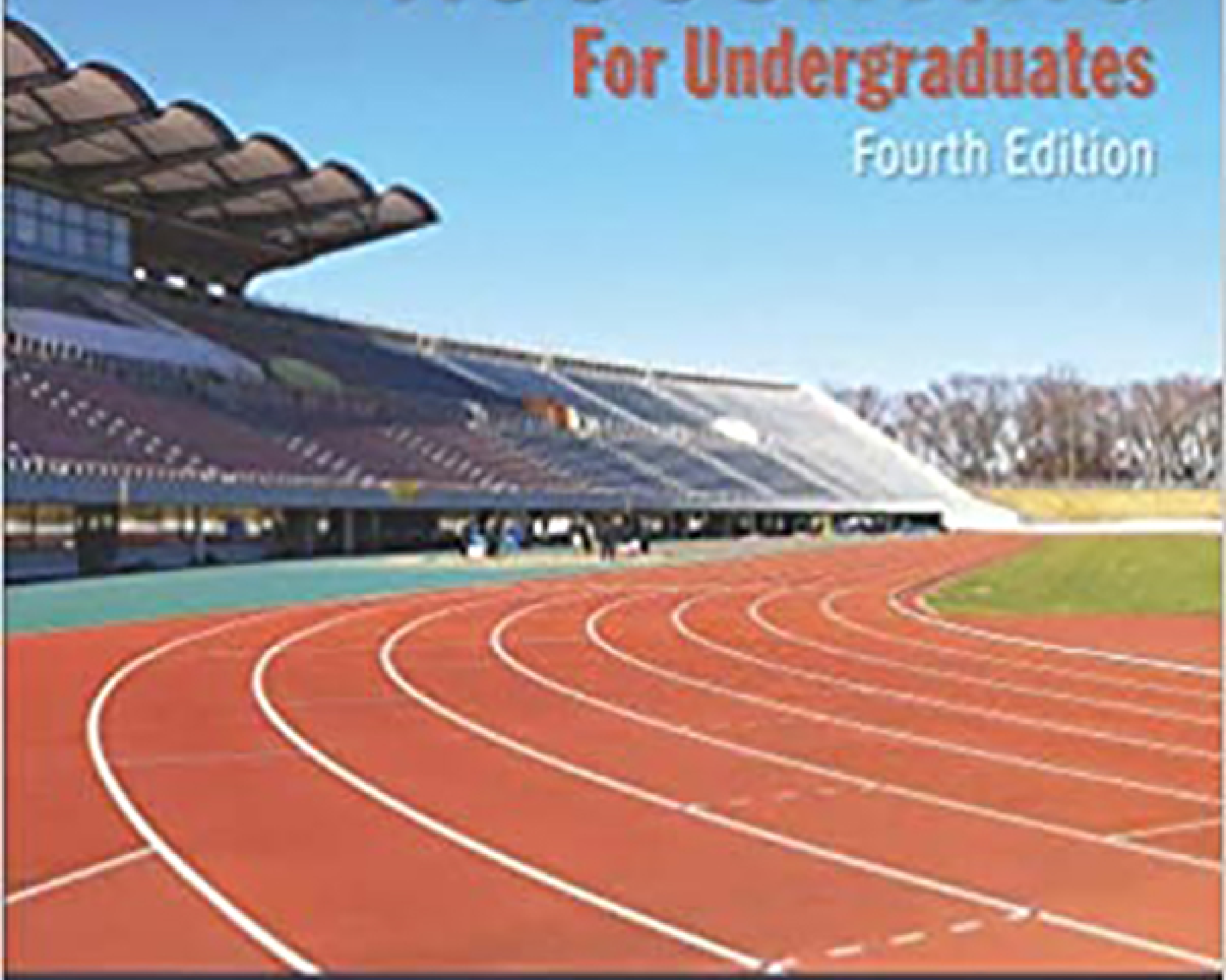
FINANCIAL ACCOUNTING

For Undergraduates

Fourth Edition



JAMES S. WALLACE

KAREN K. NELSON

THEODORE E. CHRISTENSEN

Financial Accounting
for Undergraduates

Fourth Edition

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Preface

"THE MOST COMPELLING VALUE PROPOSITION OFFERED IN THE FINANCIAL ACCOUNTING MARKET!"

That has been our goal since this product's inception, and we have made that value proposition even more compelling with the Fourth Edition of Financial Accounting for Undergraduates. We created this product to satisfy the needs of students taking their first financial accounting course by providing a **high-quality**, **contemporary**, and **engaging** textbook and online learning system at an **affordable** price. With a suggested retail price of **$80** for the hardbound, full-color textbook with **free access** to myBusinessCourse, we challenge faculty to find a better overall value for their students.

Read on to learn why Financial Accounting for Undergraduates has become a best-seller, and why you should use it in your introductory financial accounting class.

PEDAGOGY THAT ENCOURAGES STUDENT SUCCESS

Financial accounting can be challenging—especially for students lacking business experience or previous exposure to business courses. To help students succeed in the course, we use a number of pedagogical devices throughout the textbook, and we provide a wealth of resources through our online learning and homework system, **myBusinessCourse** (MBC).

The Past/Present/Future feature puts each chapter in context.

PAST

Chapter 2 explained how we analyze and record transactions (the first two steps in the *accounting cycle*), including the system of debits

PRESENT

This chapter completes our examination of the final three steps in the five-step accounting cycle: adjust, report, and close

FUTURE

Chapter 4 examines the balance sheet and income statement more closely and introduces techniques for analyzing and interpreting

Road Maps outline each chapter and provide a quick reference table that summarizes the print and digital resources for that chapter.

