1 A Framework for Financial Accounting

CHAPTER

Learning Objectives

AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:

- **LO1–1** Describe the two primary functions of financial accounting.
- **LO1–2** Understand the business activities that financial accounting measures.
- **LO1–3** Determine how financial accounting information is communicated through financial statements.
- **LO1–4** Describe the role that financial accounting plays in the decision- making process.
- **LO1–5** Explain the term generally accepted accounting principles (GAAP) and describe the role of GAAP in financial accounting.
- **LO1–6** Identify career opportunities in accounting.

Appendix

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

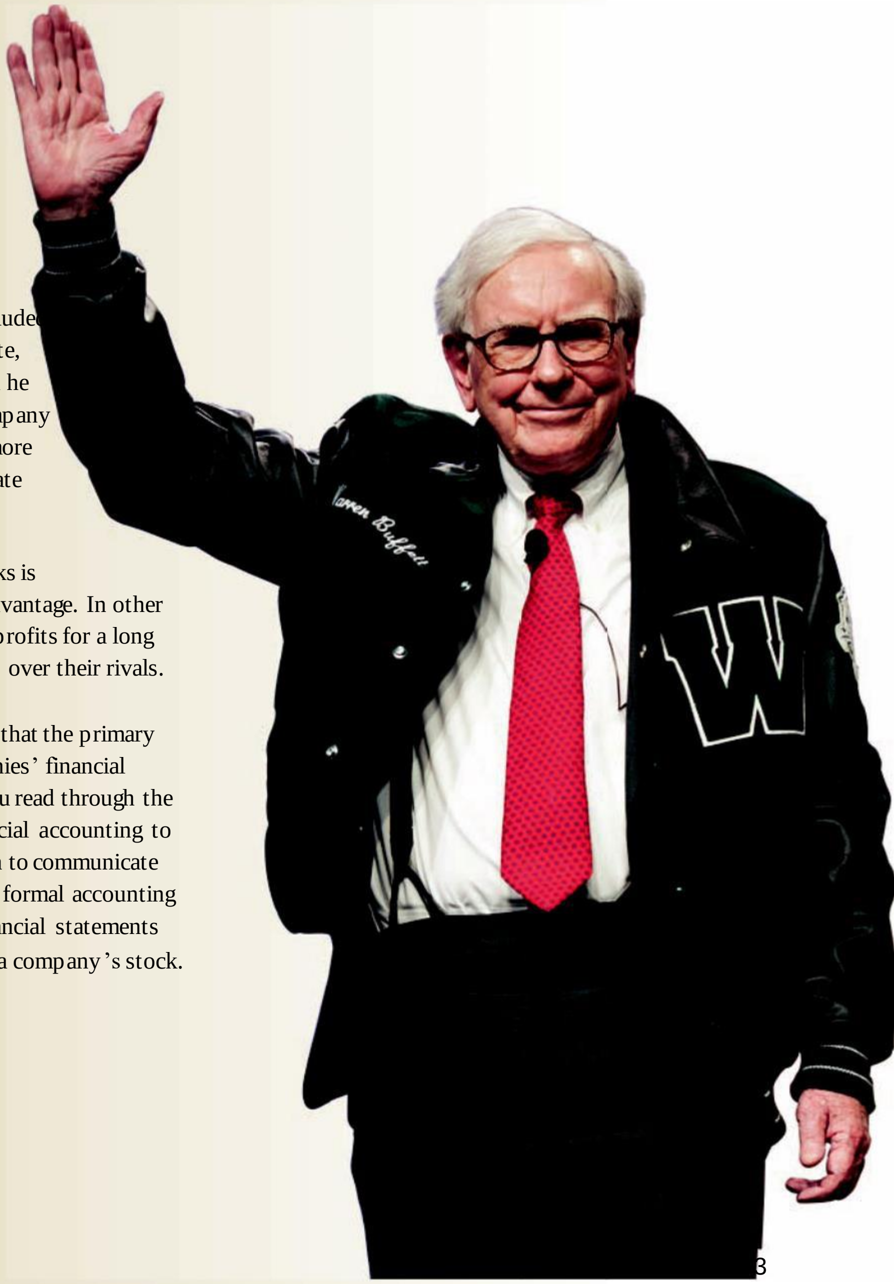
BERKSHIRE HATHAWAY: SPEAKING THE LANGUAGE OF BUSINESS

Feature Story

"You have to understand accounting and you have to understand the nuances of accounting. It's the language of business and it's an imperfect language, but unless you are willing to put in the effort to learn accounting—how to read and interpret financial statements—you really shouldn't select stocks yourself." —Warren Buffett

Warren Buffett is widely recognized as the most successful investor ever. In 1999, a survey by the Carson Group named Buffett the top money manager of the twentieth century. From 2000 to 2010, **Berkshire Hathaway**, the holding company for which Buffett serves as chairman and CEO, produced a total return for its investors of 76%, compared to a −11% return for the S&P 500 stock index. By 2008, Buffett's net worth had grown to $62 billion, making him the richest person in the world according to *Forbes* magazine.

Buffett knows not only how to make money, but also how to give it away. In 2006, he pledged $30 billion to the Bill and Melinda Gates Foundation. By the end of 2011, he had fulfilled $10 billion of that pledge. He intends to give away 99% of his wealth over his life, making him also one of the greatest philanthropists of all time.



Some of Buffett's more famous investments have included companies such as Coca-Cola, American Express, Gillette, Washington Post, Moody's, GEICO, and ABC. How did he decide which stocks to purchase? Over ten thousand company stocks are available in the United States and thousands more on stock exchanges around the world. How did he separate the successful companies from the unsuccessful ones?

Buffett explains that the key to identifying good stocks is to look for companies that have a durable competitive advantage. In other words, look for companies that are expected to produce profits for a long time because they have achieved a sustainable advantage over their rivals. How do you do this? There are, of course, many factors to consider, but Buffett explains that the primary source of this information comes from analyzing companies' financial accounting information—the subject of this book. As you read through the chapters, you'll begin to understand the purpose of financial accounting to measure the business transactions of a company and then to communicate those measurements to investors, like Warren Buffett, in formal accounting reports called *financial statements*. It is from these financial statements that investors base their decisions on buying and selling a company's stock.

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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 through-out 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

■ **LO1–1** 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 informa-tion 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. 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

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

To make the decisions outlined in Illustration 1–1, these people need information. This is where accounting plays a key role. As Illustration 1–2 shows, accountants ***measure* the activities of the company and *communicate* those measurements to others.**

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Accounting information that is provided for *internal* users (managers) is referred to as **managerial accounting;** that provided to *external* users is referred to as **financial accounting.** In this book, we focus on financial accounting. Formally

[1]S. Basu and G. Waymire. 2006. Recordkeeping and Human Evolution. *Accounting Horizons* 201–229.

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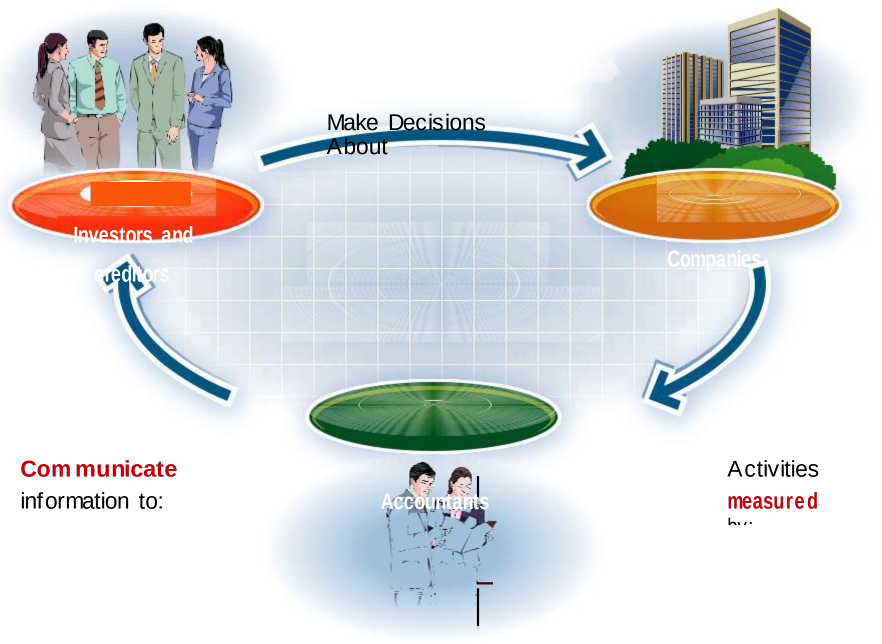

ILLUSTRATION 1–2
Framework for Financial Accounting

mhhe.com/3fa1

defined, the two functions of **financial accounting** are to measure business activi-ties of a company and then to communicate those measurements to *external* parties for decision- making purposes.

As you study the business activities discussed in this book, it is important for you to keep in mind the "framework" for financial accounting. For each topic, ask yourself: (1) How is the business activity being measured, and (2) how is it being communicated? These are the two functions of financial accounting. You'll better understand *why* this process exists by thinking about how the measurements being communicated help people make better decisions.

For example, **investors** want to make good decisions related to buying and selling the company's stock (shares of ownership): Will the company's stock increase or decrease in value? The value of a stock is directly tied to the company's abil-ity to make a profit, so what activities reflect the company's profitability? How should those activities be measured, and how should they be communicated in formal accounting reports?

