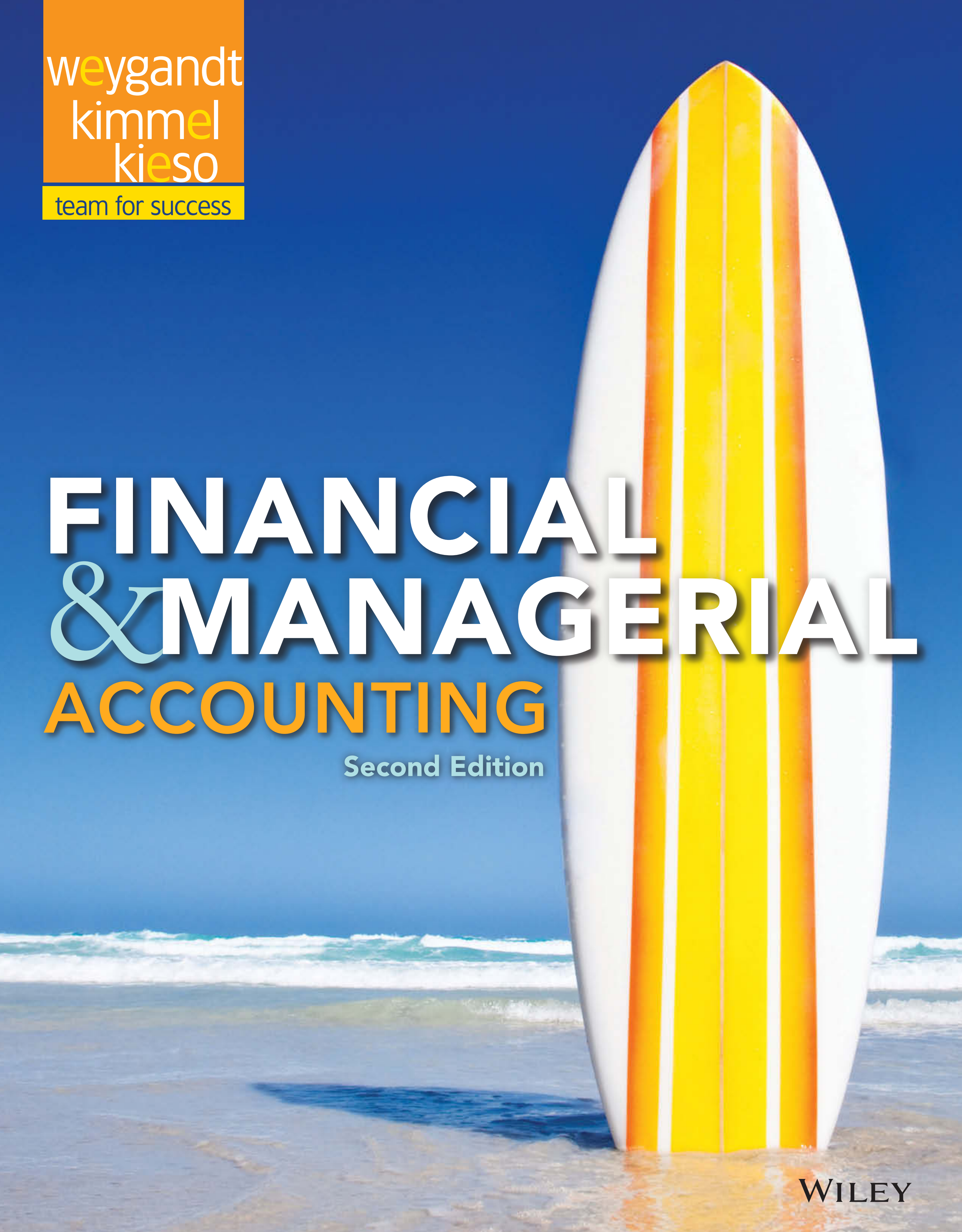

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FINANCIAL & MANAGERIAL ACCOUNTING

Second Edition

WILEY

ACCOUNT CLASSIFICATION AND PRESENTATION			
Account Title	**Classification**	**Financial Statement**	**Normal Balance**
A			
Accounts Payable	Current Liability	Balance Sheet	Credit
Accounts Receivable	Current Asset	Balance Sheet	Debit
Accumulated Depreciation—Buildings	Plant Asset—Contra	Balance Sheet	Credit
Accumulated Depreciation—Equipment	Plant Asset—Contra	Balance Sheet	Credit
Administrative Expenses	Operating Expense	Income Statement	Debit
Advertising Expense	Operating Expense	Income Statement	Debit
Allowance for Doubtful Accounts	Current Asset—Contra	Balance Sheet	Credit
Amortization Expense	Operating Expense	Income Statement	Debit
B			
Bad Debt Expense	Operating Expense	Income Statement	Debit
Bonds Payable	Long-Term Liability	Balance Sheet	Credit
Buildings	Plant Asset	Balance Sheet	Debit
C			
Cash	Current Asset	Balance Sheet	Debit
Common Stock	Stockholders' Equity	Balance Sheet	Credit
Copyrights	Intangible Asset	Balance Sheet	Debit
Cost of Goods Sold	Cost of Goods Sold	Income Statement	Debit
D			
Debt Investments	Current Asset/Long-Term Investment	Balance Sheet	Debit
Depreciation Expense	Operating Expense	Income Statement	Debit
Discount on Bonds Payable	Long-Term Liability—Contra	Balance Sheet	Debit
Dividend Revenue	Other Income	Income Statement	Credit
Dividends	Temporary account closed to Retained Earnings	Retained Earnings Statement	Debit
Dividends Payable	Current Liability	Balance Sheet	Credit
E			
Equipment	Plant Asset	Balance Sheet	Debit
F			
Freight-Out	Operating Expense	Income Statement	Debit
G			
Gain on Disposal of Plant Assets	Other Income	Income Statement	Credit
Goodwill	Intangible Asset	Balance Sheet	Debit
I			
Income Summary	Temporary account closed to Retained Earnings	Not Applicable	(1)
Income Tax Expense	Income Tax Expense	Income Statement	Debit
Income Taxes Payable	Current Liability	Balance Sheet	Credit
Insurance Expense	Operating Expense	Income Statement	Debit
Interest Expense	Other Expense	Income Statement	Debit
Interest Payable	Current Liability	Balance Sheet	Credit
Interest Receivable	Current Asset	Balance Sheet	Debit
Interest Revenue	Other Income	Income Statement	Credit
Inventory	Current Asset	Balance Sheet (2)	Debit