Road Map

LO	Learning Objective	Page	eLecture	Guided Example	Assignments
LO1	Describe the nature of liabilities and discuss various current liabilities.	464	E10-1	YT10.1	SS1, SS2, SS4, E1A, E2A, E3A, E4A, E5A, E6A, E7A, E1B, E2B, E3B, E4B, E5B, E6B, E7B, P1A, P2A, P3A, P4A, P5A, P6A, P1B, P2B, P3B, P4B, P5B, P6B
LO2	Illustrate the accounting for long-term liabilities.	470	E10-2	YT10.2	SS8, SE2, SE8, SE9, SE10, E8A, E9A, E10A, E11A, E14A, E15A, E16A, E17A, E18A, E19A, E21A, E8B, E9B, E10B, E11B, E14B, E15B, E16B, E17B, E18B, E19B, E21B, P7A, P7B
LO3	Define contingent liabilities and explain the rules for their accounting and disclosure in the financial statements.	480	E10-3	YT10.3	SS3, SS5, SE1, SE3, E1A, E7A, E7B E12A, E12B, P6A, P6B

Your Turns provide hands-on practice after each major concept to ensure mastery of a topic before proceeding to the next concept.

YOUR TURN! 6.2

The solution is on page 320.

GuidedExamples MBC

The following inventory information is gathered from the accounting records of Tucker Enterprises:

Beginning inventory	4,000 units at $5 each
Purchases	6,000 units at $7 each
Sales	9,000 units at $10 each

Calculate (a) ending inventory, (b) cost of goods sold, and (c) the gross profit using each of the following methods (i) FIFO, (ii) LIFO, and (iii) weighted-average cost.

On December 3, WebWork used cash to purchase $32,400 of office equipment.

Assets		=	Liabilities	+	Stockholders' Equity
−32,400 Cash	+32,400 Office Equipment	=			

Dec. 3	Office equipment (+A)	32,400	
	Cash (−A)		32,400
	To record purchase of office equipment.		

+	Office Equipment (A)		−
(5)	32,400		

+	Cash (A)		−
(1)	30,000	10,800	(2)
(4)	36,000	32,400	(5)

We use color and other visual cues pedagogically to help students learn and retain important concepts.

Hint: *In contrast to the percentage of net sales method, the accounts receivable aging method takes into account the beginning balance of the Allowance for Doubtful Accounts.*

A.K.A. The Allowance for Doubtful Accounts is also often referred to as the Allowance for Uncollectible Accounts.

Margin notes provide hints and identify commonly used alternative terms.

CURRENT DEVELOPMENTS AND ENGAGING EXAMPLES

The basics of accounting haven't changed much in hundreds of years, but the world in which we live has changed dramatically. Technology is rapidly altering how accounting is performed and what can be done with the data once they are collected. In this edition, we introduce students to Data Analytics and Blockchain Technology in **Chapter 1**.

Data Analytics and Blockchain Technology

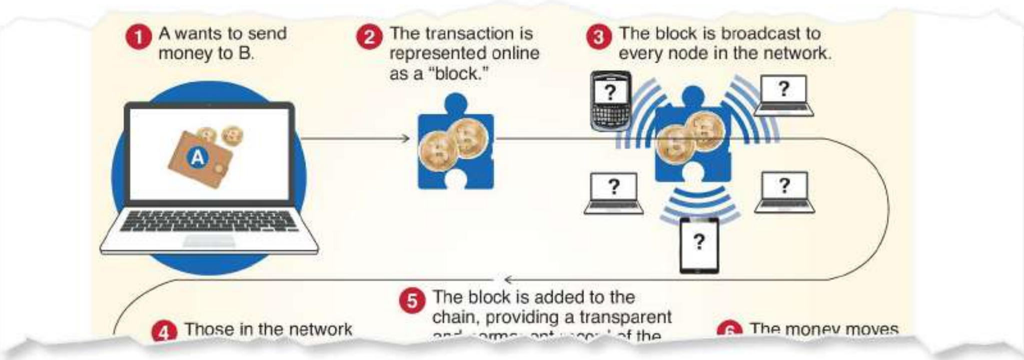
Accounting skills are not stagnant; rather they are constantly evolving. What was once done by hand is now done with the aid of specialized software. Programs like **QuickBooks** from **Intuit** have automated the basic accounting job of transaction recording, and programs like **Microsoft Excel** have greatly aided in the analysis of accounting data. While some industry observers had predicted these technological advances would replace the need for accountants, these applications have simply changed the way accountants perform their jobs. Newer technologies such as data analytics and blockchain are further

Where appropriate, we include boxed features highlighting new technologies.

Blockchain and the Future of Accounting

When most people hear the word *blockchain*, they likely think of Bitcoin. What makes blockchain so important for cybercurrencies like Bitcoin also makes it likely to revolutionize the future of accounting. Blockchain technology, which is also known as distributed ledger technology, allows multiple parties to a transaction to securely share a database. Blockchain has the potential to create a completely traceable audit trail, and could potentially automate the entire financial audit. While the future possibilities appear endless, current applications in addition to auditing include cybersecurity and financial planning and analysis.

For an expanded introduction to Data Analytics and Blockchain Technology, we added a new **Appendix F** that provides more detail and assignments that require the use of Excel and Tableau.



In addition to the changes brought about by technology, several new accounting standards have gone into effect since the last edition of this book, including standards on revenue recognition, inventory measurement methods (lower-of-cost-or-net realizable value), leases, and investments. The Fourth Edition has been updated to incorporate the new standards. However, we recognize that the goal of the introductory course is to expose students to the general principles and processes of accounting without overwhelming them with the details that are more appropriately covered in intermediate accounting courses. Consequently, we utilize examples and applications that avoid the technical detail students will learn in future courses.

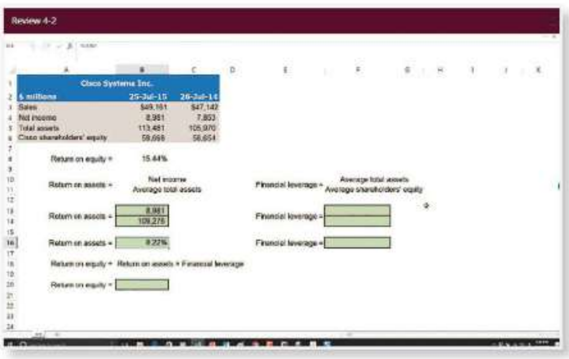
Revenue Recognition

Applying the revenue recognition principle can be quite straightforward for simple situations such as the sale of a dozen donuts at a Krispy Kreme store. More complex situations, however, can lead to more difficulty in applying the five-step revenue recognition process. For example, when Xerox Corp. sells a photocopy machine along with a three-year maintenance agreement as part of a packaged deal, the five-step process would be applied as follows:

Step 1: Identify the contract with the customer. The revenue recognition standard treats every revenue transaction as a contract between the seller to provide goods or services and the buyer to provide payment to the seller. Contracts may be informal and implicit such as the contract to purchase a dozen donuts from Krispy Kreme, or formal and explicit such as a written contract to purchase a photocopier with a maintenance agreement from Xerox.

