land, buildings, equipment, and machinery and (2) any resources not directly related to a company's normal operations. Once these investments are in place, the company has the resources needed to run the business and can perform operating activities.
- **Operating activities** include transactions that relate to the primary operations of the company, such as providing products and services to customers and the associated costs of doing so, like utilities, taxes, advertising, wages, rent, and maintenance.

The first role of financial accounting is to measure (or keep a record of) a company's financing, investing, and operating activities. Let's look at an example.

EXAMPLE OF BUSINESS ACTIVITIES

Suppose you want to start a computer-repair business. You estimate that it will cost approximately $10,000 to get the business up and going. However, you have only $1,000 available, so you need to get funding of $9,000 elsewhere. You begin by borrowing $2,000 from a local bank, which you agree to repay a year later. Thus, the bank is your creditor.

To raise the remaining $7,000, you organize your business as a corporation. A **corporation** is an entity that is legally separate from its owners. The corporation raises external funding by selling shares of ownership (typically referred to as common stock) in the corporation. Each share of stock represents a unit of ownership. Many of the corporations with which you are familiar, such as **Coca-Cola**, **American Eagle**, **Apple Inc.**, **Ford Motor Co.**, **Microsoft**, and **Starbucks** have millions of stockholders and therefore millions of owners.

For your computer-repair business, let's say you issue 800 shares of common stock for $10 each. With your original $1,000, you buy 100 shares of stock, giving you one-eighth ownership in the corporation (your 100 shares ÷ 800 shares total). Other investors purchase the remaining 700 shares, giving them seven-eighths ownership in the company.

In this example, the *financing* activities of the company are cash inflows of $2,000 from creditors and $8,000 from investors.

Creditors (local bank)	$ 2,000	Financing
Investors (you and others)	8,000	
	$10,000	

With this financing of $10,000, your company purchases a truck costing $6,000 and equipment costing $3,000. With these resources in place, you are ready to begin operations. You start by purchasing advertising in the local newspaper for $200 and paying for the first month's office rent of $800.

You've now engaged in the second and third types of business activities: Your *investing* activities include the purchase of the truck and equipment; they involve the purchase of long-term resources. Advertising and office rent are examples of *operating* activities; they are more directly related to normal operations.

Truck	$ 6,000	Investing
Equipment	3,000	
Advertising	200	Operating
Office rent	800	
	$10,000	

HOW TO MEASURE BUSINESS ACTIVITIES

How should accountants measure these business activities? In other words, what information would a company's investors and creditors be interested in knowing to make informed decisions about your computer-repair business? **Ultimately, investors and creditors want to know about the company's resources and their claims to those resources.** Accounting uses some conventional categories to describe such resources and claims.

Assets, liabilities, and stockholders' equity. We measure resources owned by a company as **assets**. Recall that with the start-up funds of \$10,000, your computer-repair business bought a truck (\$6,000) and equipment (\$3,000). You will measure the \$9,000 as assets. Other assets typical of most businesses include such items as cash, inventories, supplies, and buildings. Cash is a resource used to make purchases; inventories represent resources used to make product sales to customers; supplies include resources used to perform basic business functions; and buildings are resources used by employees as a location from which to operate a company.

User's Guide Pay close attention to the accounting categories we define here. These may be new terms for you. We promise that very soon they will be second nature to you.

As discussed earlier, two parties claim the resources of the company—creditors and investors. Amounts owed to creditors are **liabilities**. The computer-repair business has a liability of \$2,000 to a local bank. Other examples of liabilities are amounts owed to suppliers, workers, utility companies, and governments (in the form of taxes). Liabilities must be paid by a specified date.

Investors, or owners, claim any resources of the company not owed to creditors. You can see this relationship in home ownership: Your house (an asset) is worth \$300,000. The bank that helped finance its purchase holds a \$200,000 mortgage (a liability). Your *equity* in the house is \$100,000. For a corporation, we refer to owners' claims to resources as **stockholders' equity**, since stockholders are the owners of the corporation.

We express the relationship among the three measurement categories in what is called the basic **accounting equation**, depicted in Illustration 1–3. It shows that a company's resources equal creditors' and owners' claims to those resources.

$$\underbrace{\text{Assets}}_{\text{(resources)}} = \underbrace{\underset{\text{(creditors' claims)}}{\text{Liabilities}} + \underset{\text{(owners' claims)}}{\text{Stockholders' Equity}}}_{\text{(claims to resources)}}$$

ILLUSTRATION 1–3
The Basic Accounting Equation

Another way to think about this relationship is to replace the parenthetical descriptions under each of the three parts of the equation:

Assets	=	Liabilities	+	Stockholders' Equity
(company owns)		(company owes)		(difference)

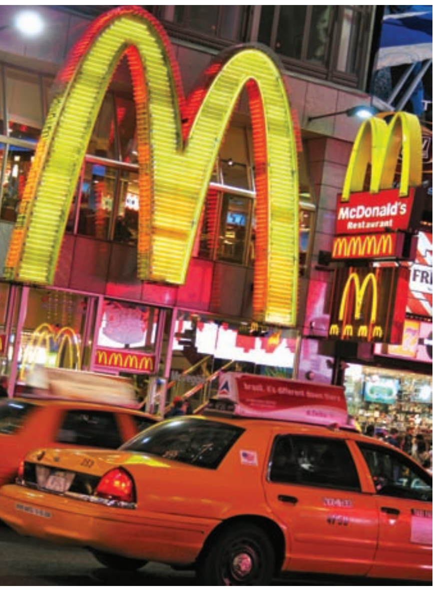
Also, as with any equation, we can move the components (by following mathematical rules you learned in high school). For example, to isolate stockholders' equity, we can subtract liabilities from both sides of the equal sign.

Assets	−	Liabilities	=	Stockholders' Equity
(company owns)		(company owes)		(difference)

Thus, the computer-repair business has assets of \$9,000 but liabilities of \$2,000. How much equity do stockholders have? They have \$9,000 − \$2,000, or \$7,000.

The accounting equation illustrates a fundamental model of business valuation. The value of a company to its owners equals total resources of the company minus amounts owed to creditors. Creditors expect to receive only resources equal to the amount owed them. Stockholders, on the other hand, can claim all resources in excess of the amount owed to creditors.

Revenues, expenses, and dividends. Of course, all businesses intend to increase the amount of their resources through their operations and eventually to own more than they owe. We broadly define such increases as profits. (Later, we'll define profits a bit more narrowly.) Because stockholders claim all resources in excess of amounts owed to creditors, profits of the company, which add to total resources, are claimed solely by stockholders, the owners of the company.



We calculate a company's profits by comparing its revenues and expenses. **Revenues** are the amounts earned from selling products or services to customers. For example, when your computer-repair business provides services to a customer, it earns revenues. When **McDonald's** sells you a burger, fries, and drink, McDonald's earns revenue.

However, as you've probably heard, "It takes money to make money." To operate your computer-repair business, for example, you purchased advertising ($200) and paid the first month's rent ($800). We record these amounts as expenses. **Expenses** are the costs of providing products and services. You'll record expenses of $1,000 for your computer-repair business.

When McDonald's sells you a Big Mac, it incurs expenses for two all-beef patties, special sauce, lettuce, cheese, pickles, onions, and a sesame-seed bun. McDonald's also pays the person who took your order, the cook behind the partition, and the person who cleans up after you're gone. Then there's the cost of having and maintaining the building, TV ads, expenses of the corporate headquarters, utilities, equipment maintenance, income taxes, interest on debt, and many, many more.

Common Terms Other common names for net income include *earnings* and *profit.*

We measure the difference between revenues and expenses as **net income**. All businesses want revenues to be greater than expenses, producing a positive net income. However, if expenses exceed revenues, as happens from time to time, the difference between them is a negative amount—a **net loss**. You'll notice the use of the term *net* to describe a company's profitability. In business, the term *net* is used often to describe the difference between two amounts. Here, we measure revenues *net* of (or minus) expenses to calculate the net income or net loss.

Illustration 1–4 reports McDonald's revenues, expenses, and net income from its operations around the world.

ILLUSTRATION 1–4

Revenue and Expenses for McDonald's Corporation, as of 2009

($ in millions)	Revenues	–	Expenses	=	Net Income
United States	$7,943.8	–	$4,712.1	=	$3,231.7
Europe	9,273.8	–	6,685.7	=	2,588.1
Asia/Pacific, Middle East, Africa	4,337.0	–	3,347.5	=	989.5

Notice that McDonald's generates only about one-third of its revenues in the United States, but almost half its net income comes from the United States. This means that McDonald's is able to make more profit per dollar of revenue in the United States than anywhere else in the world.

If the corporation has positive net income, it typically will distribute to its owners, the stockholders, some of those profits. It does so by making cash payments to its stockholders (usually every three months), in payments called **dividends**. McDonald's, for example, has paid a dividend to stockholders every three months for over 30 years. In 2009, McDonald's paid dividends of $2.05 per share. If you owned 100 shares of McDonald's stock, you would have received $205.00 from McDonald's in cash. Unlike creditors, who lend money to the company in expectation of being repaid, stockholders are not guaranteed regular cash payments from the firm.

Let's Review

Match the term with the appropriate definition.

1. _____ Assets	A. Costs of selling products or services.
2. _____ Liabilities	B. Amounts earned from sales of products or services.
3. _____ Stockholders' equity	C. Amounts owed.
4. _____ Dividends	D. Distributions to stockholders.
5. _____ Revenues	E. Owners' claims to resources.
6. _____ Expenses	F. Resources owned.

Solution:

1. F; 2. C; 3. E; 4. D; 5. B; 6. A

User's Guide *Let's Review* exercises break each chapter into manageable review modules to enhance your learning.

Suggested Homework:
BE1-4;
E1-2, E1-3;
P1-2A&B

In summary, the measurement role of accounting is to create a record of the financing, investing, and operating activities of the company. To make this possible, the firm must maintain an accurate record of its assets, liabilities, stockholders' equity, revenues, expenses, and dividends. Be sure you understand the meaning of these items. We will refer to them throughout this book. Illustration 1–5 summarizes the business activities and the categories that measure them.

	Activities Related to:	Measurement Category
Financing Activities	• Borrowing • Stockholders' investment • Distributions to stockholders	• Liabilities • Stockholders' equity • Dividends
Investing Activities	• Resources owned by the company	• Assets
Operating Activities	• Sales to customers • Costs of selling to customers	• Revenues • Expenses

ILLUSTRATION 1–5
Business Activities and Their Measurement

KEY POINT

Financing activities include transactions with creditors and owners. Investing activities generally include the purchase or disposal of productive assets. Operating activities relate to earning revenues and incurring expenses.

As you learn to measure business activities, you will often find it helpful to consider both sides of the transaction: When someone pays cash, someone else receives cash; when someone borrows money, another lends money. Likewise, an expense for one company can be a revenue for another company; one company's asset can be another company's liability. Throughout this book, you will find discussions of the "flip side" of certain transactions, indicated by the icon you see here in the margin. In addition, certain homework problems, also marked by the icon, will ask you specifically to address the "flip side" in your computations. (See page 39 for the first such example.)

Flip Side

FORMS OF BUSINESS ORGANIZATION

The computer-repair business introduced earlier was organized as a corporation. Other common business forms include sole proprietorships and partnerships. A **sole proprietorship** is a business owned by one person, whereas a **partnership** is a business owned by two or more persons. If you had decided to start the computer-repair business without outside investors, you could have formed a sole proprietorship. Or, you and a friend could have formed a partnership.

To decide on a form of business organization, you need to understand their advantages and disadvantages. The major *advantage* of the corporate form of business is the limited liability of the corporation's stockholders. **Limited liability** means the stockholders are not held personally responsible for the financial obligations of the corporation. If the business fails, stockholders can lose no more than the investment they already made by purchasing stock. In other words, stockholders are not obligated to pay the corporation's remaining debts out of their own pockets. In contrast, if a sole proprietorship or partnership is unable to pay its legal obligations to creditors, the owner(s) may be forced to surrender personal assets, such as homes, cars, computers, and furniture to satisfy those debts.

The *disadvantage* of the corporate form of business is the higher tax burden on the owners. Generally, the corporate income tax rate is greater than the individual income tax rate. Moreover, a corporation's income is taxed twice—first when the company earns it and pays corporate income taxes on it, and then again when stockholders pay personal income taxes on amounts the firm distributes to them as dividends. This is called *double taxation.* Any income of a sole proprietorship or a partnership is taxed only once, and at the personal income tax rate.

Because most of the largest companies in the United States are corporations, in this book we will primarily focus on accounting from a corporation's perspective. Focusing on corporations also highlights the importance of financial accounting—to measure and communicate activities of a company when owners (shareholders) are typically separated from management of the company. (A more detailed discussion of the advantages and disadvantages of a corporation can be found in Chapter 10.)

Communicating through Financial Statements

■ LO3
Discuss how financial accounting information is communicated through financial statements.

We've discussed that different business activities produce assets, liabilities, stockholders' equity, dividends, revenues, and expenses, and that the first important role of financial accounting is to record the relevant transactions of a company. Its second vital role is to communicate these business activities to those outside the company. The primary means of communicating business activities is through financial statements. **Financial statements** are periodic reports published by the company for the purpose of providing information to external users. We have four primary financial statements:

1. Incomes tatement
2. Statement of stockholders' equity
3. Balances heet
4. Statement of cash flows

These financial statements give investors and creditors the key information they need when making decisions about a company: Should I buy the company's stock? Should I lend money to the company? Is management efficiently operating the company? Without these financial statements, it would be difficult for those outside the company to see what's going on inside.

Let's go through a simple set of financial statements to see what they look like. We'll start with the income statement of a simple, fictitious company. Actual companies' financial statements often report items you haven't yet encountered. However, because actual companies' financial information will be useful in helping you understand certain accounting topics, we'll sample them often throughout the book.

THE INCOME STATEMENT

The **income statement** is a financial statement that reports the company's revenues and expenses over an interval of time. It shows whether the company was able to generate enough revenue to cover the expenses of running the business. If revenues exceed expenses, then the company reports *net income:*

Revenues − Expenses = Net income

If expenses exceed revenues, then the company reports a *net loss*.