As another example, **creditors** make decisions related to lending money to the company: Will the company be able to repay its debt and interest when they come due? How can debt activity be measured and how can it be communicated so that creditors better understand the ability of the company to have sufficient cash to repay debt and interest in the short term and the long term?

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 com-pany and to communicate information about those activities to investors and creditors and other outside users for decision-making purposes.

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MEASURING BUSINESS ACTIVITIES

■ **LO1–2** Understand the business activities that financial accounting measures.

Because this may be your first business-related course, let's first look at the typical activities of any start-up business. We'll do this with a simple example. Suppose you want to start a golf academy. The purpose of the academy is to provide lessons

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to develop junior players for top university programs and perhaps even one day to play on the PGA Tour. Let's look at some initial activities of your new company, which you've decided to name Eagle Golf Academy.

Assume you estimate that you'll need to obtain $35,000 to get the business up and going. You don't have that amount of money to start the business, so you begin by looking for investors. With their money, investors buy ownership in the company and have the right to share in the company's profits. Each share of own-ership is typically referred to as a share of common stock. For your company, let's say you sell 1,000 shares of common stock for $25 each, receiving cash of $25,000 from investors. The 1,000 shares include 300 sold to your grandparents for $7,500, giving them 30% (= 300/1,000) ownership in the company. The remaining 700 shares include 400 to your parents, 200 to a friend, 90 to your high school golf coach, and 10 to your little sister.

To raise the remaining cash needed, you borrow $10,000 from a local bank, which you agree to repay within three years. Thus, the bank is your creditor.

Now, with the $35,000 of cash obtained from investors and creditors, the com-pany buys equipment. This equipment costs $24,000, leaving $11,000 cash for future use. At this point, your company has the following resources that can be used for operations.

Cash	$11,000	
Equipment	24,000	Resources
	$35,000	

Who has the claims to the company's resources? Answer: The investors and creditors. Creditors have claims equal to the amount loaned to the company, $10,000. In other words, $10,000 of the company's resources are promised to the local bank. Investors have claims to all remaining resources, $25,000.

Creditors (local bank)	$10,000	
Investors (common stock)	25,000	Claims to Resources
	$35,000	

Notice that you (the manager) do not have claims to the resources. You are simply managing the resources of the company on behalf of the owners (stockholders, in this case).This owner- manager separation is the typical business structure for many corporations. Formally defined, a **corporation** is a company that is legally separate from its owners. The advantage of being legally separate is that the stockholders have limited liability. **Limited liability** prevents stockholders from being held per-sonally responsible for the financial obligations of the corporation. Stockholders of Eagle Golf Academy can lose their investment of $25,000 if the company fails, but they cannot lose any of their personal assets (such as homes, cars, computers, and furniture).

Other common business forms include sole proprietorships and partnerships. A **sole proprietorship** is a business owned by one person; a **partnership** is a busi-ness owned by two or more persons. If you had decided to start Eagle Golf Academy without outside investors, you could have formed a sole proprietorship, or you and a friend could have formed a partnership. However, because you did not have the necessary resources to start the business, being a sole proprietorship (or even one member of a partnership) was

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not a viable option. Thus, a disadvantage of selecting the sole proprietorship or partnership form of business is that owners must have

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sufficient personal funds to finance the business in addition to the ability to borrow money. Another disadvantage of being a sole proprietorship or partnership is that neither offers limited liability. Owners (and partners) are held personally respon-sible for the activities of the business.

Sole proprietorships and partnerships do offer the advantage of lower taxes compared to corporations. Sole proprietorships and partnerships are taxed at the owner's personal income tax rate, which is typically lower than the corporate income tax rate. In addition, corporations suffer a form of *double taxation*: 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.

Because most of the largest companies in the United States are corporations, in this book we will focus primarily 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 (stockholders) are typically separated from management of the company. (A more detailed dis-cussion of the advantages and disadvantages of a corporation can be found in Chapter 10.)

We'll continue the example of Eagle Golf Academy in more detail in a moment. For now, we can see that the company has engaged in financing and investing activ-ities. *Financing activities* include transactions the company has with investors and creditors, such as issuing stock ($25,000) and borrowing money from a local bank ($10,000). *Investing activities* include transactions involving the purchase and sale of resources that are expected to benefit the company for several years, such as the purchase of equipment for $24,000. With the necessary resources in place, the company is ready to begin operations. *Operating activities* will 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, salaries, rent, and utilities.

Assets, Liabilities, and Stockholders' Equity. What information would Eagle's investors and creditors be interested in knowing, in order to make informed deci-sions about your ability to manage the golf academy? In other words, what informa-tion would be important for investors and creditors to understand about whether their decision to invest in the company was a good one? **Ultimately, investors and creditors want to know about the company's resources and their claims to those resources.** Accounting uses some conventional names to describe such resources and claims.

The resources of a company are referred to as **assets**. At this point, Eagle Golf Academy has two assets—cash and equipment. Of course, there are many other possible resources that a company can have, such as supplies, inventory for sale to customers, buildings, and land. You'll learn about these and many other assets throughout the book. (For a sneak peek at the names of these assets, look at the list provided on the inside back cover of the b ook.)

As discussed earlier, two parties claim the resources of the company—investors and creditors. Amounts owed to creditors are **liabilities**. The Eagle Golf Academy has a liability of $10,000 to the local bank. Other examples of liabilities would be amounts owed to suppliers, workers, utility companies, and governments (in the form of taxes). Liabilities are claims that must be paid by a specified date.

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Investors, or owners, claim any resources of the company not owed to credi-tors. In the case of Eagle Golf Academy, this amount is $25,000. We refer to owners' claims to resources as **stockholders' equity**, because stockholders are the owners.

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

ILLUSTRATION 1–3

The Basic Accounting Equation

Assets	=	Liabilities (creditors' claims)	+	Stockholders' Equity (owners' claims)
(resources)		(claims to resources)		

As with any equation, we can move the components around. To isolate stockholders' equity, for example, we can subtract liabilities from both sides of the equal sign.

Assets	−	Liabilities	=	Stockholders' Equity
(resources)		(creditors' claims)		(owners' claims)

Eagle has assets of $35,000 and liabilities of $10,000. How much equity do stockholders have? They have $35,000 − $10,000, or $25,000.

The accounting equation illustrates a fundamental model of business valuation. The value of a company to its owners equals total resources of the com-pany 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 owners hope their claims to the company's resources increase over time. This increase occurs when the com-pany makes a profit. Stockholders claim all resources in excess of amounts owed to creditors; thus, profits of the company are claimed solely by stockholders.

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 you or one of your employees provides golf training to customers, the com-pany earns revenues. However, as you've probably heard, "It takes money to make money." To operate the academy, you'll encounter many costs. For example, you'll have costs related to salaries, rent, supplies, and utilities. We record these amounts as expenses. **Expenses** are the costs of providing products and services.

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 and adding to stockholders' equity in the business. 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 busi-ness, 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. If we assume that by the end of the first month of operations Eagle Golf Academy has total revenues of $7,200 and total expenses of $6,000, then we would say that the company has net income of $1,200 for the month. This amount of profit increases stockholders' claims to resources but has no effect on creditors' claims.

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When a business has positive net income, it may either distribute those profits back to its stockholders or retain those profits to pay for future operations. Suppose you decide that because there was net income of $1,200, a cash payment of $200 should be returned to stockholders at the end of December. These cash payments to stockholders are called **dividends**. Eagle Golf Academy pays cash of $200

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to stockholders, while the other $1,000 of net income adds to stockholders' equity of the company. Thus, stockholders receive a total benefit of $1,200, equal to $200 of dividends received plus $1,000 increase in stockholders' equity in the company they own.

Let's Review

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

Match the term with the appropriate definition.

1. _____ Assets
2. _____ Liabilities
3. _____ Stockholders' Equity
4. _____ Dividends
5. _____ Revenues
6. _____ Expenses

A. Costs of selling products or services.
B. Amounts earned from sales of products or services.
C. Amounts owed.
D. Distributions to stockholders.
E. Owners' claims to resources.
F. Resources of a company.

Solution:

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

In summary, the measurement role of accounting is to create a record of the activities of a company. To make this possible, a company must maintain an accu-rate 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 1–4 summarizes the business activities and the categories that measure them.

ILLUSTRATION 1–4

Business Activities and Their Measurement

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

KEY POINT

The measurement role of accounting is to create a record of the activities of a company. To make this possible, a company must maintain an accurate record of its assets, liabilities, stockholders' equity, revenues, expenses, and dividends.

As you learn to measure business activities, you will often find it helpful to con-sider 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

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“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 Exercise 1–2 for the first such example.)

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Communicating through Financial Statements

■ **LO1–3**
Determine 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 *measure* 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. There are four primary financial statements:

1. Income statement
2. Statement of stockholders' equity
3. Balance sheet
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 out-side 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 continue with our example of Eagle Golf Academy. Actual companies' finan-cial 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.

INCOME STATEMENT

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

The **income statement** is a financial statement that reports the company's rev-enues 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 December 1, Eagle Golf Academy begins operations by offering lessons to junior golfers. For the first month of opera-tions, Eagle Golf Academy reports its income statement as shown in Illustration 1–5.