TECHNOLOGY THAT IMPROVES LEARNING AND COMPLEMENTS FACULTY INSTRUCTION

myBusinessCourse is an online learning and assessment program intended to complement your textbook and faculty instruction. Access to **myBusinessCourse** is FREE ONLY with the purchase of a new textbook, but can be purchased separately.



MBC is ideal for faculty seeking opportunities to augment their course with an online component. MBC is also a turnkey solution for online courses. The following are some of the features of MBC.

Increase Student Readiness

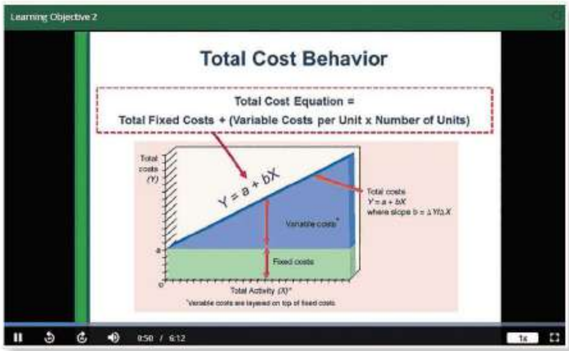
- **eLectures** cover each chapter's learning objectives and concepts. Consistent with the text and created by the authors, these videos are ideal for remediation and online instruction.

- **Guided Examples** are narrated video demonstrations created by the authors that show students how to solve select problems from the textbook.
- Immediate feedback with **auto-graded homework**.
- **Test Bank** questions that can be incorporated into your assignments.
- Instructor **gradebook** with immediate grade results.

In two recent surveys of students who used MBC, **95%** responded that MBC helped them learn accounting.*

Make Instruction Needs-Based

- Identify where your students are struggling and customize your instruction to address their needs.
- Gauge how your entire class or individual students are performing by viewing the easy-to-use gradebook.
- Ensure your students are getting the additional reinforcement and direction they need between class meetings.



Provide Instruction and Practice 24/7

- Assign homework from your Cambridge Business Publishers' textbook and have MBC grade it for you automatically.
- With our eLectures, your students can revisit accounting topics as often as they like or until they master the topic.
- Guided Examples show students how to solve select problems.
- Make homework due before class to ensure students enter your classroom prepared.
- For an additional fee, upgrade MBC to include the eBook and you have all the tools needed for an online course.

In the same two surveys, over **86%** of the students who responded said they would encourage their professor to continue using MBC in future terms.*

Integrate with LMS

myBusinessCourse integrates with many learning management systems, including **Canvas**, **Blackboard**, **Moodle**, **D2L**, **Schoology**, and **Sakai**. Your gradebooks sync automatically.

NEW TO THIS EDITION

- **Road Map:** Each chapter opens with a quick reference grid that identifies each learning objective for the chapter, the related pages, eLecture and Guided Example videos, and end of chapter assignments. This allows students and faculty to quickly identify the chapter content and to efficiently navigate to the desired resource.
- Added discussions of **Data Analytics** and **Blockchain Technology** where appropriate, and added **Appendix F**, which provides a more in-depth exploration of Data Analytics and Blockchain Technology.
- New **pedagogical use of color** in Chapter 3 to help students differentiate between the 4 types of end-of-period adjustments (accruals and deferrals).
- Added **visual cues** to journal entries and T-accounts to help students understand the type of account being affected by transactions (A, L, SE, R, E, D) and the impact the transaction has on the account (+/–).
- Updated **revenue recognition** coverage for the standard change.
- Chapter 6: Updated the inventory coverage to reflect the new standard on **lower-of-cost-or-net realizable** value.
- Chapter 9: Added coverage on **natural resources** and depletion.

* These statistics are based on the results of two surveys in which 2,330 students participated.

- Chapter 10: Updated the appendix on **leases** to reflect the new standard.
- Updated Appendix D on **Investments** to reflect the new standard.
- Updated **real financial data** throughout the text and assignments.
- Expanded the number of **Guided Example videos** and assignments included in MBC.

SUPPLEMENT PACKAGE

For Instructors

myBusinessCourse: A web-based learning and assessment program intended to complement your textbook and classroom instruction.

Solutions Manual: Created by the authors, the *Solutions Manual* contains complete solutions to all the assignment material in the text.

PowerPoint: The PowerPoint slides outline key elements of each chapter.

Test Bank: The Test Bank includes multiple-choice items, matching questions, short essay questions, and problems.

Excel Templates: We provide Excel spreadsheets for select assignments. These spreadsheets will save time in data entry and allow students to dedicate additional time to learning the material. The assignments accompanied by Excel spreadsheets are identified by the Excel icon.

Website: All instructor materials are accessible via the book's Website (password protected) along with other useful links and marketing information: www.cambridgepub.com

For Students

myBusinessCourse: A web-based learning and assessment program intended to complement your textbook and faculty instruction. This easy-to-use program grades homework automatically and provides you with additional help when your instructor is not available. Assignments with the MBC in the margin are available in myBusinessCourse. Access is free with new copies of this textbook (look for page containing the access code towards the front of the book). If you buy a used copy of the book, you can purchase access at www.mybusinesscourse.com.

Excel Templates: We provide Excel spreadsheets for select assignments. These spreadsheets will save time in data entry and allow students to dedicate additional time to learning the material. The assignments accompanied by Excel spreadsheets are identified by the Excel icon.

Website: Updates and other useful links are available to students free of charge on the book's Website.

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All four editions of this book benefited greatly from the valuable feedback of focus group attendees, reviewers, students, and colleagues. We are extremely grateful to them for their help in making this project a success.