Now, let's look at our fictitious company. On January 1 Eagle Golf Academy begins operations by offering lessons to junior golfers. The lessons include a variety of skills intended to develop players for a top university golf program and perhaps even one day playing on the PGA Tour. For the first month of operations, Eagle Golf Academy reports its income statement as shown in Illustration 1–6.

Common Terms Other common names for the income statement include *statement of operations* and *statement of income.*

ILLUSTRATION 1–6

Income Statement for Eagle Golf Academy

EAGLE GOLF ACADEMY
Income Statement
For the month ended January 31

Revenues:	
Service revenue	$6,360
Expenses:	
Salaries expense	3,100
Rent expense	500
Supplies expense	800
Interest expense	100
Utilities expense	960
Other expenses	400
Total expenses	5,860
Net income	$ 500

Notice the heading of the income statement: It includes the company's name, the title of the financial statement, and the time period covered by the financial statement. The three major captions in the income statement include **revenues** and **expenses,** discussed earlier, and the difference between them—**net income.**

We can determine from the income statement that for the month of January Eagle Golf Academy earns revenues of **$6,360**. This means that Eagle provides golf training and bills customers for a total of $6,360. Total expenses associated with generating those revenues, including salaries, rent, supplies, and other items listed here, are **$5,860**. These are typical costs that we might expect of any company. The income statement shows that revenues *exceed* expenses ($6,360 is greater than $5,860), and thus the academy is able to report net income of **$500**.

The fact that Eagle reports a positive net income is, in some sense, a signal of the company's success. The company is able to charge its customers a price higher than the costs of running the business. Do you assume most companies sell their products and services for a profit? It's not as easy as you might think. In recent years, **American Airlines**, **OfficeMax**, **Eastman Kodak**, **Ford Motor Co.**, **Goodyear Tire and Rubber**, **ConocoPhillips**, **CBS**, **U.S. Cellular**, **Gateway**, **Sirius Satellite Radio**, **Sprint PCS**, **Blockbuster**, and hundreds of others have reported net losses.

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.

Decision Point

User's Guide *Decision Points* in each chapter highlight specific decisions related to chapter topics that can be made using financial accounting information.

Question	Accounting information	Analysis
How can I tell if a company is profitable?	Income statement	If revenues exceed expenses, a company has net income and is profitable.

THE STATEMENT OF STOCKHOLDERS' EQUITY

The **statement of stockholders' equity** is a financial statement that summarizes the changes in stockholders' equity over an interval of time. The reporting period coincides with the time period covered by the income statement.

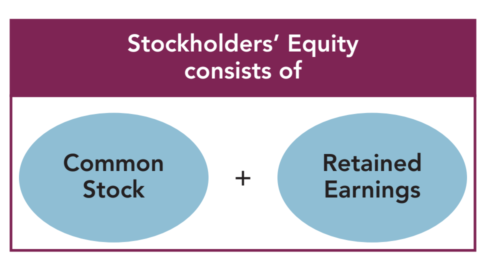
Stockholders' equity has two primary components—common stock and retained earnings. Recall that common stock represents amounts invested by stockholders (the owners of the corporation) when they purchase shares of stock. Common stock is an *external* source of stockholders' equity.

Common Terms Another common name for retained earnings is *profits reinvested in the business.*

Retained earnings, on the other hand, is an *internal* source of stockholders' equity. **Retained earnings** represents the cumulative amount of net income, earned over the life of the company, that has *not* been distributed to stockholders as dividends. Since all profits of the company are owned by stockholders, any net income in excess of dividends paid to stockholders represents stockholders' equity retained in the business. Thus, both common stock and retained earnings make up total stockholders' equity. This concept is shown in Illustration 1–7.

ILLUSTRATION 1–7

Components of Stockholders' Equity



You will notice that some financial statements have parentheses around some amounts. As you will learn as you study this book, accounting convention uses parentheses to highlight negative amounts (such as the subtraction of dividends here) or to show cash outflows (which we will point out later).

Suppose Eagle obtains financing in January by issuing common stock for $25,000. This transaction will distribute shares of common stock to investors in return for the company's receiving cash of $25,000. Let's say that at the end of January, Eagle pays dividends of $200 to stockholders. Illustration 1–8 (next page) shows the statement of stockholders' equity for Eagle Golf Academy.

When the company begins operations on January 1, the balances of common stock and retained earnings are **$0**. Once the company issues common stock, its balance increases to **$25,000**. The balance of retained earnings always increases by the amount of net income less any dividends paid to stockholders—here, $500 − $200 = $300. **The name *retained earnings* is descriptive. The balance of retained earnings represents the amount of "earnings retained" (not paid out in the form of dividends) over the life of the company.**

ILLUSTRATION 1–8

Statement of Stockholders' Equity for Eagle Golf Academy

EAGLE GOLF ACADEMY
Statement of Stockholders' Equity
For the month ended January 31

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance (Jan. 1)	$ -0-	$ -0-	$ -0-
Issuance of common stock	25,000		25,000
Add: **Net income for January**		**500**	**500**
Less: Dividends		(200)	(200)
Ending balance (Jan. 31)	$25,000	$ 300	$25,300

Retained earnings includes net income less dividends. Note that the items shown here in blue come from the income statement.

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.

User's Guide Throughout each chapter, you will see sections titled *Common Mistake.* Information in these boxes will help you avoid common mistakes on exams, quizzes, and homework.

By adding common stock and the retained earnings of $300, we calculate the balance of total stockholders' equity at January 31 to be **$25,300**. In accounting terms, this amount represents the value of the firm to its owners, the stockholders. The company creates value *externally* through investment by owners (common stock) and *internally* by generating and retaining profits (retained earnings).

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.

Decision Point

Question	Accounting information	Analysis
Was the change in company value (stockholders' equity) the result of external or internal sources?	Statement of stockholders' equity	When a company sells common stock, company value increases due to external sources (stockholders). When a company has profits during the year in excess of dividends paid, company value increases due to internal sources (company operations).

THE BALANCE SHEET

The **balance sheet** is a financial statement that presents the financial position of the company on a particular date. The financial position of a company is summarized by the basic accounting equation (see Illustration 1–3): **Assets = Liabilities + Stockholders' Equity.** As discussed earlier, this equation provides a fundamental model of business valuation. Assets are the resources owned by the company, and liabilities are amounts owed to creditors. Stockholders have equity in the company to the extent that assets exceed liabilities. Creditors also need to understand the balance sheet; it's the company's assets that will be used to pay liabilities (the amounts due creditors) as they become due.

The income statement is like a video (shows events over time), whereas a balance sheet is like a photograph (shows events at a point in time).

Illustration 1–9 shows the balance sheet of Eagle Golf Academy. The first thing to notice is the time period included in the heading. Recall that the income statement and statement of stockholders' equity both show activity over an *interval of time*. The balance sheet, in contrast, reports assets, liabilities, and stockholders' equity at a *point in time*. For example, Eagle's income statement shows revenue and expense activity occurring *from* January 1 to January 31; its balance sheet shows assets, liabilities, and stockholders' equity of the company *on* January 31.

ILLUSTRATION 1–9

Balance Sheet for Eagle Golf Academy

Total assets must equal total liabilities and stockholders' equity.

We show the stockholders' equity items in purple here, to indicate they came from the statement of stockholders' equity (Illustration 1–8).

EAGLE GOLF ACADEMY
Balance Sheet
January 31

Assets		Liabilities	
Cash	$ 6,200	Accounts payable	$ 2,300
Accounts receivable	2,700	Salaries payable	300
Supplies	1,500	Interest payable	100
Equipment, net	23,600	Utilities payable	960
Other assets	5,500	Notes payable	10,000
		Other liabilities	540
		Total liabilities	**14,200**
		Stockholders' Equity	
		Common stock	25,000
		Retained earnings	300
		Total stockholders' equity	**25,300**
Total assets	**$39,500**	**Total liabilities and stockholders' equity**	**$39,500**

Common Terms Another common name for the balance sheet is *statement of financial position.*

For Eagle Golf Academy on January 31, total assets equal **$39,500** and include some of the typical resources owned by most businesses, such as cash, supplies, and equipment. You'll learn about many other assets as you go through this book. Total liabilities equal **$14,200** and include amounts owed to regular vendors (accounts payable), as well as amounts owed for other items such as employee salaries, interest, and utilities. As you'll begin to learn, many liabilities are referred to as "payables" to signify amounts that must be paid.

The difference between assets and liabilities of **$25,300** represents stockholders' equity. Total stockholders' equity includes the amount of common stock plus the amount of retained earnings from the statement of stockholders' equity. Notice that the amounts listed in the balance sheet show that the accounting equation balances:

Assets	=	**Liabilities**	+	**Stockholders' Equity**
(resources)		(creditors' claims)		(owners' claims)
$39,500	=	$14,200	+	$25,300

KEY POINT

The balance sheet demonstrates that the company's resources (assets) equal creditors' claims (liabilities) plus owners' claims (stockholders' equity) to those resources.

Decision Point

Question	Accounting information	Analysis
What are creditors' claims and owners' claims to the company's resources?	Balance sheet	The amount of total liabilities equals creditors' claims to the company's resources. The extent to which total assets exceed total liabilities represents owners' claims.

THE STATEMENT OF CASH FLOWS

The **statement of cash flows** is a financial statement that measures activities involving cash receipts and cash payments over an interval of time. We can classify all cash transactions into three categories that correspond to the three fundamental business activities—operating, investing, and financing—we discussed earlier in the chapter:

- **Operating cash flows** include cash receipts and cash payments for transactions involving revenues and expenses.
- **Investing cash flows** generally include cash transactions for the purchase and sale of investments and productive long-term assets. Long-term assets are resources owned by a company that are thought to provide benefits for more than one year.
- **Financing cash flows** include cash transactions with lenders, such as borrowing money and repaying debt, and with stockholders, such as issuing stock and paying dividends.

Decision Maker's Perspective

User's Guide Decision Maker's Perspective sections discuss the usefulness of accounting information to decision makers such as investors, creditors, and company managers.

The statement of cash flows can be an important source of information to investors and creditors. For example, investors use the relationship between net income (revenues minus expenses) and operating cash flows (cash flows from revenue and expense activities) to forecast a company's future profitability. Creditors compare operating cash flows and investing cash flows to assess a company's ability to repay debt. Financing activities provide information to investors and creditors about the mix of external financing of the company. ●

Illustration 1–10 (next page) provides the statement of cash flows for Eagle Golf Academy. Notice that the three sections in the statement of cash flows show the types of inflows and outflows of cash during the period. Inflows are shown as positive amounts; outflows are shown in parentheses to indicate negative cash flows. The final line in each section shows, in the right-most column, the difference between inflows and outflows as *net cash flow* for that type of activity.

KEY POINT

The statement of cash flows reports cash transactions from operating, investing, and financing activities.

ILLUSTRATION 1–10

Statement of Cash Flows for Eagle Golf Academy

EAGLE GOLF ACADEMY Statement of Cash Flows For the month ended January 31		
Cash Flows from Operating Activities		
Cash inflows:		
From customers	$ 4,200	
Cash outflows:		
For salaries	(2,800)	
Forr ent	(6,000)	
Net cash flows from operating activities		($4,600)
Cash Flows from Investing Activities		
Purchase equipment	(24,000)	
Net cash flows from investing activities		(24,000)
Cash Flows from Financing Activities		
Issue common stock	25,000	
Borrow from bank	10,000	
Pay dividends	(200)	
Net cash flows from financing activities		34,800
Net increase in cash		6,200
Cash at the beginning of the month		-0-
Cash at the end of the month		$6,200

Remember, amounts in parentheses indicate outflows of cash, consistent with accounting convention.

The total of the net cash flows from operating, investing, and financing activities equals the *net change in cash* during the period. For Eagle, that net change in cash for January was an increase of **$6,200**. To this change, we add the beginning balance of cash. Because this is the first month of operations for Eagle, cash at the beginning of the month is zero. Thus, the ending balance of cash is the same as that reported in the balance sheet in Illustration 1–9. This reconciliation of the beginning and ending cash balances emphasizes that the statement of cash flows explains *why* the cash reported in the balance sheet changed.

THE LINKS AMONG FINANCIAL STATEMENTS

The four financial statements are linked, because events that are reported in one financial statement often affect amounts reported in another. Many times, a single business transaction, such as receiving cash from a customer when providing services, will affect more than one of the financial statements. Providing services to a customer, for example, results in revenues recorded in the income statement, which are used to calculate net income. Net income, in turn, is reported in the calculation of retained earnings in the statement of stockholders' equity. Then, the ending balance of retained earnings is reported in the balance sheet. **Thus, any transaction that affects the income statement ultimately affects the balance sheet through the balance of retained earnings.** The cash received from customers will be reported as part of the ending cash balance in the balance sheet and as part of operating cash flows in the statement of cash flows.

Illustration 1–11 shows the links among the financial statements of Eagle Golf Academy in Illustrations 1–6, 1–8, 1–9, and 1–10. Link (1) shows that net income from the income statement is reported in the statement of stockholders' equity as part of the calculation of retained earnings. Link (2) shows that after we calculate the balance of retained earnings, the amount of total stockholders' equity can be reported in the balance sheet. Finally, link (3) demonstrates that the balance of cash in the balance sheet equals the amount of cash reported in the statement of cash flows.

ILLUSTRATION 1–11
Relationship between Financial Statements

EAGLE GOLF ACADEMY
Income Statement

Revenues	$6,360
Expenses	5,860
Net income	$ 500

EAGLE GOLF ACADEMY
Statement of Stockholders' Equity

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance (Jan. 1)	$ -0-	$ -0-	$ -0-
Issuances	25,000		25,000
Add: Net income		500	500
Less: Dividends		(200)	(200)
Ending balance (Jan. 31)	$25,000	$ 300	$25,300

EAGLE GOLF ACADEMY
Balance Sheet

Cash	$ 6,200	Liabilities	$14,200
Other assets	33,300	Stockholders' equity	25,300
		Total liabilities and	
Total assets	$39,500	stockholders' equity	$39,500

EAGLE GOLF ACADEMY
Statement of Cash Flows

Cash flows from operating activities	$ (4,600)
Cash flows from investing activities	(24,000)
Cash flows from financing activities	34,800
Net increase in cash	6,200
Cash at the beginning of the year	-0-
Cash at the end of the year	$ 6,200

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

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

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

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

Financial statements provide a summary of the most important financial accounting information. Two other sources of information provide important detail: (1) management's discussion and analysis and (2) note disclosures to the financial statements. Publicly traded firms are required to report both of these items in their annual reports, along with the financial statements we've discussed.