Account Title	Classification	Financial Statement	Normal Balance
L			
Land	Plant Asset	Balance Sheet	Debit
Loss on Disposal of Plant Assets	Other Expense	Income Statement	Debit
M			
Maintenance and Repairs Expense	Operating Expense	Income Statement	Debit
Mortgage Payable	Long-Term Liability	Balance Sheet	Credit
N			
Notes Payable	Current Liability/ Long-Term Liability	Balance Sheet	Credit
P			
Patents	Intangible Asset	Balance Sheet	Debit
Paid-in Capital in Excess of Par—Common Stock	Stockholders' Equity	Balance Sheet	Credit
Paid-in Capital in Excess of Par—Preferred Stock	Stockholders' Equity	Balance Sheet	Credit
Preferred Stock	Stockholders' Equity	Balance Sheet	Credit
Premium on Bonds Payable	Long-Term Liability—Adjunct	Balance Sheet	Credit
Prepaid Insurance	Current Asset	Balance Sheet	Debit
R			
Rent Expense	Operating Expense	Income Statement	Debit
Retained Earnings	Stockholders' Equity	Balance Sheet and Retained Earnings Statement	Credit
S			
Salaries and Wages Expense	Operating Expense	Income Statement	Debit
Salaries and Wages Payable	Current Liability	Balance Sheet	Credit
Sales Discounts	Revenue—Contra	Income Statement	Debit
Sales Returns and Allowances	Revenue—Contra	Income Statement	Debit
Sales Revenue	Revenue	Income Statement	Credit
Selling Expenses	Operating Expense	Income Statement	Debit
Service Revenue	Revenue	Income Statement	Credit
Short-Term Investments	Current Asset	Balance Sheet	Debit
Stock Investments	Current Asset/Long-Term Investment	Balance Sheet	Debit
Supplies	Current Asset	Balance Sheet	Debit
Supplies Expense	Operating Expense	Income Statement	Debit
T			
Treasury Stock	Stockholders' Equity	Balance Sheet	Debit
U			
Unearned Service Revenue	Current Liability	Balance Sheet	Credit
Utilities Expense	Operating Expense	Income Statement	Debit

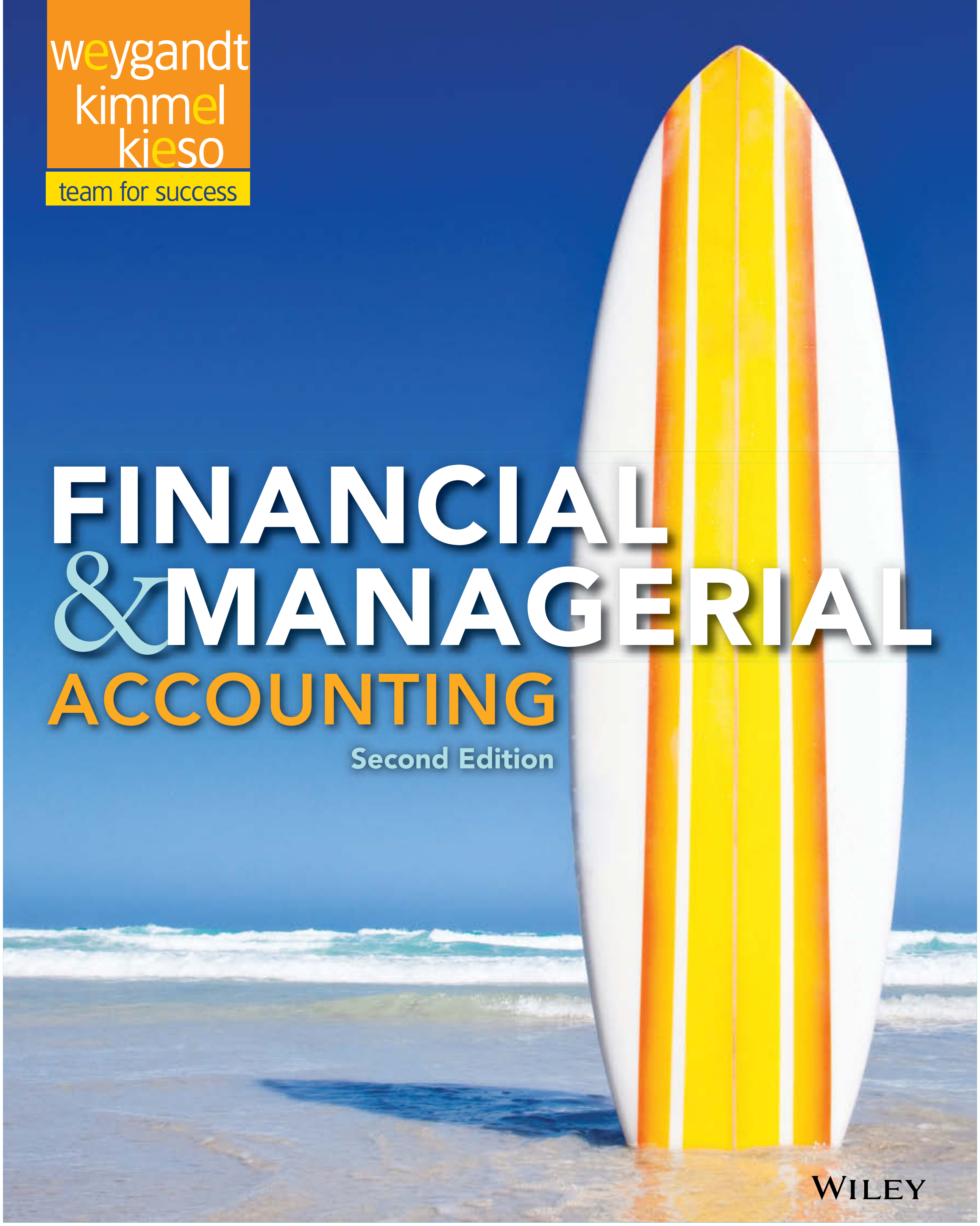
(1) The normal balance for Income Summary will be credit when there is a net income, debit when there is a net loss. The Income Summary account does not appear on any financial statement.

(2) If a periodic system is used, Inventory also appears on the income statement in the calculation of cost of goods sold.

The following is a sample chart of accounts. It does not represent a comprehensive chart of all the accounts used in this textbook but rather those accounts that are commonly used. This sample chart of accounts is for a company that generates both service revenue as well as sales revenue. It uses the perpetual approach to inventory. If a periodic system was used, the following temporary accounts would be needed to record inventory purchases: Purchases, Freight-In, Purchase Returns and Allowances, and Purchase Discounts.