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Jim Wallace Karen Nelson Ted Christensen

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Chapter 1

Financial Accounting and Business Decisions

A **Focus Company** *introduces each chapter and illustrates the relevance of accounting in everyday business.*

PRESENT

This chapter explains business formation, the uses and users of accounting information, the types of activities companies pursue, and financial statements that report on business.

FUTURE

The next chapters more fully explain financial statements, including how they are prepared, constructed, analyzed, and interpreted.

Past/Present/Future *provides an overview of where the chapter fits within the context of the whole book.*

It is often said that accounting is the language of business. Like all companies, **Columbia Sportswear Company** (Columbia.com), a maker of clothing for dedicated lovers of the greater outdoors, relies upon accounting for its success. It uses financial reports to judge its performance and that of its managers. It uses accounting controls to monitor its inventory. It uses accounting data to assess the amount and timing of dividend payments to shareholders.

This first chapter introduces many basic relations and principles underlying financial statements. It also identifies many key users of accounting information and discusses how that information is useful in businesses globally.

Road Map

Road Maps *summarize each chapter's resources and categorize them by learning objective.*

eLectures *are videos available in MBC that provide 3-5 minute reviews of each learning objective.*

Assignments *reinforce learning and can be completed by hand or within MBC.*

LO	Learning Objective	Page	eLecture	Guided Example	Assignments
LO1	Explain the three forms of business organizations.	4	E1-1	YT1.1	SE1, E1A, E1B, P1A, P1B
LO2	Describe business activities.	5	E1-2	YT1.2	SE5, SE10, E6A, E6B
LO3	Indicate who uses accounting information.	6	E1-3	YT1.3 YT1.4	SE3, SE8, E3A, E14A, E3B, P8A, P8B
LO4	Explain the accounting process and generally accepted accounting principles.	10	E1-4	YT1.5	SE2, SE4, SE9, SE15, SE19, E2A, E5A, E15A, E2B, E5B, E15B
LO5	Describe the accounting equation and each financial statement.	12	E1-5	YT1.6	SE6, SE11, SE12, SE13, SE14, E4A, E7A, E9A, E10A, E11A, E12A, E19A, E4B, E7B, E8B, E9B, E10B, E11B, E12B, 19B, P2A, P3A, P4A, P5A, P6A, P7A, P9A, P10A, P2B, P3B, P4B, P5B, P6B, P7B, P9B, P10B
LO6	Explain additional disclosures that accompany financial statements.	19	E1-6	YT1.7	SE7, E13A, E13B, P9A, P9B
LO7	Describe careers in accounting.	20	E1-7		
LO8	Appendix 1A: Discuss FASB's conceptual framework.	23	E1-8		SE16, SE17, SE18, SE20, SE21, E16A, E17A, E18A, E19A, E20A, E16B, E17B, E18B, E19B, E20B, P11A, P11B

Learning Objectives *identify the key learning goals of the chapter.*

Guided Examples *are videos that demonstrate how to solve various types of problems and are available in MBC.*

Chapter Organization charts *visually depict the key topics and their sequence within the chapter.*

FINANCIAL ACCOUNTING AND BUSINESS DECISIONS

Forms of Business Organizations	Business Activities	Accounting Information and Its Use	Information Dissemination	Other Annual Report Components	FASB Conceptual Framework (Appendix 1A)
• Sole proprietorship • Partnership • Corporation	• Financing • Investing • Operating	• External users • Internal users • Ethics and accounting	• Accounting process • Generally Accepted Accounting Principles • International Financial Reporting Standards • Financial statements	• Notes to financial statements • Independent auditor's report • Management's Discussion and Analysis	• Objectives • Elements • Characteristics • Recognition and Measurement

eLecture *icons denote the availability of an instructional video in* **myBusinessCourse** *(MBC). See the Preface for more information on MBC.*

BUSINESS ORGANIZATION

LO1 Explain the three forms of business organizations.

Learning Objectives *are repeated at the start of the section covering that topic.*

The first decision every business faces is deciding what form of organization it will take. The three principal forms of business organization are the sole proprietorship, the partnership, and the corporation. Although each of these organizational forms is treated as an accounting entity, only the corporation is viewed under the law as a legal entity separate and distinct from its owners. A corporation has an unlimited life, which means that it will continue to exist indefinitely unless it is formally dissolved. The life of a sole proprietorship or partnership is limited by the participation of the existing owners. If an owner dies or withdraws, the business typically ends as well.

A **sole proprietorship** is a business owned by one person; it is the most common of the three forms of business organization. The primary advantage of the sole proprietorship is its ease of formation. As the only owner, the sole proprietor makes all of the decisions affecting the business. This organizational form also enjoys certain income tax advantages relative to a corporation in that the income of that business is not taxed; instead, its income is included as part of the owner's income that is reported to the taxation authorities.

Key Terms *are highlighted in bold, red font.*

A **partnership** is a voluntary association of two or more persons for the purpose of conducting a business. Partnerships and sole proprietorships differ principally with respect to the number of owners. Partnerships can be as small as two people or as large as the biggest accounting or legal firms, which have hundreds or even thousands of partners. Partnerships are also easy to establish. Because a partnership involves multiple owners, the partners should establish the rights and obligations of each partner to avoid any misunderstandings that might lead to disputes and lawsuits. An advantage of the partnership form over the sole proprietorship is the broader skill set that multiple partners can bring to a business. Partnerships also enjoy the same income tax advantage as sole proprietorships.

A **corporation** is a legal entity created under the laws of a state or the federal government. A corporation can have as few as one owner but most have many owners. The owners of a corporation receive shares of stock as evidence of their ownership interest in the business, and consequently, they are referred to as **stockholders** (or *shareholders*). Since corporations are a separate legal entity, they must pay income taxes on their profits. This leads to a situation of double taxation because the income of the corporation is taxed and stockholders also pay taxes on dividends they receive from the corporation. The corporation is the dominant organizational form in terms of the volume of business activity conducted in the United States and worldwide.