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. For example, companies are required to report total revenues in the income statement, but they also often report revenues itemized by geographic region in a note disclosure. We'll discuss these items throughout the book.

Let's Review

Test your understanding of what you've read so far. The Computer Shop repairs laptops, desktops, and mainframe computers. On December 31, 2012, the company reports the following year-end amounts:

Assets:	Cash	$10,000	**Revenues:**	Service	$65,000
	Supplies	8,000			
	Equipment, net	26,000			
			Expenses:	Rent	6,000
Liabilities:	Accounts payable	4,000		Supplies	14,000
	Notes payable	10,000		Salaries	40,000

Additional information:

a. The balance of retained earnings at the beginning of the year is $7,000.

b. The company pays dividends of $1,000 on December 31, 2012.

c. Common stock is $15,000 at the beginning of the year, and additional shares are issued for $4,000 during 2012.

Suggested Homework:
BE1-5, BE1-6; E1-6, E1-7, E1-8; P1-3A&B, P1-5A&B

Required:

Prepare the (1) income statement, (2) statement of stockholders' equity, and (3) balance sheet.

Solution:

1. Income statement:

THE COMPUTER SHOP
Income Statement
For the year ended Dec. 31, 2012

Revenues:	
Service revenue	$65,000
Expenses:	
Rent expense	6,000
Supplies expense	14,000
Salaries expense	40,000
Net income	$ 5,000

2. Statement of stockholders' equity:

THE COMPUTER SHOP
Statement of Stockholders' Equity
For the year ended Dec. 31, 2012

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance (Jan. 1)	$15,000	$ 7,000	$22,000
Issuance of common stock	4,000		4,000
Add: Net income		5,000	5,000
Less: Dividends		(1,000)	(1,000)
Ending balance (Dec. 31)	$19,000	$11,000	$30,000

3. Balances heet:

THE COMPUTER SHOP
Balance Sheet
December 31, 2012

Assets		Liabilities	
Cash	$10,000	Accounts payable	$ 4,000
Supplies	8,000	Notes payable	10,000
Equipment	26,000	**Stockholders' Equity**	
		Common stock	19,000
		Retained earnings	11,000
Total assets	$44,000	Total liabilities and stockholders' equity	$44,000

FINANCIAL ACCOUNTING INFORMATION

PART B

To this point, you've had a simple, first look at how companies measure and communicate financial information to external users. Subsequent chapters will provide an even more detailed view of this measurement/communication process. However, before proceeding, it's important to first consider why we are studying financial accounting. Does it matter? In other words, does the use of financial accounting information result in better business decisions?

Is Financial Accounting Important?

■ **LO4**
Describe the role that financial accounting plays in the efficient distribution of society's resources.

One of the rewarding things about studying financial accounting is that it does matter! The concepts in this course have an impact on everyday business decisions as well as wide-ranging economic consequences. We'll see an example of this next and then more examples throughout the rest of this book.

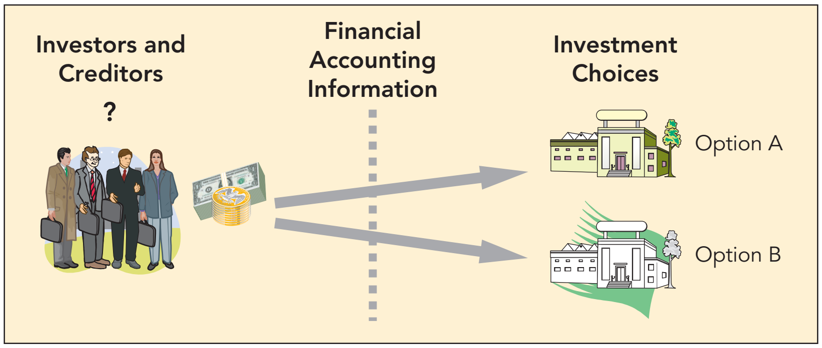
Most prospering economies in the world today are structured around free markets. In free markets, firms are allowed to compete and customers are free to choose from a variety of products and services. From which company do you prefer to buy a notebook computer—**Dell**, **Hewlett-Packard**, or **Apple**? Competition among these companies helps determine the prices they charge customers and the amounts they spend on computer components, salaries, manufacturing and distribution facilities, warranties, research and development, and other business-related activities. Can these companies offer you the notebook computer you want for a price above their costs? If they can, they'll earn a profit and stay in business. If they cannot, they'll eventually go out of business. Because companies know they are directly competing with each other, they work harder and more efficiently to please you, the customer.

Successful companies use their resources efficiently to sell products and services for a profit. When a company is able to make a profit, investors and creditors are willing to transfer their resources to it, and the company will expand its profitable operations even further.

Unsuccessful companies either offer lower-quality products and services or do not efficiently keep their costs low. In either case, they are not profitable. When a company is unprofitable, investors will neither invest in nor lend to the firm. Without these sources of financing, eventually the company will fail. Clearly, you don't want to invest in an unsuccessful company and then watch your investment shrink as the company loses your money. But how do investors and creditors know the successful companies from the unsuccessful companies? Here's where financial accounting enters the picture. Investors and creditors rely heavily on financial accounting information in making investment and lending decisions.

As Illustration 1–12 demonstrates, investors and creditors have cash they are willing to invest. How do they decide which investment option provides the better opportunity? Most often, they analyze companies' financial accounting information in making their decision. In fact, **financial accounting information is essential to making good business decisions.**

ILLUSTRATION 1–12
Use of Financial Accounting Information in Investing and Lending Decisions



KEY POINT

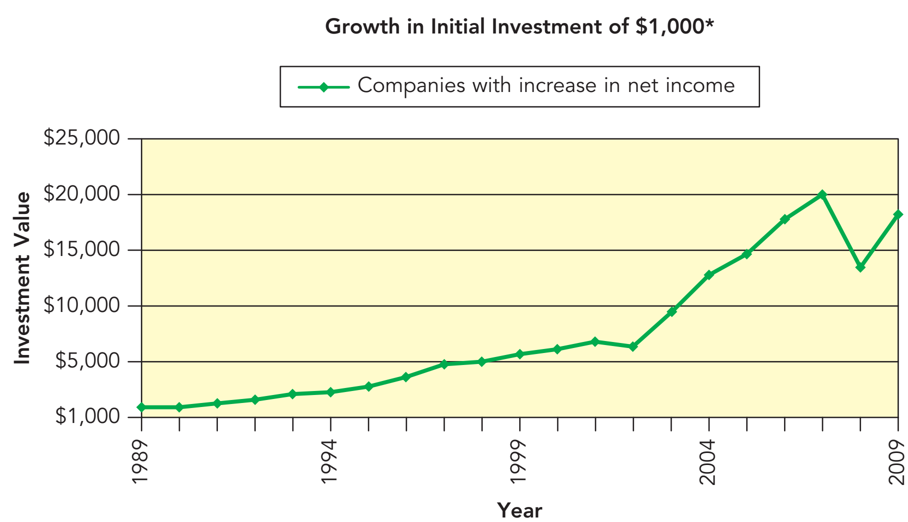
Financial accounting serves an important role by providing information useful in investment and lending decisions.

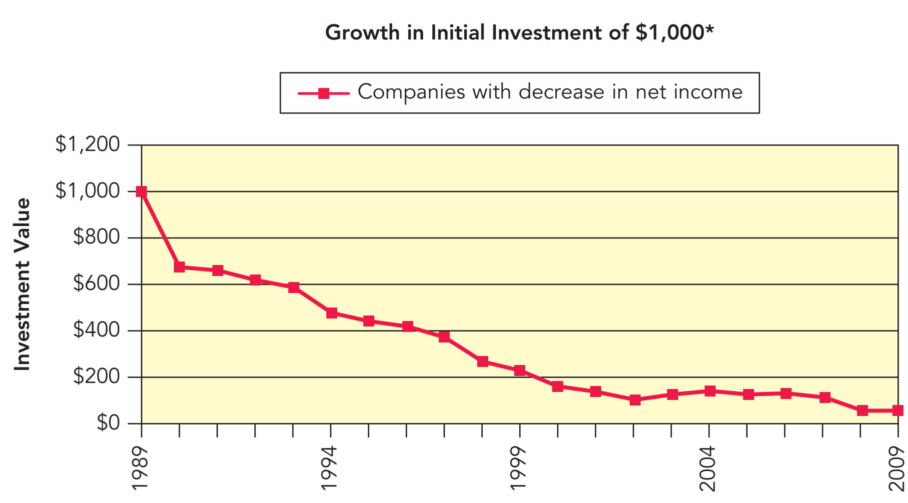
To demonstrate the importance of financial accounting information to investment decisions, we can look at the relationship between changes in stock prices and changes in net income over 20 years. As an investor, you will make money from an increase in the stock price of a company in which you invest (you can sell the stock for more than you bought it). So as an investor, you are looking for companies whose stock price is likely to increase. Is there a way to find such companies? Interestingly, there is: **No other single piece of company information better explains companies' stock price performance than does financial accounting net income,** the bottom line in the income statement.

What if you were able to accurately predict the direction of companies' changes in net income over the next year—that is, whether it would increase or decrease—and then you invested $1,000 in companies that were going to have an *increase?* In contrast, what if instead you invested in companies that would have a *decrease* in net income? Illustration 1–13 shows what would happen to your $1,000 investment over 20 years for each scenario.

ILLUSTRATION 1–13

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.

You can see that if you had invested $1,000 in companies with an increase in net income, your investment would have increased to $18,225 over the 20-year period. (The amount would have been much higher without the extraordinary events surrounding the financial crisis in 2008.) If instead you had invested $1,000 in companies with a decrease in net income, your $1,000 investment would have shrunk to $49 over this same period. This dramatic difference in the value of the investment demonstrates the importance of financial accounting information to investors. This book will provide you a thorough understanding of how net income is calculated and presented in financial statements. As you can see from the charts above, if you are able to predict the change in financial accounting's measure of profitability—net income—then you can predict the change in stock prices as well.

Investors and creditors also use information reported in the balance sheet. Consider a company's total liabilities, often referred to as *total debt*. Expanding debt levels limit management's ability to respond quickly and effectively to business situations. The "overhanging" debt, which involves legal obligation of repayment, restricts management's ability to engage in new profit-generating activities. Increased debt levels also increase interest payment burdens on the company. Failure to pay interest or to repay debt can result in creditors forcing the company to declare bankruptcy and go out of business. Understandably, then, investors and creditors keep a close eye on the company's debt level and its ability to repay.

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.

Rules of Financial Accounting

LO5
Explain the term generally accepted accounting principles (GAAP) and describe the role of GAAP in financial accounting.

Recall that accounting serves two main functions in our society: It (1) measures business activities and (2) communicates those measurements to investors and creditors. Although this process might seem straightforward, it's not always. How do we measure assets? When do we record revenues? What do we classify as an expense? How should we present financial statements? These are all important issues, and the answers are not always simple.

Because financial accounting information is so vital to investors and creditors, formal reporting standards have been established. All companies that sell their stock to the public must follow these rules and must publish financial statements in accordance with those rules. The rules of financial accounting are called **generally accepted accounting principles**, often abbreviated as **GAAP** (pronounced *gap*). The fact that all companies use these same rules is critical to financial statement users. It allows them to accurately *compare* financial information among companies when they are making decisions about where to lend or invest their resources.

CURRENT STANDARD SETTING

Today, financial accounting and reporting standards in the United States are established primarily by the **Financial Accounting Standards Board (FASB)** (pronounced either by the letters themselves or as *faz-be*). The FASB is an independent, private-sector body with full-time voting members and a very large support staff. Members include representatives from the accounting profession, large corporations, financial analysts, accounting educators, and government agencies.

For information about the activities of the Financial Accounting Standards Board, see its website, *www.fasb.org*.

Not all countries follow the same accounting and reporting standards. For example, accounting practices in the United Kingdom differ from those in the United States, and those in the United States differ from those in Japan. In recent years, the accounting profession has undertaken a project whose goal is to eliminate differences in accounting standards around the world. The standard-setting body responsible for this convergence effort is the **International Accounting Standards Board** (IASB), as detailed in the following box.

User's Guide Boxed sections on *International Financial Reporting Standards* (IFRS) are included throughout the text to emphasize the growing importance of international accounting standards throughout the world. They discuss specific instances in which U.S. GAAP and international standards differ. Appendix E at the back of the book provides more detail about differences between IFRS and U.S. GAAP.

For information about the activities of the International Accounting Standards Board, see its website, ***www.iasb.org***.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

The global counterpart to the FASB is the International Accounting Standards Board (IASB). In many ways, this organization functions like the FASB. The IASB's objectives are (1) to develop a single set of high-quality, understandable global accounting standards, (2) to promote the use of those standards, and (3) to bring about the convergence of national accounting standards and international accounting standards around the world. In 2002, the FASB and IASB signed the Norwalk Agreement, formalizing their commitment to convergence of U.S. and international accounting standards. The standards being developed and promoted by the IASB are called **International Financial Reporting Standards** (IFRS) (pronounced either by the letters or as *eye-furs*).

For more discussion, see Appendix E.

More than 100 countries have chosen to forgo their own country-specific standards and either require or allow International Financial Reporting Standards as their national standards. That movement, coupled with the convergence of U.S. GAAP and IFRS, has caused many to predict that soon both sets of rules, or perhaps only IFRS, will be acceptable for financial reporting in the United States.

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.