ILLUSTRATION 1–5
Income Statement for Eagle Golf Academy

EAGLE GOLF ACADEMY
Income Statement
For the period ended December 31

Revenues	
Service revenue	$7,200
Expenses	
Rent expense	500
Supplies expense	1,000
Salaries expense	3,100

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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 December Eagle Golf Academy earns revenues of **$7,200**. This means that Eagle provides golf training and bills customers for a total of $7,200. Total expenses associated with generating those revenues, including rent, supplies, salaries, utilities, interest, and other items listed here, are **$6,000**. These are typical costs that we might expect of any company. The income statement shows that revenues *exceed* expenses ($7,200 is greater than $6,000), and thus the academy is able to report net income of **$1,200**.

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, **Sony**, **J. C. Penney**, **Rite Aid**, **Electronic Arts**, **Six Flags Entertainment**, **Zynga**, **KB Home**, **Speedway Motorsports**, **Winn-Dixie Stores**, **Texas Industries**, **Orbitz Worldwide**, **Fannie Mae**, **Royal Bank of Scotland**, **Goodrich Petroleum**, **Callaway Golf**, and thousands of others have had 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.

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.

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.

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.

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 been kept (retained) in the business rather than distributed to stockholders as dividends (not retained). Since all profits of the com-pany are owned by stockholders, any net income in excess of dividends paid to stockholders represents

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additional stockholders ’ equity. Thus, both common stock and retained earnings make up total stockholders ’ equity:

Stockholders’ Equity = Common Stock + Retained Earnings

When Eagle begins operations on December 1, the balances of common stock and retained earnings are **$0**. Once the company issues 1,000 shares of common stock

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

for $25 per share, the balance of common stock increases by **$25,000**. The balance of retained earnings increases by the amount of net income less any dividends paid to stockholders. For the month of December, net income was $1,200, and dividends paid to stockholders was $200, so retained earnings increased by $1,000 ($1,200 − $200). **The name *retained earnings* is descriptive. The balance of retained earn-ings represents the amount of "earnings retained" (not paid out in the form of dividends) over the life of the company.** Illustration 1–6 shows the statement of stockholders' equity for Eagle Golf Academy.

ILLUSTRATION 1–6

Statement of Stockholders' Equity for Eagle Golf Academy

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

Note that the amounts shown here come from the income statement.

Accounting convention uses parentheses to signify an amount to be subtracted (such as dividends here) or negative amounts (such as a net loss in the income statement).

EAGLE GOLF ACADEMY
Statement of Stockholders' Equity
For the period ended December 31

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance (Dec. 1)	$ -0-	$ -0-	$ -0-
Issuance of common stock	25,000		25,000
Add: Net income for the period		1,200	1,200
Less: Dividends		(200)	(200)
Ending balance (Dec. 31)	$ 25,000	$ 1,000	$ 26,000

COMMON MISTAKE

Dividends represent the payment of cash but are not considered an expense in run-ning 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.

By adding common stock of $25,000 and the retained earnings of $1,000, we cal-culate the balance of total stockholders' equity at December 31 to be **$26,000**. In accounting terms, this amount represents the value of the firm to its owners, the stock-holders. The company creates value *externally* through investment by owners (com-mon stock), and *internally* by generating and retaining profits (retained earnings).

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.

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

Analysis

Question	Accounting information
Was the change in company value (stockholders' equity) the result of external or internal sources?	Statement of stockholders' equity

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When a company sells com- mon stock, company value increases due to external sources (stockholders). When a company has profits dur-ing the year in excess of dividends paid, company value increases due to internal sources (company operations).

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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 summa-rized by the basic accounting equation (see Illustration 1–3):

Assets = Liabilities + Stockholders' Equity

As discussed earlier, this equation provides a fundamental model of business valu-ation. Assets are the resources of 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 com-pany's assets that will be used to pay liabilities (the amounts due creditors) as they become due.

Illustration 1–7 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* December 1 to December 31; its balance sheet shows assets, liabilities, and stockholders' equity of the company *on* December 31.

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

ILLUSTRATION 1–7

Balance Sheet for Eagle Golf Academy

EAGLE GOLF ACADEMY
Balance Sheet
December 31

Assets		Liabilities	
Cash	$ 6,900	Accounts payable	$ 2,300
Accounts receivable	2,700	Salaries payable	300
Supplies	1,300	Utilities payable	900
Equipment, net	23,600	Interest payable	100
Other assets	5,500	Notes payable	10,000
		Other liabilities	400
		Total liabilities	14,000
		Stockholders' Equity	
		Common stock	25,000
		Retained earnings	1,000
		Total stockholders' equity	26,000
Total assets	$40,000	Total liabilities and stockholders' equity	$40,000

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

We show the stockholders' equity items in purple here to indicate they came from the statement of stockholders' equity (Illustration 1–6).

Let's first take a look at Eagle's assets—the resources of the company. *Cash* is a resource because it can be used to make purchases. *Accounts receivable* repre-sent money the company expects to receive in the future from customers. While accounts receivable are not cash now, the expectation of receiving cash in the future is a benefit, and thus they are a resource of the company. *Supplies* include resources used to perform basic

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business functions. *Equipment* is a resource that can be used to provide services to customers. There are many other assets a busi-ness can have, and we will discuss those in other chapters. **For now, understand that assets are the resources of the company that are expected to provide benefits to the company in the future.** Total assets of Eagle Golf Academy on December 31 equal **$40,000**.

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Total liabilities on December 31 equal **$14,000**. These include amounts owed to regular vendors (accounts payable), as well as amounts owed for other items such as employee salaries, utilities, interest, and bank borrowing (notes payable).

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 **$26,000** represents stockhold-ers' 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:

Total assets must equal total liabilities and stockholders'

Assets (resources)	=	Liabilities (creditors' claims)	+	Stockholders' Equity (owners' claims)
$40,000	=	$14,000	+	$26,000

KEY POINT

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

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.

STATEMENT OF CASH FLOWS

The **statement of cash flows** is a financial statement that measures activities involv-ing 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:

- **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.

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- **Financing cash flows** include cash transactions with lenders, such as borrow-ing money and repaying debt, and with stockholders, such as issuing stock and paying dividends.

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Illustration 1–8 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 for the period.

ILLUSTRATION 1–8

Statement of Cash Flows for Eagle Golf Academy

EAGLE GOLF ACADEMY Statement of Cash Flows For the period ended December 31		
Cash Flows from Operating Activities		
Cash inflows:		
From customers	$ 4,900	
Cash outflows:		
For salaries	(2,800)	
For rent	(6,000)	
Net cash flows from operating activities		($3,900)
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		6,900
Cash at the beginning of the period		-0-
Cash at the end of the period		$6,900

Remember, amounts parentheses indicate outflow s of cash, consistent w ith accounting

Decision Maker's Perspective

The statement of cash flows can be an important source of information to inves-tors 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.

Change in cash = Operating cash flows + Investing cash flows + Financing

The total of the net cash flows from operating, investing, and financing activities equals the *net change in cash* during the period:

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cash flows

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

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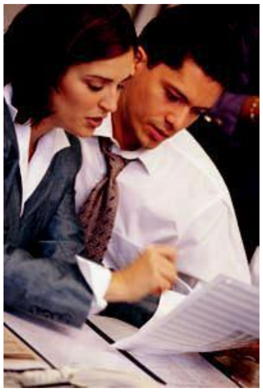
For Eagle, that net change in cash for December was an increase of **$6,900**. That amount equals the sum of its operating cash flows of −$3,900, investing cash flows of −$24,000, and financing cash flows of $34,800. We next add the beginning balance of cash. Because this is the first month of operations for Eagle, cash at the beginning of the period is zero. The ending balance of cash is the same as that reported in the balance sheet in Illustration 1–7. This reconciliation of the begin-ning 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. Pro-viding 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 stock-holders' equity. Then, the ending balance of retained earnings is reported in the balance sheet. **Thus, any transaction that affects the income statement ulti-mately affects the balance sheet through the balance of retained earnings.** The cash received from customers will be reported as part of the ending cash bal-ance in the balance sheet and as part of operating cash flows in the statement of cash flows.

Illustration 1–9 (next page) shows the links among the financial statements of Eagle Golf Academy in Illustrations 1–5, 1–6, 1–7, and 1–8. 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.

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 account-ing information. Two other sources of information provided along with the finan-cial statements we've discussed are: (1) management's discussion and analysis and (2) note disclosures to the financial statements.

The **management discussion and analysis** (MD&A) section typically includes management's views on significant events, trends, and uncertainties pertaining to

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the company's operations and resources. **Note disclosures** offer additional infor-mation either to explain the information presented in the financial statements or to provide information not included in the financial statements. For example, com-panies 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 dis-cuss these items throughout the book.

