Williams

Haka

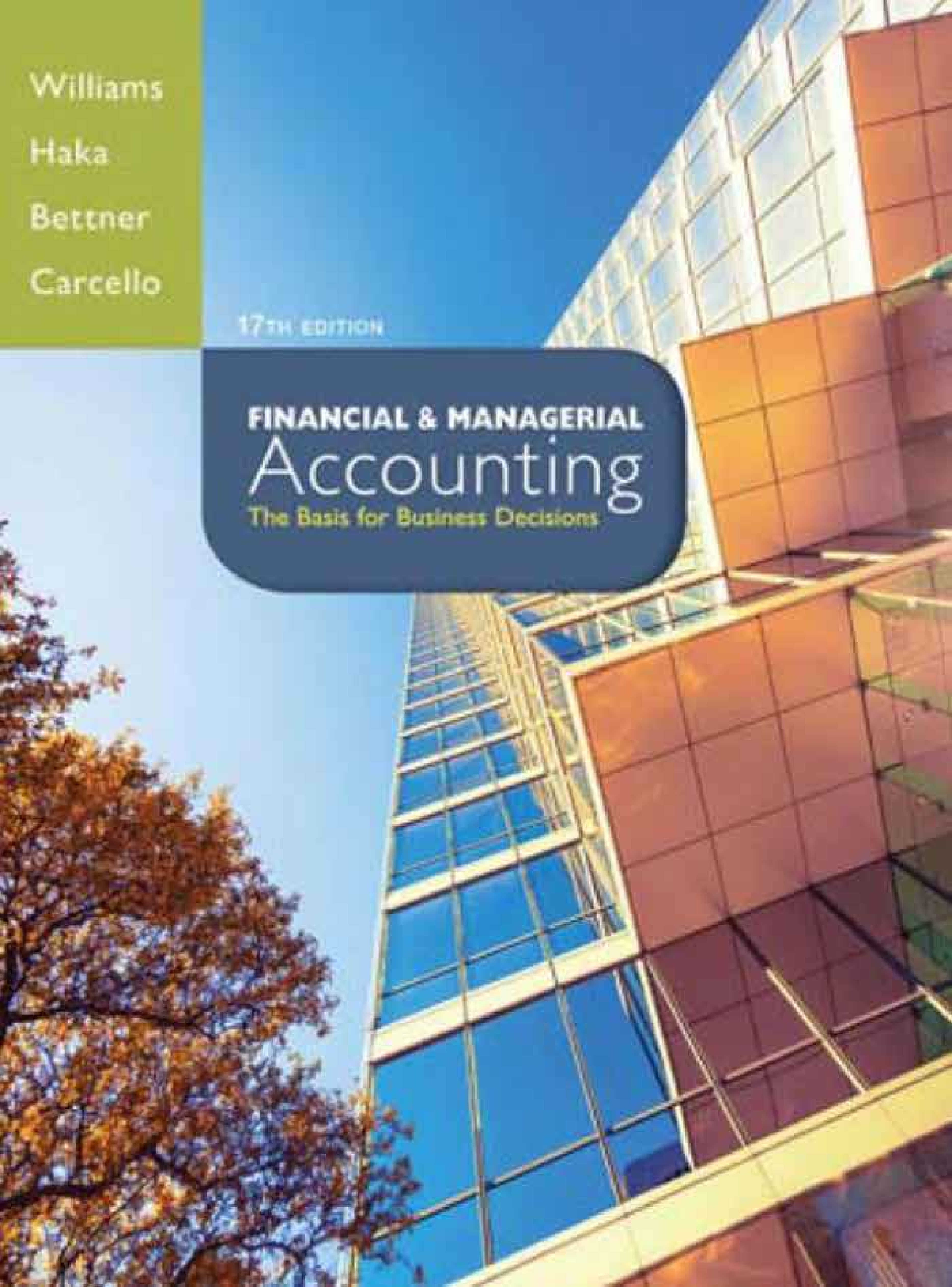
Bettner

Carcello

17TH EDITION

FINANCIAL & MANAGERIAL Accounting

The Basis for Business Decisions



17TH EDITION

Financial & Managerial Accounting

THE BASIS FOR BUSINESS DECISIONS

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To Ben and Meg Wishart and Asher, Lainey, and Lucy Hunt, who have taught me the joys of being a grandfather.

—Jan R. Williams

For Cliff, Abi, and my mother, Fran.

—Susan F. Haka

To my parents, Fred and Marjorie.

—Mark S. Bettner

To Terri, Stephen, Karen, and Sarah, whose sacrifices enabled me to participate in writing this book. Thank you—I love you!

—Joseph V. Carcello

Meet the Authors

Jan R. Williams is Dean and Professor Emeritus of the College of Business Administration at the University of Tennessee—Knoxville, where he has been a faculty member since 1977. He received a BS degree from George Peabody College, an MBA from Baylor University, and a PhD from the University of Arkansas. He previously served on the faculties at the University of Georgia and Texas Tech University. A CPA in Tennessee and Arkansas, Dr. Williams is also the coauthor of three books and has published over 70 articles on issues of corporate financial reporting and accounting education. He served as president of the American Accounting Association in 1999–2000 and has been actively involved in Beta Alpha Psi, the Tennessee Society of CPAs, the American Institute of CPAs, and AACSB International—the Association to Advance Collegiate Schools of Business—the accrediting organization for business schools and accounting programs worldwide. He served as chair of the Board of Directors of AACSB International in 2011 through 2012. He retired from the University of Tennessee in 2013, and remains active in several business and accounting professional organizations.

Susan F. Haka is the Senior Associate Dean for Academic Affairs and Research in the Broad College of Business and the EY Professor of Accounting in the Department of Accounting and Information Systems at Michigan State University. Dr. Haka received her PhD from the University of Kansas and a master's degree in accounting from the University of Illinois. She served as president of the American Accounting Association in 2008–2009 and has previously served as president of the Management Accounting Section. Dr. Haka is active in editorial processes and has been editor of *Behavioral Research in Accounting* and an associate editor of *Journal of Management Accounting Research, Accounting Horizons, The International Journal of Accounting,* and *Contemporary Accounting Research.* Dr. Haka has been honored by Michigan State University with several teaching and research awards, including both the university-wide Teacher-Scholar and Distinguished Faculty awards. In 2012, Dr. Haka was honored with the Outstanding Accounting Educator Award from the American Accounting Association.

Mark S. Bettner is the Christian R. Lindback Chair of Accounting & Financial Management at Bucknell University. Dr. Bettner received his PhD in business administration from Texas Tech University and his MS in accounting from Virginia Tech University. In addition to his work on *Financial Accounting* and *Financial & Managerial Accounting,* he has written many ancillary materials, published in scholarly journals, and presented at academic and practitioner conferences. Professor Bettner is also on the editorial advisory boards of several academic journals, including the *International Journal of Accounting and Business Society* and the *International Journal of Business and Accounting,* and has served as a reviewer for several journals, including *Advances in Public Interest Accounting, Essays in Economics and Business History, Critical Perspectives on Accounting,* and *International Journal on Critical Accounting*. Professor Bettner also offers professional development courses for the Pennsylvania Bankers Association.

Joseph V. Carcello is the EY and Business Alumni Professor in the Department of Accounting and Information Management at the University of Tennessee. He also is the cofounder and executive director for UT's Corporate Governance Center. Dr. Carcello received his PhD from Georgia State University, his MAcc from the University of Georgia, and his BS from the State University of New York College at Plattsburgh. Dr. Carcello is currently the author or coauthor of three books, more than 60 journal articles, and five monographs. Dr. Carcello serves on the Public Company Accounting Oversight Board's (PCAOB) Investor Advisory Group, and he previously served three terms on the PCAOB's Standing Advisory Group. He has testified before committees and working groups of the U.S. Department of the Treasury on the future of the auditing profession and on the JOBS Act. Dr. Carcello has also testified before a subcommittee of the U.S. House of Representatives Financial Services Committee on accounting and auditing regulation. He served as a member of the COSO task force that developed guidance on applying COSO's internal control framework for smaller public companies. Dr. Carcello is active in the academic community—he serves as an editor of *Contemporary Accounting Research*, and serves on the editorial boards of *The Accounting Review, Auditing: A Journal of Practice & Theory, Accounting Horizons*, and *Contemporary Issues in Auditing*. Dr. Carcello has taught professional development programs for two of the Big Four accounting firms and for state CPA societies; conducted funded research for another Big Four firm, the AICPA, and the Center for Audit Quality; and served as an expert for the U.S. Securities and Exchange Commission and for private attorneys.

REACHING GREAT HEIGHTS BEGINS WITH A SOLID BASE

As our eyes are drawn upward to the skyline of great cities, it's important to remember that these impressive constructions are able to reach such heights only because their foundations are strong. In much the same way, being successful in the business world begins with fundamental courses like financial and managerial accounting. It is only when students have a firm grasp of concepts like the accounting cycle and managerial decision making that they have a base on which to stand, a strong foundation on which to grow.

