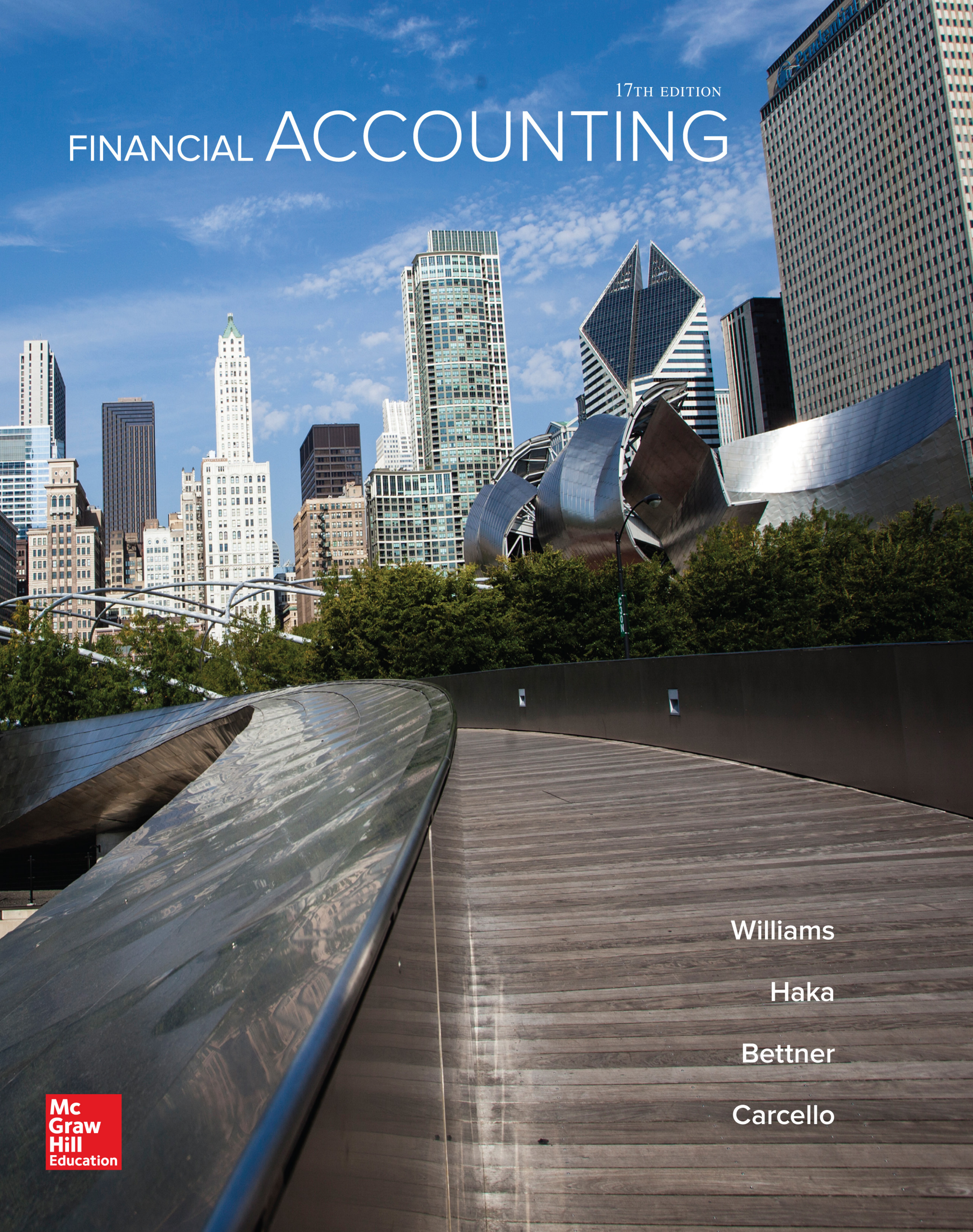
17TH EDITION

FINANCIAL ACCOUNTING



Williams

Haka

Bettner

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17TH EDITION

Financial Accounting

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17TH EDITION

Financial Accounting

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DEDICATION

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

—Jan R. Williams

For Cliff, Abi, and my mother, Fran.

—Susan F. Haka

To my parents, Fred and Marjorie.

—Mark S. Bettner

In memory of Gilbert E. Bernhard, and to my wife, Terri, and children Stephen, Karen, and Sarah.