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ILLUSTRATION 1–9

Links among Financial Statements

EAGLE GOLF ACADEMY
Income Statement

Revenues	$7,200
Expenses	6,000
Net income	$1,200

EAGLE GOLF ACADEMY
Statement of Stockholders' Equity

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance (Dec. 1)	$ -0-	$ -0-	$ -0-
Issuances	25,000		25,000
Add: Net income	–	1,200	1,200
Less: Dividends	–	(200)	(200)
Ending balance (Dec. 31)	$25,000	$ 1,000	$26,000

EAGLE GOLF ACADEMY
Balance Sheet

Cash	$ 6,900	Liabilities	$14,000
Other assets	33,100	Stockholders' equity	26,000
Total assets	$40,000	Total liabilities and stockholders' equity	$40,000

EAGLE GOLF ACADEMY
Statement of Cash Flows

Cash flows from operating activities	$ (3,900)
Cash flows from investing activities	(24,000)
Cash flows from financing activities	34,800
Net increase in cash	6,900
Cash at the beginning of the year	-0-
Cash at the end of the year	$ 6,900

[1] Notice that the amount of net income in the income statement reappears in the state- ment 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 flow s.

mhhe.com/3fa2

Let's Review

mhhe.com/3fa3

Test your understanding of what you've read so far. The Computer Shop repairs laptops, desktops, and mainframe computers. On December 31, 2015, 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	
Liabilities:	Accounts payable	4,000		Supplies	
	Notes payable	10,000		Salaries	

Additional information:

a. The balance of retained earnings at the beginning

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of the year is $7,000. b. The company pays dividends of $1,000 on December 31, 2015.

c. Common stock is $15,000 at the beginning of the year, and additional shares are issued for $4,000 during 2015.

6,000
14,000
40,000

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Suggested Homework:
BE1–7, BE1–8;
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 Year ended Dec. 31, 2015

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 Year ended Dec. 31, 2015

	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. Balance sheet:

THE COMPUTER SHOP
Balance Sheet
December 31, 2015

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

Making Decisions with Accounting Information

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

To this point, you’ve had a simple, first look at how companies measure and com-municate 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?

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 mar-kets. In free markets, firms are allowed to compete and customers are free to choose from a

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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

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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 infor-mation in making investment and lending decisions.

As Illustration 1–10 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.**

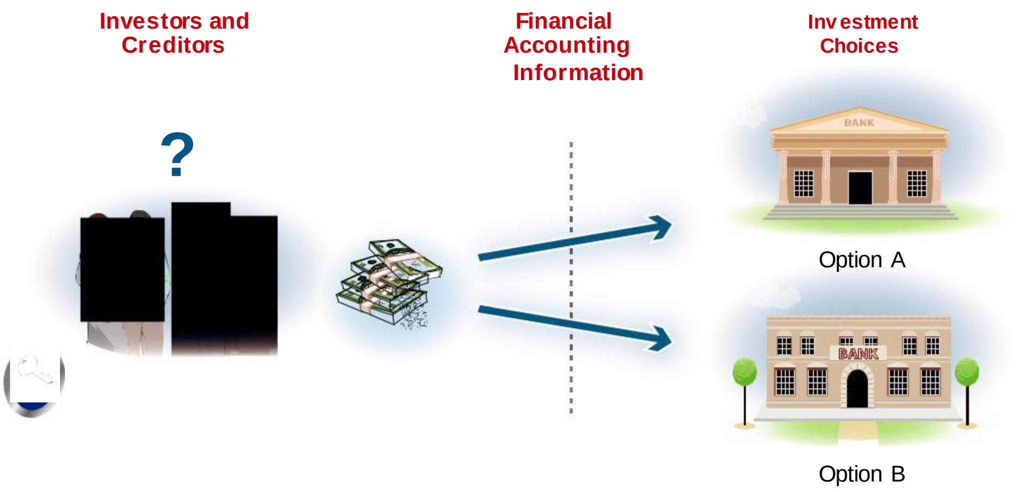

ILLUSTRATION 1–10

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 invest-ment 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

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company in which you invest (you can sell the stock for more than you bought it). So as an investor, you are looking for compa-nies 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

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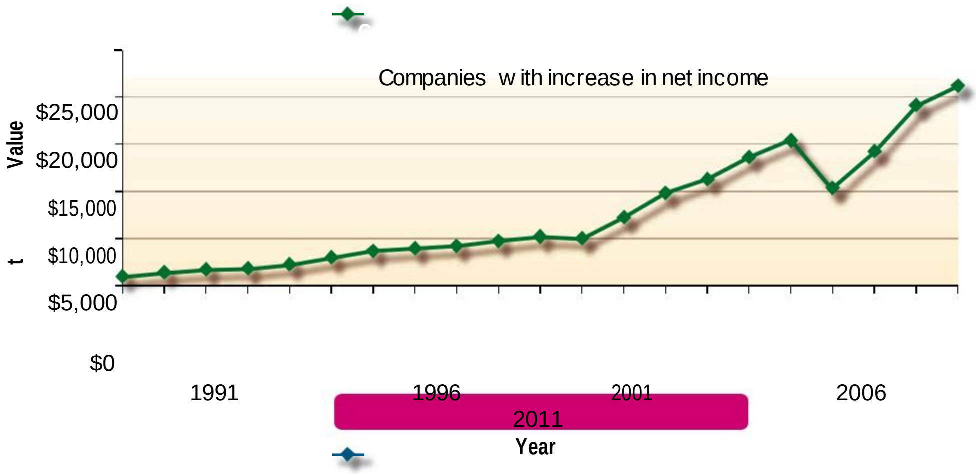
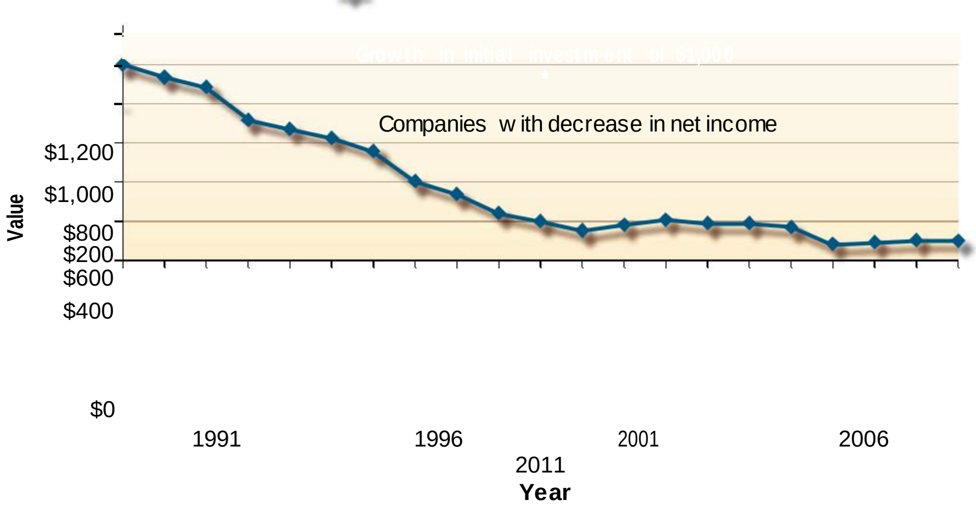
then you invested $1,000 in companies that were going to have an *increase?* In contrast, what if instead you invested in companies that would have a *decrease* in net income? Illustration 1–11 shows what would happen to your $1,000 investment over 20 years for each scenario.

ILLUSTRATION 1–11

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





*Amounts in this chart represent the inv estment growth based on the median stock return of each group each y ear. Companies included in this analy sis are all U.S. companies with listed stocks, which av erages about 6,000 companies per y ear.

You can see that if you had invested $1,000 in companies with an increase in net income, your investment would have increased to $21,079 over the 20-year period. (The amount would have been much higher without the extraordinary events sur-rounding the financial crisis in 2008.) If instead you had invested $1,000 in compa-nies with a decrease in net income, your $1,000 investment would have shrunk to $101 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.

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Investors and creditors also use information reported in the balance sheet. Con-sider 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.

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KEY POINT

No single piece of company information better explains companies' stock price per-formance 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.

FINANCIAL ACCOUNTING INFORMATION

Recall that accounting serves two main functions: It (1) measures business activities and (2) communicates those measurements to investors and creditors so they can make decisions. 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 issues have been heav-ily debated, and the answers have changed over time. Next, we'll take a look at factors that shape the measurement and communication processes of financial accounting.

Rules of Financial Accounting

Because financial accounting information is so vital to investors and creditors, for-mal standards for reporting it have been established. 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.

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

CURRENT STANDARD SETTING

Today, financial accounting and reporting standards in the United States are estab-lished primarily by the **Financial Accounting Standards Board (FASB)** (pro-nounced 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 corpora-tions, financial analysts, accounting educators, and government agencies.

Not all countries follow the same accounting and reporting standards. For exam-ple, 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 dif-ferences 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.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

WHAT IS THE IASB?

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, understand-able 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 con-vergence of U.S. and international accounting standards. The standards

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being developed and promoted by the IASB are called **International Financial Reporting Standards (IFRS)**. (*For more discussion, see Appendix E.*)

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

User's Guide Boxed sections on *International Financial Reporting Standards* (IFRS) are included throughout the book to emphasize the grow ing importance of international accounting standards throughout the w orld. They discuss specific instances in w hich U.S. GAAP and interna- tional standards differ. Appendix E at the back of the book provides more detail about differences betw een IFRS and U.S. GAAP.

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

More than 100 countries have chosen to forgo their own country-specific standards and either require or allow International Financial Reporting Stan-dards as their national standards. That movement, coupled with the conver-gence 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 princi-ples (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 com-panies to engage in inaccurate financial reporting to enhance their reported per-formance. 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 set-ting 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 responsi-bility, 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

For many businesses, there is a natural separation between those who run the busi-ness (managers) and those who own the business or finance operations (investors and creditors). This separation creates the need to ensure honest financial report-ing. While it is the responsibility of management to apply GAAP when communicat-ing with investors and creditors through financial statements, sometimes those in charge of preparing financial statements do not always follow the rules. Instead, some

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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.