CHART OF ACCOUNTS

Assets	Liabilities	Stockholders' Equity	Revenues	Expenses
Cash	Notes Payable	Common Stock	Service Revenue	Administrative Expenses
Accounts Receivable	Accounts Payable	Paid-in Capital in Excess of Par—Common Stock	Sales Revenue	Amortization Expense
Allowance for Doubtful Accounts	Unearned Service Revenue	Preferred Stock	Sales Discounts	Bad Debt Expense
Interest Receivable	Salaries and Wages Payable	Paid-in Capital in Excess of Par—Preferred Stock	Sales Returns and Allowances	Cost of Goods Sold
Inventory	Interest Payable	Treasury Stock	Interest Revenue	Depreciation Expense
Supplies	Dividends Payable	Retained Earnings	Gain on Disposal of Plant Assets	Freight-Out
Prepaid Insurance	Income Taxes Payable	Dividends		Income Tax Expense
Land	Bonds Payable	Income Summary		Insurance Expense
Equipment	Discount on Bonds Payable			Interest Expense
Accumulated Depreciation—Equipment	Premium on Bonds Payable			Loss on Disposal of Plant Assets
Buildings	Mortgage Payable			Maintenance and Repairs Expense
Accumulated Depreciation—Buildings				Rent Expense
Copyrights				Salaries and Wages Expense
Goodwill				Selling Expenses
Patents				Supplies Expense
				Utilities Expense



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Brief Contents

*Available at the book's companion website, **www.wiley.com/college/weygandt**.

From the Authors

Dear Student,

Why This Course? *Remember your biology course in high school? Did you have one of those "invisible man" models (or maybe something more high-tech than that) that gave you the opportunity to look "inside" the human body? This accounting course offers something similar. To understand a business, you have to understand the financial insides of a business organization. An accounting course will help you understand the essential financial components of businesses. Whether you are looking at a large multinational company like Apple or Starbucks or a single-owner software consulting business or coffee shop, knowing the fundamentals of accounting will help you understand what is happening. As an employee, a manager, an investor, a business owner, or a director of your own personal finances—any of which roles you will have at some point in your life—you will make better decisions for having taken this course.*

> "Whether you are looking at a large multinational company like Apple or Starbucks or a single-owner software consulting business or coffee shop, knowing the fundamentals of accounting will help you understand what is happening."

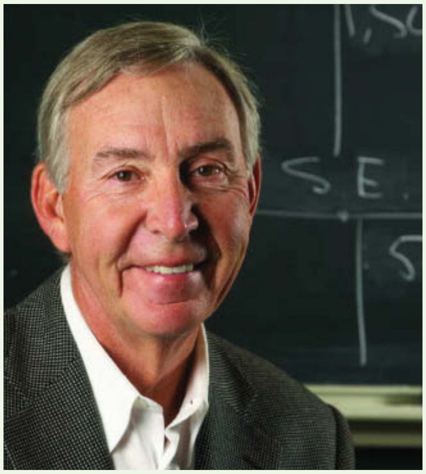
Why This Book? *Hundreds of thousands of students have used this textbook. Your instructor has chosen it for you because of its trusted reputation. The authors have worked hard to keep the book fresh, timely, and accurate.*

How to Succeed? *We've asked many students and many instructors whether there is a secret for success in this course. The nearly unanimous answer turns out to be not much of a secret: "Do the homework." This is one course where doing is learning. The more time you spend on the homework assignments—using the various tools that this textbook provides—the more likely you are to learn the essential concepts, techniques, and methods of accounting. Besides the textbook itself, WileyPLUS and the book's companion website also offers various support resources.*

Good luck in this course. We hope you enjoy the experience and that you put to good use throughout a lifetime of success the knowledge you obtain in this course. We are sure you will not be disappointed.

Jerry J. Weygandt
Paul D. Kimmel
Donald E. Kieso

Author **Commitment**



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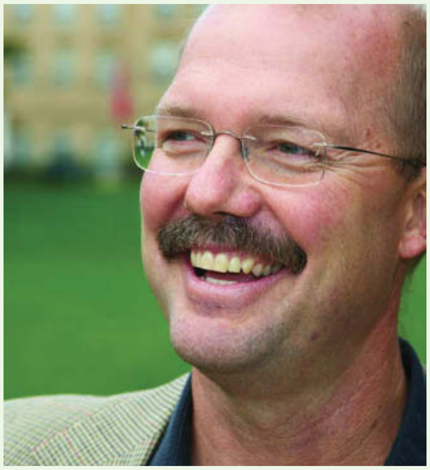

Paul Kimmel

PAUL D. KIMMEL, PhD, CPA, received his bachelor's degree from the University of Minnesota and his doctorate in accounting from the University of Wisconsin. He is an Associate Professor at the University of Wisconsin—Milwaukee, and has public accounting experience with Deloitte & Touche (Minneapolis). He was the recipient of the UWM School of Business Advisory Council Teaching Award, the Reggie Taite Excellence in Teaching Award and a three-time winner of the Outstanding Teaching Assistant Award at the University of Wisconsin. He is also a recipient of the Elijah Watts Sells Award for Honorary Distinction for his results on the CPA exam. He is a member of the American Accounting Association and the Institute of Management Accountants and has published articles in *Accounting Review, Accounting Horizons, Advances in Management Accounting, Managerial Finance, Issues in Accounting Education, Journal of Accounting Education,* as well as other journals. His research interests include accounting for financial instruments and innovation in accounting education. He has published papers and given numerous talks on incorporating critical thinking into accounting education, and helped prepare a catalog of critical thinking resources for the Federated Schools of Accountancy.

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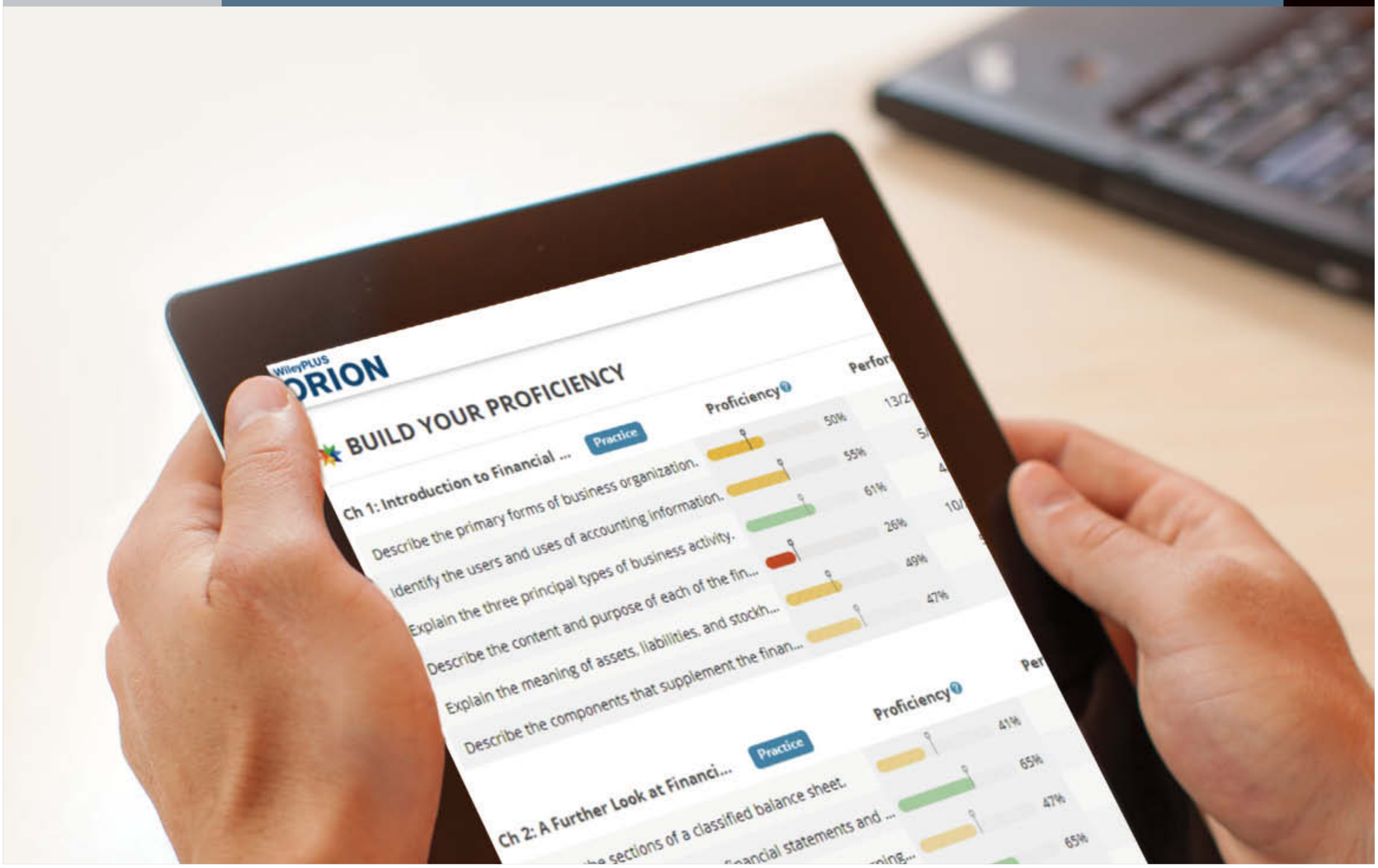
Practice Made Simple