—Joseph V. Carcello

Meet the Authors

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

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

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

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

REACHING GREAT HEIGHTS BEGINS WITH A SOLID BASE

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

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

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

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

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

Hossein Noorian, Wentworth Institute

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

Naser Kamleh, Wallace Community College

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

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

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

Karen Mozingo, Pitt Community College

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

Mark Anderson, Bob Jones University

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

How Does **Williams** Help Students

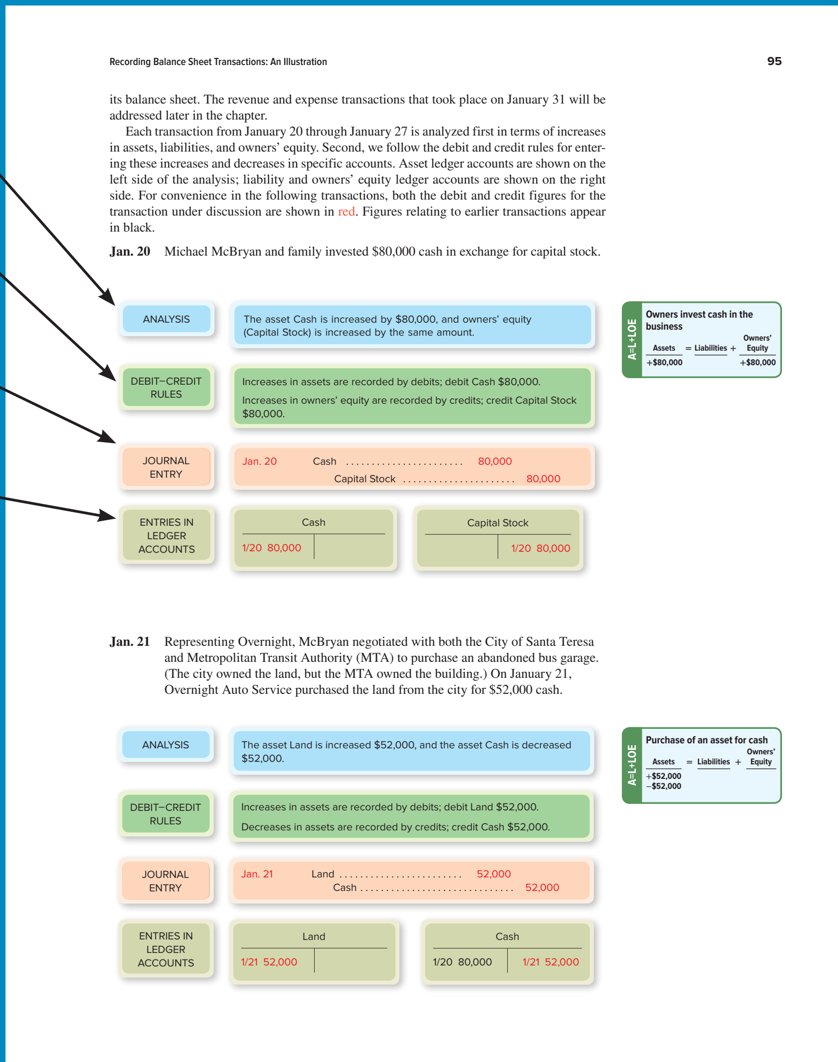
Step-by-Step Process for the Accounting Cycle

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

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

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

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



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

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

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

ANALYSIS: The asset Cash is increased by $80,000, and owners' equity (Capital Stock) is increased by the same amount.

DEBIT–CREDIT RULES: Increases in assets are recorded by debits; debit Cash $80,000. Increases in owners' equity are recorded by credits; credit Capital Stock $80,000.

JOURNAL ENTRY:

Jan. 20	Cash	80,000	
	Capital Stock		80,000

ENTRIES IN LEDGER ACCOUNTS:

Cash: 1/20 80,000 |

Capital Stock: | 1/20 80,000

A=L+LOE — Owners invest cash in the business

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

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

ANALYSIS: The asset Land is increased $52,000, and the asset Cash is decreased $52,000.

DEBIT–CREDIT RULES: Increases in assets are recorded by debits; debit Land $52,000. Decreases in assets are recorded by credits; credit Cash $52,000.