HISTORICAL PERSPECTIVE ON STANDARD SETTING

Pressures on the accounting profession to establish uniform accounting standards began to surface after the stock market crash of 1929. The Dow Jones Industrial Average, a major stock market index in the United States, fell 40% over the period September 3 to October 29 that year. The Dow bottomed out in July 1932, after losing 89% of its value.

Many blamed financial accounting for the stock market crash and the ensuing Great Depression of the 1930s. At the time of the crash, accounting practices and reporting procedures were not well established, providing the opportunity for companies to engage in inaccurate financial reporting to enhance their reported performance. This led to many stocks being valued too highly. As investors began to recognize this, their confidence in the stock market fell. They panicked and sold stocks in a frenzy. The Dow did not reach precrash levels again until 1954.

The 1933 Securities Act and the 1934 Securities Exchange Act were designed to restore investor confidence in financial accounting. The 1933 act sets forth accounting and disclosure requirements for initial offerings of securities (stocks and bonds). The 1934 act created a government agency, the **Securities and Exchange Commission (SEC).** The 1934 act gives the SEC the power to require companies that publicly trade their stock to prepare periodic financial statements for distribution to investors and creditors.

While Congress has given the SEC both the power and the responsibility for setting accounting and reporting standards for publicly traded companies, the SEC has delegated the primary responsibility for setting accounting standards to the private sector, currently the FASB. Note that the SEC delegated only the responsibility, not the authority, to set these standards. The power still lies with the SEC. If the SEC does not agree with a particular standard issued by the FASB, it can force a change in the standard. In fact, it has done so in the past.

THE ROLE OF THE AUDITOR

It is the responsibility of management to apply GAAP when communicating with investors and creditors through financial statements. Unfortunately, however, sometimes those in charge of preparing financial statements do not always follow the rules. Instead, some purposely provide misleading financial accounting information, commonly referred to as "cooking the books." The phrase implies that the accounting records ("books") have been presented in an altered form ("cooked"). Managers may cook the books for several reasons, such as to hide the poor operating performance of the company or to increase their personal wealth at stockholders' expense.

To help ensure that management has in fact appropriately applied GAAP, the SEC requires independent outside verification of the financial statements of publicly traded companies. Such independent examination is done by **auditors**, who are hired by a company as an independent party to express a professional opinion of the accuracy of that company's financial statements. They are not employees of the company they are auditing. Auditors provide an independent opinion of the extent to which financial statements are prepared in compliance with GAAP. If they find mistakes or fraudulent reporting behavior, auditors require the company to correct all significant information before issuing financial statements.

Illustration 1–14 presents an excerpt from the report of the independent auditors for **Dell**'s financial statements. The auditor's report indicates that Dell's financial statements for the period mentioned have been prepared in conformity with GAAP.

ILLUSTRATION 1–14
Excerpts from the 2009 Independent Auditor's Report of Dell Incorporated

DELL INCORPORATED
Report of Independent Registered Public Accounting Firm

To the Board of Directors and
Shareholders of Dell Inc.:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Dell Inc. and its subsidiaries at January 29, 2010, and January 30, 2009, and the results of their operations and their cash flows for each of the three years in the period ended January 29, 2010, in conformity with accounting principles generally accepted in the United States of America.

Our audits of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

User's Guide In this book, information from actual companies is illustrated using a flipped page in the lower-right corner.

Auditors play a major role in investors' and creditors' decisions by adding credibility to a company's financial statements.

OBJECTIVES OF FINANCIAL ACCOUNTING

After measuring business activities and communicating those measurements to investors and creditors, what do financial accountants hope to have achieved? What benefit will their services have brought to users of financial statements? The FASB has explicitly stated the specific objectives of financial accounting. These objectives are presented in Illustration 1–15.

ILLUSTRATION 1–15
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.

The first objective is specific to investors and creditors. In addition to those users, though, financial accounting information is likely to have general usefulness to other groups of external users, who are interested in essentially the same financial aspects of a business as are investors and creditors. Some of these other groups were discussed in Illustration 1–1.

The second objective refers to the specific cash flow information needs of investors and creditors. The third objective emphasizes the need for information about economic resources (assets) and claims to those resources (liabilities and stockholders' equity) and their changes over time.

KEY POINT

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

Underlying these three key objectives is a conceptual framework that is the foundation upon which financial accounting is built. We discuss the FASB's conceptual framework in detail in the appendix to this chapter.

An Ethical Foundation

Like all structures, accounting requires a strong foundation. For accounting, part of that foundation is the ethical behavior of those who practice its rules. You have probably encountered the topic of ethics in other business courses. **Ethics** refers to a code or moral system that provides criteria for evaluating right and wrong behavior. Investors, creditors, government, and the general public rely on general ethical behavior among those who record and report the financial activities of businesses. A lack of public trust in financial reporting can undermine business and the economy. Indeed, the dramatic collapse of **Enron** in 2001 and the dismantling of the international public accounting firm of **Arthur Andersen** in 2002 severely shook investors' confidence in the stock market. Some questioned the credibility of corporate America as well as the accounting profession itself.

Public outrage over accounting scandals at high-profile companies increased the pressure on lawmakers to pass measures that would restore credibility and investor confidence in the financial reporting process. These pressures resulted in the issuance of the Public Company Accounting Reform and Investor Protection Act of 2002, commonly referred to as the **Sarbanes-Oxley Act (SOX)**, named for the two congressmen who sponsored the bill. The Sarbanes-Oxley Act provides for the regulation of auditors and the types of services they furnish to clients, increases accountability of corporate executives, addresses conflicts of interest for securities analysts, and provides for stiff criminal penalties for violators. These increased requirements have dramatically increased the need for good accounting and, at the same time, highlighted the value of accounting information to investors and creditors. We discuss the specific provisions of SOX in more detail in Chapter 4.

Important as such legislation is in supporting the ethical foundation of accounting, it is equally important that accountants themselves have their own personal standards for ethical conduct. You cannot, though, just go out and suddenly obtain ethics when you need them. ("I'd like a pound of ethics, please.") Rather, accountants need to *develop* their ability to identify ethical situations and know the difference between right and wrong in the context of the accounting topics you will learn in this course. One of the keys to ethical decision making is having an appreciation for how your actions affect others.

When you face ethical dilemmas in your professional life (and indeed in your personal life), you can apply the following simple framework as you think through what to do:

1. Identify the ethical situation and the people who will be affected (the stakeholders).
2. Specify the options for alternative courses of action.
3. Understand the impact of each option on the stakeholders.
4. Make a decision.

Throughout the book, we will discuss some ethical decisions relating to accounting and will make clear their financial impact. These discussions will give you opportunities to practice some ethical decision making in a classroom setting.

ETHICAL DILEMMA

You have been the manager of a local restaurant for the past five years. Because of increased competition, you notice you're getting fewer customers. Despite all your attempts to attract new customers and cut costs, the restaurant's profitability continues to decline. The restaurant owner tells you that if this year's profit is lower than last year's, you'll lose your job.

When preparing financial statements at the end of the year, you notice that this year's profit *is* lower. You know that by purposely understating certain expenses, you can falsely report higher profits to the owner for this year. That will allow you to keep your job for at least one more year and look for a new job in the meantime.

What should you do? What if you really believe the lower profitability is caused by factors outside your control? Would this make the false reporting acceptable?

User's Guide
Throughout the book, you will see boxed discussions of *Ethical Dilemmas.* These dilemmas are designed to raise your awareness of accounting issues that have ethical ramifications.

PART C

CAREERS IN ACCOUNTING

At this point in your college career, you may be uncertain of your major. Here are three important questions to consider when you make your choice: (1) Will you enjoy your major as a career? (2) Will you be good at your chosen field? (3) Will you be well paid?

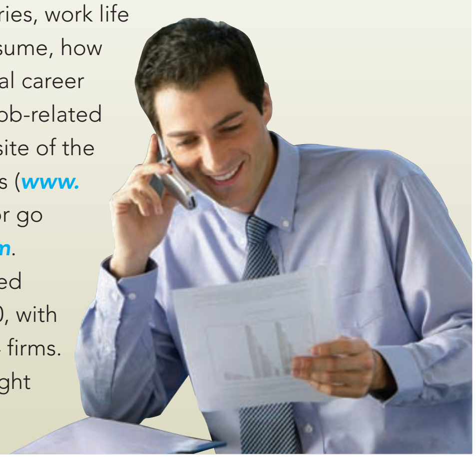
After completing the first course in accounting, you will have some idea of the answers to the first two questions. You will find out whether you might enjoy accounting. You will also find out through exams, quizzes, and homework whether you have the aptitude to be good at it. Realize, however, that besides being good at

CAREER CORNER

Over 20,000 employees join public accounting firms in entry-level jobs each year, and thousands more go into other areas of accounting. While financial accountants learn how to measure business transactions and prepare financial reports, they also learn a great deal about the business itself. Because of this widespread business knowledge, accountants often play a key role on the management team. In fact, it should come as no surprise to learn that most chief financial officers (CFOs) started their careers as accountants.

Accounting, because of its dynamic and professional nature, offers an attractive career option. You can learn more about a career in accounting by visiting the website of the American Institute of Certified Public Accountants (***www.aicpa.org***). There, you can look under the *Career Development and Workplace Issues* link to find current information about job opportunities, salaries, work life for women, how to write a resume, how to interview, and other general career advice. For salary and other job-related information, consult the website of the U.S. Bureau of Labor Statistics (***www.bls.gov/oco/ocos001.htm***) or go to ***careers-in-accounting.com***. In 2009, entry-level jobs ranged between $50,000 and $70,000, with $55,000 as the norm for Big-4 firms.

Is an accounting degree right for you?



the technical side of accounting, you will need interpersonal skills such as working well in teams, making presentations to clients, and leading co-workers in complex projects. As for the third question, someone definitely will pay you to be an accountant, as we discuss in the following section.

Demand for Accounting

One of the greatest benefits of an accounting degree is the wide variety of job opportunities it opens to you. With an accounting degree you can apply for almost any position available to finance majors. However, it doesn't work the other way: Finance majors often lack the accounting background necessary to apply for accounting positions.

For the past several years, accounting has ranked as one of the top majors on university campuses. Accounting firms are anticipating a 20% increase in new hires over the next several years. Because of their importance in our society, accountants are in high demand. And because of this high demand, accounting salaries are on the rise. Starting salaries are among the highest of all majors across the university.

Career Options in Accounting

User's Guide Throughout the book, you will see sections titled ***Career Corner.*** These sections highlight a link between a particular topic and a career.

■ **LO6** Identify career opportunities in accounting.

The first big decision a student makes as an accounting graduate is the choice between a career in public accounting and a career in private accounting.

PUBLIC ACCOUNTING

Public accounting firms are professional service firms that traditionally have focused on three areas: auditing, tax preparation/planning, and business consulting. We already have discussed the role of *auditors* in attesting to the accuracy of companies' financial statements. *Tax preparation/planning* is an increasingly important activity in the United States, as the complexity of tax laws related to personal and corporate taxes continues to increase. *Business consulting* is perhaps the most lucrative activity of accountants. Managers who want to better understand their companies' financial strengths and weaknesses often turn to public accountants for guidance. Who knows the business activities better than the one measuring and communicating them?

If you choose a career in public accounting, the next big decision is whether to work for one of the "Big 4" public accounting firms (**Deloitte**, **Ernst & Young**, **PricewaterhouseCoopers**, and **KPMG**) or one of the thousands of medium or smaller-sized firms. The Big 4 firms are huge, each having annual revenues in the billions. They audit almost all the Fortune 500 companies in the United States and most of the largest companies around the world, and they hire thousands of accounting majors each year. The thousands of smaller international, regional, and local accounting firms also hire thousands of accounting majors right out of college.

Most public accountants become *Certified Public Accountants (CPAs)*. You become a CPA by passing the four parts of the CPA exam and meeting minimum work experience requirements (in some states). Most states require that you have 150 semester hours (225 quarter hours) of college credit to take the exam. Becoming a CPA can provide a big boost in salary and long-term job opportunities.

PRIVATE ACCOUNTING

A career in **private accounting** means providing accounting services to the company that employs you. Every major company in the world hires accountants. Just think of all the accounting issues at **Dell**, for example. Dell, and all other large companies, need accountants with training and experience in financial accounting, management accounting, taxation, internal auditing, and accounting information systems. Whereas working as a public accountant provides the advantage of experience working with a number of different clients, private accountants sometimes earn higher starting salaries. In fact, many accounting students begin their careers in public accounting, gaining experience across a wide array of companies and industries, and then eventually switch over to one of their favorite clients as private accountants. Other students take positions directly in private accounting right out of college.

Because of their special training and valuable knowledge base, both public and private accountants are expanding their roles to include the following: financial planning, information technology development, financial analysis, forensic accounting, information risk management, investment banking, environmental accounting, tax law, FBI work, management consulting, and much, much more. Illustration 1–16 outlines just a few of the many career options in accounting.

ILLUSTRATION 1–16
Some of the Career Options in Accounting

	Public Accounting (Big 4 and Non-Big 4)	Private Accounting
Clients	Corporations Governments Nonprofit organizations Individuals	Your particular employer
Traditional roles	Auditors Tax preparers/planners Business consultants	Financial accountants Managerial accountants Budget analysts Internal auditors Tax preparers Payroll managers
Expanding roles	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
Other career options	Governmental accounting, sole proprietorships, and education.	

A recent survey by *BusinessWeek* on ideal employers for undergraduate business majors listed the Big 4 public accounting firms in the top 12 of all companies in the United States. Three of the Big 4 were in the top five. All of the firms in the list hire accountants. This is a great time to be an accounting major.

KEY POINT

Because of the high demand for accounting graduates, wide range of job opportunities, and increasing salaries, this is a great time to obtain a degree in accounting.

APPENDIX

CONCEPTUAL FRAMEWORK

■ **LO7**
Explain the nature of the conceptual framework used to develop generally accepted accounting principles.