The Team for Success is focused on helping students get the most out of their accounting course by **making practice simple**. Both in the printed text and the online environment of *WileyPLUS*, new opportunities for self-guided practice allow students to check their knowledge of accounting concepts, skills, and problem-solving techniques as they receive individual feedback at the question, learning objective, and course level.

Personalized Practice

Based on cognitive science, **WileyPLUS with ORION** is a personalized, adaptive learning experience that gives students the practice they need to build proficiency on topics while using their study time most effectively. The adaptive engine is powered by hundreds of unique questions per chapter, giving students endless opportunities for practice throughout the course.



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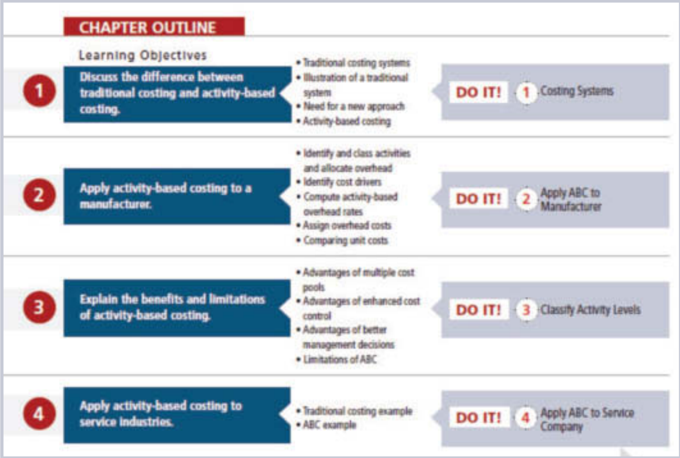
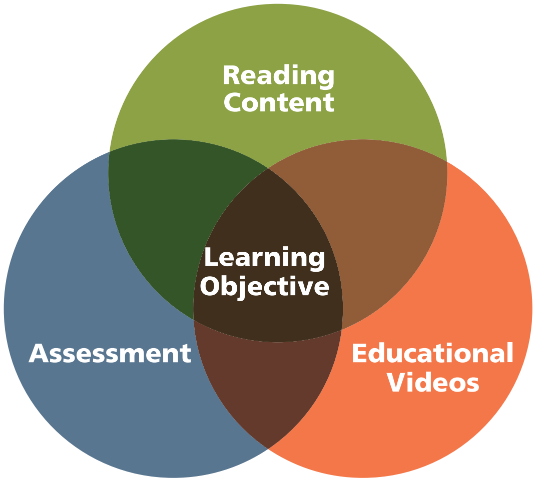
Streamlined Learning Objectives

Newly streamlined learning objectives help students make the best use of their time outside of class. Each learning objective is addressed by reading content, answering a variety of practice and assessment questions, and watching educational videos, so that no matter where students begin their work, the relevant resources and practice are readily accessible.


CHAPTER OUTLINE

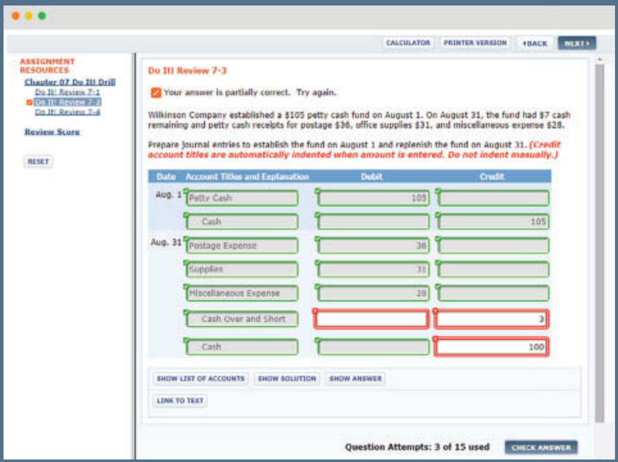
Learning Objectives

1 Discuss the difference between traditional costing and activity-based costing.	• Traditional costing systems • Illustration of a traditional system • Need for a new approach • Activity-based costing	DO IT! 1 Costing Systems
2 Apply activity-based costing to a manufacturer.	• Identify and class activities and allocate overhead • Identify cost drivers • Compute activity-based overhead rates • Assign overhead costs • Comparing unit costs	DO IT! 2 Apply ABC to Manufacturer
3 Explain the benefits and limitations of activity-based costing.	• Advantages of multiple cost pools • Advantages of enhanced cost control • Advantages of better management decisions • Limitations of ABC	DO IT! 3 Classify Activity Levels
4 Apply activity-based costing to service industries.	• Traditional costing example • ABC example	DO IT! 4 Apply ABC to Service Company



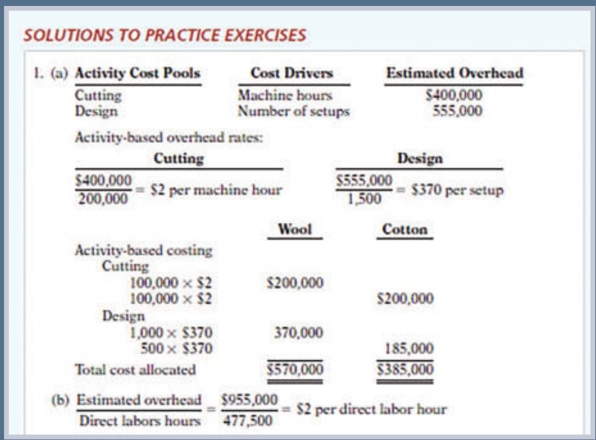
Review and Practice

A new section in the text and in **WileyPLUS** offers students more opportunities for self-guided practice.