While most businesses start off as either a sole proprietorship or as a partnership, some outgrow these organizational forms and convert to the corporate form. For example, **Columbia Sportswear Company** was incorporated in 1961 after beginning as a sole proprietorship in 1938. Two primary reasons for converting a sole proprietorship or a partnership to the corporate form of business are the relative ease of raising capital to grow the business and the protection afforded to stockholders against personal liability. A third advantage of the corporate form is the relative ease of selling ownership shares. For example, stock exchanges, such as the **New York Stock Exchange (NYSE)**, exist to enable stockholders to readily buy and sell their ownership shares. No such exchanges exist for sole proprietors or partners, and thus, selling an ownership interest in a sole proprietorship or a partnership is a more difficult, time-consuming event.

Proprietorship	Partnership	Corporation
		
• One owner control • Business not taxed, but owner taxed • Not legal entity • Limited life	• Shared owner control • Business not taxed, but owners taxed • Not legal entity • Limited life	• All types of owner control • Business taxed and owners taxed • Separate legal entity • Unlimited life

Your Turn! boxes reinforce the material just presented with self-study questions. To aid learning, solutions are provided at the end of the chapter.

YOUR TURN! 1.1

Identify three characteristics for each of the principal forms of business organizations.

1. sole proprietorship
2. partnership
3. corporation

The solution is on page 53.

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ACTIVITIES OF A BUSINESS

LO2 **Describe** business activities.

Every business, regardless of its organizational form, its industry, or its size, is involved in three types of business activities—financing, investing, and operating.

Financing Activities

Before a company can begin operations, it must acquire money to support its operations. Employees need to be hired, buildings constructed, raw materials purchased, and machinery put in place. Companies can obtain the necessary funds to undertake these activities in several ways. These **financing activities** are generally categorized as either debt financing or equity financing.

Debt financing involves borrowing money from sources such as a bank by signing a note payable or directly from investors by issuing bonds payable. The individuals or financial institutions that lend money to companies are called their **creditors**. Debt financing involves an obligation to repay a creditor both the amount initially borrowed, called the **principal**, and an interest fee for the use of the funds.

Equity financing involves selling shares of stock to investors. In contrast to creditors who lend money to a business and expect to receive that money back with interest, investors that purchase shares of stock are buying an ownership interest in the company. Investors hope that their stock will increase in value so that they can earn a profit when they sell their shares. The owners of a company's stock may also receive dividend payments when the company decides to distribute some of its profits.

Investing Activities

A.K.A. Land, buildings, and equipment is often referred to as property, plant, and equipment, or simply PP&E.

A.K.A. *(Also Known As) identify commonly used alternative terms.*

Before a company can begin operations, it must purchase the long-term resources necessary to conduct its business, such as land, buildings and equipment. **Investing activities** involve the acquisition and disposition of factories, office furniture, computer and data systems, delivery vehicles, and other items that will be used to carry out the company's business plans. These items are referred to as assets.

Companies can obtain the money needed to make these investments from either the financing activities discussed previously or from any excess cash accumulated from operating the business profitably.

Operating Activities

The day-to-day activities of producing and selling a product or providing a service are referred to as **operating activities**. Operating activities are critical for a business because if a company is unable to generate income from its operations it is very likely that the business will fail. If creditors and stockholders do not believe that a company will be able to generate a profit, they are unlikely to provide the financing needed to start, or maintain, its operations.

Exhibit 1-1 provides a summary of the three types of business activities. Arrows are pointing both toward, and away from, operating activities. This is because financing and investing activities are necessary to carry out a company's operating activities; however, if a company's operating activities generate excess cash, then the excess cash can be used to either finance additional investments, repay the company's creditors, or pay dividends to shareholders.

Exhibit 1-1 **Business Activities**

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YOUR TURN! 1.2

The solution is on page 53.

Classify each of the following activities as a financing, investing, or operating activity.

1. Receiving a loan from a bank.
2. Selling merchandise online.
3. Purchasing a delivery truck.
4. Purchasing merchandise for resale to customers.
5. Issuing shares of stock in exchange for cash.
6. Paying employee salaries.

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ACCOUNTING INFORMATION AND ITS USE

LO3 **Indicate** who uses accounting information.

In today's society, many individuals and agencies are involved in the economic life of a business. The information needs of these parties are fulfilled, in part, by accounting information. The users of accounting information are classified by their relation to a business as either *external users* or *internal users*.

External Users of Accounting

An important function of the accounting process is to accumulate and report accounting information that details a business's results of operations, cash flows, and financial position. By U.S. law, publicly owned businesses must publish financial statements annually and quarterly. The subset of accounting that produces these publicly available financial statements is referred to as **financial accounting**.

Financial accounting information serves a variety of users. Potential investors and investment professionals need financial data to compare prospective investments to determine which, if any, they should invest in, and at what price. Creditors must consider the financial strength of a business before lending it funds, and stockholders must evaluate whether to remain invested in a business, buy more shares, or sell their existing shares of stock.

The financial statements issued by a company are the main source of financial information for these external users. Because financial statements are often used to evaluate the management team running the business, their objectivity is sometimes called into question because the reports are prepared by the management team itself. To establish the validity of financial statements, most businesses have their financial data audited by an independent public accountant. Publicly owned businesses are required to have their financial statements audited. The independent public accountant, or independent auditor, examines the financial statements and recommends any changes or improvements that are warranted. The independent auditor then expresses a professional opinion as to whether the financial statements are fairly presented "in conformity with generally accepted accounting principles." External users have greater confidence in financial statements that have been audited by an independent, certified public accountant.

ACCOUNTING IN PRACTICE

The Big Four

Independent auditors are licensed by the state in which they do their auditing work and are identified as **certified public accountants (CPAs)**. To qualify as a CPA, an individual must pass a rigorous examination that is administered nationally and must meet the educational and work experience requirements set by each state to ensure high standards of accounting and auditing performance. The four largest U.S. public accounting firms, referred to as the *Big Four*, have offices located throughout the world and employ thousands of auditors. These firms are **Deloitte & Touche**, **Ernst & Young**, **KPMG, LLP**, and **PricewaterhouseCoopers**.

