CHAPTER 1

Uses of Accounting Information and the Financial Statements

REVIEWING THE CHAPTER

Objective 1: Define *accounting* and describe its role in making informed decisions, identify business goals and activities, and explain the importance of ethics in accounting.

1. **Accounting** is an information system that measures, processes, and communicates financial information about an identifiable economic entity. It provides information that is essential for decision making.
2. A **business** is an economic unit that sells goods and services at prices that will provide an adequate return to its owners. To survive, a business must meet two goals: **profitability,** which means earning enough income to attract and hold investment capital, and **liquidity,** which means keeping sufficient cash on hand to pay debts as they fall due.
3. Businesses pursue their goals by engaging in operating, investing, and financing activities.
   a. **Operating activities** are the everyday activities needed to run the business, such as hiring personnel; buying, producing, and selling goods or services; and paying taxes.
   b. **Investing activities** spend the funds raised. They include such activities as buying and selling land, buildings, and equipment.
   c. **Financing activities** are needed to obtain funding for the business. They include such activities as obtaining capital from owners and creditors, paying a return to owners, and repaying creditors.
4. **Performance measures** indicate the extent to which managers are meeting their business goals and whether the business activities are well managed. Performance measures thus often serve as the basis for evaluating managers. Examples of performance measures include cash flow (for liquidity), net income or loss (for profitability), and the ratio of expenses to revenue (for operating activities).
5. A distinction is usually made between **management accounting,** which focuses on information for internal users, and **financial accounting,** which involves generating and communicating accounting information in the form of **financial statements** to persons outside the organization.
6. Accounting information is processed by bookkeeping, computers, and management information systems.
   a. A small but important part of accounting, **bookkeeping** is the mechanical and repetitive process of recording financial transactions and keeping financial records.
   b. The computer is an electronic tool that rapidly collects, organizes, and communicates vast amounts of information. The computer does not take the place of the accountant, but the accountant must understand how the computer operates because it is an integral part of the accounting information system.

c. A **management information system (MIS)** is an information network of all major functions (called *subsystems*) of a business. The accounting information system is the financial hub of the management information system.

7. **Ethics** is a code of conduct that addresses the question of whether an individual's actions are right or wrong. Users depend on management and its accountants to act ethically and with good judgment in the preparation of financial statements. This responsibility is often expressed in the report of management that accompanies financial statements.

8. The intentional preparation of misleading financial statements is called **fraudulent financial reporting.** It can result from the distortion of records, falsified transactions, or the misapplication of accounting principles. Individuals who perpetrate fraudulent financial reporting are subject to criminal and financial penalties.

9. In 2002, Congress passed the **Sarbanes-Oxley Act** to regulate financial reporting and the accounting profession. A key provision of this legislation requires chief executives and chief financial officers of all publicly traded U.S. companies to swear (based on their knowledge) that the quarterly statements and annual reports filed with the SEC are accurate and complete.

Objective 2: Identify the users of accounting information.

10. The users of accounting information basically fall into three groups: management, outsiders with a direct financial interest in the business, and outsiders with an indirect financial interest.

    a. **Management** steers a business toward its goals by making the business's important decisions. Specifically, management must ensure that the business is adequately financed; that it invests in productive assets; that it develops, produces, and markets goods or services; that its employees are well managed; and that pertinent information is provided to decision makers.

    b. Present or potential investors and creditors are considered outside users with a direct financial interest in a business. Most businesses publish financial statements that report on their profitability and financial position. Investors use these statements to assess the business's strength or weakness; creditors use them to determine the business's ability to repay debts on time.

    c. Society as a whole, through government officials and public groups, can be viewed as an accounting information user with an indirect financial interest in a business. Such users include tax authorities, regulatory agencies, and other groups, such as labor unions, economic planners, and financial analysts. Among the regulatory agencies is the **Securities and Exchange Commission (SEC),** an agency of the federal government set up by Congress to protect the investing public by regulating the issuing, buying, and selling of stocks in the United States.

11. Managers in government and not-for-profit organizations (hospitals, universities, professional organizations, and charities) also make extensive use of financial information.

Objective 3: Explain the importance of business transactions, money measure, and separate entity.

12. To make an accounting measurement, the accountant must answer the following basic questions:

    a. What is measured?

    b. When should the measurement be made?

    c. What value should be placed on the item being measured?

    d. How should what is measured be classified?