In the text, the new Review and Practice section includes:

- Learning Objectives Review
- Glossary Review
- Practice Multiple-Choice Questions and Solutions
- Practice Exercises and Solutions
- Practice Problem and Solution


SOLUTIONS TO PRACTICE EXERCISES

1. (a)

Activity Cost Pools	Cost Drivers	Estimated Overhead
Cutting	Machine hours	$400,000
Design	Number of setups	555,000

Activity-based overhead rates:

Cutting: $\frac{\$400,000}{200,000} = \$2$ per machine hour

Design: $\frac{\$555,000}{1,500} = \$370$ per setup

	Wool	Cotton
Activity-based costing		
Cutting		
100,000 × $2	$200,000	
100,000 × $2		$200,000
Design		
1,000 × $370	370,000	
500 × $370		185,000
Total cost allocated	$570,000	$385,000

(b) $\frac{\text{Estimated overhead}}{\text{Direct labors hours}} = \frac{\$955,000}{477,500} = \$2$ per direct labor hour

In **WileyPLUS**, the new practice assignments include several Do ITs, Brief Exercises, Exercises, and Problems, giving students the opportunity to check their work or see the answer and solution after their final attempt.

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What's New?

WileyPLUS with ORION

Over 5,500 new questions are available for practice and review. WileyPLUS with Orion is an adaptive study and practice tool that helps students build proficiency in course topics.

Updated Content and Design

We scrutinized all chapter material to find new ways to engage students and help them learn accounting concepts. Homework problems were updated in all chapters.

A new learning objective structure helps students practice their understanding of concepts with DO IT! exercises before they move on to different topics in other learning objectives. Coupled with a new interior design and revised infographics, the new outcomes-oriented approach motivates students and helps them make the best use of their time.

WileyPLUS Videos

Over 250 videos are available in WileyPLUS. More than 80 of the videos are new to the Second Edition. The videos walk students through relevant homework problems and solutions, review important concepts, provide overviews of Excel skills, and explore topics in a real-world context.

Student Practice and Solutions

New practice opportunities with solutions are integrated throughout the textbook and WileyPLUS course. Each textbook chapter now provides students with a **Review and Practice** section that includes learning objective summaries, multiple-choice questions with feedback for each answer choice, and both practice exercises and problems with solutions. Also, each learning objective module in the textbook is now followed by a DO IT! exercise with an accompanying solution.

In **WileyPLUS**, two brief exercises, two DO IT! exercises, two exercises, and a new problem are available for practice with each chapter. These new practice questions are algorithmic, providing students with multiple opportunities for advanced practice.

Real World Context

We expanded our practice of using numerous examples of real companies throughout the textbook. For example, new feature stories highlight operations of Clif Bar, Groupon, and REI. Also, new financial reporting problems in each chapter require students to analyze the financial statements of Apple, Wal-Mart, Louis Vuitton, and Amazon.com. Finally, in WileyPLUS, real-world Insight boxes now have questions that can be assigned as homework.

Excel

New Excel skill videos help students understand Excel features they can apply in their accounting studies. A new continuing Excel tutorial is also available at the end of each managerial accounting chapter.

More information about the Second Edition is available on the book's website at **www.wiley.com/college/weygandt**.

Table of Contents

*Available online at **www.wiley.com/college/weygandt.**

Acknowledgments

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1 Accounting in Action

*The **Chapter Preview** describes the purpose of the chapter and highlights major topics.*

CHAPTER PREVIEW The Feature Story below about Clif Bar & Company highlights the importance of having good financial information and knowing how to use it to make effective business decisions. Whatever your pursuits or occupation, the need for financial information is inescapable. You cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or dispensing financial information. Good decision-making depends on good information. The purpose of this chapter is to show you that accounting is the system used to provide useful financial information.

*The **Feature Story** helps you picture how the chapter topic relates to the real world of accounting and business.*

FEATURE STORY

Knowing the Numbers

Many students who take this course do not plan to be accountants. If you are in that group, you might be thinking, "If I'm not going to be an accountant, why do I need to know accounting?" Well, consider this quote from Harold Geneen, the former chairman of IT&T: "To be good at your business, you have to know the numbers—cold." In business, accounting and financial statements are the means for communicating the numbers. If you don't know how to read financial statements, you can't really know your business.

Many businesses agree with this view. They see the value of their employees being able to read financial statements and understand how their actions affect the company's financial results. For example, consider Clif Bar & Company. The original Clif Bar® energy bar was created in 1990 by Gary Erickson and his mother in her kitchen. Today, the company has almost 300 employees.

Clif Bar is guided by what it calls its Five Aspirations—Sustaining Our Business, Our Brands, Our People, Our Community, and the Planet. Its website documents its efforts and accomplishments in these five areas. Just a few examples include the company's use of organic products to protect soil, water, and biodiversity; the "smart" solar array (the largest in North America), which provides nearly all the electrical needs for its 115,000-square foot building; and the incentives Clif Bar provides to employees to reduce their personal environmental impact, such as $6,500 toward the purchase of an efficient car or $1,000 per year for eco-friendly improvements toward their homes.

One of the company's proudest moments was the creation of an employee stock ownership plan (ESOP) in 2010. This plan gives its employees 20% ownership of the company (Gary and his wife Kit own the other 80%). The ESOP also resulted in Clif Bar enacting an open-book management program, including the commitment to educate all employee-owners about its finances. Armed with this basic financial knowledge, employees are more aware of the financial impact of their actions, which leads to better decisions.

Many other companies have adopted this open-book management approach. But even in companies that do not practice open-book management, employers generally assume that managers in all areas of the company are "financially literate."

Taking this course will go a long way to making you financially literate. In this textbook, you will learn how to read and prepare financial statements, and how to use basic tools to evaluate financial results. Throughout this textbook, we attempt to increase your familiarity with financial reporting by providing numerous references, questions, and exercises that encourage you to explore the financial statements of well-known companies.