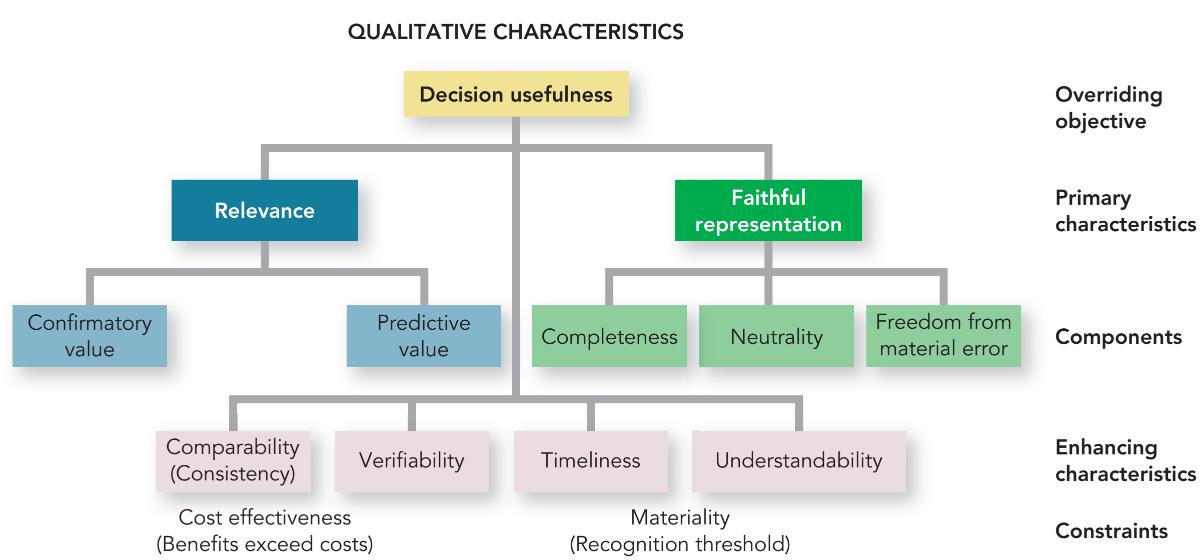
The FASB establishes financial accounting standards based on a **conceptual framework,** which you can think of as the "theory" of accounting. In much the same way that our nation's Constitution provides the underlying principles that guide the "correctness" of all laws, the FASB's conceptual framework prescribes the correctness of financial accounting rules. Having a conceptual framework provides standard setters with a benchmark for creating a consistent set of financial reporting rules now and in the future. It also 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.

In the chapter, we discussed the three objectives of financial accounting as outlined in the FASB's conceptual framework. To satisfy these stated objectives, accounting information should possess certain characteristics. What are the desired characteristics? Illustration 1–17 provides a graphical depiction of the qualitative characteristics of accounting information.

ILLUSTRATION 1–17 Qualitative Characteristics of Accounting Information



Notice that at the top of the figure is **decision usefulness**—the ability of the information to be useful in decision making. Accounting information should help investors, lenders, and other creditors make important decisions about providing funds to a company.

PRIMARY QUALITATIVE CHARACTERISTICS

The two primary decision-specific qualitative characteristics that make accounting information useful are *relevance* and *faithful representation*. Both are critical. No matter how representative, if information is not relevant to the decision at hand, it is useless. Conversely, relevant information is of little value if it does not accurately represent the underlying activity.

Relevance. To have **relevance**, accounting information should possess *confirmatory value* and/or *predictive value*. Generally, useful information will possess both of these components. For example, the ability of **Dell** to report a positive net income confirms that its management is effectively and efficiently using the company's resources to sell quality products. In this case, net income has *confirmatory value*. At the same time, reporting a positive and growing net income for several consecutive years should provide information that has *predictive value* for the company's future cash-generating ability.

Faithful representation. To be a **faithful representation** of business activities, accounting information should be complete, neutral, and free from material error. *Completeness* means including all information necessary for faithful representation of the business activity the firm is reporting. For example, when Dell reports inventory in its balance sheet, investors understand it to represent *all* items (and only those items) that are intended for sale to customers in the ordinary course of business. If the amount reported for inventory includes only some of the items to be sold, then it lacks completeness. Adequate note disclosure is another important component of completeness. Dell must disclose in the notes to the financial statements the method it used to calculate inventory reported on its balance sheet. (We discuss alternative inventory methods in Chapter 6.)

Neutrality means to be unbiased, and this characteristic is highly related to the establishment of accounting standards. Sometimes a new accounting standard may favor one group of companies over others. In such cases, the FASB must convince the financial community that this was a *consequence* of the standard, and not an *objective* used to set the standard. For example, the FASB requires that all research and development (R&D) costs be reported as an expense in the income statement, reducing the current year's net income. The FASB's objective in adopting this approach was not to weaken the financial appearance of those companies in R&D-intensive industries, such as telecommunications, pharmaceuticals, and software, even though that may have been the effect.

Freedom from material error indicates that reported amounts reflect the best available information. As you'll come to find out in this course, some amounts reported in the financial statements are based on estimates, and the accuracy of those estimates is subject to uncertainty. Because of this, financial statements are not expected to be completely free of error, but they are expected to reflect management's unbiased judgments.

KEY POINT

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

ENHANCING QUALITATIVE CHARACTERISTICS

Four enhancing qualitative characteristics are comparability, verifiability, timeliness, and understandability. **Comparability** refers to the ability of users to see similarities and differences between two different business activities. For example, how does **Dell**'s net income compare with net income for other computer manufacturers such as **Hewlett-Packard** or **Gateway**? Comparability also refers to the ability of users to see similarities and differences in the same company over time. How does Dell's net income this year compare to last year's? Closely related to the notion of comparability is consistency. **Consistency** refers to the use of similar accounting procedures either over time for the same company, or across companies at the same point in time. Comparability of financial information is the overriding goal, while consistency of accounting procedures is a means of achieving that goal.

Verifiability implies a consensus among different measurers. For instance, different graders will arrive at the same exam score for multiple-choice tests, but they are more likely to differ in scoring essay exams. Multiple-choice tests are highly verifiable. The same idea holds in the business world. For example, the price Dell paid to purchase a patent from another company is usually highly verifiable because there is an exchange at a certain point in time. In contrast, the fair value of a patent for a product Dell developed internally over an extended period is more subjective and less verifiable.

Firms must also disclose information related to net income that is *timely*. **Timeliness** refers to information being available to users early enough to allow them to use it in the decision process. Large companies like Dell are required to report information related to net income within 40 days after the end of the quarter and within 60 days after the end of the year.

Understandability means that users must be able to understand the information within the context of the decision they are making. This is a user-specific quality because users will differ in their ability to comprehend any set of information.

PRACTICAL CONSTRAINTS ON ACHIEVING DESIRED QUALITATIVE CHARACTERISTICS

Sometimes, certain information involves more time and effort than the information is worth. For example, if a friend asks what you did today, she probably wants to know the general outline of your day, but does not want to hear a recital of every move you made. Similarly, there may be practical constraints (limits) on each of the qualitative characteristics of accounting information.

One such constraint is **cost effectiveness**, which suggests that financial accounting information is provided only when the benefits of doing so exceed the costs. For example, knowing the profit margin earned by Dell in each country provides decision-useful information to investors and creditors. However, this information is also helpful to the company's current and potential competitors such as Hewlett-Packard and Apple as they make their own expansion plans. The competitive costs of providing this information may outweigh the benefits.

A related constraint on the type of information we provide is the concept of materiality. **Materiality** reflects the impact of financial accounting information on investors' and creditors' decisions. Unless an item is *material* in amount or nature—that is, sufficient in amount or nature to affect a decision—it need not be reported in accordance with GAAP. Based on the concept of materiality, Dell probably does not record all its assets as assets. Most companies record assets such as wastebaskets and staplers as *expenses,* even though these items will benefit the company for a long period. Recording a $6 wastebasket as a current expense instead of a long-term asset for a multi-billion dollar company like Dell has no impact on investors' decisions.

UNDERLYING ASSUMPTIONS

Four basic assumptions underlie GAAP. As pictured in Illustration 1–18, they are (1) the economic entity assumption, (2) the monetary unit assumption, (3) the periodicity assumption, and (4) the going concern assumption.

ILLUSTRATION 1-18
Assumptions That Underlie GAAP

GAAP

UNDERLYING ASSUMPTIONS			
Economic Entity	Monetary Unit	Periodicity	Going Concern

Economic Entity Assumption. The **economic entity assumption** states that we can identify all economic events with a particular economic entity. In other words, only business transactions involving Dell should be reported as part of Dell's financial accounting information. Another key aspect of this assumption is the distinction between the economic activities of owners and those of the company. For example, Michael Dell's personal residence is not an asset of Dell Incorporated.

Monetary Unit Assumption. Information would be difficult to use if, for example, we listed assets as "three machines, two trucks, and a building." According to the **monetary unit assumption**, in order to *measure* financial statement elements, we need a unit or scale of measurement. The dollar in the United States is the most appropriate common denominator to express information about financial statement elements and changes in those elements. In Europe, the common denominator is the euro. Dell has operations throughout the world, so it must translate all its financial information to U.S. dollars under the monetary unit assumption.

Periodicity Assumption. The periodicity assumption relates to the qualitative characteristic of *timeliness*. External users need *periodic* information to make decisions. The **periodicity assumption** divides the economic life of an enterprise (presumed to be indefinite) into artificial time periods for periodic financial reporting. Corporations, like Dell, whose securities are publicly traded are required to provide financial information to the SEC on a quarterly *and* an annual basis.

Going Concern Assumption. The **going concern assumption** states that in the absence of information to the contrary, a business entity will continue to operate indefinitely. This assumption is critical to many broad and specific accounting principles. It provides justification for measuring many assets based on their original costs (a practice known as the *historical cost principle*). If we knew an enterprise was going to cease operations in the near future, we would measure assets and liabilities not at their original costs but at their current liquidation values.

In addition to the four basic assumptions that underlie GAAP are four principles (historical cost, full disclosure, realization, and matching) that guide the application of GAAP. We will explain each of these in an appropriate context in later chapters.

KEY POINTS BY LEARNING OBJECTIVE

LO1 Describe the two primary functions of financial accounting.

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.

LO2 Identify the three fundamental business activities that financial accounting measures.

Financing activities include transactions with lenders and owners. Investing activities generally include the purchase or disposal of productive assets. Operating activities relate to earning revenues and incurring expenses.

LO3 Discuss how financial accounting information is communicated through financial statements.

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.

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.

The balance sheet demonstrates that the company's resources (assets) equal creditors' claims (liabilities) plus owners' claims (stockholders' equity) to those resources.

The statement of cash flows reports cash transactions from operating, investing, and financing activities.

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

LO4 Describe the role that financial accounting plays in the efficient distribution of society's resources.

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

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.

LO5 Explain the term generally accepted accounting principles (GAAP) and describe the role of GAAP in financial accounting.

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.

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

LO6 Identify career opportunities in accounting.

Because of the high demand for accounting graduates, the wide range of job opportunities, and increasing salaries, this is a great time to obtain a degree in accounting.

Appendix

LO7 Explain the nature of the conceptual framework used to develop generally accepted accounting principles.

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

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

GLOSSARY

Accounting: A system of maintaining records of a company's operations and communicating that information to decision makers. **p. 4**

Accounting equation: Equation that shows a company's resources (assets) equal creditors' and owners' claims to those resources (liabilities and stockholders' equity). **p. 7**

Assets: Resources owned by a company. **p. 7**

Auditors: Trained individuals hired by a company as an independent party to express a professional opinion of the accuracy of that company's financial statements. **p. 23**

Balance sheet: A financial statement that presents the financial position of the company on a particular date. **p. 13**

Comparability: The ability of users to see similarities and differences between two different business activities. **p. 30**

Consistency: The use of similar accounting procedures either over time for the same company, or across companies at the same point in time. **p. 30**

Corporation: An entity that is legally separate from its owners. **p. 6**

Cost effectiveness: Financial accounting information is provided only when the benefits of doing so exceed the costs. **p. 30**

Decision usefulness: The ability of the information to be useful in decision making. **p. 29**

Dividends: Cash payments to stockholders. **p. 8**

Economic entity assumption: All economic events with a particular economic entity can be identified. **p. 31**

Ethics: A code or moral system that provides criteria for evaluating right and wrong behavior. **p. 24**

Expenses: Costs of providing products and services. **p. 8**

Faithful representation: Accounting information that is complete, neutral, and free from material error. **p. 29**

Financial accounting: Measurement of business activities of a company and communication of those measurements to external parties for decision-making purposes. **p. 5**

Financial Accounting Standards Board (FASB): An independent, private body that has primary responsibility for the establishment of GAAP in the United States. **p. 21**

Financial statements: Periodic reports published by the company for the purpose of providing information to external users. **p. 10**

Financing activities: Transactions involving external sources of funding. **p. 5**

Generally accepted accounting principles (GAAP): The rules of financial accounting. **p. 21**

Going concern assumption: In the absence of information to the contrary, a business entity will continue to operate indefinitely. **p. 31**

Income statement: A financial statement that reports the company's revenues and expenses over an interval of time. **p. 11**

International Accounting Standards Board (IASB): An international accounting standard-setting body responsible for the convergence of accounting standards worldwide. **p. 22**

International Financial Reporting Standards (IFRS): The standards being developed and promoted by the International Accounting Standards Board. **p. 22**

Investing activities: Transactions involving the purchase and sale of (1) long-term resources such as land, buildings, equipment, and machinery and (2) any resources not directly related to a company's normal operations. **p. 5**

Liabilities: Amounts owed to creditors. **p. 7**

Materiality: The impact of financial accounting information on investors' and creditors' decisions. **p. 30**

Monetary unit assumption: A unit or scale of measurement can be used to measure financial statement elements. **p. 31**

Net income: Difference between revenues and expenses. **p. 8**

Operating activities: Transactions involving the primary operations of the company, such as providing products and services to customers and the associated costs of doing so, like utilities, taxes, advertising, wages, rent, and maintenance. **p. 5**

Partnership: Business owned by two or more persons. **p. 9**

Periodicity assumption: The economic life of an enterprise (presumed to be indefinite) can be divided into artificial time periods for financial reporting. **p. 31**

Relevance: Accounting information that possesses confirmatory value and/or predictive value. **p. 29**

Retained earnings: Cumulative amount of net income earned over the life of the company that has not been distributed to stockholders as dividends. **p. 12**

Revenues: Amounts earned from selling products or services to customers. **p. 8**

Sarbanes-Oxley Act (SOX): Formally titled the Public Company Accounting Reform and Investor Protection Act of 2002, this act provides regulation of auditors and the types of services they furnish to clients, increases accountability of corporate executives, addresses conflicts of interest for securities analysts, and provides for stiff criminal penalties for violators. **p. 24**

Sole proprietorship: A business owned by one person. **p. 9**

Statement of cash flows: A financial statement that measures activities involving cash receipts and cash payments over an interval of time. **p. 15**

Statement of stockholders' equity: A financial statement that summarizes the changes in stockholders' equity over an interval of time. **p. 12**

Stockholder's equity: Stockholders', or owners', claims to resources, which equal the difference between total assets and total liabilities. **p. 7**

Timeliness: Information being available to users early enough to allow them to use it in the decision process. **p. 30**

Understandability: Users must understand the information within the context of the decision they are making. **p. 30**

Verifiability: A consensus among different measurers. **p. 30**

SELF-STUDY QUESTIONS

■ LO1

1. Based on the introductory section of this chapter, which course is most like financial accounting?
   a. College algebra.
   b. Foreign language.
   c. Molecular biology.
   d. Physical education.