In this edition, as before, the Williams team has revised the text with a keen eye toward the principle of helping students establish the foundation they will need for future success in business. However, through new coverage of International Financial Reporting Standards and a revised globalization chapter, the Williams book also introduces students to larger themes and evolving concerns. This dual emphasis allows students to keep their eyes trained upward even as they become solidly grounded in accounting fundamentals.

The Williams book continues to rest on a bedrock of four key components:

Balanced Coverage. The 17th edition of Williams provides the most balanced coverage of financial and managerial topics on the market. By giving equal weight to financial and managerial topics, the authors emphasize the need for a strong foundation in both aspects of accounting.

"This is a **well balanced textbook** that encompasses many issues, yet provides them in a precise, readable, and orderly fashion to students. The extent of the real-world examples makes this edition **clearly a superior choice.**"

Hossein Noorian,
Wentworth Institute

"**Excellent book**! Explains difficult subjects in easy-to-understand terms."

Naser Kamleh, Wallace
Community College

Clear Accounting Cycle Presentation. In the first five chapters of *Financial & Managerial Accounting,* the authors present the Accounting Cycle in a clear, graphically interesting four-step process. Central to this presentation is the dedication of three successive chapters to three key components of the cycle: recording entries (Chapter 3), adjusting entries (Chapter 4), and closing entries (Chapter 5). The Williams team places easy-to-read margin notes explaining each equation used in particular journal entries.

Student Motivation. The Williams team has put together a market-leading student package that will not only motivate your students, but help you see greater retention rates in your accounting courses. Vital pieces of technology supplement the core curriculum covered in the book: McGraw-Hill *Connect Accounting* uses end-of-chapter material pulled directly from the textbook to create static and algorithmic questions that can be used for homework and practice tests; and the Online Learning Center provides supplemental tools for both students and instructors.

"This textbook is current and very interactive. It brings in excellent "real-world" applications for the students to use in applying the concepts. It has **excellent student and instructor resources.** Some of the resources would be especially valuable for instructors teaching online."

Karen Mozingo, Pitt
Community College

"The text is excellent. **I wish the texts had been this well written** when I was a student!"

Mark Anderson, Bob Jones University

Problem-Solving Skills. *Financial & Managerial Accounting* challenges your students to think about real-world situations and put themselves in the role of the decision maker through Case in Point, Your Turn, and Ethics, Fraud, & Corporate Governance boxes. Students reference the Home Depot Financial Statements—included in the text as an appendix—to further hone problem-solving skills by evaluating real world financial data. The authors show a keen attention to detail when creating high-quality end-of-chapter material, such as the Critical Thinking Cases and Problems, ensuring that all homework is tied directly back to chapter learning objectives.

How Does **Williams** Help Students

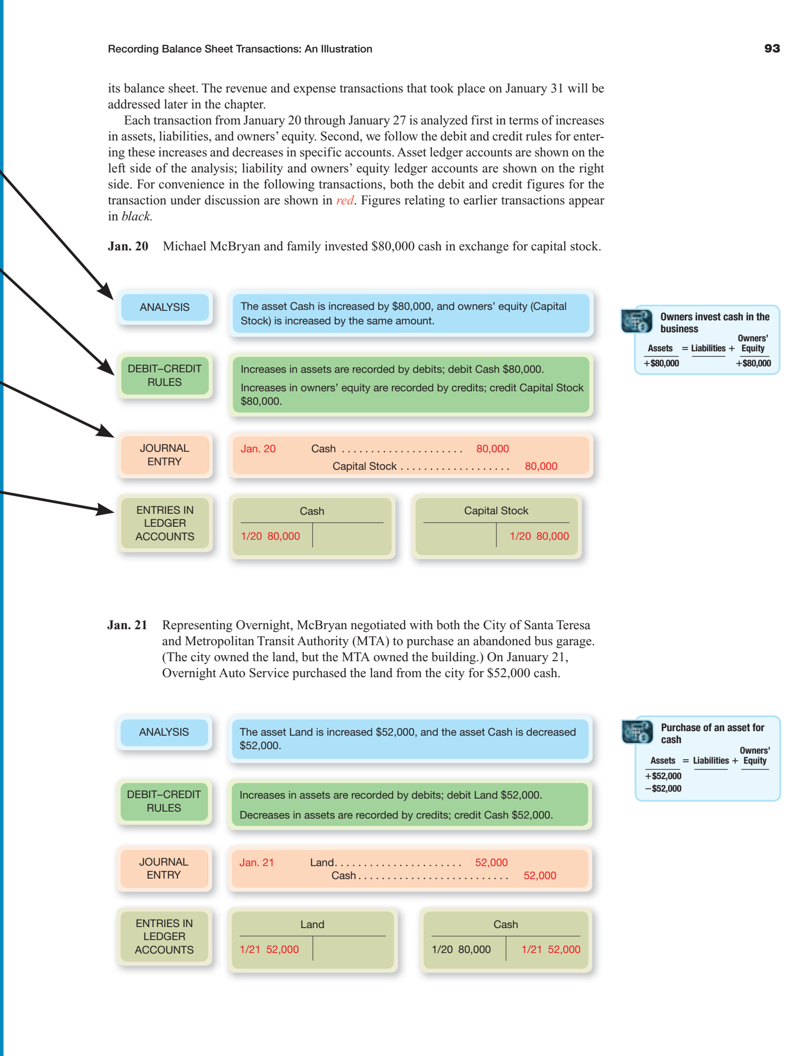
Step-by-Step Process for the Accounting Cycle

Financial & Managerial Accounting was the FIRST text to illustrate Balance Sheet and Income Statement transactions using the four-step process described below. This hallmark coverage has been further revised and refined in the 17th edition.

The Williams team breaks down the Accounting Cycle into three full chapters to help students absorb and understand this material: recording entries (Chapter 3), adjusting entries (Chapter 4), and closing entries (Chapter 5). Transactions are demonstrated visually to help students conquer recording transactions by showing the **four steps in the process:**

1. **Analysis**—shows which accounts are recorded with an increase/decrease.
2. **Debit/Credit Rules**—helps students to remember whether the account should be debited/credited.
3. **Journal Entry**—shows the result of the two previous steps.
4. **Ledger T-Accounts**—shows students what was recorded and where.

The Williams team puts the Accounting Equation **(A = L + OE)** in the margin by transaction illustrations to show students the big picture!



Recording Balance Sheet Transactions: An Illustration **93**

its balance sheet. The revenue and expense transactions that took place on January 31 will be addressed later in the chapter.

Each transaction from January 20 through January 27 is analyzed first in terms of increases in assets, liabilities, and owners' equity. Second, we follow the debit and credit rules for entering these increases and decreases in specific accounts. Asset ledger accounts are shown on the left side of the analysis; liability and owners' equity ledger accounts are shown on the right side. For convenience in the following transactions, both the debit and credit figures for the transaction under discussion are shown in *red*. Figures relating to earlier transactions appear in *black*.

Jan. 20 Michael McBryan and family invested $80,000 cash in exchange for capital stock.

ANALYSIS	The asset Cash is increased by $80,000, and owners' equity (Capital Stock) is increased by the same amount.
DEBIT–CREDIT RULES	Increases in assets are recorded by debits; debit Cash $80,000. Increases in owners' equity are recorded by credits; credit Capital Stock $80,000.
JOURNAL ENTRY	Jan. 20 Cash . . . . 80,000 Capital Stock 80,000

ENTRIES IN LEDGER ACCOUNTS

Cash	
1/20 80,000	

Capital Stock	
	1/20 80,000

Owners invest cash in the business

Assets	= Liabilities +	Owners' Equity
+$80,000		+$80,000

Jan. 21 Representing Overnight, McBryan negotiated with both the City of Santa Teresa and Metropolitan Transit Authority (MTA) to purchase an abandoned bus garage. (The city owned the land, but the MTA owned the building.) On January 21, Overnight Auto Service purchased the land from the city for $52,000 cash.