13. Financial accounting uses money measures to gauge the impact of business transactions on specific business entities.

    a. **Business transactions** are economic events that affect a business's financial position. They can involve an exchange of value (e.g., a purchase, sale, payment, collection, or loan) or a "nonexchange" (e.g., the physical wear and tear on machinery, and losses due to fire or theft).

    b. The **money measure** concept states that business transactions should be measured in terms of money. Financial statements are normally prepared in terms of the monetary unit of the country in which the business resides (i.e., in dollars, euros, etc.). When transactions occur between countries that have different monetary units, the appropriate **exchange rate,** or the value of one currency in terms of another, must be used to translate amounts from one currency to another.

    c. For accounting purposes, a business is treated as a **separate entity,** distinct from its owner or owners, creditors, and customers—that is, the business owner's personal bank account, resources, debts, and financial records should be kept separate from those of the business.

Objective 4: Identify the three basic forms of business organization.

14. The three basic forms of business organization are sole proprietorships, partnerships, and corporations. Accountants recognize each form as an economic unit separate from its owners.

    A **sole proprietorship** is an unincorporated business owned by one person. The owner receives all profits, absorbs all losses, and is personally liable for all debts of the business.

    A **partnership** is an unincorporated business owned and managed by two or more persons. The owners share profits and losses according to a predetermined formula. In some cases, one or more partners limit their liability for the business's debts, but at least one partner must have unlimited liability.

    A **corporation** is a business unit chartered by the state and legally separate from its owners (the stockholders). Corporations are run by a board of directors, who are elected by the stockholders. Stockholders enjoy limited liability (i.e., their risk of loss is limited to the amount they paid for their shares), and ownership of stock can be transferred without affecting operations. The corporation is the dominant form of American business because it enables companies to amass large quantities of capital.

Objective 5: Define *financial position,* and state the accounting equation.

15. Every business transaction affects a firm's financial position. **Financial position** (a company's economic resources and the claims against those resources) is shown by a balance sheet, so called because the two sides of the balance sheet must always equal each other. In a sense, the balance sheet presents two ways of viewing the same business: the left side shows the assets (resources) of the business, whereas the right side shows who provided the assets. Providers consist of owners (listed under "owner's equity") and creditors (represented by the listing of "liabilities"). Therefore, it is logical that the total dollar amount of assets must equal the total dollar amount of liabilities and owner's equity. This is the **accounting equation,** which is formally stated as

    Assets = Liabilities + Owner's Equity

    Another correct form is

    Assets – Liabilities = Owner's Equity

16. **Assets** are the economic resources of a business that are expected to benefit future operations. Examples of assets are cash, accounts receivable, inventory, buildings, equipment, patents, and copyrights.
17. **Liabilities** are a business's present obligations to pay cash, transfer assets, or provide services to other entities in the future. Examples of such debts are money owed to banks, amounts owed to creditors for goods bought on credit, and taxes owed to the government.
18. **Owner's equity** represents the claims by the owners of a business to the assets of the business. It equals the residual interest in assets after deducting the liabilities. Because it is equal to assets minus liabilities, owner's equity is said to equal the **net assets** of the business.
19. Owner's equity is affected by four types of transactions. Owner's investments increase owner's equity. **Revenues**, which result from selling goods and services, also increase owner's equity. **Expenses,** which represent the costs of doing business, decrease owner's equity, as do owner's withdrawals. When its revenues exceed its expenses, a company has a **net income.** When its expenses exceed its revenues, a company has suffered a **net loss.**

Objective 6: Identify the four basic financial statements.