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To help ensure that management has in fact appropriately applied GAAP, the SEC requires independent outside verification of the financial statements of pub-licly 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 extent to which financial statements are prepared in compliance with GAAP and are free of material misstatement. If they find mistakes or fraudulent reporting behavior, auditors require the company to correct all significant information before issuing financial statements. Auditors are not employees of the company they are auditing.

Common Terms The auditor's report is also commonly referred to as the *auditor's opinion.*

Illustration 1–12 presents an excerpt from the report of the independent auditors for **Adams Golf, Inc.'s** financial statements. The auditor's report indicates that the financial statements for the period mentioned have been prepared in conformity with GAAP.

ADAMS GOLF, INC.
Report of Independent Auditors

Audit Committee, Board of Directors and Stockholders
Adams Golf, Inc.
Plano, Texas
We have audited the accompanying consolidated balance sheets of Adams Golf, Inc. (the "Company") as of December 31, 2011 and 2010, and the related consolidated statements of operations, stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Adams Golf, Inc. as of December 31, 2011 and 2010, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

ILLUSTRATION 1–12

Excerpts from the 2011 Independent Auditor's Report of **Adams Golf, Inc.**

User's Guide In this book, information from actual companies is illustrated using a flipped page in the low er-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 1–13.

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

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is likely to have general usefulness to other groups of external users, who are interested in essentially the same finan-cial aspects of a business as are investors and creditors. Some of these other groups were discussed in Illustration 1–1.

ILLUSTRATION 1–13

Objectives of Financial Accounting

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The second objective refers to the specific cash flow information needs of inves-tors and creditors. The third objective emphasizes the need for information about economic resources (assets) and claims to those resources (liabilities and stock-holders' 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 foun-dation 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 busi-nesses. 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 inves-tor 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 securi-ties 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 inves tors and credi-tors. We discuss the specific provisions of SOX in more detail in Chapter 4.

Important as such legislation is in supporting the ethical foundation of account-ing, 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, accoun-tants need to *develop* their ability to identify ethical situations and know the differ-ence 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:

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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.

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Throughout the book, we will discuss some ethical decisions relating to account -ing 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 w ill see boxed discussions of *Ethical Dilemmas.* These dilemmas are designed to raise your aw areness of accounting issues that have ethical ramifications.

CAREERS IN ACCOUNTING

Whether you plan to major in accounting or not, this section is important for you. Accounting majors need to realize the many different options available upon gradu -ation. Those who do not plan to major in accounting need a solid understanding of the many different bus iness decisions involving accounting information.

After completing the first course in accounting, you will have some idea whether you enjoy accounting and might like to major in it. You will also find out through exams, quizzes, and homework whether you have the aptitude to be good at it. Real-ize, however, that besides being good at 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. If you do major in accounting, the job prospects are numerous.

Demand for Accounting

One of the greatest benefits of an accounting degree is the wide variety of job oppor-tunities 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

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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 CORNER

Over 20,000 employees join public accounting firms in entry-level jobs each year, and thousands more go into other areas of acc ounting. While financial accountants learn how to measure business transactions and pre-pare financial reports, they also learn a great deal about the business itself. Because of this w idespread business know ledge, 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 w ebsite of the American Institute of Certified Public Accoun- tants (*www.aicpa.org*). There, you can look under the *Career* link to find current information about job opportunities, salaries, w ork life for w omen, how to w rite a resume, how to interview , and other general career advice. For salary and other job-related information, con- sult the w ebsite of the U.S. Bureau of Labor Statistics (*www.bls.gov/ oco/ocos001.htm*) or go to *careers-in-accounting.com*. In 2010, entry-level jobs ranged betw een $50,000 and $70,000, w ith $55,000 as the norm for Big 4 firms.

Is an accounting degree right for you?

Career Options 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 profes-sional service firms that traditionally have focused on three areas: auditing, tax preparation/planning, and business con-sulting. We already have discussed the role of *auditors* in attesting to the confor-mity of companies' financial statements with GAAP. *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 con-sulting* is perhaps the most lucrative activity of accountants. Managers who want to better understand their compa-nies' financial strengths and weaknesses often turn to public accountants for guid-ance. Who knows the business activi-ties better than the one measuring and communicating them?

User's Guide Throughout the book, you w ill see sections titled *Career Corner.* These sections highlight a link betw een a particular topic and a business career, and thus are intended for both accounting majors and nonmajors.

■ **LO1–6**
Identify career opportunities in accounting.

If you choose a career in public accounting, the next big decision is whether to work for one of the "Big 4" pub-lic 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 For- tune 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 expe rience requirements (in some states). Most states require that you have 150 semester hours (225 quarter hours) of college credit to take the exam. Becom-ing 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 com-pany that employs you. Every major company in the world needs employees with training and experience in financial accounting, management accounting, taxation, internal auditing, and accounting information systems. Whereas working as a pub-lic accountant provides the advantage of experience working with a number of dif-ferent clients, private accountants sometimes earn higher starting salaries. In fact, many accounting students begin their careers in public accounting, gaining experi-ence across a wide array of companies and industries, and then eventually switch

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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 account-ing, information risk management, investment banking, environmental accounting, tax law, FBI work, management consulting, and much, much more. Illustration 1–14 outlines just a few of the many career options in public and private accounting. In addition, there are career opportunities in government accounting and education.

ILLUSTRATION 1–14
Some of the Career Options in Accounting

	Public Accounting (Big 4 and Non-Big 4)	Private Accounting
Who are the clients?	Corporations Governments Nonprofit organizations Individuals	Your particular employer
What are the traditional career opportunities?	Auditors Tax preparers/planners Business consultants	Financial accountants Managerial accountants Budget analysts Internal auditors Tax preparers Payroll managers
What other career opportunities are available?	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

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 opportu-nities, and increasing salaries, this is a great time to obtain a degree in accounting.

CONCEPTUAL FRAMEWORK

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

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setters with a benchmark for creating a consistent set of

■ **LO1–7**
Explain the nature of the conceptual framew ork used to develop generally accepted accounting principles.

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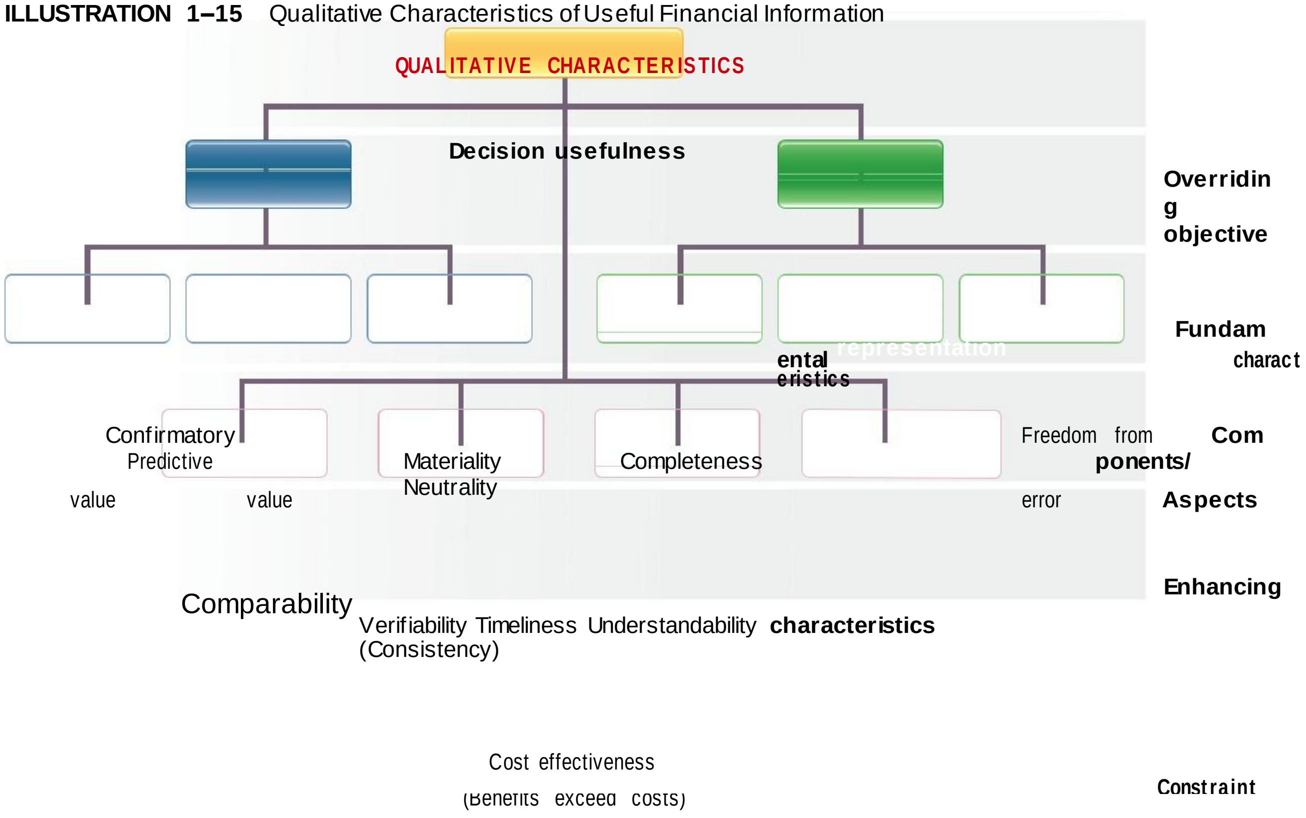
financial reporting rules now and in the future. It also provides others with a *written* framework so that everyone understands the underlying concepts that accountants are to consider in
preparing and interpreting financial accounting information.