ANALYSIS	The asset Land is increased $52,000, and the asset Cash is decreased $52,000.
DEBIT–CREDIT RULES	Increases in assets are recorded by debits; debit Land $52,000. Decreases in assets are recorded by credits; credit Cash $52,000.
JOURNAL ENTRY	Jan. 21 Land. . . . . 52,000 Cash 52,000

ENTRIES IN LEDGER ACCOUNTS

Land	
1/21 52,000	

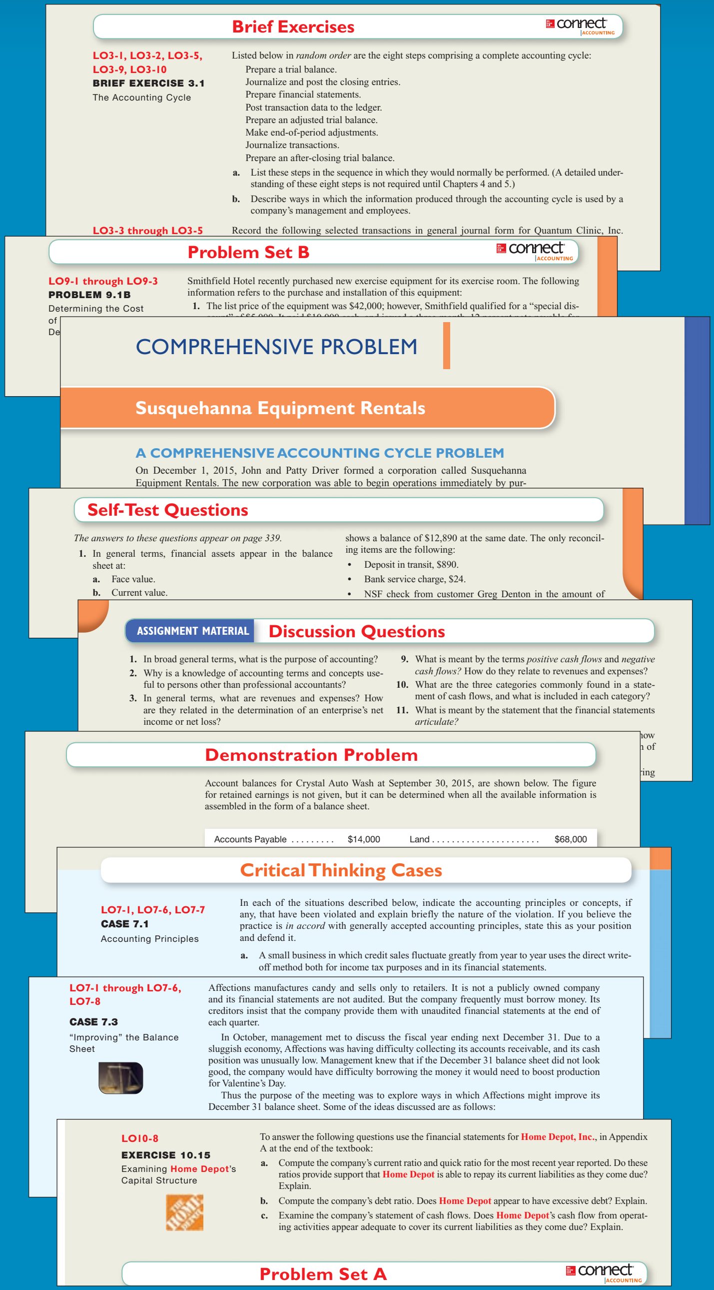
Cash	
1/20 80,000	1/21 52,000

Purchase of an asset for cash

Assets	= Liabilities +	Owners' Equity
+$52,000 −$52,000		

Build a Strong Foundation?

Robust End-of-Chapter Material



Brief Exercises

LO3-1, LO3-2, LO3-5, LO3-9, LO3-10
BRIEF EXERCISE 3.1
The Accounting Cycle

Listed below in *random order* are the eight steps comprising a complete accounting cycle:

Prepare a trial balance.
Journalize and post the closing entries.
Prepare financial statements.
Post transaction data to the ledger.
Prepare an adjusted trial balance.
Make end-of-period adjustments.
Journalize transactions.
Prepare an after-closing trial balance.

a. List these steps in the sequence in which they would normally be performed. (A detailed understanding of these eight steps is not required until Chapters 4 and 5.)

b. Describe ways in which the information produced through the accounting cycle is used by a company's management and employees.

LO3-3 through LO3-5

Record the following selected transactions in general journal form for Quantum Clinic, Inc.

Problem Set B

LO9-1 through LO9-3
PROBLEM 9.1B
Determining the Cost

Smithfield Hotel recently purchased new exercise equipment for its exercise room. The following information refers to the purchase and installation of this equipment:

1. The list price of the equipment was $42,000; however, Smithfield qualified for a "special dis-

COMPREHENSIVE PROBLEM

Susquehanna Equipment Rentals

A COMPREHENSIVE ACCOUNTING CYCLE PROBLEM

On December 1, 2015, John and Patty Driver formed a corporation called Susquehanna Equipment Rentals. The new corporation was able to begin operations immediately by pur-

Self-Test Questions

The answers to these questions appear on page 339.

1. In general terms, financial assets appear in the balance sheet at:
   - **a.** Face value.
   - **b.** Current value.

shows a balance of $12,890 at the same date. The only reconciling items are the following:

- Deposit in transit, $890.
- Bank service charge, $24.
- NSF check from customer Greg Denton in the amount of

ASSIGNMENT MATERIAL **Discussion Questions**

1. In broad general terms, what is the purpose of accounting?
2. Why is a knowledge of accounting terms and concepts useful to persons other than professional accountants?
3. In general terms, what are revenues and expenses? How are they related in the determination of an enterprise's net income or net loss?

9. What is meant by the terms *positive cash flows* and *negative cash flows?* How do they relate to revenues and expenses?
10. What are the three categories commonly found in a statement of cash flows, and what is included in each category?
11. What is meant by the statement that the financial statements *articulate?*

Demonstration Problem

Account balances for Crystal Auto Wash at September 30, 2015, are shown below. The figure for retained earnings is not given, but it can be determined when all the available information is assembled in the form of a balance sheet.

Accounts Payable	$14,000	Land	$68,000

Critical Thinking Cases

LO7-1, LO7-6, LO7-7
CASE 7.1
Accounting Principles

In each of the situations described below, indicate the accounting principles or concepts, if any, that have been violated and explain briefly the nature of the violation. If you believe the practice is *in accord* with generally accepted accounting principles, state this as your position and defend it.

a. A small business in which credit sales fluctuate greatly from year to year uses the direct write-off method both for income tax purposes and in its financial statements.

LO7-1 through LO7-6, LO7-8
CASE 7.3
"Improving" the Balance Sheet

Affections manufactures candy and sells only to retailers. It is not a publicly owned company and its financial statements are not audited. But the company frequently must borrow money. Its creditors insist that the company provide them with unaudited financial statements at the end of each quarter.

In October, management met to discuss the fiscal year ending next December 31. Due to a sluggish economy, Affections was having difficulty collecting its accounts receivable, and its cash position was unusually low. Management knew that if the December 31 balance sheet did not look good, the company would have difficulty borrowing the money it would need to boost production for Valentine's Day.

Thus the purpose of the meeting was to explore ways in which Affections might improve its December 31 balance sheet. Some of the ideas discussed are as follows:

LO10-8
EXERCISE 10.15
Examining **Home Depot**'s Capital Structure

To answer the following questions use the financial statements for **Home Depot, Inc.**, in Appendix A at the end of the textbook:

a. Compute the company's current ratio and quick ratio for the most recent year reported. Do these ratios provide support that **Home Depot** is able to repay its current liabilities as they come due? Explain.

b. Compute the company's debt ratio. Does **Home Depot** appear to have excessive debt? Explain.

c. Examine the company's statement of cash flows. Does **Home Depot**'s cash flow from operating activities appear adequate to cover its current liabilities as they come due? Explain.

Problem Set A

Brief Exercises supplement the exercises with shorter, single-concept exercises that test the basic concepts of each chapter. These brief exercises give instructors more flexibility in their homework assignments.

An Alternate Problem Set provides students with even more practice on important concepts.

Six **Comprehensive Problems,** ranging from two to five pages in length, present students with real-world scenarios and challenge them to apply what they've learned in the chapters leading up to them.

Defined **Key Terms** and **Self-Test Questions** review and reinforce chapter material.

Demonstration Problems and their solutions allow students to test their knowledge of key points in the chapters.

Critical Thinking Cases and **Problems** put students' analytical skills to the test by having them think critically about key concepts from the chapter and apply them to business decisions. **TWO** sets of Problems and a full set of Exercises in EACH chapter give *Financial & Managerial Accounting* the edge in homework materials.

Ethics Cases in *each* chapter challenge students to explore the ethical impact of decisions made in business.

The **2012 Home Depot Financial Statements** are included in Appendix A. Students are referred to key aspects of the 10-K in the text material and in end-of-chapter material to illustrate actual business applications of chapter concepts.

Connect Accounting System

Ethical

Group Activities

Writing

Internet

International

The Williams Pedagogy Helps

- High-profile companies frame each chapter discussion through the use of dynamic **CHAPTER OPENER** vignettes. Students learn to frame the chapter's topic in a real-world scenario.