Accounting In Practice *boxes describe how accounting is used in real companies.*

There are many other external users of a company's accounting information. For example, a business's customers may want information to help them determine if a company like **Whirlpool** will be able to honor its product warranties. Labor unions require information to determine the level of pay raises that they can demand from companies like **United Parcel Service**. **Exhibit 1-2** illustrates the kind of accounting information that is required by a company's external users.

Real Companies *and* **Institutions** *are highlighted in bold, blue font.*

Exhibit 1-2 Accounting Information Needs of External Users

User Group		Accounting Information Used to Answer Questions such as:
Potential investors and current stockholders		How does the profitability of **Target** compare to that of **WalMart**? How does **Bank of America Corporation** compare with **Wells Fargo & Company** in terms of firm size?
Creditors and lenders		Will **Delta Airlines** be able to repay its creditors in a timely fashion? Is it safe to provide a bank loan to the **Federal Express Corporation**?
Taxation authorities and regulators		Is **Tesla Motors, Inc.** reporting the proper amount of taxable income? Is **Duke Energy**'s rate hike justified by its operating costs?

Internal Users of Accounting

A major function of accounting is to provide the internal management of a company with the data needed for decision making and the efficient management of the business. While managers have an interest in the information reported to external users, managers also require various other types of information, such as the cost of its products, estimates of the income to be earned from a sales campaign, cost comparisons of alternative courses of action, and long-range budgets. Because of the strategic nature of much of this information, it is usually only available to a company's top-level management. The process of generating and analyzing such data is referred to as **managerial accounting**. **Exhibit 1-3** illustrates the various types of accounting information that are required by a company's internal users.

Exhibit 1-3 Accounting Information Needs of Internal Users

User Group		Accounting Information Used to Answer Questions such as:
Marketing Department		What is the optimal price to sell the **Samsung** Galaxy phone to maximize the company's sales revenue? Was the promotional campaign by **Netflix** successful in promoting the company's *Stranger Things* series?
Management Team		How much is the Olive Garden restaurant chain contributing to the overall profitability of its parent company, the **Darden Restaurant Group**? What is the projected profitability of the **General Motors**' Chevrolet brand for the coming year?
Finance Department		Is there sufficient cash available for **Hewlett Packard** to buy back a large amount of its outstanding common stock? Will **General Electric** have sufficient cash flow to pay its short-term expenses?

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YOUR TURN! 1.3

The solution is on page 53.

1. Are financial statements the primary output of managerial or financial accounting? Explain.
2. Identify at least two internal users and explain why they need accounting information.
3. Identify at least two external users and explain why they need accounting information.

Ethics and Accounting

Ethics deals with the values, rules, and justifications that govern one's way of life. Although fundamental ethical concepts such as right and wrong, good and evil, justice and morality are abstract, many issues in our daily lives have ethical dimensions. The way that we respond to these issues defines our ethical profile. In both our personal and professional lives, our goal is to act ethically and responsibly.

Ethical behavior has not always been the rule in business. Business history reveals unethical activities such as price gouging of customers, using inside information for personal gain, paying bribes to government officials for favors, ignoring health and safety regulations, selling arms and military equipment to aggressor governments, polluting the environment, and issuing misleading financial information. Well-known accounting scandals at such companies as **Enron**, **WorldCom**, and **Lehman Brothers** have again brought ethics to the forefront.

Increasingly, business managers recognize the importance and value of ethical behavior by their employees. It is now commonplace for businesses to develop a written code of ethics to help guide the behavior of employees. Similarly, professional organizations of accountants have written ethics codes. The **American Institute of Certified Public Accountants (AICPA)**, for example, has a professional code of ethics to guide the conduct of its member CPAs. Similarly, the **Institute of Management Accountants (IMA)** has written standards of ethical conduct for accountants employed in the private sector.

Unethical behavior that results in misleading financial statements has the potential to erode public confidence and trust in accounting information. In response to this decline in public confidence, the U.S. Congress passed the **Sarbanes-Oxley Act** in 2002 with the goal of restoring investor trust by reducing the likelihood of future accounting scandals. Among the many changes required by this legislation is that a company's top management must certify in writing the accuracy of its reported financial statement information, and these executives risk criminal prosecution for fraudulent certification. In addition, companies must now report on the internal controls put into place to help deter errors in the financial reporting process and to detect them should they occur.

A.K.A. The Sarbanes-Oxley Act of 2002 is often referred to as SarBox or SOX.

Accountant as Detective—CSI in Real Life

FORENSIC ACCOUNTING

Law enforcement personnel are not the only people who perform criminal investigations. A branch of accounting known as **forensic accounting** is vitally important in many types of criminal investigations, from financial statement fraud, to money laundering, to massive investment frauds such as the one perpetrated by Bernard Madoff (who is currently serving a 150-year prison sentence). Unlike law enforcement personnel, forensic accountants are involved both before and after the commission of a crime.

Forensic Accounting *boxes highlight how financial accounting knowledge can help aid in the prevention of errors and fraud.*

Accountants face several unique ethical dilemmas, such as:

1. The output produced by accountants has financial implications for individuals, as well as businesses. These situations generate considerable pressure on the accountant to "improve" the reported results. The amount of income taxes to be paid by an individual or business, the amount of a bonus to be received by an employee, the price to be paid by a customer, and the amount of money to be distributed to a business's owners are examples of situations in which the financial implications can lead to efforts to influence the outcome. *Ethical behavior mandates that accountants ignore these pressures.*
2. Accountants have access to confidential, sensitive information. Tax returns, salary data, details of financial arrangements, planned acquisitions, and proposed price changes are examples of this type of information. *Ethical behavior mandates that accountants respect the confidentiality of information.*
3. A criticism of U.S. business practices is that they are too "bottom-line" (that is, short-term profit) oriented. This orientation can lead to unethical actions by management to increase reported short-term profits. Because accountants measure and report a firm's profit, they must be particularly concerned about these ethical breakdowns. *Both accountants and management must recognize the importance of a long-run perspective.* Studies indicate that, over the long term, successful companies and ethical practices go hand in hand.

YOUR TURN! 1.4

The solution is on page 54.