JOURNAL ENTRY:

Jan. 21	Land	52,000	
	Cash		52,000

ENTRIES IN LEDGER ACCOUNTS:

Land: 1/21 52,000 |

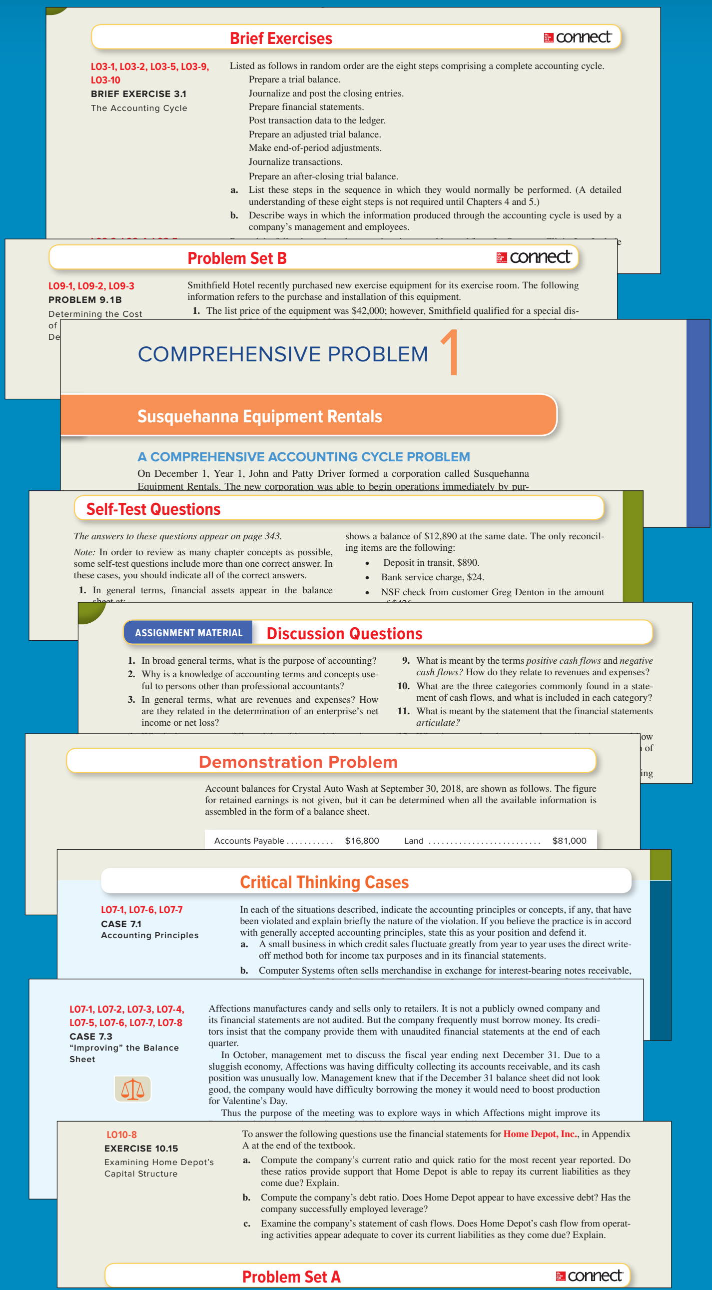
Cash: 1/20 80,000 | 1/21 52,000

A=L+LOE — Purchase of an asset for cash

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

Build a Strong Foundation?

Robust End-of-Chapter Material



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

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

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

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

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

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

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

The **2015 Home Depot Financial Statements** are included in Appendix A. Students are referred to key aspects of the 10-K in the text material and in end-of-chapter material to illustrate actual business applications of chapter concepts.

The Williams Pedagogy Helps

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

CHAPTER 2

Basic Financial Statements

After studying this chapter, you should be able to:

Learning Objectives

LO2-1 Explain the nature and general purposes of financial statements.

LO2-2 Explain certain accounting principles that are important for an understanding of financial statements and how professional judgment by accountants may affect the application of those principles.

LO2-3 Demonstrate how certain business transactions affect the elements of the accounting equation: Assets = Liabilities + Owners' Equity.

LO2-4 Explain how the statement of financial position, often referred to as the balance sheet, is an expansion of the basic accounting equation.

LO2-5 Explain how the income statement reports an enterprise's financial performance for a period of time in terms of the relationship of revenues and expenses.

LO2-6 Explain how the statement of cash flows presents the change in cash for a period of time in terms of the company's operating, investing, and financing activities.

LO2-7 Explain how the statement of financial position (balance sheet), income statement, and statement of cash flows relate to each other.