20. Accountants communicate information through financial statements. The four principal statements are the income statement, statement of owner's equity, balance sheet, and statement of cash flows.
21. Every financial statement has a three-line heading. The first line gives the name of the company. The second line gives the name of the statement. The third line gives the relevant dates (the date of the balance sheet or the period of time covered by the other three statements).
22. The **income statement,** whose components are revenues and expenses, is perhaps the most important financial statement. Its purpose is to measure the business's success or failure in achieving its goal of profitability.
23. The **statement of owner's equity** relates the income statement to the balance sheet by showing how the owner's capital changed during the accounting period. The owner's capital at the beginning of the period is the first item on the statement. Because net income belongs to the owner, it is added to beginning capital, as are any additional investments that the owner made during the period. Finally, any owner's withdrawals during the period are subtracted, as is a net loss, to arrive at the owner's capital at the end of the period. This ending figure is then stated as the owner's capital on the balance sheet.
24. The **balance sheet** shows the financial position of a business as of a certain date. The resources owned by the business are called *assets;* debts of the business are called *liabilities;* and the owners' financial interest in the business is called *stockholders' equity.* The balance sheet is also known as the *statement of financial position.*
25. The **statement of cash flows** focuses on the business's goal of liquidity and contains much information not found in the other three financial statements. It discloses the cash flows that result from the business's operating, investing, and financing activities during the accounting period. **Cash flows** refer to the business's cash inflows and cash outflows. *Net cash flows* represent the difference between these inflows and outflows. The statement of cash flows indicates the net increase or decrease in cash produced during the period.

Objective 7: Explain how generally accepted accounting principles (GAAP) relate to financial statements and the independent CPA's report, and identify the organizations that influence GAAP.

26. **Generally accepted accounting principles (GAAP)** are the set of conventions, rules, and procedures that constitute acceptable accounting practice at a given time. The set of GAAP changes continually as business conditions change and practices improve.
27. The financial statements of publicly held corporations are audited (examined) by licensed professionals, called **certified public accountants (CPAs),** to ensure the quality of the statements. CPAs must be independent of their audit clients (without financial or other ties). On completing the **audit,** the CPA reports on whether the audited statements "present fairly, in all material respects" and are "in conformity with generally accepted accounting principles."
28. The **Public Company Accounting Oversight Board (PCAOB)** is a governmental body created by the Sarbanes-Oxley Act to regulate the accounting profession.
29. The **Financial Accounting Standards Board (FASB)** is the authoritative body for development of GAAP. This group is separate from the AICPA and issues *Statements of Financial Accounting Standards.*
30. The **American Institute of Certified Public Accountants (AICPA)** is the professional association of CPAs. Its senior technical committees help influence accounting practice.
31. The **Securities and Exchange Commission (SEC)** is an agency of the federal government. It has the legal power to set and enforce accounting practices for companies whose securities are traded by the general public.
32. The **Governmental Accounting Standards Board (GASB)** was established in 1984 and is responsible for issuing accounting standards for state and local governments.
33. The **International Accounting Standards Board (IASB)** is responsible for developing international accounting standards used in many countries throughout the world.
34. The **Internal Revenue Service (IRS)** enforces and interprets the set of rules governing the assessment and collection of federal income taxes.
35. Ethics is a code of conduct that applies to everyday life. **Professional ethics** is the application of a code of conduct to the practice of a profession. The accounting profession has developed such a code, intended to guide the accountant in carrying out his or her responsibilities to the public. In short, the accountant must act with integrity, objectivity, independence, and due care.
    a. **Integrity** means that the accountant is honest, regardless of consequences.
    b. **Objectivity** means that the accountant is impartial in performing his or her job.
    c. **Independence** is the avoidance of all relationships that impair or appear to impair the objectivity of the accountant, such as owning stock in a company he or she is auditing.
    d. **Due care** means carrying out one's responsibilities with competence and diligence.
36. The **Institute of Management Accountants (IMA)** has adopted a code of professional conduct for management accountants. This code emphasizes that management accountants have responsibilities in the areas of competence, confidentiality, integrity, and objectivity.
37. The much-publicized financial scandals of some major U.S. corporations have highlighted the importance of **corporate governance,** or the oversight of a corporation's management and ethics by its board of directors. To strengthen corporate governance, the Sarbanes-Oxley Act requires all public corporations to establish an **audit committee,** which is the front line of defense against fraudulent financial reporting. One of the audit committee's functions is to engage independent auditors and review their work.

38. Ratios are used to compare a company's financial performance from one year to the next and to make comparisons among companies. One such ratio is the **return on assets,** which shows how efficiently a company is using its assets to produce income. Expressed as a percentage, it equals net income divided by average total assets.

SELF-TEST

Test your knowledge of the chapter by choosing the best answer for each item below.