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CHAPTER OUTLINE

*The **Chapter Outline** presents the chapter's topics and subtopics, as well as practice opportunities.*

Learning Objectives

	Learning Objectives	Topics	Practice
1	**Identify the activities and users associated with accounting.**	• Three activities • Accounting data users	**DO IT!** 1 Basic Concepts
2	**Explain the building blocks of accounting: ethics, principles, and assumptions.**	• Ethics • GAAP • Measurement principles • Assumptions	**DO IT!** 2 Building Blocks of Accounting
3	**State the accounting equation, and define its components.**	• Assets • Liabilities • Stockholders' equity	**DO IT!** 3 Stockholders' Equity Effects
4	**Analyze the effects of business transactions on the accounting equation.**	• Transaction analysis • Summary of transactions	**DO IT!** 4 Tabular Analysis
5	**Describe the four financial statements and how they are prepared.**	• Income statement • Retained earnings statement • Balance sheet • Statement of cash flows	**DO IT!** 5 Financial Statement Items

Go to the ***REVIEW AND PRACTICE*** section at the end of the chapter for a review of key concepts and practice applications with solutions.

Visit **WileyPLUS with ORION** for additional tutorials and practice opportunities.

LEARNING OBJECTIVE 1

Identify the activities and users associated with accounting.

Essential terms are printed in blue when they first appear, and are defined in the end-of-chapter ***Glossary Review.***

What consistently ranks as one of the top career opportunities in business? What frequently rates among the most popular majors on campus? What was the undergraduate degree chosen by Nike founder Phil Knight, Home Depot co-founder Arthur Blank, former acting director of the Federal Bureau of Investigation (FBI) Thomas Pickard, and numerous members of Congress? Accounting.[1] Why did these people choose accounting? They wanted to understand what was happening financially to their organizations. Accounting is the financial information system that provides these insights. In short, to understand your organization, you have to know the numbers.

Accounting consists of three basic activities—it **identifies**, **records**, and **communicates** the economic events of an organization to interested users. Let's take a closer look at these three activities.

Three Activities

As a starting point to the accounting process, a company **identifies** the **economic events relevant to its business**. Examples of economic events are the sale of snack chips by PepsiCo, the provision of telephone services by AT&T, and the payment of wages by Facebook.

Once a company like PepsiCo identifies economic events, it **records** those events in order to provide a history of its financial activities. Recording consists of keeping a **systematic**, **chronological diary of events**, measured in dollars and cents. In recording, PepsiCo also classifies and summarizes economic events.

Finally, PepsiCo **communicates** the collected information to interested users by means of **accounting reports**. The most common of these reports are called **financial statements**. To make the reported financial information meaningful, PepsiCo reports the recorded data in a standardized way. It accumulates information resulting from similar transactions. For example, PepsiCo accumulates all sales transactions over a certain period of time and reports the data as one amount in the company's financial statements. Such data are said to be reported **in the aggregate**. By presenting the recorded data in the aggregate, the accounting process simplifies a multitude of transactions and makes a series of activities understandable and meaningful.

A vital element in communicating economic events is the accountant's ability to **analyze and interpret** the reported information. Analysis involves use of ratios, percentages, graphs, and charts to highlight significant financial trends and relationships. Interpretation involves **explaining the uses**, **meaning**, **and limitations of reported data**. Appendices A–E show the financial statements of Apple Inc., PepsiCo, Inc., The Coca-Cola Company, Amazon.com, Inc., and Wal-Mart Stores, Inc., respectively. (In addition, in the *A Look at IFRS* section at the end of each chapter, the French company Louis Vuitton Moët Hennessy is analyzed.) We refer to these statements at various places throughout the textbook. At this point, these financial statements probably strike you as complex and confusing. By the end of this course, you'll be surprised at your ability to understand, analyze, and interpret them.

Illustration 1-1 summarizes the activities of the accounting process.

[1]The appendix to this chapter describes job opportunities for accounting majors and explains why accounting is such a popular major.

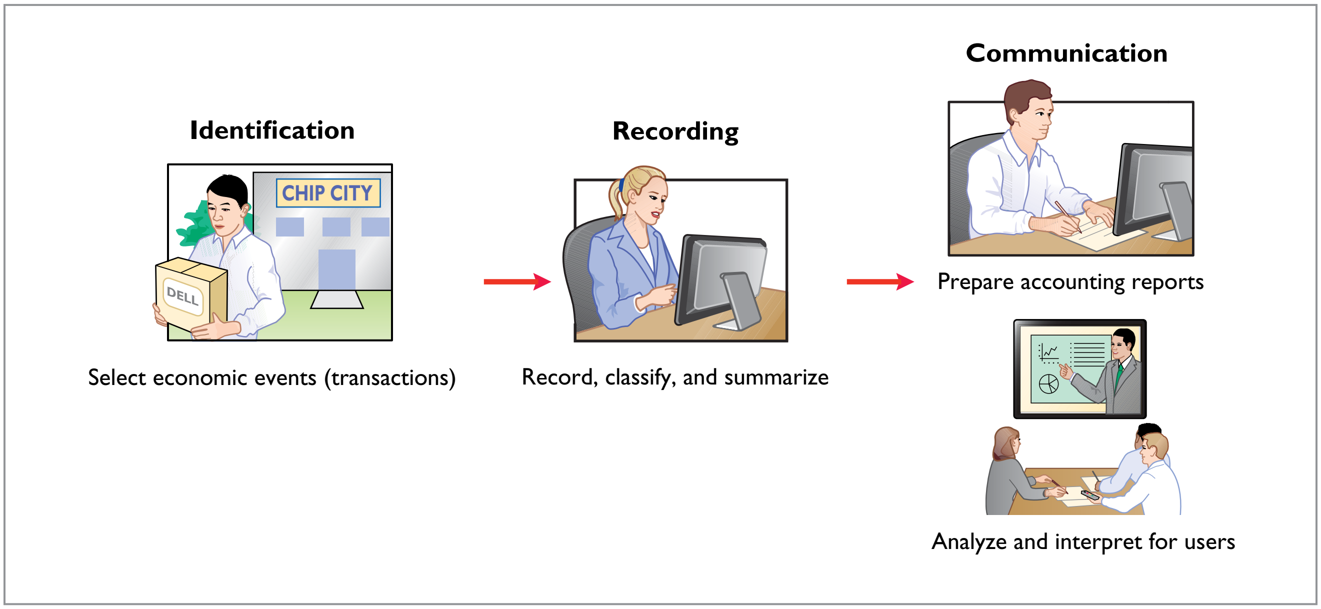


Illustration 1-1
The activities of the accounting process

You should understand that the accounting process **includes** the bookkeeping function. **Bookkeeping** usually involves **only** the recording of economic events. It is therefore just one part of the accounting process. In total, accounting involves **the entire process of identifying, recording, and communicating economic events**.[2]

Who Uses Accounting Data

The financial information that users need depends upon the kinds of decisions they make. There are two broad groups of users of financial information: internal users and external users.

INTERNAL USERS

Internal users of accounting information are managers who plan, organize, and run the business. These include marketing managers, production supervisors, finance directors, and company officers. In running a business, internal users must answer many important questions, as shown in Illustration 1-2.