LO2-8 Explain common forms of business ownership—sole proprietorship, partnership, and corporation—and demonstrate how they differ in terms of their statements of financial position.

LO2-9 Discuss the importance of financial statements to a company and its investors and creditors and why management may take steps to improve the appearance of the company in its financial statements.

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

YOUR TURN | **You as a Financial Analyst**

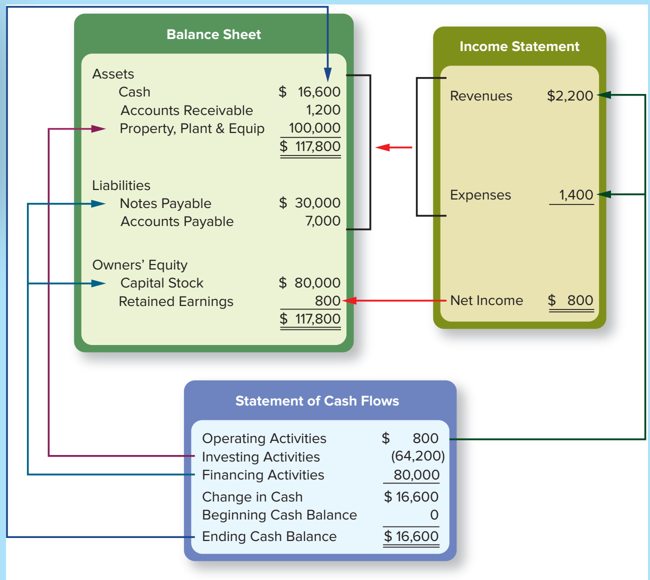
Assume that you are a financial analyst and that two of your clients are requesting your advice on certain companies as potential investments. Both clients are interested in purchasing common stock. One is primarily interested in the dividends to be received from the investment. The second is primarily interested in the growth of the market value of the stock. What information would you advise your clients to focus on in their respective analyses?

(See our comments in Connect.)

"Lots of eye appeal and in-depth coverage. **Students will love it.**"

James Specht, Concordia College

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



Students Reach Great Heights

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

Malcolm E. White, Columbia College

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AMAZON

Amazon opened its doors on the World Wide Web in 1995 with the goal of being "the Earth's most customer-centric company." Amazon sells both merchandise it has purchased from vendors for resale and merchandise offered by third-party sellers, and it also manufactures and sells electronic devices. Amazon focuses on providing customers with selection, price, and convenience. Amazon began its operations by selling books, but it now sells millions of unique products from a variety of product categories. Although Amazon has been very successful since its inception, it faces intense competition from both digital and bricks-and-mortar retailers.

Technology-based companies like Amazon must continuously innovate to stay ahead of the competition. Amazon states that it follows four principles: "customer obsession rather than competitor focus, passion for invention, commitment to operational excellence, and long-term thinking."[1] Amazon was willing to forego operating at a profit in its early years to build its brand name and to obtain market share and, as a result, did not report a quarterly profit until 2001.[2]

(continued)

[1] https://www.sec.gov/Archives/edgar/data/1018724/000101872415000006/amzn-20141231x10k.htm

[2] AMZN-2014.12.31-10K. United States Securities and Exchange Commission, 16 Jan. 2015. https://www.sec.gov/Archives/edgar/data/1018724/000101872415000006/amzn-20141231x10k.htm.

CASE IN POINT

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

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

ETHICS, FRAUD, & CORPORATE GOVERNANCE

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

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

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

PATHWAYS CONNECTION

Would you be interested in investing in or lending money to a company that reported eight straight years of losses in the following amounts (all in millions): \$0.3, \$6, \$31, \$125, \$720, \$1.4, \$567, \$149? Those numbers were the reported net income (actually net loss) for Amazon in every year from 1995 through 2002. Amazon did not report a profit until 2003 when it reported a \$35 million profit. Moreover, it took until 2009 before Amazon reported a positive balance in retained earnings. Amazon was reporting large net losses as it invested heavily in building its infrastructure and brand. By investing for the long haul, Amazon grew net sales from \$147 million in 1997 to \$6.9 billion in 2004, a compound annual growth rate of over 70 percent.