■ LO2

2. Financial accounting serves which primary function(s)?
   a. Measures business activities.
   b. Communicates business activities to interested parties.
   c. Makes business decisions on behalf of interested parties.
   d. Both a. and b. are functions of financial accounting.

■ LO2

3. Financing activities of a company include which of the following?
   a. Selling products or services to customers.
   b. Using cash to purchase long-term assets such as machinery.
   c. Borrowing money from the bank.
   d. Paying salaries to employees.

■ LO2

4. Investing activities of a company include which of the following?
   a. Paying salaries to workers.
   b. Using cash to purchase long-term assets such as equipment.
   c. Issuing common stock to investors.
   d. Borrowing money from the bank.

■ LO3

5. Which financial statement conveys a company's ability to generate profits in the current period?
   a. Income statement.
   b. Statement of cash flows.
   c. Balance sheet.
   d. Statement of stockholders' equity.

■ LO3

6. Which financial statement shows that a company's resources equal claims to those resources?
   a. Income statement.
   b. Statement of stockholders' equity.
   c. Balance sheet.
   d. Statement of cash flows.

■ LO4

7. Why does financial accounting have a positive impact on our society?
   a. It entails a detailed transaction record necessary for filing taxes with the Internal Revenue Service (IRS).
   b. It allows investors and creditors to redirect their resources to successful companies and away from unsuccessful companies.
   c. It prevents competitors from being able to steal the company's customers.
   d. It provides a system of useful internal reports for management decision making.

■ LO5

8. The body of rules and procedures that guide the measurement and communication of financial accounting information is known as:
   a. Standards of Professional Compliance (SPC).
   b. Code of Ethical Decisions (COED).
   c. Rules of Financial Reporting (RFP).
   d. Generally Accepted Accounting Principles (GAAP).

9. What is a benefit to a career in accounting? ■ LO6
   a. High salaries.
   b. Wide range of job opportunities.
   c. High demand for accounting graduates.
   d. All of the above.

10. What are the two primary qualitative characteristics identified by the Financial Accounting Standards Board's (FASB) conceptual framework? ■ LO7
    a. Relevance and faithful representation.
    b. Materiality and efficiency.
    c. Comparability and consistency.
    d. Costs and benefits.

Check out *www.mhhe.com/succeed* for more multiple-choice questions.

Note: For answers, see the last page of the chapter.

REVIEW QUESTIONS

1. Explain what it means to say that an accounting class is not the same as a math class. ■ LO1
2. Identify some of the people interested in making decisions about a company. ■ LO1
3. What is the basic difference between financial accounting and managerial accounting? ■ LO1
4. What are the two primary functions of financial accounting? ■ LO1
5. What are the three basic business activities that financial accounting seeks to measure and communicate to external parties? Define each. ■ LO2
6. What are a few of the typical financing activities for a company like **United Parcel Service, Inc. (UPS)**, the world's largest package delivery company and a leading global provider of specialized transportation and logistics services? ■ LO2
7. What are a few of the typical investing activities for a company like **Trump Entertainment Resorts, Inc.**, a leading gaming company that owns and operates casinos, resorts, and hotels? ■ LO2
8. What are a few of the typical operating activities for a company like **Oracle Corporation**, one of the world's leading suppliers of software for information management? ■ LO2
9. What are the three major legal forms of business organizations? Which one is chosen by most of the largest companies in the United States? ■ LO2
10. Provide the basic definition for each of the account types: assets, liabilities, stockholders' equity, dividends, revenues, and expenses. ■ LO2
11. What are the major advantages and disadvantages of each of the legal forms of business organizations? ■ LO2
12. What are the four primary financial statements? What basic information is shown on each? ■ LO3
13. What does it mean to say that the income statement, statement of stockholders' equity, and statement of cash flows measure activity over an *interval of time,* but the balance sheet measures activity at a *point in time?* ■ LO3
14. Give some examples of the basic revenues and expenses for a company like **The Walt Disney Company**. ■ LO3
15. What is the accounting equation? Which financial statement reports the accounting equation? ■ LO3

■ LO3 16. Give some examples of the basic assets and liabilities of a company like **Walmart Stores, Inc.**

■ LO3 17. "The retained earnings account is a link between the income statement and the balance sheet." Explain what this means.

■ LO3 18. What are the three types of cash flows reported in the statement of cash flows? Give an example of each type of activity for a company like **Oakley, Inc.**, a designer, manufacturer, and distributor of high-performance eyewear, footwear, watches, and athletic equipment.

■ LO3 19. In addition to financial statements, what are some other ways to disclose financial information to external users?

■ LO4 20. How does financial accounting have an impact on society?

■ LO5 21. What is meant by GAAP? Why should companies follow GAAP in reporting to external users?

■ LO5 22. Which body is primarily responsible for the establishment of GAAP in the United States? What body serves this function on an international basis?

■ LO5 23. In general terms, explain the terms U.S. GAAP and IFRS.

■ LO5 24. What was the primary reason for the establishment of the 1933 Securities Act and the 1934 Securities Exchange Act? What power does the Securities and Exchange Commission (SEC) have?

■ LO5 25. What is the role of the auditor in the financial reporting process?

■ LO5 26. What are the three primary objectives of financial reporting?

■ LO6 27. What are some of the benefits to obtaining a degree in accounting? What is the difference between a career in public accounting and private accounting? What are some of the traditional careers of accounting graduates? What new areas are accountants expanding into?

■ LO7 28. Discuss the terms *relevance* and *faithful representation* as they relate to financial accounting information.

■ LO7 29. What are the two components of relevance? What are the three components of faithful representation?

■ LO7 30. What is meant by the terms *cost effectiveness* and *materiality* in financial reporting?

■ LO7 31. Define the four basic assumptions underlying GAAP.

BRIEF EXERCISES

connect ACCOUNTING

Define accounting **(LO1)**

BE1–1 Indicate whether the definition provided is true or false.

(True/False) Accounting can be defined as:

1. ______ The language of business.
2. ______ A measurement/communication process.
3. ______ A mathematics course.

Identify the different types of business activities **(LO2)**

BE1–2 Match each business activity with its description.

Business Activities	Descriptions
1. ______ Financing	a. Transactions related to revenues and expenses.
2. ______ Investing	b. Transactions with lenders and owners.
3. ______ Operating	c. Transactions involving the purchase and sale of productive assets.

BE1–3 Match each form of business organization with its description.

Identify the different forms of business organizations (LO2)

Business Organizations	Descriptions
1. ______ Sole proprietorship	a. Business owned by two or more persons.
2. ______ Partnership	b. Entity legally separate from its owners.
3. ______ Corporation	c. Business owned by a single person.

BE1–4 Match each account type with its description.

Recognize the different account classifications (LO2)

Account Classifications	Descriptions
1. ______ Assets	a. Amounts earned from sales of products or services.
2. ______ Liabilities	b. Owners' claims to resources.
3. ______ Stockholders' equity	c. Distributions to stockholders.
4. ______ Dividends	d. Costs of selling products or services.
5. ______ Revenues	e. Resources owned.
6. ______ Expenses	f. Amounts owed.

BE1–5 Match each financial statement with its description.

Describe each financial statement (LO3)

Financial Statements	Descriptions
1. ______ Income statement	a. Change in owners' claims to resources.
2. ______ Statement of stockholders' equity	b. Profitability of the company.
3. ______ Balance sheet	c. Change in cash as a result of operating, investing, and financing activities.
4. ______ Statement of cash flows	d. Resources equal creditors' and owners' claims to those resources.

BE1–6 Determine on which financial statement you find the following items.

Determine the location of items in financial statements (LO3)

Financial Statements	Items
1. ______ Income statement	a. The change in retained earnings due to net income and dividends.
2. ______ Statement of stockholders' equity	b. Amount of cash received from borrowing money from a local bank.
3. ______ Balance sheet	c. Revenue earned from sales to customers during the year.
4. ______ Statement of cash flows	d. Total amounts owed to workers at the end of the year.

BE1–7 Each of these parties plays a role in the quality of financial reporting. Match each group with its function.

Identify different groups engaged in providing high-quality financial reporting (LO5)

Groups	Functions
1. ______ Financial Accounting Standards Board	a. Group that has been given power by Congress to enforce the proper application of financial reporting rules for companies whose securities are publicly traded.
2. ______ International Accounting Standards Board	b. Independent, private-sector group that is primarily responsible for setting financial reporting standards in the United States.
3. ______ Securities and Exchange Commission	c. Independent intermediaries that help to ensure that management appropriately applies financial reporting rules in preparing the company's financial statements.
4. ______ Auditors	d. Body that is attempting to develop a single set of high-quality, understandable global accounting standards.

Identify the objectives of financial accounting **(LO5)**

BE1–8 Indicate which of the following are objectives of financial accounting.

(Yes/No)	Objectives
1. ______	Provide information that is useful to investors and creditors.
2. ______	Guarantee that businesses will not go bankrupt.
3. ______	Provide information about resources and claims to resources.
4. ______	Prevent competitors from offering lower-priced products.
5. ______	Provide information to help users in predicting future cash flows.
6. ______	Maximize tax revenue to the federal government.

Identify careers for accounting majors **(LO6)**

BE1–9 Below are possible career opportunities for those earning a degree in accounting. Indicate whether the statement related to each career is true or false.

(True/False)	Someone earning a degree in accounting could pursue the following career:
1. ______	Auditor
2. ______	Tax preparer
3. ______	Business consultant
4. ______	Financial planner
5. ______	Forensic investigator
6. ______	Tax planner
7. ______	Financial analyst
8. ______	Information technology developer
9. ______	Investment banker
10. ______	Tax lawyer
11. ______	FBI agent
12. ______	Information risk manager

Identify the components of relevance **(LO7)**

BE1–10 Match each of the components of relevance with its definition.

Relevance	Definitions
1. ______ Confirmatory value	a. Information is useful in helping to forecast future outcomes.
2. ______ Predictive value	b. Information provides feedback on past activities.

Identify the components of faithful representation **(LO7)**

BE1–11 Match each of the components of faithful representation with its definition.

Faithful Representation	Definition
1. ______ Freedom from material error	a. All information necessary to describe an item is reported.
2. ______ Neutrality	b. Information that does not bias the decision maker.
3. ______ Completeness	c. Reported amounts reflect the best available information.

EXERCISES

Identify the different types of business activities **(LO2)**

E1–1 The following provides a list of transactions and a list of business activities.

Transactions	Business Activities
1. ______ Borrow from the bank.	a. Financing
2. ______ Provide services to customers.	b. Investing
3. ______ Issue common stock to investors.	c. Operating
4. ______ Purchase land.	
5. ______ Pay rent for the current period.	
6. ______ Pay dividends to stockholders.	
7. ______ Purchase building.	

Required:

Match the transaction with the business activity by indicating the letter that corresponds to the appropriate business activity.

Identify account classifications and business activities **(LO2)**

Flip Side of E1–3

E1–2 Falcon Incorporated has the following transactions with Wildcat Corporation.

Transactions	Falcon's Related Account
1. Falcon purchases common stock of Wildcat.	Investment
2. Falcon borrows from Wildcat by signing a note.	Notes payable
3. Wildcat pays dividends to Falcon.	Dividend revenue
4. Falcon provides services to Wildcat.	Service revenue
5. Falcon pays interest to Wildcat on borrowing.	Interest expense

Required:

1. For each transaction, indicate whether Falcon would classify the related account as an (a) asset, (b) liability, or (c) stockholders' equity to be reported in the balance sheet; a (d) revenue or (e) expense to be reported in the income statement; or an (f) dividend to be reported in the statement of stockholders' equity.
2. Classify the type of activity as financing, investing, or operating.

Identify account classifications and business activities **(LO2)**

Flip Side of E1–2

E1–3 The transactions in this problem are identical to those in E1–2, but now with a focus on Wildcat.

Transactions	Wildcat's Related Account
1. Falcon purchases common stock of Wildcat.	Common stock
2. Falcon borrows from Wildcat by signing a note.	Notes receivable
3. Wildcat pays dividends to Falcon.	Dividend
4. Falcon provides services to Wildcat.	Service fee expense
5. Falcon pays interest to Wildcat on borrowing.	Interest revenue

Required:

1. For each transaction, indicate whether Wildcat would classify the related account as an (a) asset, (b) liability, or (c) stockholders' equity to be reported in the balance sheet; a (d) revenue or (e) expense to be reported in the income statement; or an (f) dividend to be reported in the statement of stockholders' equity.
2. Classify the type of activity as financing, investing, or operating.

Calculate net income and stockholders' equity **(LO2)**

E1–4 Eagle Corp. operates Magnetic Resonance Imaging (MRI) clinics throughout the Northeast. At the end of the current period, the company reports the following amounts: Assets = \$40,000; Liabilities = \$22,000; Dividends = \$2,000; Revenues = \$12,000; Expenses = \$8,000.