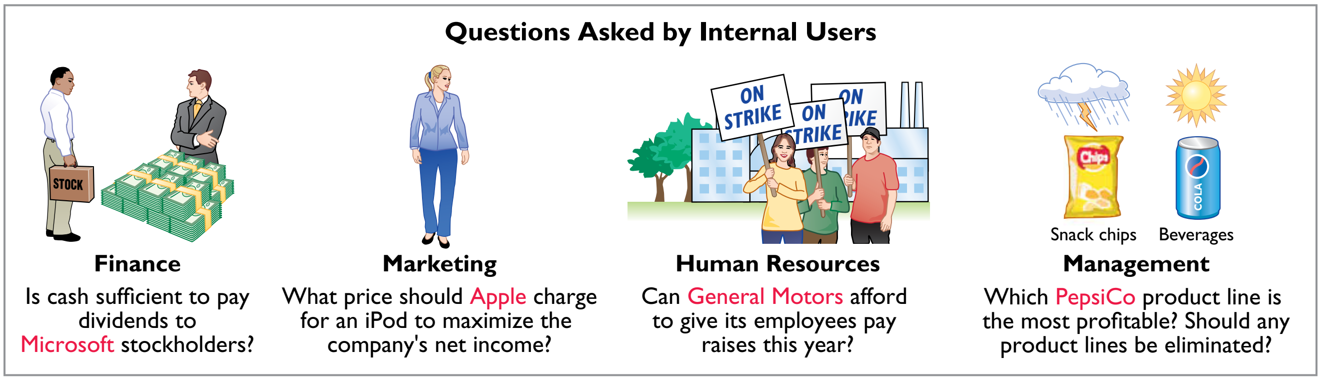


Illustration 1-2
Questions that internal users ask

[2]The origins of accounting are generally attributed to the work of Luca Pacioli, an Italian Renaissance mathematician. Pacioli was a close friend and tutor to Leonardo da Vinci and a contemporary of Christopher Columbus. In his 1494 text *Summa de Arithmetica, Geometria, Proportione et Proportionalite*, Pacioli described a system to ensure that financial information was recorded efficiently and accurately.

To answer these and other questions, internal users need detailed information on a timely basis. **Managerial accounting** provides internal reports to help users make decisions about their companies. Examples are financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year.

Accounting Across the Organization Rhino Foods

© Agnieszka Pastuszak-Maksim/iStockphoto

The Scoop on Accounting

Accounting can serve as a useful recruiting tool even for the human resources department. Rhino Foods, located in Burlington, Vermont, is a manufacturer of specialty ice cream. Its corporate website includes the following:

"Wouldn't it be great to work where you were part of a team? Where your input and hard work made a difference? Where you weren't kept in the dark about what management was thinking? . . . Well—it's not a dream! It's the way we do business . . . Rhino Foods believes in family, honesty and open communication—we really care about and appreciate our employees—and it shows. Operating results are posted and monthly group meetings inform all employees about what's happening in the Company. Employees also share in the Company's profits, in addition to having an excellent comprehensive benefits package."

Source: www.rhinofoods.com/workforus/workforus.html.

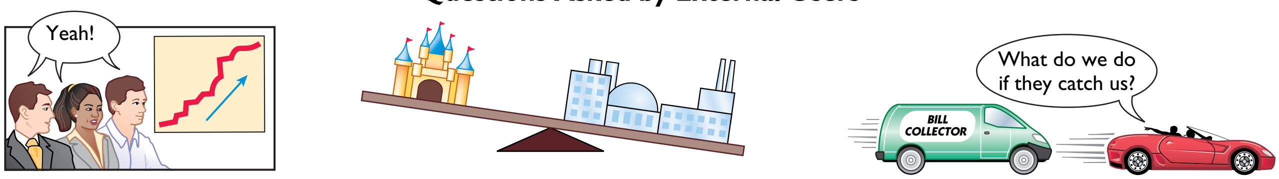
What are the benefits to the company and its employees of making the financial statements available to all employees? (Go to **WileyPLUS** for this answer and additional questions.)

***Accounting Across the Organization** boxes demonstrate applications of accounting information in various business functions.*

EXTERNAL USERS

External users are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors. **Investors** (owners) use accounting information to decide whether to buy, hold, or sell ownership shares of a company. **Creditors** (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money. Illustration 1-3 shows some questions that investors and creditors may ask.

Questions Asked by External Users



Investors	Investors	Creditors
Is General Electric earning satisfactory income?	How does Disney compare in size and profitability with Time Warner?	Will United Airlines be able to pay its debts as they come due?

Illustration 1-3
Questions that external users ask

Financial accounting answers these questions. It provides economic and financial information for investors, creditors, and other external users. The information needs of external users vary considerably. **Taxing authorities**, such as the Internal Revenue Service, want to know whether the company complies with tax laws. **Regulatory agencies**, such as the Securities and Exchange

Commission or the Federal Trade Commission, want to know whether the company is operating within prescribed rules. **Customers** are interested in whether a company like Telsa will continue to honor product warranties and support its product lines. **Labor unions** such as the Major League Baseball Players Association want to know whether the owners have the ability to pay increased wages and benefits.

*The **DO IT!** exercises ask you to put newly acquired knowledge to work. They outline the **Action Plan** necessary to complete the exercise, and they show a **Solution**.*

DO IT! 1 Basic Concepts

Indicate whether each of the five statements presented below is true or false.

1. The three steps in the accounting process are identification, recording, and communication.
2. Bookkeeping encompasses all steps in the accounting process.
3. Accountants prepare, but do not interpret, financial reports.
4. The two most common types of external users are investors and company officers.
5. Managerial accounting activities focus on reports for internal users.

Solution

1. True. **2.** False. Bookkeeping involves only the recording step. **3.** False. Accountants analyze and interpret information in reports as part of the communication step. **4.** False. The two most common types of external users are investors and creditors. **5.** True.

Action Plan

✔ Review the basic concepts discussed.

✔ Develop an understanding of the key terms used.

Related exercise material: **E1-1, E1-2, and DO IT! 1-1.**

LEARNING OBJECTIVE 2 Explain the building blocks of accounting: ethics, principles, and assumptions.

A doctor follows certain protocols in treating a patient's illness. An architect follows certain structural guidelines in designing a building. Similarly, an accountant follows certain standards in reporting financial information. These standards are based on specific principles and assumptions. For these standards to work, however, a fundamental business concept must be present—ethical behavior.

Ethics in Financial Reporting

People won't gamble in a casino if they think it is "rigged." Similarly, people won't play the stock market if they think stock prices are rigged. In recent years, the financial press has been full of articles about financial scandals at Enron, WorldCom, HealthSouth, AIG, and other companies. As the scandals came to light, mistrust of financial reporting in general grew. One article in the *Wall Street Journal* noted that "repeated disclosures about questionable accounting practices have bruised investors' faith in the reliability of earnings reports, which in turn has sent stock prices tumbling." Imagine trying to carry on a business or invest money if you could not depend on the financial statements to be honestly prepared. Information would have no credibility. There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

United States regulators and lawmakers were very concerned that the economy would suffer if investors lost confidence in corporate accounting because of unethical financial reporting. In response, Congress passed the **Sarbanes-Oxley Act (SOX)**. Its intent is to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals. As a result of SOX, top management must now certify the accuracy of financial information. In addition, penalties for

ETHICS NOTE

Circus-founder P.T. Barnum is alleged to have said, "Trust everyone, but cut the deck." What Sarbanes-Oxley does is to provide measures that (like cutting the deck of playing cards) help ensure that fraud will not occur.