1. Which of the following is an example of an exchange of value?
   a. Collection from a customer
   b. Loss from fire
   c. Accumulation of interest
   d. Loss from theft
2. Which of the following groups uses accounting information for planning a company's profitability and liquidity?
   a. Management
   b. Investors
   c. Creditors
   d. Economic planners
3. Economic events that affect the financial position of a business are called
   a. separate entities.
   b. business transactions.
   c. money measures.
   d. financial actions.
4. For legal purposes, which of the following forms of business organization is (are) treated as a separate economic unit from its owner(s)?
   a. Sole proprietorship
   b. Corporation
   c. Partnership
   d. All of the above
5. If a company has liabilities of $20,000 and owner's equity of $37,000, its assets are
   a. $38,000.
   b. $76,000.
   c. $57,000.
   d. $19,000.
6. Revenues and withdrawals appear, respectively, on the
   a. balance sheet and income statement.
   b. income statement and balance sheet.
   c. statement of owner's equity and balance sheet.
   d. income statement and statement of owner's equity.
7. Generally accepted accounting principles
   a. define accounting practice at a point in time.
   b. are similar in nature to the principles of chemistry or physics.
   c. rarely change.
   d. are not affected by changes in the ways businesses operate.

8. Independence is an important characteristic of which of the following in performing audits of financial statements?
   a. Governmental accountants
   b. Certified management accountants
   c. Certified public accountants
   d. Accounting educators
9. All of the following are considered basic management functions *except*
   a. Producing goods and services
   b. Financing the business
   c. Managing employees
   d. Electing the board of directors
10. The purchase of land would appear within which section, if any, of the statement of cash flows?
   a. Operating activities
   b. Investing activities
   c. Financing activities
   d. It would not appear in the statement of cash flows.

TESTING YOUR KNOWLEDGE

Matching*

Match each term with its definition by writing the appropriate letter in the blank.

1. _____Accounting
2. _____Bookkeeping
3. _____Computer
4. _____Management information system (MIS)
5. _____Management accounting
6. _____Financial accounting
7. _____Accounting equation
8. _____Withdrawals
9. _____Certified public accountant (CPA)
10. _____Sole proprietorship
11. _____Partnership
12. _____Corporation
13. _____Generally accepted accounting principles (GAAP)
14. _____Balance sheet
15. _____Income statement
16. _____Statement of owner’s equity
17. _____Statement of cash flows

a. The value of one currency in terms of another
b. A business owned by stockholders but managed by a board of directors
c. Assets taken from the business by the owner for personal use
d. The concept that all business transactions should be measured in terms of money
e. The statement that shows the financial position of a company on a certain date
f. The repetitive recordkeeping process
g. An economic resource of a business
h. An information system that measures, processes, and communicates economic information
i. A business owned and managed by two or more persons
j. An expert accountant licensed by the state

18. _____Separate entity
19. _____Money measure
20. _____Asset
21. _____Liability
22. _____Owner's equity
23. _____Audit
24. _____Sarbanes-Oxley Act
25. _____Exchange rate

k. An examination of a company's financial statements

l. The statement that shows a company's profit or loss over a certain period

m. The statement that discloses the operating, investing, and financing activities during a period

n. The branch of accounting concerned with providing external users with financial information needed to make decisions

o. An electronic tool that processes information with great speed

p. The balance sheet section that represents the owner's economic interest in a company

q. The statement that shows the changes in the owner's Capital account during the period

r. An information network that links a company's functions

s. Assets = Liabilities + Owner's Equity

t. The accounting concept that treats a business as distinct from its owners, creditors, and customers

u. The guidelines that define acceptable accounting practice at a given point in time

v. A business owned and managed by one person

w. The branch of accounting concerned with providing managers with financial information needed to make decisions

x. Legislation that regulates financial reporting and the accounting profession

y. A debt of a business

**Note to student:* The matching quiz might be completed more efficiently by starting with the definition and searching for the corresponding term.

Short Answer

Use the lines provided to answer each item.

1. On the lines that follow, insert the correct heading for the annual income statement of Tolan Company on July 31, 20xx.

___

___

___

2. Briefly distinguish between *bookkeeping* and *accounting*.

___

___

___

3. Briefly define the terms below, all of which relate to the accountant's Code of Professional Conduct.

   a. Integrity ___

   ___

   b. Objectivity ___

   ___

   c. Independence ___

   ___

   d. Due care ___

   ___

4. What three broad groups use accounting information?

___

___

___

5. What two objectives must be met for a company to survive?

___

___

6. List the four principal financial statements and briefly state the purpose of each.

Statement

   a. ___

   b. ___

   c. ___

   d. ___

Purpose

a. ____

____

b. ____

____

c. ____

____

d. ____

____

True-False

Circle T if the statement is true, F if it is false. Provide explanations for false answers, using the blank lines below.