CHAPTER 2

Basic Financial Statements

AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:

Learning Objectives

LO2-1	Explain the nature and general purposes of financial statements.
LO2-2	Explain certain accounting principles that are important for an understanding of financial statements and how professional judgment by accountants may affect the application of those principles.
LO2-3	Demonstrate how certain business transactions affect the elements of the accounting equation: Assets = Liabilities + Owners' Equity.
LO2-4	Explain how the statement of financial position, often referred to as the balance sheet, is an expansion of the basic accounting equation.
LO2-5	Explain how the income statement reports an enterprise's financial performance for a period of time in terms of the relationship of revenues and expenses.
LO2-6	Explain how the statement of cash flows presents the change in cash for a period of time in terms of the company's operating, investing, and financing activities.
LO2-7	Explain how the statement of financial position (balance sheet), income statement, and statement of cash flows relate to each other.
LO2-8	Explain common forms of business ownership—sole proprietorship, partnership, and corporation—and demonstrate how they differ in terms of their statements of financial position.
LO2-9	Discuss the importance of financial statements to a company and its investors and creditors and why management may take steps to improve the appearance of the company in its financial statements.

- **YOUR TURN** boxes challenge students with ethically demanding situations. They must apply what they've learned in the text to situations faced by investors, creditors, and managers in the real world.

YOUR TURN You as a Financial Advisor

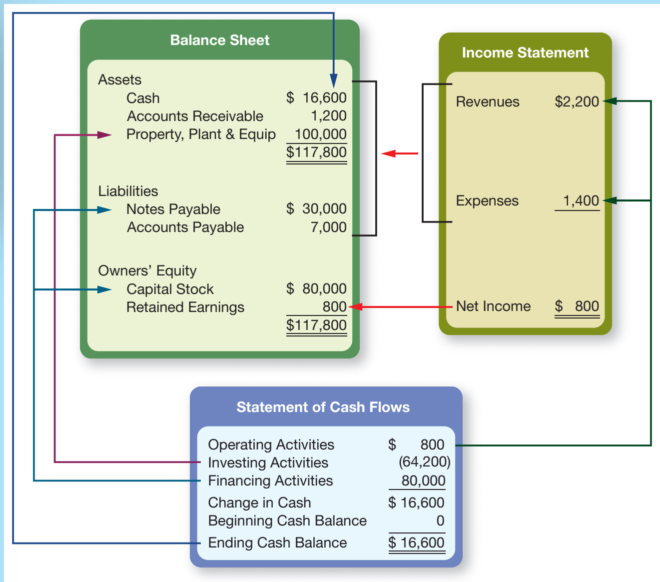
Assume that you are the financial advisor for a recently retired investor. Your client wants to invest her savings in such a way as to receive a stable stream of cash flow every year throughout her retirement. She has expressed concern to you regarding the volatility of long-term bond prices when interest rates fluctuate.

If your client invests her savings in a variety of long-term bonds and holds these bonds until maturity, will interest rate fluctuations affect her annual cash flow during her retirement years?

(See our comments on the Online Learning Center website.)

> "Lots of eye appeal and in-depth coverage. **Students will love it.**"
>
> *James Specht, Concordia College*

- **EXHIBITS** illustrate key concepts in the text.



Balance Sheet

Assets	
Cash	$ 16,600
Accounts Receivable	1,200
Property, Plant & Equip	100,000
	$117,800
Liabilities	
Notes Payable	$ 30,000
Accounts Payable	7,000
Owners' Equity	
Capital Stock	$ 80,000
Retained Earnings	800
	$117,800

Income Statement

Revenues	$2,200
Expenses	1,400
Net Income	$ 800

Statement of Cash Flows

Operating Activities	$ 800
Investing Activities	(64,200)
Financing Activities	80,000
Change in Cash	$ 16,600
Beginning Cash Balance	0
Ending Cash Balance	$ 16,600

Students Reach Great Heights


© Tony Avelar/Bloomberg via Getty Images

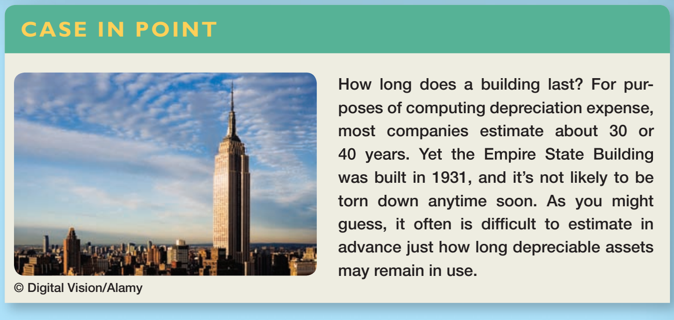
INTEL

Intel was created in 1968 with a vision of providing semiconductor memory products. By 1971, the company introduced the world's first microprocessor. Today Intel supplies the computing and communications industries with chips, boards, and systems building blocks that are the ingredients of computers and servers as well as networking and communications products. These industries use Intel's products to create advanced computing and communications systems. Intel states that its mission is to be the preeminent building block supplier in the worldwide Internet economy.

Technology-based companies like Intel operate in highly competitive markets and continuously introduce new products. In a recent corporate information communication on the company's website, management explains the importance of meeting the needs of customers: "Our goal is to be the preeminent provider of semiconductor chips and platforms for the worldwide digital economy . . . We offer products at various levels of integration, to allow our customers flexibility in creating computing and communications systems. The substantial majority of our revenue is from the sale of microprocessors and chipsets."

Modern-day historians agree that we have moved from the industrial age to the information age. Companies like Intel, Microsoft, and Cisco Systems are major players in this transformation of business. Information-age companies rely more heavily on intellectual capital, research and development, and other intangibles that were less important for companies whose focus was heavy manufacturing or, even earlier in our history, primarily agricultural. ■

> "Williams is a great text overall. It provides excellent and accurate coverage of the accounting principles curriculum. **Students like it better than any other text I have used.** A few years ago I was in a situation where I had to use a different text, since I took over a class for another teacher at the last minute. Students were getting the Williams text on their own and **I saw immediate improvement in their understanding and grades** across the board. Williams comes through again and again, where other texts fall hopelessly short."
>
> *Malcolm E White, Columbia College*


CASE IN POINT

How long does a building last? For purposes of computing depreciation expense, most companies estimate about 30 or 40 years. Yet the Empire State Building was built in 1931, and it's not likely to be torn down anytime soon. As you might guess, it often is difficult to estimate in advance just how long depreciable assets may remain in use.

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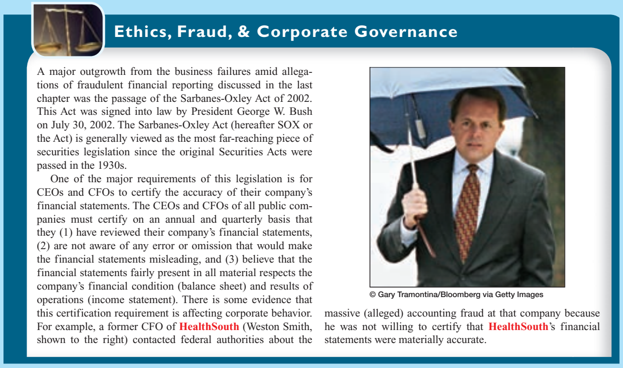
CASE IN POINT boxes link accounting concepts in the chapter to their use in the real world. These examples often present an international scenario to expose students to accounting practices around the world.


Ethics, Fraud, & Corporate Governance

A major outgrowth from the business failures amid allegations of fraudulent financial reporting discussed in the last chapter was the passage of the Sarbanes-Oxley Act of 2002. This Act was signed into law by President George W. Bush on July 30, 2002. The Sarbanes-Oxley Act (hereafter SOX or the Act) is generally viewed as the most far-reaching piece of securities legislation since the original Securities Acts were passed in the 1930s.

One of the major requirements of this legislation is for CEOs and CFOs to certify the accuracy of their company's financial statements. The CEOs and CFOs of all public companies must certify on an annual and quarterly basis that they (1) have reviewed their company's financial statements, (2) are not aware of any error or omission that would make the financial statements misleading, and (3) believe that the financial statements fairly present in all material respects the company's financial condition (balance sheet) and results of operations (income statement). There is some evidence that this certification requirement is affecting corporate behavior. For example, a former CFO of HealthSouth (Weston Smith, shown to the right) contacted federal authorities about the massive (alleged) accounting fraud at that company because he was not willing to certify that HealthSouth's financial statements were materially accurate.

© Gary Tramontina/Bloomberg via Getty Images

ETHICS, FRAUD, & CORPORATE GOVERNANCE boxes discuss the accounting scandals of recent years that have sparked such comprehensive legislation as Sarbanes-Oxley. The inclusion of EFCG boxes in each chapter offers instructors the opportunity to bring complex accounting and ethical issues into the classroom.