Required:

1. Calculate net income.
2. Calculate stockholders' equity at the end of the period.

Calculate net loss and stockholders' equity **(LO2)**

E1–5 Cougar's Accounting Services provides low-cost tax advice and preparation to those with financial need. At the end of the current period, the company reports the following amounts: Assets = \$17,000; Liabilities = \$14,000; Revenues = \$26,000; Expenses = \$32,000.

Required:

1. Calculate net loss.
2. Calculate stockholders' equity at the end of the period.

Prepare an income statement **(LO3)**

E1–6 Below are the account balances for Cowboy Law Firm at the end of December.

Accounts	Balances
Cash	\$ 4,400
Salaries expense	1,700
Accounts payable	2,400
Retained earnings	4,300
Utilities expense	1,100
Supplies	12,800
Service revenue	8,300
Common stock	5,000

Required:
Use only the appropriate accounts to prepare an income statement.

Prepare a statement of stockholders' equity **(LO3)**

E1–7 At the beginning of the year (January 1), Buffalo Drilling has $10,000 of common stock outstanding and retained earnings of $7,200. During the year, Buffalo reports net income of $7,500 and pays dividends of $2,200. In addition, Buffalo issues additional common stock for $7,000.

Required:
Prepare the statement of stockholders' equity at the end of the year (December 31).

Prepare a balance sheet **(LO3)**

E1–8 Wolfpack Construction has the following account balances at the end of the year.

Accounts	Balances
Equipment	$21,000
Accounts payable	2,000
Salaries expense	28,000
Common stock	10,000
Land	13,000
Notes payable	15,000
Service revenue	34,000
Cash	5,000
Retained earnings	?

Required:
Use only the appropriate accounts to prepare a balance sheet.

Prepare a statement of cash flows **(LO3)**

E1–9 Tiger Trade has the following cash transactions for the period.

Accounts	Amounts
Cash received from sale of products to customers	$ 35,000
Cash received from the bank for long-term loan	40,000
Cash paid to purchase factory equipment	(45,000)
Cash paid to merchandise suppliers	(11,000)
Cash received from the sale of an unused warehouse	12,000
Cash paid to workers	(23,000)
Cash paid for advertisement	(3,000)
Cash received for sale of services to customers	25,000
Cash paid for dividends to stockholders	(5,000)

Required:
1. Calculate the ending balance of cash, assuming the balance of cash at the beginning of the period is $4,000.
2. Prepare a statement of cash flows.

Compute missing amounts from financial statements **(LO3)**

E1–10 Each of the following independent situations represents amounts shown on the four basic financial statements.

1. Revenues = $25,000; Expenses = $17,000; Net income = ___________.
2. Increase in stockholders' equity = $16,000; Issuance of common stock = $10,000; Net income = $11,000; Dividends = ___________.
3. Assets = $23,000; Stockholders' equity = $17,000; Liabilities = ___________.
4. Total change in cash = $24,000; Net operating cash flows = $32,000; Net investing cash flows = ($15,000); Net financing cash flows = ___________.

Required:
Fill in the missing blanks using your knowledge of amounts that appear on the financial statements.

E1–11 During its first five years of operations, Red Raider Consulting reports net income and pays dividends as follows.

Calculate the balance of retained earnings **(LO3)**

Year	Net Income	Dividends	Retained Earnings
1	$1,200	$ 500	______
2	1,700	500	______
3	2,100	1,000	______
4	3,200	1,000	______
5	4,400	1,000	______

Required:

Calculate the balance of retained earnings at the end of each year. Note that retained earnings will always equal $0 at the beginning of year 1.

E1–12 Below is information related to retained earnings for five companies.

Calculate amounts related to the balance of retained earnings **(LO3)**

1. **Coca-Cola** reports an increase in retained earnings of $2.2 billion and net income of $4.9 billion. What is the amount of dividends?
2. **Pepsico** reports an increase in retained earnings of $2.4 billion and dividends of $1.6 billion. What is the amount of net income?
3. **Google** reports an increase in retained earnings of $1.5 billion and net income of $1.5 billion. What is the amount of dividends?
4. **Sirius Satellite Radio** reports beginning retained earnings of −$1.8 billion, net loss of $0.9 billion, and $0 dividends. What is the amount of ending retained earnings?
5. **Abercrombie & Fitch** reports ending retained earnings of $1.36 billion, net income of $0.33 billion, and dividends of $0.05 billion. What is the amount of beginning retained earnings?

Required:

Calculate the answer to each.

E1–13 Below is balance sheet information for five companies.

Use the accounting equation to calculate amounts related to the balance sheet **(LO3)**

1. **ExxonMobil** reports total assets of $208 billion and total liabilities of $97 billion. What is the amount of stockholders' equity?
2. **Citigroup** reports total liabilities of $1,400 billion and stockholders' equity of $100 billion. What is the amount of total assets?
3. **Amazon.com** reports total assets of $3.7 billion and total stockholders' equity of $0.2 billion. What is the amount of total liabilities?
4. **Nike** reports an increase in assets of $1.1 billion and an increase in liabilities of $0.4 billion. What is the amount of the change in stockholders' equity?
5. **Kellogg** reports a decrease in liabilities of $0.24 billion and an increase in stockholders' equity of $0.03 billion. What is the amount of the change in total assets?

Required:

Calculate the answer to each.

E1–14 Below is cash flow information for five companies.

Calculate missing amounts related to the statement of cash flows **(LO3)**

1. **Kraft Foods** reports operating cash flows of $3.5 billion, investing cash flows of $0.5 billion, and financing cash flows of −$4.0 billion. What is the amount of the change in total cash?
2. **Sara Lee** reports operating cash flows of $1.3 billion, investing cash flows of −$0.2 billion, and financing cash flows of −$1.2 billion. If the beginning cash amount is $0.6 billion, what is the ending cash amount?
3. **Performance Food Group** reports operating cash flows of $0.08 billion, investing cash flows of $0.53 billion, and a change in total cash of $0.05 billion. What is the amount of cash flows from financing activities?
4. **Smithfield Foods** reports operating cash flows of $0.50 billion, financing cash flows of $0.32 billion, and a change in total cash of $0.01 billion. What is the amount of cash flows from investing activities?

5. **Tyson Foods** reports investing cash flows of −$1.22 billion, financing cash flows of $0.93 billion, and a change in total cash of $0.01 billion. What is the amount of cash flows from operating activities?

Required:
Calculate the answer to each.

Identify the purpose of qualitative characteristics **(LO7)**

E1–15 The qualitative characteristics outlined in the FASB's conceptual framework include:

Primary Characteristics		Enhancing Characteristics
Relevance	**Faithful Representation**	
a. Confirmatory value	c. Completeness	f. Comparability
b. Predictive value	d. Neutrality	g. Verifiability
	e. Freedom from material error	h. Timeliness
		i. Understandability

Consider the following independent situations.

1. In deciding whether to invest in **Southwest Airlines** or **American Airlines**, investors evaluate the companies' income statements. ______
2. To provide the most reliable information about future sales, **Walmart**'s management provides unbiased estimates of the decline in inventory value each year. ______
3. In deciding whether to loan money, **Wells Fargo** uses balance sheet information to forecast the probability of bankruptcy. ______
4. **IBM** is required to issue public financial statements within 60 days of its year-end. ______
5. Employees of **Starbucks** can use the company's financial statements to understand the efficiency with which management has conducted operations over the past year. ______
6. When first requiring firms to prepare a statement of cash flows, the FASB's intent was not to discourage or promote investment in the automobile industry. ______
7. When **Harley–Davidson** reports revenue for the year, the amount includes sales not only in the United States but also those outside the United States. ______
8. The amount of total assets reported by **General Mills** can be substantiated by its auditors. ______
9. The **Cheesecake Factory** prepares its balance sheet in a clear format using basic accounting terminology to allow users to easily comprehend the company's assets, liabilities, and stockholders' equity. ______

Required:
Determine which qualitative characteristic best applies to each situation. Note: Each of the nine characteristics is used once and only once.

Identify business assumptions underlying GAAP **(LO7)**

E1–16 Below are the four underlying assumptions of generally accepted accounting principles.

Assumptions	**Descriptions**
1. ______ Economic entity	a. A common denominator is needed to measure all business activities.
2. ______ Going concern	b. Economic events can be identified with a particular economic body.
3. ______ Periodicity	c. In the absence of information to the contrary, it is anticipated that a business entity will continue to operate indefinitely.
4. ______ Monetary unit	d. The economic life of a company can be divided into artificial time intervals for financial reporting.

Required:
Match each business assumption with its description.

*For additional exercises, visit **www.mhhe.com/succeed** for Exercises: Set B.*

PROBLEMS: SET A

Classify business activities **(LO2)**

P1–1A Below are typical transactions for **Hewlett-Packard**.

Type of Business Activity	Transactions
1. ____________	Pay amount owed to the bank for previous borrowing.
2. ____________	Pay utility costs.
3. ____________	Purchase equipment to be used in operations.
4. ____________	Provide services to customers.
5. ____________	Purchase office supplies.
6. ____________	Purchase a building.
7. ____________	Pay workers' salaries.
8. ____________	Pay for research and development costs.
9. ____________	Pay taxes to the IRS.
10. ____________	Sell common stock to investors.

Required:

Indicate whether each transaction is classified as a financing, investing, or operating activity.

Assign account classifications **(LO2)**

P1–2A Account classifications include assets, liabilities, stockholders' equity, dividends, revenues, and expenses.

Account Classifications	Accounts	Related Transactions
1. ____________	Common stock	Sale of common stock to investors.
2. ____________	Equipment	Equipment used for operations.
3. ____________	Salaries payable	Amounts owed to employees.
4. ____________	Service revenue	Sales of services to customers.
5. ____________	Utilities expense	Cost of utilities.
6. ____________	Supplies	Purchase of office supplies.
7. ____________	Research and development expense	Cost of research and development.
8. ____________	Land	Property used for operations.
9. ____________	Income tax payable	Amounts owed to the IRS for federal income taxes.
10. ____________	Interest payable	Amount of interest owed on borrowing.

Required:

For each transaction, indicate whether the related account would be classified as an (a) asset, (b) liability, or (c) stockholders' equity to be reported in the balance sheet; a (d) revenue or (e) expense to be reported in the income statement; or an (f) dividend to be reported in the statement of stockholders' equity.

Prepare financial statements **(LO3)**

P1–3A Longhorn Corporation provides low-cost food delivery services to senior citizens. At the end of the year, the company reports the following amounts:

Cash	$ 1,300	Service revenue	$ 62,700
Equipment	24,000	Cost of goods sold (food expense)	52,400
Accounts payable	3,400	Buildings	30,000
Delivery expense	1,600	Supplies	2,400
Salaries expense	4,500	Salaries payable	900

User's Guide Problems marked with this icon can be solved using Microsoft Excel templates.

In addition, the company had common stock of $30,000 at the beginning of the year and issued an additional $3,000 during the year. The company also had retained earnings of $16,200 at the beginning of the year.

Required:

Prepare the income statement, statement of stockholders' equity, and balance sheet for Longhorn Corporation.

Understand the format of financial statements and the links among them **(LO3)**

P1–4A Below are incomplete financial statements for Bulldog, Inc.

BULLDOG, INC.
Income Statement

Revenues	$34,000
Expenses:	
Salaries	(a)
Advertising	5,000
Utilities	3,000
Net income	(b)

BULLDOG, INC.
Statement of Stockholders' Equity

	Common Stock	Retained Earnings	Total S. Equity
Beginning balance	$ 9,000	$6,000	$15,000
Issuances	1,000		1,000
Add: Net income		(c)	(c)
Less: Dividends		(2,000)	(2,000)
Ending balance	$10,000	$9,000	$19,000

BULLDOG, INC.
Balance Sheet

Assets		Liabilities	
Cash	$ 3,000	Accounts payable	(d)
Accounts receivable	2,000	**Stockholders' Equity**	
Supplies	8,000	Common stock	(e)
Equipment	9,000	Retained earnings	(f)
Total assets	$22,000	Total liabilities and stockholders' equity	(g)

Required:

Calculate the missing amounts.

Prepare financial statements **(LO3)**

P1–5A Cornhusker Company provides the following information at the end of 2012.

Cash remaining	$ 3,800
Rent expense for the year	6,000
Land that has been purchased	20,000
Retained earnings	?
Utility expense for the year	3,900
Accounts receivable from customers	6,200
Service revenue earned during the year	32,000
Salary expense for the year	12,300
Accounts payable to suppliers	1,700
Dividends paid to shareholders during the year	2,200
Common stock that has been issued prior to 2012	15,000
Salaries owed at the end of the year	1,900
Insurance expense for the year	2,500

Required:

Prepare the income statement, statement of stockholders' equity, and balance sheet for Cornhusker Company on December 31, 2012. No common stock is issued during 2012, and the balance of retained earnings at the beginning of 2012 equals $6,300.

Identify underlying assumptions of GAAP **(LO7)**

P1–6A The four underlying assumptions of generally accepted accounting principles are economic entity, monetary unit, periodicity, and going concern. Consider the four independent situations below.

1. McAdam's is a local restaurant. Due to a bad shipment of potatoes, several of the company's customers become ill, and the company receives considerable bad publicity. Revenues are way down, several of its bills are past due, and the company

is making plans to close the restaurant at the end of the month. The company continues to report its assets in the balance sheet at historical (original) cost.

2. Uncle Sam's Tax Services is owned and operated by Sam Martin. The company has the usual business assets: land, building, cash, equipment, and supplies. In addition, Sam decides to buy a boat for him and his family to enjoy on the weekends. Sam includes the boat as an asset on the balance sheet of Uncle Sam's Tax Services.
3. Tison International, a U.S.-based company, has operations in the United States and in Europe. For the current year, the company purchased two trucks in the United States for $10,000 and three trucks in Europe for €20,000 (euros). Because of the differences in currencies, the company reported "Five Trucks" with no corresponding amount in the balance sheet.
4. Trumpets Etc. sells specialty music equipment ranging from African bongo drums to grand pianos. Because of the fluctuating nature of the business, management decides to publish financial statements only when a substantial amount of activity has taken place. Its last set of financial statements covered a period of 14 months, and the set of financial statements before that covered a period of 18 months.