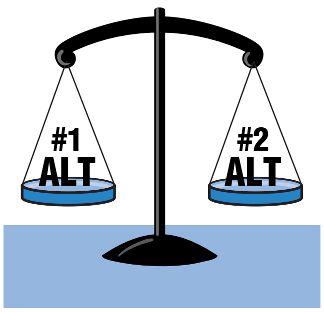
fraudulent financial activity are much more severe. Also, SOX increased the independence requirements of the outside auditors who review the accuracy of corporate financial statements and increased the oversight role of boards of directors.

The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair, are **ethics**. Effective financial reporting depends on sound ethical behavior. To sensitize you to ethical situations in business and to give you practice at solving ethical dilemmas, we address ethics in a number of ways in this textbook:

1. A number of the *Feature Stories* and other parts of the textbook discuss the central importance of ethical behavior to financial reporting.
2. *Ethics Insight* boxes and marginal *Ethics Notes* highlight ethics situations and issues in actual business settings.
3. Many of the *People, Planet, and Profit Insight* boxes focus on ethical issues that companies face in measuring and reporting social and environmental issues.
4. At the end of the chapter, an *Ethics Case* simulates a business situation and asks you to put yourself in the position of a decision-maker in that case.

Ethics Notes help sensitize you to some of the ethical issues in accounting.

When analyzing these various ethics cases, as well as experiences in your own life, it is useful to apply the three steps outlined in Illustration 1-4.



1. Recognize an ethical situation and the ethical issues involved.
Use your personal ethics to identify ethical situations and issues. Some businesses and professional organizations provide written codes of ethics for guidance in some business situations.

2. Identify and analyze the principal elements in the situation.
Identify the **stakeholders**—persons or groups who may be harmed or benefited. Ask the question: What are the responsibilities and obligations of the parties involved?

3. Identify the alternatives, and weigh the impact of each alternative on various stakeholders.
Select the most ethical alternative, considering all the consequences. Sometimes there will be one right answer. Other situations involve more than one right solution; these situations require an evaluation of each and a selection of the best alternative.

Illustration 1-4
Steps in analyzing ethics cases and situations

Insight *boxes provide examples of business situations from various perspectives—ethics, investor, international, and corporate social responsibility. Guideline answers to the critical thinking questions are available in* ***WileyPLUS*** *and at* ***www.wiley.com/college/weygandt****. Additional questions are offered in* ***WileyPLUS****.*

Ethics Insight Dewey & LeBoeuf LLP


© Alliance/Shutterstock

I Felt the Pressure—Would You?

"I felt the pressure." That's what some of the employees of the now-defunct law firm of Dewey & LeBoeuf LLP indicated when they helped to overstate revenue and use accounting tricks to hide losses and cover up cash shortages. These employees worked for the former finance director and former chief financial officer (CFO) of the firm. Here are some of their comments:

- "I was instructed by the CFO to create invoices, knowing they would not be sent to clients. When I created these invoices, I knew that it was inappropriate."
- "I intentionally gave the auditors incorrect information in the course of the audit."

What happened here is that a small group of lower-level employees over a period of years carried out the instructions of their bosses. Their bosses, however, seemed to have no concern as evidenced by various e-mails with one another in which they referred to their financial manipulations as accounting tricks, cooking the books, and fake income.

Source: Ashby Jones, "Guilty Pleas of Dewey Staff Detail the Alleged Fraud," *Wall Street Journal* (March 28, 2014).

Why did these employees lie, and what do you believe should be their penalty for these lies? (Go to **WileyPLUS** for this answer and additional questions.)

Generally Accepted Accounting Principles

The accounting profession has developed standards that are generally accepted and universally practiced. This common set of standards is called **generally accepted accounting principles (GAAP)**. These standards indicate how to report economic events.

The primary accounting standard-setting body in the United States is the **Financial Accounting Standards Board (FASB)**. The **Securities and Exchange Commission (SEC)** is the agency of the U.S. government that oversees U.S. financial markets and accounting standard-setting bodies. The SEC relies on the FASB to develop accounting standards, which public companies must follow. Many countries outside of the United States have adopted the accounting standards issued by the **International Accounting Standards Board (IASB)**. These standards are called **International Financial Reporting Standards (IFRS)**.

International Note

Over 100 countries use International Financial Reporting Standards (called IFRS). For example, all companies in the European Union follow international standards. The differences between U.S. and international standards are not generally significant.

***International Notes** highlight differences between U.S. and international accounting standards.*

As markets become more global, it is often desirable to compare the results of companies from different countries that report using different accounting standards. In order to increase comparability, in recent years the two standard-setting bodies have made efforts to reduce the differences between U.S. GAAP and IFRS. This process is referred to as **convergence**. As a result of these convergence efforts, it is likely that someday there will be a single set of high-quality accounting standards that are used by companies around the world. Because convergence is such an important issue, we highlight any major differences between GAAP and IFRS in *International Notes* (as shown in the margin here) and provide a more in-depth discussion in the *A Look at IRFS* section at the end of each chapter.

Measurement Principles

GAAP generally uses one of two measurement principles, the historical cost principle or the fair value principle. Selection of which principle to follow generally relates to trade-offs between relevance and faithful representation. **Relevance** means that financial information is capable of making a difference in a decision. **Faithful representation** means that the numbers and descriptions match what really existed or happened—they are factual.

Helpful Hint
Relevance and *faithful representation* are two primary qualities that make accounting information useful for decision-making.

***Helpful Hints** further clarify concepts being discussed.*

HISTORICAL COST PRINCIPLE

The **historical cost principle** (or cost principle) dictates that companies record assets at their cost. This is true not only at the time the asset is purchased, but also over the time the asset is held. For example, if Best Buy purchases land for $360,000, the company initially reports it in its accounting records at $360,000. But what does Best Buy do if, by the end of the next year, the fair value of the land has increased to $400,000? Under the historical cost principle, it continues to report the land at $360,000.

FAIR VALUE PRINCIPLE

The **fair value principle** states that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability). Fair value information may be more useful than historical cost for certain types of assets and liabilities. For example, certain investment securities are reported at fair value because market price information is usually readily available for these types of assets. In determining which measurement principle to use, companies weigh the factual nature of cost figures versus the relevance of fair value. In general, most companies choose to use cost. Only in situations where assets are actively traded, such as investment securities, do companies apply the fair value principle extensively.

Assumptions

Assumptions provide a foundation for the accounting process. Two main assumptions are the **monetary unit assumption** and the **economic entity assumption**.