Leading Technology Extends Learning

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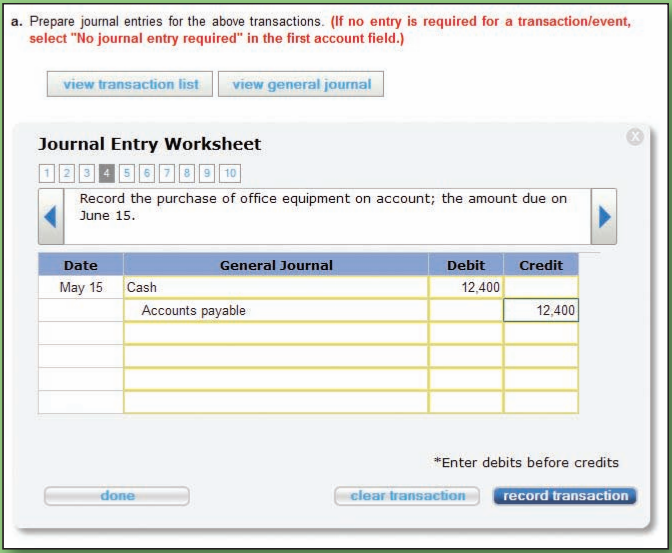
Online Assignments

Connect Accounting helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. *Connect Accounting* grades homework automatically and gives immediate feedback on any questions students may have missed.



a. Prepare journal entries for the above transactions. **(If no entry is required for a transaction/event, select "No journal entry required" in the first account field.)**

Journal Entry Worksheet

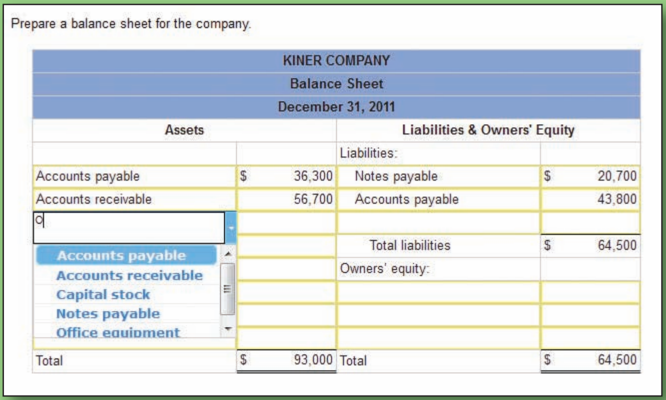
Record the purchase of office equipment on account; the amount due on June 15.

Date	General Journal	Debit	Credit
May 15	Cash	12,400	
	Accounts payable		12,400

*Enter debits before credits

Intelligent Response Technology (IRT)

IRT is a redesigned student interface for our end-of-chapter assessment content. The benefits include improved answer acceptance to reduce students' frustration with formatting issues (such as rounding); and a general journal application that looks and feels more like you would find in a general ledger software package.



Prepare a balance sheet for the company.

KINER COMPANY
Balance Sheet
December 31, 2011

Assets			Liabilities & Owners' Equity		
			Liabilities:		
Accounts payable	$	36,300	Notes payable	$	20,700
Accounts receivable		56,700	Accounts payable		43,800
O					
			Total liabilities	$	64,500
			Owners' equity:		
Total	$	93,000	Total	$	64,500

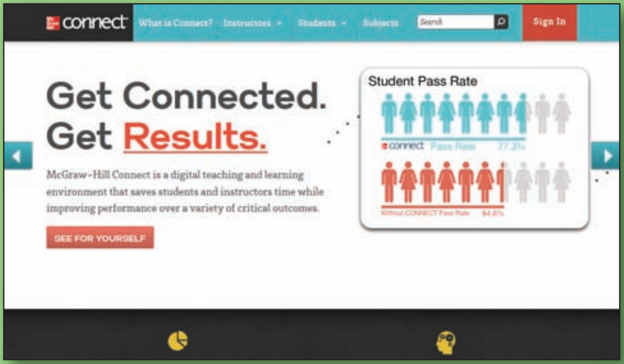
Student Library

The *Connect Accounting* Student Library gives students access to additional resources such as recorded lectures, online practice materials, an eBook, and more.

Beyond the Classroom

MCGRAW-HILL *CONNECT ACCOUNTING* FEATURES

Connect Accounting offers a number of powerful tools and features to make managing assignments easier, so faculty can spend more time teaching.



Get Connected.
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- Collect data and generate reports required by many accreditation organizations, such as AACSB and AICPA.

83.59%* overall section average for 41 assignment(s)

6 student(s) have an overall average between 0-59%

*As of 05/10/2013 12:37 PM EDT

Find out all you can do with Connect Reports.

assignment results
See assignment scores listed by student and color-coded into high, medium, and low score ranges, and customize results.

student performance
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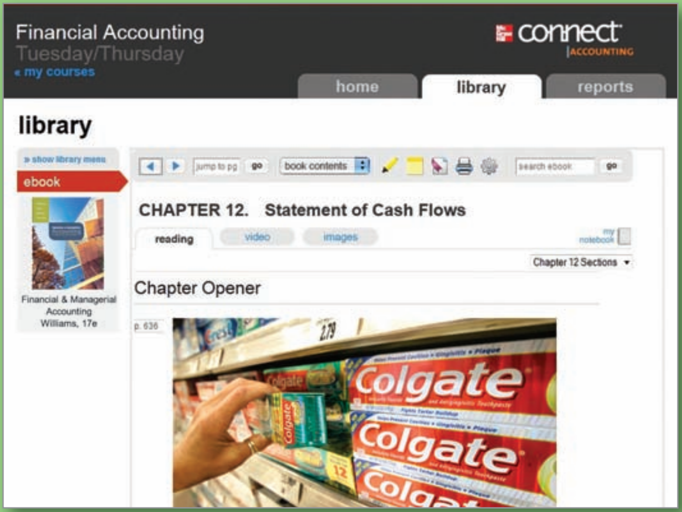

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Supplements *for Financial & Managerial Accounting*

INSTRUCTOR SUPPLEMENTS

A strong foundation needs support.

Financial & Managerial Accounting authors Williams, Haka, Bettner, and Carcello know that every component of the learning package must be integrated and supported by strong ancillaries. Instructors and students have a wealth of material at their fingertips to help make the most of a challenging course in accounting.

Online Learning Center (OLC)

www.mhhe.com/williams_basis17e

The Online Learning Center (OLC) that accompanies *Financial & Managerial Accounting* provides a wealth of extra material for both instructors and students. With content specific to each chapter of the book, the Williams OLC doesn't require any building or maintenance on your part.

A secure **Instructor Resource Center** stores your essential course materials to save you prep time before class. The **Instructor's Manual, Solutions Manual, PowerPoint presentations,** and **Testbank** are now just a couple of clicks away.

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This manual provides for each chapter: (1) a chapter summary detailing what has changed, new problems that have been added, and author suggestions on how to incorporate new material; (2) brief topical outline; (3) sample "10-minute quizzes" designed to test the basic concepts in each chapter; and (4) suggestions for group, Internet, and other class exercises to supplement the material in the book.

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This comprehensive Testbank contains over 3,000 problems and true/false, multiple-choice, and essay questions. Included in this edition are written explanations to the solutions—making it easier than ever for you to see where students have gone wrong in their calculations.

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Many educational institutions today are focused on the notion of assurance of learning, an important element of some accreditation standards. *Financial and Managerial Accounting,* 17e, is designed specifically to support your assurance of learning initiatives with a simple, yet powerful, solution.

Each testbank question for *Financial and Managerial Accounting,* 17e, maps to a specific chapter learning outcome/objective listed in the text. You can use our test-bank software, *EZ Test,* and *EZ Test Online,* or in *Connect Accounting* to easily query for learning outcomes/objectives that directly relate to the learning objectives for your course. You can then use the reporting features of *EZ Test* or in *Connect Accounting* to aggregate student results similar fashion, making the collection and presentation of assurance of learning data simple and easy.

AACSB Statement

McGraw-Hill Education is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *Financial and Managerial Accounting*, 17e, recognizes the curricula guidelines detailed in AACSB standards for business accreditation by connecting selected questions in the text and testbank to six of the general knowledge and skill guidelines found in the AACSB standards.

The statements contained in *Financial and Managerial Accounting,* 17e, are provided only as a guide for the users of this text. The AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the faculty. While *Financial and Managerial Accounting,* 17e, and its teaching package make no claim of any specific AACSB qualification or evaluation, we have, within *Financial and Managerial Accounting,* 17e, labeled selected questions according to six of the general knowledge and skills areas.

STUDENT SUPPLEMENTS

Online Learning Center (OLC)

www.mhhe.com/williams_basis17e

The OLC is full of resources for students, including: Online Quizzes and PowerPoint Presentations.

What's New about the 17th Edition of *Financial & Managerial Accounting?*

The following list of revisions is a testament to the enthusiastic response of dozens of reviewers who contributed their considerable expertise. In doing so they have helped make the 17th edition of *Financial & Managerial Accounting* the best book of its kind.