As an accountant for the Madoff Corporation, you are responsible for measuring and reporting the company's net income. It appears that actual results are going to be less than was expected by Wall Street analysts. Your supervisor has asked that you report some of next period's sales revenue early so that the current period's net income will be in line with analyst expectations. You know that reporting revenue like this represents a violation of generally accepted accounting principles. Your supervisor states that you will not really be doing anything wrong because the sales revenues are real—the company will just be reporting the revenue earlier than accounting guidelines allow. What should you do?

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THE ACCOUNTING PROCESS

LO4 **Explain** the accounting process and generally accepted accounting principles.

Accounting is *the process of measuring economic activity of an entity in monetary terms and communicating results to users.* The accounting process consists of two principal activities—measurement and communication.

The measurement process must (1) identify the relevant economic activities of a business, (2) quantify these economic activities, and (3) record the resulting measures in a systematic manner. Measurement is done in monetary terms. In the United States, measurements are stated in U.S. dollars. In other countries, measurements are expressed in the local currency.

Thinking Globally *boxes emphasize the similarities and differences in business practices between companies in the U.S. and companies in other countries.*

Because the purpose of accounting is to provide useful financial information, the communication process is extremely important. Accordingly, the accounting process (1) prepares financial reports to meet the needs of the user and (2) helps interpret the financial results for that user. To provide reports that serve users effectively, managers must be aware of how these users are likely to apply the reports. The needs of the various users differ; as such, there are different types of accounting reports. Managers employ various techniques to help users interpret the content of reports. These techniques include the way the report is formatted, the use of charts and graphs to highlight trends, and the calculation of ratios to emphasize important financial relations.

THINKING GLOBALLY

Companies measure their operating performance using the currency of their principal place of business. The **Johnson & Johnson Company**, a well-known maker of baby shampoo and Band-Aids, is headquartered in New Jersey, and reports its financial results using the U.S. dollar. On the other hand, **Moet Hennessy Louis Vuitton**, the luxury goods manufacturer, is headquartered in Paris, France, and reports its financial results using the euro. Some companies prepare "convenience translations" of their financial statements in the currency and language of other countries so that potential foreign investors can more readily understand the company's financial performance and condition.

Generally Accepted Accounting Principles

It is important that financial statements be prepared under a set of rules that is understood by the users of those reports. Imagine if every business were free to determine exactly how it measured and communicated its financial health and operating performance. How would a user of this information be able to compare one company's results to another if each played by a different set of rules? Financial statement users who rely on accounting data expect that all companies will follow the same standards and procedures when preparing their statements. In the United States these standards and procedures are called **generally accepted accounting principles (GAAP)**.

A.K.A. Generally accepted accounting principles are often referred to as GAAP (pronounced like the clothing store "Gap").

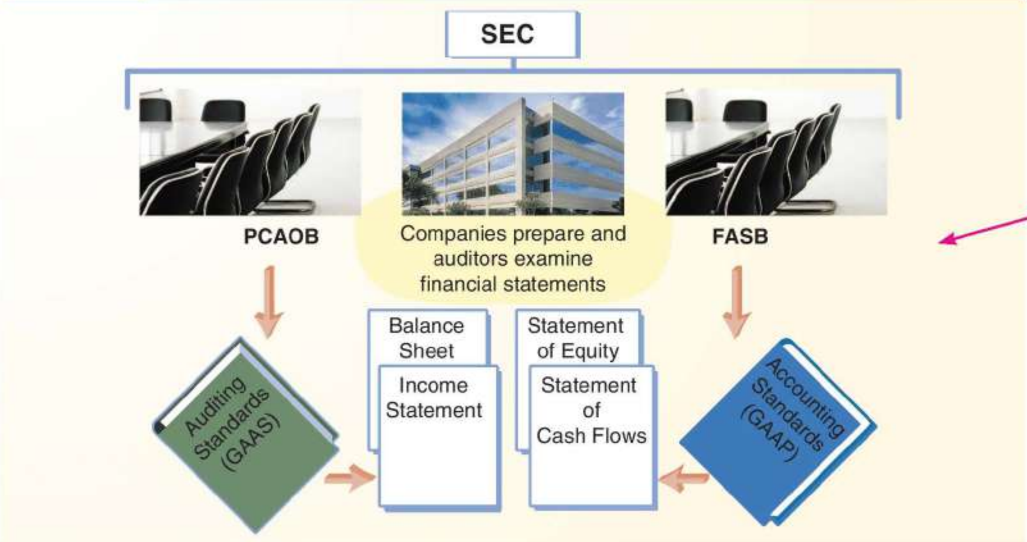
Generally accepted accounting principles are guides to action that can (and do) change over time. Sometimes specific accounting principles must be altered or new principles formulated to fit a changing set of economic circumstances or changes in business practices.

Financial Accounting Oversight

The **Financial Accounting Standards Board (FASB)**, the American Institute of Certified Public Accountants (AICPA), and the **U.S. Securities and Exchange Commission (SEC)** are instrumental in the development of generally accepted accounting principles in the United States. As a federal agency, the SEC's primary focus is to regulate the interstate sale of stocks and bonds. The SEC requires companies under its jurisdiction to submit audited annual financial statements to the agency which it then makes available to the general public. The SEC has the power to set the accounting principles used by these companies, but the agency has largely delegated that principle-setting responsibility to the FASB.

The FASB is a nongovernmental entity whose pronouncements establish U.S. GAAP.[1] The FASB consists of a seven-member board and follows a process that allows for input from interested parties as it considers a new or changed accounting principle (see the appendix to this chapter for additional information on the conceptual framework the FASB has developed to formulate accounting standards). A new or changed principle requires the support of at least a majority of the board members. More recently, the **Public Company Accounting Oversight Board (PCAOB)** was established. The PCAOB approves auditing standards, known as **generally accepted auditing standards (GAAS)**, and monitors the quality of financial statements and audits. **Exhibit 1-4** illustrates the structure of financial accounting oversight in the United States.

Exhibit 1-4 **Financial Accounting Oversight**



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Infographics illustrate difficult concepts and procedures.