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 out-lined in the FASB's conceptual framework. To satisfy these stated objectives, finan-cial reporting of accounting information should possess certain characteristics to be useful. What are the desired characteristics? Illustration 1–15 provides a graphi-cal depiction of the qualitative characteristics of useful financial information.

ILLUSTRATION 1–15 Qualitative Characteristics of Useful Financial 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.

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FUNDAMENTAL QUALITATIVE CHARACTERISTICS

The two fundamental 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 faithfully represent the underlying activity.

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Relevance. To have **relevance**, accounting information should possess *confirma-tory 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 consecu-tive years should provide information that has *predictive value* for the company's future cash-generating ability.

Materiality reflects the impact of financial accounting information on inves-tors' 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 multibillion-dollar company like Dell has no impact on investors' decisions. Thus, materiality is an aspect of the relevance characteristic with regard to values users deem significant in their decision-making process.

Faithful representation. To be a **faithful representation** of business activities, accounting information should be complete, neutral, and free from error. *Complete-ness* 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. Because of the topic and the nature of the business, sometimes a new accounting standard may prominently affect 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 develop-ment (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 indus-tries, such as telecommunications, pharmaceuticals, and software, even though that may have been the effect.

Freedom from 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 manage-ment's unbiased judgments and due diligence in reflecting appropriate accounting principles.

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KEY POINT

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

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ENHANCING QUALITATIVE CHARACTERISTICS

Four enhancing qualitative characteristics are comparability, verifiability, timeli-ness, and understandability. **Comparability** refers to the ability of users to see simi-larities 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 achiev ing that goal.

Verifiability implies a consensus among different measurers. For instance, differ-ent 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 pur-chase 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.* **Time-liness** 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 informa-tion within the context of the decision they are making. This is a user-specific qual-ity because users will differ in their ability to comprehend any set of information.

COST EFFECTIVENESS CONSTRAINT

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 a cost constraint (limit) to reporting financial information.

The **cost constraint** 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 compa-ny's current and potential competitors such as Hewlett-Packard and Apple as they make their own expansion plans. The competitive costs of providing this informa-tion may outweigh the benefits.

UNDERLYING ASSUMPTIONS

Four basic assumptions underlie GAAP. As pictured in Illustration 1–16, they are (1) the economic entity assumption, (2) the monetary unit assumption, (3) the peri-odicity assumption, and (4) the going concern assumption.

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ILLUSTRATION 1–16

Assumptions That Underlie GAAP

GAAP

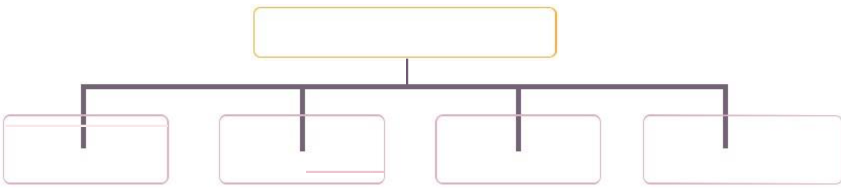
Underlying assumptions

Economic entity

Going concern

Monetary unit

Periodicity



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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 finan-cial accounting information. Another key aspect of this assumption is the distinc-tion 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 exam-ple, 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 state-ment elements and changes in those elements. In Europe, the common denomina-tor 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 deci-sions. The **periodicity assumption** divides the economic life of an enterprise (pre-sumed 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 princi-ples. 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.

LO1–1 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.

LO1–2 Understand the business activities that accounting measures.

The measurement role of accounting is to create a record of the activities of a company. To make this possible, a company must maintain an accurate record of its assets, liabilities, stockholders' equity, revenues, expenses, and dividends.

LO1–3 Determine 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 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 on a particular date.

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

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

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

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.

LO1–5 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 informa-tion to investors and creditors in making decisions.

LO1–6 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

LO1–7 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 infor-mation to decision makers. **p. 4**

Accounting equation: Equation that shows a com-pany's resources (assets) equal creditors' and owners' claims to those resources (liabilities and stockholders' equity). **p. 8**

Assets: Resources of a company. **p. 7**

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

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

Cost constraint: 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. 28**

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 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**

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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**

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. 10**

International Accounting Standards Board (IASB): An international accounting standard-setting body responsible for the convergence of accounting standards worldwide. **p. 21**

International Financial Reporting Standards (IFRS): The standards being developed and promoted by the International Accounting Standards Board. **p. 21**

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

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

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

Partnership: Business owned by two or more persons. **p. 6**

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 been kept (retained) in the business rather than distributed to stockholders as dividends (not retained). **p. 11**

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. 6**

Statement of cash flows: A financial statement that measures activities involving cash receipts and cash payments over an interval of time. **p. 14**

Statement of stockholders' equity: A financial statement that summarizes the changes in stockholders' equity over an interval of time. **p. 11**

Stockholders' 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

1. Based on the introductory section of this chapter, which course is most like financial accounting? **(LO1–1)**
   a. College algebra.
   b. Foreign language.
   c. Molecular biology.
   d. Physical education.

2. Financial accounting serves which primary function(s)? **(LO1–2)**
   a. Measures business activities.
   b. Communicates business activities to interested parties.

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c. Makes business decisions on behalf of interested parties.
d. Both a. and b. are functions of financial accounting.

3. Resources of a company are referred to as: **(LO1–2)**
a. Liabilities.
b. Stockholders' equity.
c. Dividends.
d. Assets.

4. Amounts earned from sales of products or services are referred to as: **(LO1–2)**
a. Assets.
b. Revenues.

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c. Liabilities. d. Expenses.

5. Which financial statement conveys a company's ability to generate profits in the current period? **(LO1–3)**
   a. Income statement.
   b. Statement of cash flows. c. Balance sheet.
   d. Statement of stockholders' equity.

6. Which financial statement shows that a company's resources equal claims to those resources? **(LO1–3)**
   a. Income statement.
   b. Statement of stockholders' equity.
   c. Balance sheet.
   d. Statement of cash flows.

7. Why does financial accounting have a positive impact on our society? **(LO1–4)**
   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.

8. The body of rules and procedures that guide the measurement and communication of financial accounting information is known as: **(LO1–5)**
   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? **(LO1-5)**
   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 fundamental qualitative characteristics identified by the Financial Accounting Standards Board's (FASB) conceptual framework? **(LO1–5)**
    a. Relevance and faithful representation. b. Materiality and efficiency.
    c. Comparability and consistency.
    d. Costs and benefits.

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

For additional study materials, including 10 more multiple-choice Self-Study Questions, visit the book's website, *www.mhhe.com/succeed.*

■ **LO1–1** 1. Explain what it means to say that an accounting class is not the same as a math class.

■ **LO1–1** 2. Identify some of the people interested in making decisions about a company.

■ **LO1–1** 3. What is the basic difference between financial accounting and managerial accounting?

■ **LO1–1** 4. What are the two primary functions of financial accounting?

■ **LO1–2** 5. What are the three basic business activities that financial accounting seeks to measure and communicate to external parties? Define each.

■ **LO1–2** 6. What are a few of the typical financing activities for a company like **United Service, Inc. (UPS)**, the world's largest package delivery company and a leading global provider of specialized transportation and logistics services?

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■ **LO1–2**

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?

■ **LO1–2**

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?

■ LO1–2

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?

■ LO1–2

10. Provide the basic definition for each of the account types: assets, liabilities, stockholders' equity, dividends, revenues, and expenses.

■ LO1–2

11. What are the major advantages and disadvantages of each of the legal forms of business organizations?

■ LO1–3

12. What are the four primary financial statements? What basic information is shown on each?

■ LO1–3

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?*

■ LO1–3

14. Give some examples of the basic revenues and expenses for a company like **The Walt Disney Company**.

■ LO1–3

15. What is the accounting equation? Which financial statement reports the accounting equation?

■ LO1–3

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

■ LO1–3

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

■ LO1–3

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.

■ LO1–3

■ LO1–4

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

■ LO1–5

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

■ LO1–5

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

■ LO1–5

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

■ LO1–5

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

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?

■ LO1–5

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

■ LO1–5

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

■ LO1–6

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

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

29. What are the three

components/aspects of relevance? What are the three components/aspects of faithful representation? ■ LO1–7

30. What is meant by the term *cost effectiveness* in financial reporting? ■ LO1–7

31. Define the four basic assumptions underlying GAAP.

■ LO1–7

■ LO1–7

BRIEF EXERCISES

Define accounting **(LO1–1)**

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

(True/Fals e) 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 **(LO1–2)**

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.

Identify the different forms of business organizations **(LO1–2)**

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

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.

Recognize the different account classifications **(LO1–2)**

BE1–4 Match each account type with its description.

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

Assign account classifications **(LO 1–2)**

BE1–5 For each transaction, indicate whether each account would be classified as (a) an asset, (b) a liability, or (c) stockholders' equity to be reported in the balance sheet; (d) a revenue or (e) an expense to be reported in the income statement; or (f) a dividend to be reported in the statement of stockholders' equity.