Chapter 1:

- New chapter opener using Hewlett-Packard
- Updated Case in Point using Sony
- Briefly covered the new COSO framework on internal control *(Internal Control–Integrated Framework: 2013)*
- Briefly covered the SEC Report on incorporating IFRS into the financial reporting system for U.S. public companies
- Briefly discussed the managerial role of the chief accounting officer
- Extended the discussion of the importance of accounting for non-accounting majors in response to reviewer feedback
- Revised end-of-chapter material

Chapter 2:

- Updated chapter opener to include new data for Intel
- Added an explanation about the order in which assets are presented in the balance sheet and then revised the EOC material accordingly. This is a small but important change and one triggered by user input
- Revised end-of-chapter material

Chapter 3:

- Updated chapter opener to include new data for Kraft Foods Group, Inc.
- Updated in-chapter illustration to include new data for Walmart
- Updated and streamlined Ethics, Fraud, & Corporate Governance boxed feature
- Revised end-of-chapter material

Chapter 4:

- New chapter opener using Royal Caribbean Cruises, LTD.
- Updated in-chapter illustration to include new data for the New York Times
- Updated two Case in Point boxes
- Revised end-of-chapter material

Chapter 5:

- Updated chapter opener to include new data for Best Buy
- Incorporated a number of suggestions from adopters, including:
    - ◦ Providing a more detailed discussion of the closing process
    - ◦ Better articulating the relationship between the income statement and balance sheet
    - ◦ Introducing and briefly explaining a classified balance sheet
- Revised end-of-chapter material

Chapter 6:

- Updated chapter opener to include new data for Saks, Inc.
- Brief coverage of the SEC whistleblower "bounty" program under the Dodd-Frank Act in the EFCG case
- Revised end-of-chapter material

Chapter 7:

- New chapter opener using Apple, Inc.
- Wrote a new Ethics, Fraud, and Corporate Governance case based on SEC AAER #2673
- Added a new learning objective covering internal controls over accounts receivable based on reviewer suggestion
- Wrote a new International Case in Point based on IFRS No. 9
- Revised end-of-chapter material

Chapter 8:

- New chapter opener using Belk, Inc.
- Target illustration in text updated
- Revised end-of-chapter material including updating and replacing real company data
- Comprehensive Problem 2 refreshed

Chapter 9:

- Updated chapter opener to include new data for United Parcel Service
- Updated references to the financial statements of all real companies
- Revised end-of-chapter material

Chapter 10:

- New chapter opener using Procter & Gamble Company
- Significant revision within the chapter, both text and end-of-chapter material, to more reasonable (i.e., lower) interest rates to better reflect our current and projected economic climate
- Revised end-of-chapter material

Chapter 11:

- Updated chapter opener to include new data for Target Corporation
- Updated all real company references
- Revised end-of-chapter material

Chapter 12:

- New chapter opener using Colgate-Palmolive
- Briefly covered the new FASB standard on the reporting of comprehensive income, requiring either a combined statement of Income and Comprehensive Income or separate statements of Income and Comprehensive Income
- Revised end-of-chapter material

Chapter 13:

- New chapter opener using Pepsi Co.
- Revised end-of-chapter material

Chapter 14:

- Updated chapter opener to include new data for Johnson & Johnson
- Updated all real company references
- Revised end-of-chapter material

Chapter 15:

- Updated chapter opener on IASB and IFRS
- Updated Exhibit 15-1 to include changes of the number of multinational companies
- Updated Exhibits 15-4 through 15-7 for international changes and exchange rates
- Replaced Ethics, Fraud, & Corrupt Governance for more recent Foreign Corrupt Practices Act example
- Changed demonstration problem with more current exchange rates
- Revised end-of-chapter material

Chapter 16:

- Updated chapter opener to include new data for Coca-Cola Company
- Updated Case in Point on Dell
- Replaced Exhibit 16-4 based on reviewer feedback
- Deleted end-of-chapter discussion on IFRS and inventories based on reviewer feedback
- Revised end-of-chapter material

Chapter 17:

- New chapter opener using Bechtel
- Revised end-of-chapter material

Chapter 18:

- Updated chapter opener to include new data for Kellogg Company
- Revised end-of-chapter material

Chapter 19:

- Updated chapter opener to include new data for Kimberly-Clark Corporation
- New International Case in Point
- Updated demonstration problem
- Revised end-of-chapter material

Chapter 20:

- Revised end-of-chapter material

Chapter 21:

- Updated chapter opener to include new data for Mars, Inc.
- Revised end-of-chapter material
- Revised Comprehensive Problem 5

Chapter 22:

- Updated chapter opener to include new data for Columbia Sportswear Company
- New International Case in Point
- New Ethics, Fraud, & Corporate Governance
- Revised end-of-chapter material

Chapter 23:

- New Ethics, Fraud, & Corporate Governance feature on the budgetary funding by the government
- Clarified the discussion of production budgets
- Suggested changes to flowcharting arrows for better alignment
- Removed brief discussion of budgeting and international standards
- Revised end-of-chapter material

Chapter 24:

- Moved the Ethics, Fraud, & Corporate Governance feature to follow JIT Systems and Variance Analysis
- Clarified the discussion of production budgets
- Revised end-of-chapter material

Chapter 25:

- Updated the chapter opener to include new data for Google
- Moved Ethics, Fraud, & Corporate Governance feature to follow Goals and Rewards in Life
- Clarified wording in Return on Investment and The Components of Return on Investment sections
- Revised end-of-chapter material
- Revised Comprehensive Problem 6

Chapter 26: Changes

- Revised end-of-chapter material

We are grateful . . .

We would like to acknowledge the following individuals for their help in developing some of the text's supplements: Barbara Muller, Arizona State University; LuAnn Bean, Florida Technical Institute; Helen Roybark, Radford University; Teri Zuccaro, Clarke University; Teressa Farough; and the team at ANSR Source.

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Sincerely,

Jan R. Williams, Susan F. Haka, Mark S. Bettner, and Joseph V. Carcello

Acknowledgments

Many of our colleagues reviewed *Financial & Managerial Accounting.* Through their time and effort, we are able to continually improve and update the book to meet the needs of students and professors. We sincerely thank each of you for your valuable time and suggestions.

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Financial & Managerial Accounting

THE BASIS FOR BUSINESS DECISIONS

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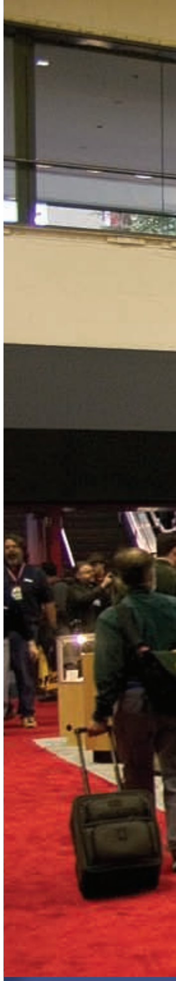
CHAPTER 1

Accounting

Information for Decision Making



AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:

Learning Objectives

LO1-1 Discuss accounting as the language of business and the role of accounting information in making economic decisions.

LO1-2 Discuss the significance of accounting systems in generating reliable accounting information and understand the five components of internal control.

LO1-3 Explain the importance of financial accounting information for external parties—primarily investors and creditors—in terms of the objectives and the characteristics of that information.

LO1-4 Explain the importance of accounting information for internal parties—primarily management—in terms of the objectives and the characteristics of that information.

LO1-5 Discuss elements of the system of external and internal financial reporting that create integrity in the reported information.

LO1-6 Identify and discuss several professional organizations that play important roles in preparing and communicating accounting information.

LO1-7 Discuss the importance of personal competence, professional judgment, and ethical behavior on the part of accounting professionals.

LO1-8 Describe various career opportunities in accounting.

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HEWLETT-PACKARD

Hewlett-Packard (HP) was founded by Bill Hewlett and Dave Packard in 1939 in a garage. Over the years, HP grew to be become a multinational information technology company, with revenues and assets of well over $100 billion. HP has often grown in recent years by acquiring other companies. Just as an individual is making an investment when he or she buys shares of stock, a corporation is making a much larger investment when it buys an entire company. And, just as reliable financial information is critical to individuals when making investment decisions, it is equally important when one company is considering buying another company.

In 2011, HP bought the British software company, Autonomy, for over $11 billion. Just a year later, HP wrote down the value of its investment in Autonomy by $8.8 billion. HP alleged that the write-down was due to its having overpaid, a result of Autonomy willfully overstating its revenues, margins (revenues − cost of sales), and growth rate prior to the acquisition. HP claims that approximately $5 billion of the $8.8 billion write-off is due to the alleged accounting improprieties. Autonomy and its founder Mike Lynch strongly deny HP's accusations. Autonomy claims that its accounting practices were permissible under international accounting standards, which it followed given its location in the UK, and which differed from U.S. accounting standards. Given the magnitude and seriousness of these charges, securities regulators and law enforcement agencies in both the United States and United Kingdom are investigating.