The FASB completed the Accounting Standards Codification in 2009 concerning how GAAP is organized and communicated. This codification represents the authoritative U.S. GAAP for non-governmental entities and is easily researched through an online database maintained by the FASB. A major justification for the codification project was to ease the convergence of U.S. GAAP and international standards.

International Financial Reporting Standards

The past few decades have witnessed a steady acceptance of international financial reporting standards. This acceptance coincides with the increasing globalization of business. Although several organizations are working to increase international harmonization in accounting, the organization that has taken the lead in formulating international accounting principles is the **International Accounting Standards Board (IASB)**. The accounting standards formulated by the IASB are referred to as the **International Financial Reporting Standards (IFRS)**. Approximately 120 nations or reporting jurisdictions either require or permit the use of IFRS. This includes the European Union, Australia, New Zealand, Israel, and Canada.

U.S. companies are not currently allowed to report their financial statements using IFRS. However, the FASB and IASB coordinate their standard-setting activities in an effort to reduce or eliminate as many differences as possible.

IFRS

A.K.A. International financial reporting standards are often referred to as IFRS (pronounced "eye furs").

[1] Paralleling the FASB structure, the **Governmental Accounting Standards Board (GASB)** was organized in 1984 to formulate generally accepted accounting principles for state and local governments.

YOUR TURN! 1.5

The solution is on page 54.

Match the items from column 1 with the correct item in column 2.

1. Accounting
2. Generally Accepted Accounting Principles (GAAP)
3. Public Company Accounting Oversight Board (PCAOB)
4. International Accounting Standards Board (IASB)

a. Guides to action for financial reporting
b. Responsible for formulating international accounting standards
c. The process of measuring economic activity of an entity in monetary terms and communicating the results to users
d. The organization empowered to approve auditing standards

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FINANCIAL STATEMENTS

LO5 Describe the accounting equation and each financial statement.

There are four basic financial statements: the balance sheet, the income statement, the statement of stockholders' equity, and the statement of cash flows. Each financial statement begins with a heading. The heading provides the name of the company, the name of the financial statement, and the date or time period of the statement.

Balance Sheet

A.K.A. The balance sheet is also referred to as the statement of financial position.

A.K.A. The accounting equation is also called the balance sheet equation.

The **balance sheet** is a listing of a firm's assets, liabilities, and stockholders' equity as of a given date, usually the end of an accounting period. The balance sheet depicts a framework called the **accounting equation**. The accounting equation states that the sum of a business's economic resources must equal the sum of any claims on those resources. That is, a business obtains resources that it utilizes in its operations from outside sources, principally creditors and stockholders, who maintain claims on those resources. Consequently, the accounting equation can be written as:

Resources of a company = Claims on resources

Assets refer to a company's resources, liabilities refer to creditor claims on those resources, and stockholders' equity refers to owner claims on those resources. Using these terms, the accounting equation can be reformulated as:

Assets = Liabilities + Stockholders' equity

Hints help explain difficult concepts.

This equation states that the firm's assets equals the sum of its liabilities plus its stockholders' equity—see **Exhibit 1-5**. Throughout the accounting process, the accounting equation must always remain in balance.

Exhibit 1-5 Accounting Equation for a Business

Economic Terms	Resources	=	Creditor claims on resources	+	Stockholder (owner) claims on resources
Business Terms	Assets	=	Liabilities	+	Stockholders' equity

Hint: Only resources that can be expressed in monetary terms are included among the assets reported on the balance sheet. There exist some assets that cannot be expressed in monetary terms, such as the value of a company's workforce, and, therefore, are not reported on a balance sheet.

Assets are the economic resources of a business that can be expressed in monetary terms. Assets take many forms. Cash is an asset, as are claims to receive cash payments from customers for goods or services provided, called accounts receivable. Other types of assets include inventory, supplies, land, buildings, and equipment. The key characteristic of any asset is that it represents a probable future economic benefit to a business.

Liabilities are the obligations or debts that a business must pay in cash or in goods and services at some future time as a consequence of past transactions or events. For example, a business can borrow money and sign a promissory note agreeing to repay the borrowed amount in six months. The business reports this obligation as a liability called notes payable. Similarly, if a business owes money to various suppliers for goods or services already provided, it is called accounts payable, or if it owes wages to its employees for work already performed, it is called wages payable. The business reports these obligations as liabilities on its balance sheet.

Stockholders' equity refers to the ownership (stockholder) claims on the assets of the business. Stockholders' equity represents a *residual claim* on a business's assets; that is, it is a claim on the assets of a business that remain after all liabilities to creditors have been satisfied. For this reason, stockholders' equity is sometimes referred to as a business's **net assets**, where net assets equal the difference between total assets and total liabilities. In equation format,

Assets − Liabilities = Stockholders' equity

and,

Net assets = Stockholders' equity

Columbia's balance sheet is shown in **Exhibit 1-6** and reports the company's assets, liabilities, and stockholders' equity. (All Columbia Sportswear amounts are in thousands of dollars.) Columbia's assets totaled $2,212,902 at year-end 2017, with the largest asset being cash of $673,166 followed by inventories of $457,927. Total assets ($2,212,902) are equal to the sum of liabilities ($560,643) and stockholders' equity ($1,652,259). This equality must always exist as required by the accounting equation.

Exhibit 1-6 Columbia Sportswear Balance Sheet

COLUMBIA SPORTSWEAR COMPANY
Balance Sheet
December 31, 2017
(In thousands)

Assets	
Cash	$ 673,166
Investments	94,983
Accounts receivable	364,862
Inventories	457,927
Prepaid expenses and other current assets	58,559
Property, plant, and equipment, net	281,394
Other assets	282,011
Total assets	$2,212,902
Liabilities and Stockholders' Equity	
Liabilities	
Accounts payable	$ 252,301
Income taxes payable	77,211
Other liabilities	231,131
Total liabilities	560,643
Stockholders' Equity	
Common stock	45,829
Retained earnings	1,606,430
Total stockholders' equity	1,652,259
Total liabilities and stockholders' equity	$2,212,902

Real financial data *for focus companies illustrate key concepts of each chapter.*

Hint: *Final totals in the financial statements are double underlined. Follow this format whenever asked to prepare a financial statement.*