Required:

For each situation, indicate which of the underlying assumptions of GAAP is violated.

Understand the components of the FASB's conceptual framework **(LO7)**

P1–7A Listed below are nine terms and definitions associated with the FASB's conceptual framework.

Terms	Definitions
1. ______ Completeness	a. Requires the consideration of the costs and value of information.
2. ______ Comparability	b. Ability to make comparisons between firms.
3. ______ Neutrality	c. Comprehending the meaning of accounting information.
4. ______ Understandability	d. Including all information necessary to report the business activity.
5. ______ Cost effectiveness	e. The business will last indefinitely unless there is evidence otherwise.
6. ______ Verifiability	f. Recording transactions only for the company.
7. ______ Decision usefulness	g. Implies consensus among different measures.
8. ______ Economic entity assumption	h. Accounting should be useful in making decisions.
9. ______ Going concern assumption	i. Accounting information should not favor a particular group.

Required:

Pair each term with its related definition.

PROBLEMS: SET B

connect ACCOUNTING

Classify accounts **(LO2)**

P1–1B Below are typical transactions for **Caterpillar Inc.**

Type of Business Activity	Transactions
1. ______	Pay for advertising.
2. ______	Pay dividends to stockholders.
3. ______	Collect cash from customer for previous sale.
4. ______	Purchase a building to be used for operations.
5. ______	Purchase equipment.
6. ______	Sell land.
7. ______	Receive a loan from the bank by signing a note.
8. ______	Pay suppliers for purchase of supplies.
9. ______	Provide services to customers.
10. ______	Invest in securities of another company.

Required:
Indicate whether each transaction is classified as a financing, investing, or operating activity.

Assign business transactions to account classifications **(LO2)**

P1–2B Account classifications include assets, liabilities, stockholders' equity, dividends, revenues, and expenses.

Account Classifications	Accounts	Related Transactions
1. ______	Cash	Receive cash from customers.
2. ______	Service revenue	Provide services to customers.
3. ______	Supplies	Purchase supplies.
4. ______	Buildings	Purchase factory for operations.
5. ______	Advertising expense	Pay for cost of advertising.
6. ______	Equipment	Purchase equipment for operations.
7. ______	Interest expense	Pay for cost of interest.
8. ______	Accounts payable	Purchase supplies on credit.
9. ______	Dividends	Distribute cash to stockholders.
10. ______	Notes payable	Borrow from the bank.

Required:
For each transaction, indicate whether the related account would be classified as an (a) asset, (b) liability, or (c) stockholders' equity to be reported in the balance sheet; a (d) revenue or (e) expense to be reported in the income statement; or an (f) dividend to be reported in the statement of stockholders' equity.

Prepare financial statements **(LO3)**

P1–3B Gator Investments provides financial services related to investment selections, retirement planning, and general insurance needs. For the current year, the company reports the following amounts:

Advertising expense	$ 32,500	Service revenue	$122,600
Buildings	140,000	Interest expense	2,500
Salaries expense	64,100	Utilities expense	14,500
Accounts payable	5,400	Equipment	22,000
Cash	4,500	Notes payable	25,000

In addition, the company had common stock of $100,000 at the beginning of the year and issued an additional $10,000 during the year. The company also had retained earnings of $21,300 at the beginning of the year and paid dividends of $4,200.

Required:
Prepare the income statement, statement of stockholders' equity, and balance sheet for Gator Investments.

Understand the format of financial statements and the link among them **(LO3)**

P1–4B Below are incomplete financial statements for Cyclone, Inc.

CYCLONE, INC.
Income Statement

Revenues	(a)
Expenses:	
Salaries	$12,000
Rent	6,000
Advertising	4,000
Net income	(b)

CYCLONE, INC.
Statement of Stockholders' Equity

	Common Stock	Retained Earnings	Total S. Equity
Beginning balance	$13,000	$6,000	$19,000
Issuances of stock	(c)		(c)
Add: Net income		4,000	4,000
Less: Dividends		(d)	(d)
Ending balance	$15,000	$7,000	$22,000

CYCLONE, INC. Balance Sheet			
Assets		**Liabilities**	
Cash	$ 1,000	Accounts payable	$3,000
Supplies	(e)	**Stockholders' Equity**	
Land	5,000	Common stock	(g)
Building	15,000	Retained earnings	(h)
Total assets	(f)	Total liabilities and stockholders' equity	(i)

Required:
Calculate the missing amounts.

P1–5B Tar Heel Corporation provides the following information at the end of 2012.

Prepare financial statements **(LO3)**

Salaries payable to workers at the end of the year	$ 2,300
Advertising expense for the year	9,400
Building that has been purchased	70,000
Supplies at the end of the year	3,600
Retained earnings	36,000
Utility expense for the year	5,000
Note payable to the bank	20,000
Service revenue earned during the year	64,400
Salary expense for the year	25,700
Accounts payable to suppliers	6,700
Dividends paid to shareholders during the year	(?)
Common stock that has been issued, including $5,000 that was issued this year	25,000
Cash remaining	4,200
Interest expense for the year	1,600
Accounts receivable from customers	12,200

Required:
Prepare the income statement, statement of stockholders' equity, and balance sheet for Tar Heel Corporation on December 31, 2012. The balance of retained earnings at the beginning of the year equals $23,300.

P1–6B The four underlying assumptions of generally accepted accounting principles are economic entity, monetary unit, periodicity, and going concern. Consider the following four independent situations.

Identify underlying assumptions of GAAP **(LO7)**

1. Fine Groceries has over 1,000 grocery stores throughout the Northwest. Approximately 200,000 customers visit its stores each day. Because of the continual nature of grocery sales, the company does not publish an income statement. The company feels that it has an indefinite life and a periodic report would mislead investors.
2. Pacific Shipping provides delivery of packages between the United States and Japan. During the current year, the company delivered 3,000 packages for its U.S. customers totaling $25,000 in revenue. For its Japanese customers, the company delivered 1,000 packages totaling ¥1,000,000 (yen). The company's income statement indicates that total revenue equals 4,000 packages delivered with no corresponding amount in the income statement.
3. Schuster Typewriter has provided some of the finest typewriters in town for the past 50 years. Because of the advance of electronic word processors and computers, customer demand has dwindled over the years to almost nothing in the current year and the company can no longer pay its debts. For the most recent year, the company reports its assets in the balance sheet at historical (original) cost.

4. John Brewer Carpet specializes in the installation of carpet and wood flooring. The company has the usual business expenses: salaries, supplies, utilities, advertising, and taxes. John took his wife and two daughters to Disney World. John reported the airfare and hotel expenses in the income statement of John Brewer Carpet.

Required:
For each situation, indicate which of the underlying assumptions of GAAP is violated.

Understand the components of the FASB's conceptual framework **(LO7)**

P1–7B Listed below are several terms and definitions associated with the FASB's conceptual framework.

Terms	**Definitions**
1. ______ Predictive value	a. Decreases in equity resulting from transfers to owners.
2. ______ Relevance	b. Business transactions are measured using a common denominator.
3. ______ Timeliness	c. The indefinite life of a company can be broken into definite periods.
4. ______ Dividends	d. Information helps in understanding prior activities.
5. ______ Confirmatory value	e. Agreement between a measure and the phenomenon it represents.
6. ______ Faithful representation	f. Information arrives prior to the decision.
7. ______ Materiality	g. Information is related to the decision at hand.
8. ______ Monetary unit assumption	h. Information is useful in predicting the future.
9. ______ Periodicity assumption	i. Concerns the relative size of an item and its effect on decisions.

Required:
Pair each term with its related definition.

*For additional problems, visit **www.mhhe.com/succeed** for Problems: Set C.*

ADDITIONAL PERSPECTIVES

Continuing Problem

Great Adventures

(The Great Adventures problem continues in each chapter.)

AP1–1 Tony Matheson plans to graduate from college in May 2012 after spending four years earning a degree in sports and recreation management. Since beginning T-ball at age five, he's been actively involved in sports and enjoys the outdoors. Each summer growing up, he and his father would spend two weeks at a father/son outdoor camp. These fond memories are part of the reason he chose his major. He wants to remain involved in these outdoor activities and provide others with the same adventures he was able to share with his dad. He decides to start an outdoor adventure company. However, he's not sure he has the business background necessary to do this.

This is where Suzie Ramos can help. Suzie also plans to graduate in May 2012 with a major in business. Suzie and Tony first met their sophomore year and have been friends ever since as they share a strong interest in sports and outdoor activities.

They decide to name their company Great Adventures. They will provide clinics for a variety of outdoor activities such as kayaking, mountain biking, rock climbing, wilderness survival techniques, orienteering, backpacking, and other adventure sports.

Required:
1. What are the three primary forms of business organizations Tony and Suzie might choose for Great Adventures? Explain the advantages and disadvantages of each. Which form do you recommend for Great Adventures?

2. Discuss some of the typical financing, investing, and operating activities that a company like Great Adventures is likely to have.
3. What specific account names for assets, liabilities, stockholders' equity, revenues, and expenses would the company likely use to record its business transactions?
4. To report company performance, Suzie plans to prepare the four primary financial statements. Explain the type of information provided by each statement.

American Eagle Outfitters, Inc.

Financial Analysis

AP1–2 Financial information for **American Eagle** is presented in Appendix A at the end of the book.

Required:

1. Determine the amounts American Eagle reports for total assets, total liabilities, and total stockholders' equity in the balance sheet for the most recent year. Verify that the basic accounting equation balances.
2. American Eagle refers to its income statement using another name. What is it?
3. Determine the amounts American Eagle reports for net sales and net income in its income statement for the most recent year.
4. For investing activities, what are the largest inflows and largest outflows for the most recent year reported in the statement of cash flows? For financing activities, what are the largest inflows and largest outflows?
5. Who is the company's auditor? (See the Report of Independent Registered Public Accounting Firm.) What does the report indicate about the amounts reported in the company's financial statements?

The Buckle, Inc.

Financial Analysis

AP1–3 Financial information for **The Buckle** is presented in Appendix B at the end of the book.

Required:

1. Determine the amounts The Buckle reports for total assets, total liabilities, and total stockholders' equity in the balance sheet for the most recent year. Verify that the basic accounting equation balances.
2. The Buckle refers to its income statement using another name. What is it?
3. Determine the amounts The Buckle reports for net sales and net income in its income statement for the most recent year.
4. For investing activities, what are the largest inflows and largest outflows for the most recent year reported in the statement of cash flows? For financing activities, what are the largest inflows and largest outflows?
5. Who is the company's auditor? (See the Report of Independent Registered Public Accounting Firm.) What does the report indicate about the amounts reported in the company's financial statements?

American Eagle Outfitters, Inc. vs. The Buckle, Inc.

Comparative Analysis

AP1–4 Financial information for **American Eagle** is presented in Appendix A at the end of the book, and financial information for **The Buckle** is presented in Appendix B at the end of the book.

Required:

1. Which company reports higher total assets?
2. Which company reports higher total liabilities? Does this always mean this company has a higher chance of not being able to repay its debt and declare bankruptcy? Explain.
3. What relevant information do total assets and total liabilities provide to creditors deciding whether to lend money to American Eagle versus The Buckle?

4. Which company reports higher net income? Does this always mean this company's operations are more profitable? Explain.
5. What relevant information does net income provide to investors who are deciding whether to invest in American Eagle versus The Buckle?

Ethics

AP1–5 Management has the responsibility of accurately preparing financial statements when communicating with investors and creditors. Another group, auditors, serves an independent role by helping to ensure that management has in fact appropriately applied GAAP in preparing the company's financial statements. Auditors examine (audit) financial statements to express a professional, independent opinion. The opinion reflects the auditors' assessment of the statements' fairness, which is determined by the extent to which they are prepared in compliance with GAAP.

Suppose an auditor is being paid $1,000,000 by the company to perform the audit. In addition, the company plans to pay the auditor $500,000 over the next year for business consulting advice and another $200,000 for preparing its tax returns. The auditor and management of the company have always shared a friendly relationship, which partly explains the company's willingness to give the auditor additional work for $700,000.

Required:
How might an auditor's ethics be challenged while performing an audit?

Internet Research

AP1–6 The purpose of this research case is to introduce you to the Internet home pages of the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB).

Required:
1. Access the SEC home page on the Internet (***www.sec.gov***). Under "About the SEC," choose "What We Do." What is the mission of the SEC? Why was the SEC created? What are the two objectives of the 1933 Securities Act? The 1934 Securities Exchange Act established the SEC. What does the 1934 Act empower the SEC to require?
2. Access ***www.sec.gov/investor/pubs/begfinstmtguide.htm***. What are the four main financial statements discussed by the SEC? What does each report? What information is disclosed in the notes and management discussion and analysis (MD&A)?
3. Access the FASB home page on the Internet (***www.fasb.org***). Select "Facts About FASB." Describe the mission of the FASB. What is the relation between the SEC and the FASB?
4. Obtain a copy of the annual report of **ConocoPhillips** for the most recent year. You can find the annual report at the company's website (***www.conocophillips.com***) in the investor information section or at the SEC's website (***www.sec.gov***) using EDGAR (Electronic Data Gathering, Analysis, and Retrieval). The SEC requires that Form 10-K, which includes the annual report, be filed on EDGAR. Answer the following questions:
   (a) Did ConocoPhillips prepare the four financial statements discussed by the SEC?
   (b) In the MD&A section, how does the company describe its business environment?
   (c) Find the note disclosures to the financial statements. What does the disclosure on segment information discuss?

Written Communication

AP1–7 Maria comes to you for investment advice. She asks, "Which company's stock should I buy? There are so many companies to choose from and I don't know anything about any of them."

Required:

Respond to Maria by explaining the two functions of financial accounting. Specifically address the four financial statements reported by companies and the information contained in each. Also explain the role of the auditor in the preparation of financial statements. What advice can you give her about finding a company's stock to buy?

Answers to the Self-Study Questions

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