(continued)

Before buying another company, the purchaser typically performs due diligence procedures, including reviewing and evaluating the target company's financial results. HP ostensibly performed extensive due diligence procedures, including relying on Autonomy's auditor and another accounting firm that HP hired to perform due diligence procedures; both of these accounting firms are very large international firms. In addition, a number of prominent law and investment banking firms were retained by HP to vet the proposed acquisition. It has been reported that advisors on both sides of this deal earned over $60 million. Yet, if HP's allegations are ultimately proven true, these advisors did not appear to discover the accounting improprieties. Regardless of the ultimate veracity of HP's allegations, the Autonomy acquisition clearly has to be labeled as a failure, and HP's shareholders are the ones left holding the bag—HP's stock price declined by over 58 percent from the time when the Autonomy deal was announced until shortly after the alleged accounting improprieties were made public. ■

Understanding and using accounting information is an important ingredient of any business undertaking. Terms such as sales revenue, net income, cost, expense, operating margin, and cash flow have clearly defined meanings and are commonly used in business-related communications. Although the precise meaning of these terms may be unfamiliar to you at this point, to become an active participant in the business world, you must gain a basic understanding of these and other accounting concepts. Our objective in this book is to provide those who both use and prepare accounting information with that basic understanding.

Information that is provided to external parties who have an interest in a company is sometimes referred to as financial accounting information. Information used internally by management and others is commonly referred to as managerial accounting information. Whereas these two types of information have different purposes and serve different audiences, they have certain attributes in common. For example, both financial and managerial accounting require the use of judgment and information prepared for either purpose should be subject to the company's system of internal control. Financial accounting concepts are critical in order to understand the financial condition of a business enterprise. Determining a company's net income by subtracting its expenses from its revenue is a particularly important part of financial reporting today. This may appear to be a simple process of keeping accounting records and preparing reports from those records, but a great deal of judgment is required. For example, when should the cost of acquiring a resource that is used for several years be recognized as an expense in the company's financial statements? What information is particularly useful for management, but not appropriate for public distribution because of the potential competitive disadvantage that might result? These are among the many complex issues that business faces on a day-to-day basis and which have a critical impact on the company's responsibility to its owners, creditors, the government, and society in general.

As we begin the study of accounting, keep in mind that business does not exist solely to earn a return for its investors and creditors that supply a company's financial resources. Business also has a responsibility to operate in a socially responsible manner and to balance its desire for financial success within this broader social responsibility. We begin our development of these ideas in this chapter, and continue their emphasis throughout this text.

Accounting Information: A Means to an End

The primary objective of accounting is to provide information that is useful for decision-making purposes. From the very start, we emphasize that accounting is *not an end,* but rather it is *a means to an end.* The final product of accounting information is the decision that is enhanced by the use of that information, whether the decision is made by owners, management, creditors, governmental regulatory bodies, labor unions, or the many other groups that have an interest in the financial performance of an enterprise.

Because accounting is widely used to describe all types of business activity, it is sometimes referred to as the *language of business.* Costs, prices, sales volume, profits, and return on investment are all accounting measurements. Investors, creditors, managers, and others who have a financial interest in an enterprise need a clear understanding of accounting terms and concepts if they are to understand and communicate about the enterprise. While our primary orientation in this text is the use of accounting information in business, from time to time we emphasize that accounting information is also used by governmental agencies, nonprofit organizations, and individuals in much the same manner as it is by business organizations.

L01-1

LEARNING OBJECTIVE

Discuss accounting as the language of business and the role of accounting information in making economic decisions.

ACCOUNTING FROM A USER'S PERSPECTIVE

Many people think of accounting as simply a highly technical field practiced only by professional accountants. In reality, nearly everyone uses accounting information daily. Accounting information is the means by which we measure and communicate economic events. Whether you manage a business, make investments, or monitor how you receive and use your money, you are working with accounting concepts and accounting information.

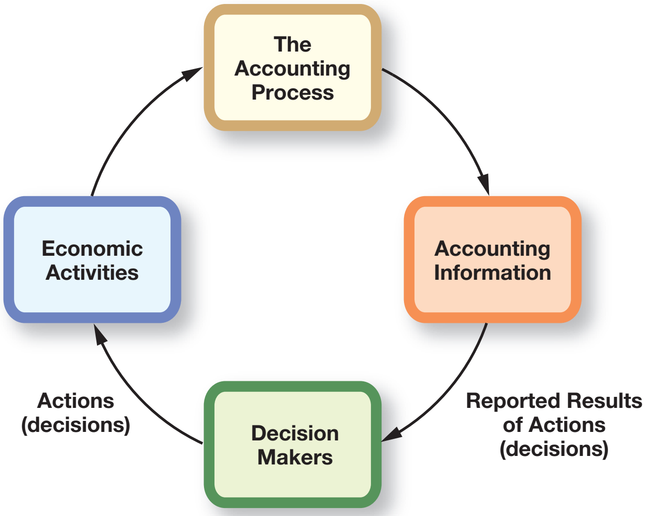
Our primary goal in this book is to develop your ability to understand and use accounting information in making economic decisions. To do this, you need to understand the following:

- The nature of economic activities that accounting information describes.
- The assumptions and measurement techniques involved in developing accounting information.
- The information that is most relevant for making various types of decisions.

Exhibit 1–1 illustrates how economic activities flow into the accounting process. The accounting process produces accounting information used by decision makers in making economic decisions and taking specific actions. These decisions and actions result in economic activities that continue the cycle.

EXHIBIT 1–1

The Accounting Process



Accounting links decision makers with economic activities—and with the results of their decisions

TYPES OF ACCOUNTING INFORMATION

Just as there are many types of economic decisions, there are also many types of accounting information. The terms *financial accounting, management accounting,* and *tax accounting* often are used in describing three types of accounting information that are widely used in the business community.

Financial Accounting **Financial accounting** refers to information describing the financial resources, obligations, and activities of an economic entity (either an organization or an individual). Accountants use the term *financial position* to describe an entity's financial resources and obligations at a point in time and the term *results of operations* to describe its financial activities during the year.

CASE IN POINT

In **Sony Corporation**'s 2012 financial statements to owners, financial position is presented as consisting of ¥13,295 trillion in assets (including cash, inventories, property, and equipment), with obligations against those assets of ¥10,805 trillion. This leaves ¥2,490 trillion as the owners' interest in those assets. In the same report, results of operations indicate that Sony had a net loss (expenses exceeded revenues) of ¥456 billion for the year ending March 31, 2012.

Financial accounting information is designed primarily to assist investors and creditors in deciding where to place their scarce investment resources. Such decisions are important to society, because they determine which companies and industries will receive the financial resources necessary for growth.

Financial accounting information also is used by managers and in income tax returns. In fact, financial accounting information is used for so many different purposes that it often is called "general-purpose" accounting information.

Management Accounting **Management** (or managerial) **accounting** involves the development and interpretation of accounting information intended *specifically to assist management* in operating the business. Managers use this information in setting the company's overall goals, evaluating the performance of departments and individuals, deciding whether to introduce a new line of products, and making virtually all types of managerial decisions.

A company's managers and employees constantly need information to run and control daily business operations. For example, they need to know the amount of money in the company's bank accounts; the types, quantities, and dollar amounts of merchandise in the company's warehouse; and the amounts owed to specific creditors. Much management accounting information is financial in nature but is organized in a manner relating directly to the decision at hand.

Tax Accounting The preparation of income tax returns is a specialized field within accounting. To a great extent, tax returns are based on financial accounting information. However, the information often is adjusted or reorganized to conform with income tax reporting requirements. We introduce the idea of tax accounting information to contrast it with financial and management accounting information. Although tax information is important for a company's successful operations and is related to financial and management accounting information, it results from a different system and complies with specialized legal requirements that relate to a company's responsibility to pay an appropriate amount of taxes. Laws and regulations governing taxation are often different from those underlying the preparation of financial and management accounting information, so it should not be a surprise that the resulting figures and reports are different. Because the focus of this text is introductory accounting, and because tax accounting is quite complex, we defer coverage of tax accounting subjects to subsequent accounting courses.

L01-2

LEARNING OBJECTIVE
Discuss the significance of accounting systems in generating reliable accounting information and understand the five components of internal control.