Account Classifications	Accounts	Related Transactions
1. ______	Rent expense	Cost of rent.
2. ______	Interest revenue	Interest earned on savings account.
3. ______	Dividends	Cash payments to stockholders.
4. ______	Land	Land used for operations.
5. ______	Accounts payable	Amounts owed to suppliers.

Assign account classifications **(LO1–2)**

BE1–6 For each transaction, indicate whether each account would be classified as (a) an asset, (b) a liability, or (c) stockholders' equity to be reported in the balance sheet; (d) a revenue or (e) an expense to be reported in the income statement; or (f) a dividend to be reported in the statement of stockholders' equity.

Account Classifications	Account	Related Transactions
1. ______	Utilities payable	Amounts owed for utilities.
2.	Cash	Cash available for use.
3.	Salaries expense	Cost of salaries.
4.	Common stock	Shares of ownership sold to investors.
5.	Service revenue	Sale of services to customers.

BE1–7 Match each financial statement with its description.

Describe each financial statement **(LO1–3)**

Financial Statements	Related Transactions
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.

BE1–8 Determine on which financial statement you find the following items.

Determine the location of items in financial statements **(LO1–3)**

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.

BE1–9 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

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.

reporting **(LO1–5)**

Identify the objectives of financial accounting **(LO1–5)**

BE1–10 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 **(LO1–6)**

BE1–11 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/ aspects of relevance **(LO1–7)**

BE1–12 Match each of the components of relevance with its definition.

Relevance	Definitions
1. _______ Confirmatory future value	a. Information is useful in helping to forecast outcomes.
2. _______ Predictive value	b. Information provides feedback on past activities.
3. _______ Materiality	c. The nature or amount of an item has the ability to affect decisions.

Identify the components/ aspects of faithful representation **(LO1–7)**

BE1–13 Match each of the components of faithful representation with its definition.

Faithful Representation	Definition
1. _______ Freedom from 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.

Identify the different types of business activities **(LO1–2)**

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 **(LO1–2)**

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 **(LO1–2)**

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

Flip Side of E1–2

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 **(LO1–2)**

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 = $50,000; Liabilities = $27,000; Dividends = $3,000; Revenues = $14,000; Expenses = $9,000.

Required:

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

Calculate net loss and stockholders' equity **(LO1–2)**

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 = $19,000; Liabilities = $15,000; Revenues = $28,000; Expenses = $33,000.

Required:

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

Prepare an income statement **(LO1–3)**

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

Accounts	Balances
Cash	$ 5,400
Salaries expense	2,200
Accounts payable	3,400
Retained earnings	3,900
Utilities expense	1,200
Supplies	13,800
Service revenue	9,300
Common stock	6,000

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

Prepare a statement of stockholders' equity **(LO1–3)**

E1–7 At the beginning of the year (January 1), Buffalo Drilling has $11,000 of common stock outstanding and retained earnings of $8,200. During the year, Buffalo reports net income of $8,500 and pays dividends of $3,200. In addition, Buffalo issues additional common stock for $8,000.

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

Prepare a balance sheet **(LO1–3)**

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

Accounts	Balances
Equipment	$26,000
Accounts payable	3,000
Salaries expense	33,000
Common stock	11,000
Land	18,000
Notes payable	20,000
Service revenue	39,000
Cash	6,000
Retained earnings	?

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

Prepare a statement of cash flows **(LO1–3)**

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

Accounts	Amounts
Cash received from sale of products to customers	$ 40,000
Cash received from the bank for long-term loan	45,000
Cash paid to purchase factory equipment	(50,000)
Cash paid to merchandise suppliers	(12,000)
Cash received from the sale of an unused warehouse	13,000
Cash paid to workers	(24,000)
Cash paid for advertisement	(4,000)
Cash received for sale of services to customers	30,000
Cash paid for dividends to stockholders	(6,000)

Required:
1. Calculate the ending balance of cash, assuming the balance of cash at the beginning of the period is $5,000.
2. Prepare a statement of cash flows.

Link the income statement to the statement of stockholders' equity **(LO1–3)**

E1–10 On December 31, Fighting Okra Cooking Services reports the following revenues and expenses.

Service revenue	$75,000	Rent expense	$10,600
Postage expense	1,500	Salaries expense	24,000
Legal fees expense	2,400	Supplies expense	14,500

In addition, the balance of common stock at the beginning of the year was $200,000, and the balance of retained earnings was $32,000. During the year, the company issued additional shares of common stock for $25,000 and paid dividends of $10,000.

Required:

1. Prepare an income statement.
2. Prepare a statement of stockholders' equity.

E1–11 At the beginning of 2015, Artichoke Academy reported a balance in common stock of
$150,000 and a balance in retained earnings of $50,000. During the year, the company issued additional shares of stock for $40,000, earned net income of $30,000, and paid dividends of
$10,000. In addition, the company reported balances for the following assets and liabilities on
December 31.

Link the statement of stockholders' equity to the balance sheet **(LO1–3)**

Assets		Liabilities	
Cash	$ 52,600	Accounts payable	$ 9,100
Supplies	13,400	Unearned revenue	2,400
Prepaid rent	24,000	Salaries payable	3,500
Land	200,000	Notes payable	15,000

Required:
1. Prepare a statement of stockholders' equity.
2. Prepare a balance sheet.

E1–12 Squirrel Tree Services reports the following amounts on December 31.

Link the balance sheet to the statement of cash flows **(LO1–3)**

Assets		Liabilities and Stockholders' Equity	
Cash	$ 7,700	Accounts payable	$9,700
Supplies	1,800	Salaries payable	3,500
Prepaid insurance	3,500	Notes payable	20,000
Building	72,000	Common stock	40,000
		Retained earnings	11,800

In addition, the company reported the following cash flows.

Cash Inflows		Cash Outflows	
Customers	$60,000	Employee salari	$22,000
Borrow from the bank (note)	20,000	Supplies	4,000
Sale of investments	10,000	Dividends	6,500
		Purchase building	62,000

Required:
1. Prepare a balance sheet.
2. Prepare a statement of cash flows.

E1–13 Each of the following independent situations represents amounts shown on the four basic financial statements.

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

1. Revenues = $27,000; Expenses = $18,000; Net income = ______________.
2. Increase in stockholders' equity = $17,000; Issuance of common stock = $11,000; Net income = $12,000; Dividends = ______________.
3. Assets = $24,000; Stockholders' equity = $15,000; Liabilities = ______________.
4. Total change in cash = $26,000; Net operating cash flows = $34,000; Net investing cash flows = ($17,000); Net financing cash flows = ______________.

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financial statements.

Compute missing amounts from financial statements **(LO1–3)**

Calculate the balance of retained earnings **(LO1–3)**

E1–14 During its first five years of operations, Red Raider Consulting reports net income and pays dividends as follows.

Year	Net Income	Dividends	Retained Earnings
1	$1,700	$ 600	______
2	2,200	600	______
3	3,100	1,500	______
4	4,200	1,500	______
5	5,400	1,500	______

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.

Calculate amounts related to the balance of retained earnings **(LO1–3)**

E1–15 Below are approximate amounts related to retained earnings reported by five companies in previous years.

1. **Coca-Cola** reports an increase in retained earnings of $3.2 billion and net income of $6.9 billion. What is the amount of dividends?
2. **PepsiCo** reports an increase in retained earnings of $3.4 billion and dividends of $2.6 billion. What is the amount of net income?
3. **Google** reports an increase in retained earnings of $1.6 billion and net income of $1.6 billion. What is the amount of dividends?
4. **Sirius Satellite Radio** reports beginning retained earnings of −$1.6 billion, net loss of $1.0 billion, and $0 dividends. What is the amount of ending retained earnings?
5. **Abercrombie & Fitch** reports ending retained earnings of $1.56 billion, net income of $0.43 billion, and dividends of $0.06 billion. What is the amount of beginning retained earnings?

Required:

Calculate the answer to each.

Use the accounting equation to calculate amounts related to the balance sheet **(LO1–3)**

E1–16 Below are approximate amounts related to balance sheet information reported by five companies in previous years.

1. **ExxonMobil** reports total assets of $228 billion and total liabilities of $107 billion. What is the amount of stockholders' equity?
2. **Citigroup** reports total liabilities of $1,500 billion and stockholders' equity of $110 billion. What is the amount of total assets?
3. **Amazon.com** reports total assets of $4.7 billion and total stockholders' equity of $0.3 billion. What is the amount of total liabilities?
4. **Nike** reports an increase in assets of $1.2 billion and an increase in liabilities of $0.3 billion. What is the amount of the change in stockholders' equity?
5. **Kellogg** reports a decrease in liabilities of $0.34 billion and an increase in stockholders' equity of $0.02 billion. What is the amount of the change in total assets?

Required:

Calculate the answer to each.

Calculate missing amounts related to the statement of cash flows **(LO1–3)**

E1–17 Below are approximate amounts related to cash flow information reported by five companies in previous years.

1. **Kraft Foods** reports operating cash flows of $3.6 billion, investing cash flows of $0.6 billion, and financing cash flows of −$4.2 billion. What is the amount of the change in total cash?