1. T F Financial position can best be determined by referring to the balance sheet.
2. T F The IRS is responsible for interpreting and enforcing GAAP.
3. T F One form of the accounting equation is Assets – Liabilities = Owner's Equity.
4. T F Revenues have the effect of increasing owner's equity.
5. T F The existence of Accounts Receivable on the balance sheet indicates that the company has one or more creditors.
6. T F When expenses exceed revenues, a company has suffered a net loss.
7. T F The return on assets is expressed in terms of a dollar amount.
8. T F Withdrawals appear as a deduction on the income statement.
9. T F The current authoritative body dictating accounting practice is the PCAOB.
10. T F A sole proprietor is personally liable for all debts of the business.
11. T F The statement of cash flows would disclose whether or not land was purchased for cash during the period.
12. T F The statement of owner's equity links a company's income statement to its balance sheet.
13. T F The IASB is responsible for setting guidelines for state and local governments.
14. T F A corporation is managed directly by its stockholders.
15. T F Generally accepted accounting principles are not like laws of math and science; they are guidelines that define correct accounting practice at a given point in time.
16. T F Net assets equal assets plus liabilities.
17. T F The major sections of a balance sheet are assets, liabilities, owner's equity, revenues, and expenses.
18. T F A business transaction must always involve an exchange of money.

19. T F A management information system deals not only with accounting, but with other activities of a business as well.
20. T F The income statement is generally considered to be the most important financial statement.
21. T F A business should be understood as an entity that is separate and distinct from its owners, customers, and creditors.
22. T F Economic planners are accounting information users with a direct financial interest.
23. T F The essence of an asset is that it is expected to benefit future operations.
24. T F Cash flow is a measure of profitability.
25. T F Violation of the Sarbanes-Oxley Act can result in criminal penalties.
26. T F Investments of assets into a business by its owner appear in the statement of cash flows as an investing activity.

Multiple Choice

Circle the letter of the best answer.

1. Which of the following accounts would *not* appear on the balance sheet?
   a. Utilities Expense
   b. Charles Mason, Capital
   c. Accounts Receivable
   d. Wages Payable
2. Companies whose stock is publicly traded must file financial statements with the
   a. FASB.
   b. GASB.
   c. SEC.
   d. AICPA.
3. One characteristic of a corporation is
   a. unlimited liability of its owners.
   b. the ease with which ownership is transferred.
   c. ownership by the board of directors.
   d. dissolution upon the death of an owner.
4. Which of the following statements does *not* involve a distinct period of time?
   a. Income statement
   b. Balance sheet
   c. Statement of cash flows
   d. Statement of owner's equity
5. The principal purpose of an audit by a CPA is to
   a. express an opinion on the fairness of a company's financial statements.
   b. detect fraud by a company's employees.
   c. prepare the company's financial statements.
   d. assure investors that the company will be profitable in the future.
6. The intentional preparation of fraudulent financial statements can result from all of the following *except*
   a. fictitious sales or order.
   b. the manipulation of inventory records.
   c. recording an expense that has been incurred but not yet paid.
   d. the misapplication of accounting principles.
7. In a partnership,
   a. profits are always divided equally among partners.
   b. management consists of the board of directors.
   c. no partner is liable for more than a proportion of the company's debts.
   d. dissolution results when any partner leaves the partnership.
8. Which of the following is *not* a major heading on a balance sheet or income statement?
   a. Accounts receivable
   b. Owner's equity
   c. Liabilities
   d. Revenues

9. Which of the following is *not* an activity listed on the statement of cash flows?
   a. Investing activities
   b. Funding activities
   c. Operating activities
   d. Financing activities
10. Which of the following transactions does *not* involve an exchange of value?
    a. Purchase of land on credit
    b. The sale of goods and services
    c. The wear and tear on equipment
    d. Payment on a loan

APPLYING YOUR KNOWLEDGE

Exercises

1. Pacific Enterprises, a publicly held corporation, always publishes annual financial statements. This year, however, it has suffered a very large loss, and it therefore would like to limit access to its financial statements. Why might each of the following insist on seeing Pacific's financial statements?
   a. Potential investors in Pacific
   b. The Securities and Exchange Commission
   c. The bank, which is considering a loan request by Pacific
   d. Present stockholders of Pacific
   e. Pacific's management
2. Indian Ridge Company had assets of $120,000 and liabilities of $80,000 at the beginning of the year. During the year assets decreased by $15,000 and owner's equity increased by $10,000. What is the amount of liabilities at year end? (*Hint:* Try using the accounting equation to solve this one.)