Accounting Systems

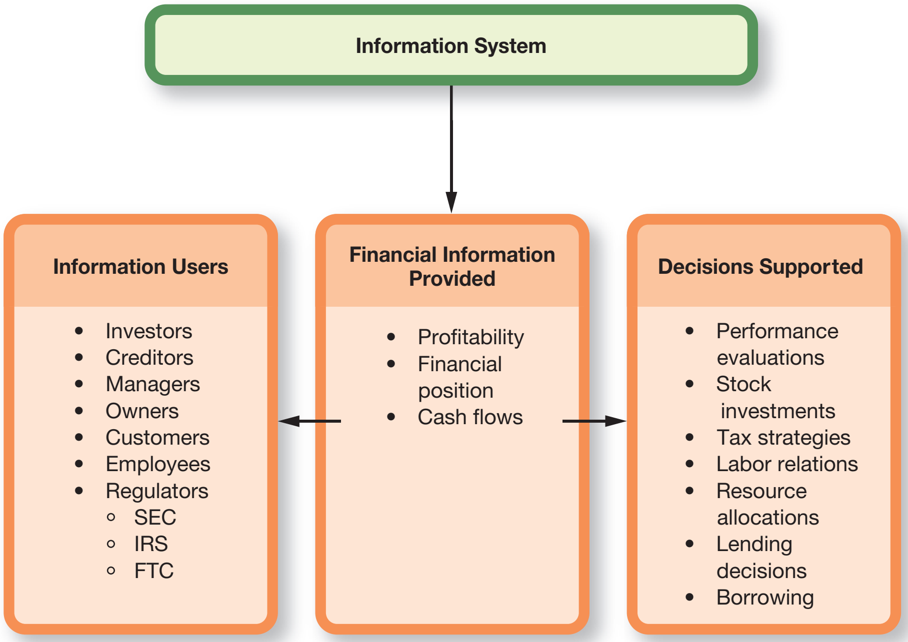
An **accounting system** consists of the personnel, procedures, technology, and records used by an organization (1) to develop accounting information and (2) to communicate this information to decision makers. The design and capabilities of these systems vary greatly from one organization to another. In small businesses, accounting systems may consist of little more than a cash register, a checkbook, and an annual trip to an income tax preparer. In large businesses, accounting systems include computers, highly trained personnel, and accounting reports that affect the daily operations of every department. But in every case, the basic purpose of the accounting system remains the same: *to meet the organization's needs for information as efficiently as possible.*

Many factors affect the structure of the accounting system within a particular organization. Among the most important are (1) the company's *needs for accounting information* and (2) the *resources available* for operation of the system.

Describing accounting as an information system focuses attention on the information accounting provides, the users of the information, and the support for financial decisions that is provided by the information. These relationships are depicted in Exhibit 1–2. While some of the terms may not be familiar to you at this early point in your study of business and accounting, you will be introduced to them more completely as we proceed through this textbook and as you undertake other courses in business and accounting. Observe, however, that the information system produces the information presented in the middle of the diagram—financial position, profitability, and cash flows. This information meets the needs of users of the information—investors, creditors, managers, and so on—and supports many kinds of financial decisions—performance evaluation and resource allocation, among others. These relationships are consistent with what we have already learned—namely, that accounting information is intended to be useful for decision-making purposes.

EXHIBIT 1–2

Accounting as an Information System



DETERMINING INFORMATION NEEDS

The types of accounting information that a company develops vary with such factors as the size of the organization, whether it is publicly owned, and the information needs of management. The need for some types of accounting information may be prescribed by law. For example, income tax regulations require every business to have an accounting system that can measure the company's taxable income and explain the nature and source of every item in the company's income tax return. Federal securities laws require publicly owned companies to prepare financial statements in conformity with generally accepted accounting principles. These statements must be filed with the Securities and Exchange Commission, distributed to stockholders, and made available to the public.

Other types of accounting information are required as matters of practical necessity. For example, every business needs to know the amounts owed to it by each customer and the amounts owed by the company to each creditor. Although much accounting information clearly is essential to business operations, management still has many choices as to the types and amount of accounting information to be developed. For example, should the accounting system of a department store measure separately the sales of each department and of different types of merchandise? The answer to such questions depends on *how useful* management considers the information to be and the *cost* of developing the information.

THE COST OF PRODUCING ACCOUNTING INFORMATION

Accounting systems must be *cost-effective*—that is, the value of the information produced should exceed the cost of producing it. Management has no choice but to produce the types of accounting reports required by law or contract. In other cases, however, management may use *cost-effectiveness* as a criterion for deciding whether or not to produce certain information.

In recent years, the development and installation of computer-based information systems have increased greatly the types and amount of accounting information that can be produced in a cost-effective manner.

BASIC FUNCTIONS OF AN ACCOUNTING SYSTEM

In developing information about the activities of a business, every accounting system performs the following basic functions:

1. *Interpret and record* the effects of business transactions.
2. *Classify* the effects of similar transactions in a manner that permits determination of the various *totals* and *subtotals* useful to management and used in accounting reports.
3. *Summarize and communicate* the information contained in the system to decision makers.

The differences in accounting systems arise primarily in the manner, frequency, and speed with which these functions are performed.

In our illustrations, we often assume the use of a simple manual accounting system. Such a system is useful in illustrating basic accounting concepts, but it is too slow and cumbersome to meet the needs of most business organizations. In a large business, transactions may occur at a rate of several hundred or several thousand per hour. To keep pace with such a rapid flow of information, these companies must use accounting systems that are largely computer-based. The underlying principles within these systems are generally consistent with the basic manual system we frequently refer to in this text. Understanding manual systems allows users to understand the needs that must be met in a computerized system.

WHO DESIGNS AND INSTALLS ACCOUNTING SYSTEMS?

The design and installation of large accounting systems is a specialized field. It involves not just accounting, but expertise in management, information systems, marketing, and—in many cases—computer programming. Thus accounting systems generally are designed and installed by a team of people with many specialized talents.

Large businesses have a staff of systems analysts, internal auditors, and other professionals who work full-time in designing and improving the accounting system. Medium-size companies often hire a CPA firm to design or update their systems. Small businesses with limited resources often purchase one of the many packaged accounting systems designed for small companies in their line of business. These packaged systems are available through office supply stores, computer stores, and software manufacturers.

COMPONENTS OF INTERNAL CONTROL[1]

In developing its accounting system, an organization also needs to be concerned with developing a sound system of internal control. **Internal control** is a process designed to provide

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[1] The information in this section is taken from *Internal Control–Integrated Framework: 2013,* Committee of Sponsoring Organizations of the Treadway Commission, May 2013.

reasonable assurance that the organization produces reliable financial reports, complies with applicable laws and regulations, and conducts its operations in an efficient and effective manner. A company's board of directors, its management, and other personnel are charged with developing and monitoring internal control. The five components of internal control, as discussed in *Internal Control–Integrated Framework: 2013* (Committee of Sponsoring Organizations of the Treadway Commission), are the *control environment, risk assessment, control activities, information and communication,* and *monitoring activities.*

An organization's **control environment** is the foundation for all the other elements of internal control, setting the overall tone for the organization. Factors that affect a company's control environment are: (1) the organization's commitment to integrity and ethical values, (2) the independence of the board of directors from management, and the board's oversight of internal control, (3) management assignment, with board oversight, of appropriate levels of authority and responsibility, (4) an organizational commitment to attract, develop, and retain competent individuals, and (5) individuals being held accountable for the performance of their control responsibilities. The control environment is particularly important because fraudulent financial reporting often results from an ineffective control environment.

Risk assessment involves identifying, analyzing, and managing those risks that pose a threat to the achievement of the organization's objectives. For example, a company should assess the risks that might prevent it from preparing reliable financial reports and then take steps to minimize those risks. The situation described in the chapter opener involving **Hewlett-Packard and Autonomy** provides an example of where that firm's risk assessment procedures failed.

Control activities are the policies and procedures that management puts in place to address the risks identified during the risk assessment process. Examples of control activities include approvals, authorizations, verifications, reconciliations, reviews of operating performance, physical safeguarding of assets, and segregation of duties.

Information and communication involves developing information systems to capture and communicate operational, financial, and compliance-related information necessary to run the business. Effective information systems capture both internal and external information. In addition, an effective control system is designed to facilitate the flow of information downstream (from management to employees), upstream (from employees to management), and across the organization. Employees must receive the message that top management views internal control as important, and they must understand their role in the internal control system and the roles of others.

All internal control systems need to be monitored. **Monitoring activities** enable the company to evaluate the effectiveness of its system of internal control over time. Monitoring activities are generally accomplished through ongoing management and supervisory activities, as well as by periodic separate evaluations of the internal control system. Most large organizations have an internal audit function, and the activities of internal audit represent separate evaluations of internal control. In fact, the NYSE requires all listed companies to maintain an internal audit function.

As a result of the large financial frauds at **Enron** and **WorldCom**, the U.S. Congress passed, and President George W. Bush signed, the **Sarbanes-Oxley Act** (SOX) of 2002. SOX has been described as the most far-reaching securities law since the 1930s. One of the SOX requirements is that public companies issue a yearly report indicating whether they have an effective system of internal control over financial reporting. In essence, management must indicate whether the entity's internal control system provides reasonable assurance that financial statements will be prepared in accordance with laws and regulations governing financial reporting. In addition for all but the smallest public companies, the company's external auditor must issue its own report as to whether the auditor believes that the company's internal control system is effective. These requirements are contained in Section 404 of SOX; therefore, many businesspeople describe the above process as the 404 certification and the audit under Section 404. This certification process has been extremely expensive and time-consuming, and some businesspeople believe that the costs associated with this certification requirement exceed the benefits.