2. **Sara Lee** reports operating cash flows of \$1.4 billion, investing cash flows of −\$0.3 billion, and financing cash flows of −\$1.4 billion. If the beginning cash amount is \$0.7 billion, what is the ending cash amount?
3. **Performance Food Group** reports operating cash flows of \$0.07 billion, investing cash flows of \$0.63 billion, and a change in total cash of \$0.04 billion. What is the amount of cash flows from financing activities?

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4. **Smithfield Foods** reports operating cash flows of $0.60 billion, financing cash flows of $0.42 billion, and a change in total cash of $0.02 billion. What is the amount of cash flows from investing activities?
5. **Tyson Foods** reports investing cash flows of –$1.42 billion, financing cash flows of $1.03 billion, and a change in total cash of $0.02 billion. What is the amount of cash flows from operating activities?

Required:

Calculate the answer to each.

E1–18 Below are concepts associated with the role of the auditor in financial reporting.

Understand the role of the auditor **(LO1–5)**

Concept	Description
1. ____ Securities and Exchange Commission	a. Phrase meaning to present the accounting records in an altered format.
2. ____ Need for auditing	b. Auditors are not employees of the company they audit.
3. ____ Cooking the books	c. Responsible for applying generally accepted accounting principles (GAAP).
4. ____ Management	d. Regulatory body that requires audits of all publicly traded companies.
5. ____ Auditor	e. Separation of management from those who own the business or finance operations.
6. ____ Independent	f. Party that reports on whether a company's financial statements are in accordance with GAAP.
7. ____ Opinion	g. View expressed by an auditor as to the accuracy of a company's financial statements.

Required:

Match each concept with its description.

E1–19 The qualitative characteristics outlined in the FASB's conceptual framework include:

Identify the purpose of qualitative characteristics **(LO1–7)**

Fundamental Characteristics		Enhancing Characteristics
Relevance	Faithful Representation	g. Comparability
a. Confirmatory value	d. Completeness	h. Verifiability
b. Predictive value	e. Neutrality	i. Timeliness
c. Materiality	f. Freedom from error	j. 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 uses an appropriate process to estimate 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 analyze the efficiency with which management has conducted operations over the past year. ____

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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. ______

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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. ______
10. **Target** prepays $600 to rent a post office box for the next six months and decides to record the entire payment to Rent expense (instead of Prepaid rent) in the current month.

Required:

Determine which qualitative characteristic best applies to each situation. Note: Each of the 10 characteristics is used once and only once.

Identify business assump- tions underlying GAAP **(LO1–7)**

E1–20 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

connect ACCOUNTING

Classify business activities **(LO1–2)**

classifications **(LO1–2)**

Assign account

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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.

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

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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 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.

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:

Prepare financial statements **(LO1–3)**

Cash	$ 1,200	Service revenue	$67,700
Equipment	29,000	Cost of goods sold (food expense)	53,400
Accounts payable	4,400	Buildings	40,000
Delivery expense	2,600	Supplies	3,400
Salaries expense	5,500	Salaries payable	800

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

In addition, the company had common stock of $40,000 at the beginning of the year and issued an additional $4,000 during the year. The company also had retained earnings of $18,200 at the beginning of the year.

Required
:

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

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

Understand the format of financial statements and the links among them **(LO1–3)**

BULLDOG, INC.
Income Statement

Revenues	$39,000
Expenses:	
Salaries	(a)
Advertising	6,000
Utilities	4,000

BULLDOG, INC.
Statement of Stockholders' Equity

	Common Stock	Retained Earnings	Total S. Equity
Beginning balance	$10,000	$7,000	$17,000
Issuances	1,100		1,100
Add: Net income		(c)	(c)
Less: Dividends		(3,000)	(3,000)

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Net income	(b)	Ending balance	$11,100	$10,000	$21,100

BULLDOG, INC.
Balance Sheet

Assets		Liabilities	
Cash	$ 4,000	Accounts payable	(d)
Accounts receivable	3,000	**Stockholders' Equity**	
Supplies	9,000	Common stock	(e)
Equipment	10,000	Retained earnings	(f)
Total assets	$ 26,000	Total liabilities and stockholders' equity	(g)

Required:

Calculate the missing amounts.

Prepare financial statements **(LO1–3)**

P1–5A Cornhusker Company provides the following information at the end of 2015.

Cash remaining	$ 4,800
Rent expense for the year	7,000
Land that has been purchased	21,000
Retained earnings	12,400
Utility expense for the year	4,900
Accounts receivable from customers	7,200
Service revenue earned during the year	37,000
Salary expense for the year	13,300
Accounts payable to suppliers	2,200
Dividends paid to shareholders during the year	3,200
Common stock that has been issued prior to 2015	16,000
Salaries owed at the end of the year	2,400
Insurance expense for the year	3,500

Required:

Prepare the income statement, statement of stockholders' equity, and balance sheet for Cornhusker Company on December 31, 2015. No common stock is issued during 2015, and the balance of retained earnings at the beginning of 2015 equals $7,300.

Identify underlying assumptions of GAAP **(LO1–7)**

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. Jumbo'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. Gorloks 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 Gorloks Tax Services.
3. Claim Jumpers 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

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$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. Cobbers 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 framew ork **(LO1–7)**

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

Classify accounts **(LO1–2)**

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 **(LO1–2)**

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

Account Classifications	Accounts
1. ____________	Cash

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		Related Transactions
2. ____________	Service revenue	Receive cash fromcustomers. Provide services to customers.
3. ____________	Supplies	Purchase supplies.
4. ____________	Buildings	Purchase factory for operations.
5. ____________ expense	Advertising	Pay for cost of advertising.
6. ____________	Equipment	Purchase equipment for operations.
7. ____________	Interest expense	Pay for cost of interest.

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Account Classifications	Accounts	Related Transactions
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 **(LO1–3)**

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	$ 33,500	Service revenue	$127,600
Buildings	150,000	Interest expense	3,500
Salaries expense	65,100	Utilities expense	15,500
Accounts payable	6,400	Equipment	27,000
Cash	5,500	Notes payable	30,000

In addition, the company had common stock of $100,000 at the beginning of the year and issu ed an additional $11,000 during the year. The company also had retained earnings of $30,300 at the beginning of the year and paid dividends of $5,200.

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 **(LO1–3)**

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

CYCLONE, INC.
Income Statement

Revenues		(a)
Expenses:		
Salaries	$13,000	
Rent	7,000	
Advertising	5,000	
Net income		(b)

CYCLONE, INC.
Statement of Stockholders' Equity

	Common Stock	Retained Earnings	Total S. Equity
Beginning balance	$14,000	$7,000	$21,000
Issuances of stock	(c)		(c)
Add: Net income		5,000	5,000
Less: Dividends		(d)	(d)
Ending balance	$17,000	$8,000	$25,000

CYCLONE, INC.
Balance Sheet

Assets		Liabilities	
Cash	$ 1,100	Accounts payable	$4,000
Supplies	(e)	Stockholders' Equity	

Land	6,000	Common stock	(g)
Building	16,000	Retained earnings	(h)
Total assets	(f)	Total liabilities and stockholders' equity	(i)

Required:

Calculate the missing amounts.

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P1–5B Tar Heel Corporation provides the following information at the end of 2015.

Prepare financial statements **(LO1–3)**

Salaries payable to workers at the end of the year	$ 3,300
Advertising expense for the year	10,400
Building that has been purchased	80,000
Supplies at the end of the year	4,600
Retained earnings	40,000
Utility expense for the year	6,000
Note payable to the bank	25,000
Service revenue earned during the year	69,400
Salary expense for the year	26,700
Accounts payable to suppliers	7,700
Dividends paid to shareholders during the year	(?)
Common stock that has been issued, including $6,000 that was issued this year	27,000
Cash remaining	5,200
Interest expense for the year	2,100
Accounts receivable from customers	13,200

Required:

Prepare the income statement, statement of stockholders' equity, and balance sheet for Tar Heel Corporation on December 31, 2015. The balance of retained earnings at the beginning of the year equals $26,800.

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.

Required:

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

1. Mound Builders Groceries has over 1,000 grocery stores throughout the North-west. Approximately 200,000 customers visit its stores each day. Because of the continual nature of grocery sales, the company does not publish an income state-ment. The company feels that it has an indefinite life and a periodic report would mislead investors.

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

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Identify underlying assumptions of GAAP **(LO1–7)**

Understand the components of the FASB's conceptual framew ork **(LO1–7)**

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

Terms

1. ______ Predictive value
2. ______ Relevance
3. ______ Timeliness
4. ______ Dividends
5. ______ Confirmatory value
6. ______ Faithful representation
7. ______ Materiality
8. ______ Monetary unit assumption
9. ______ Periodicity assumption

Definitions

a. Decreases in equity resulting from transfers to owners.
b. Business transactions are measured using a common denominator.
c. The indefinite life of a company can be broken into definite periods.
d. Information helps in understanding prior activities.
e. Agreement between a measure and the phenomenon it represents.
f. Information arrives prior to the decision.
g. Information is related to the decision at hand.
h. Information is useful in predicting the future.
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 2015 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 2015 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:

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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 financi

ng, investing, and operating activities that a company like Great Adventures is likely to have.

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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 **Buckle** is presented in Appendix B at the end of the book.

Required:

1. Determine the amounts 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. Buckle refers to its income statement using another name. What is it?
3. Determine the amounts 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 **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 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 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 as ks, “Which company’s stock should I buy? There are so many companies to choose fromand 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. d 4. b 5. a 6. c 7. b 8. d 9. d 10. a