   $_______________

3. Following are the accounts of Philo's TV Repair Company as of December 31, 20xx:

Accounts Payable	$ 1,300
Accounts Receivable	1,500
Buildings	8,000
Cash	?
P. Farnsworth, Capital	17,500
Equipment	850
Land	1,000
Truck	4,500

Using this information, prepare a balance sheet *in good form*. (You must derive the dollar amount for Cash.)

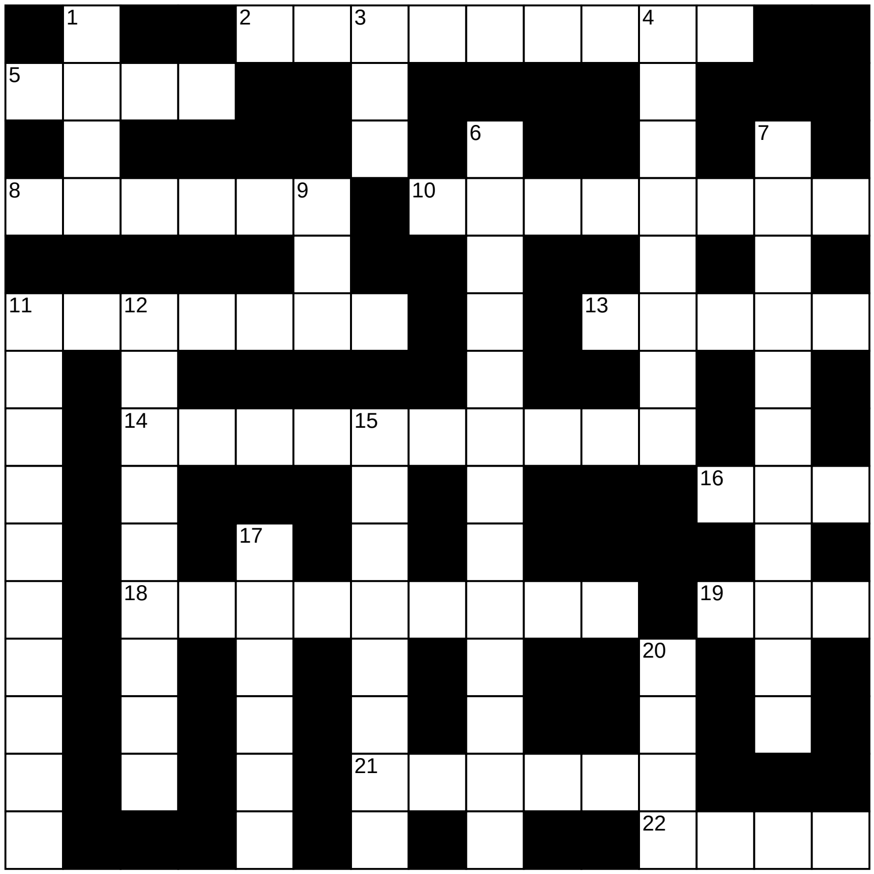
Philo's TV Repair Company
Balance Sheet
December 31, 20xx

Assets

Liabilities

Owner's Equity

Crossword Puzzle: Chapter 1



ACROSS

2 Accounting mainly for external use
5 _____ of professional ethics
8 Economic resources of a company
10 One to whom another is indebted
11 _____ sheet
13 Professional organization of accountants
14 The "A" in FASB
16 IRS's concern
18 Measure of debt-paying ability
19 Data-generating network
21 Separate _____ concept
22 _____ proprietorship

DOWN

1 See 3-Down
3 With 1-Down, income statement measure
4 Independent CPA activity
6 Measure of business performance
7 Form of business organization
9 Regulatory agency of publicly held corporations
11 Recorder of business transactions
12 Debt of a company
15 Impartial
17 Ownership in a company
20 Settles an account payable