The market recognized that Amazon's reported losses were enabling it to build a dominant online presence and, as a result, during that time Amazon was able to finance itself by issuing debt and stock (including the exercise of stock options). For example, Amazon issued long-term debt of \$326 million and \$1.2 billion in 1998 and 1999, respectively. Moreover, Amazon received cash proceeds from issuing stock (including exercised stock options) of \$64 million, \$122 million, and \$163 million in 1999, 2002, and 2003, respectively. Finally, although Amazon reported net losses every year from 1995 to 2002, its cash flows from operations were in some years positive. Certain expenses reduced Amazon's net income but not its cash flows—items like depreciation, amortization, and stock-based compensation. And Amazon financed much of its operations (i.e., generated cash flow) by vendor-provided financing. These concepts are covered when we introduce the Statement of Cash Flows in Chapter 13. Amazon shows that a business can report losses for many years and still be viable, even quite successful, if it is able to generate sufficient cash flow to finance its operations.

PATHWAYS CONNECTION boxes emphasize that financial statements are a means to an end, providing useful information for making good decisions, and eventually benefiting society.

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

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

A new and unique feature, Pathways Connection, has been added, emphasizing that financial statements are a means to an end, providing useful information for making good decisions, and eventually benefiting society.

Chapter 1:

New chapter opener using The Walt Disney Company

- Used the Pathways Commission model to introduce accounting
- Updated Case in Point using Sony
- Updated coverage of the American Cancer Society and Procter & Gamble
- Revised the Demonstration Problem
- Revised end-of-chapter material

Chapter 2:

- New chapter opener using Amazon
- Updated Case in Point using Carnival Corporation
- Added Pathways Connection box
- Updated demonstration problem
- Revised end-of-chapter material

Chapter 3:

- New chapter opener using PwC
- Replaced Walmart with Apple in discussing ending retained earnings
- Updated International Case in Point box with current IFRS and U.S. GAAP information
- Added Pathways Connection box
- Revised end-of-chapter material

Chapter 4:

- New chapter opener using Carnival Corporation
- Added Pathways Connection box
- Revised end-of-chapter material

Chapter 5:

- New chapter opener using Abercrombie & Fitch
- Added Pathways Connection box
- Revised end-of-chapter material

Chapter 6:

- New chapter opener using Lowe's
- Added Pathways Connection box, including discussion of the link between business strategy and a company's gross profit rate and sales volume
- Revised end-of-chapter material

Chapter 7:

- Updated the chapter opener to include more current information on Apple
- Updated International Case in Point box with current IFRS information
- Added Pathways Connection box, including the use of the accounts receivable turnover rate for management decision making
- Revised end-of-chapter material

Chapter 8:

- Added Pathways Connection box
- Revised end-of-chapter material

Chapter 9:

- Refined section on depreciation using the units of output method and depreciation for fractional periods
- Updated units-of-output method
- Updated demonstration problem
- Revised end-of-chapter material

Chapter 10:

- Updated real world example used in section on corporate bonds
- Added Pathways Connection box
- Streamlined coverage of deferred income taxes
- Updated Your Turn box
- Updated section on leases to include updated FASB requirements
- Revised end-of-chapter material

Chapter 11:

- Added Pathways Connection box
- Revised end-of-chapter material
- Updated Comprehensive Problem 3

Chapter 12:

- New chapter opener using Under Armour
- Revised reporting the results of operations to reflect FASB elimination of extraordinary items
- Added Pathways Connection box
- Revised and refined coverage of other transactions affecting retained earning
- Updated demonstration problem
- Revised end-of-chapter material with particular attention to changes resulting from the exclusion of extraordinary items and related impact on the financial statements

Chapter 13:

- Added Pathways Connection box
- Revised end-of-chapter material

Chapter 14:

- Refined section on quality of assets and the relative amount of debt
- Added Pathways Connection box
- Added more in-depth text in select areas (e.g., income statement, working capital, lines of credit)
- Significant revision and update of demonstration problem
- Revised end-of-chapter material

Chapter 15:

- Updated the chapter opener to include more current information on the International Financial Reporting Standards Foundation
- Updated and revised discussion of Foreign Corrupt Practices Act (FCPA)
- Updated and revised the Your Turn feature
- Added Pathways Connection box on the country-level differences in political, legal, and economic systems, and the effects of such on the emissions-cheating scandal at Volkswagen
- IFRS coverage revised to reflect updated information
- Updated exchange rates in Exhibit 15-7
- Revised end-of-chapter material

We are grateful . . .

We would like to acknowledge the following individuals for their help in developing some of the text's supplements: Barbara Muller, Arizona State University; Malcolm White, Columbia College; Teri Zuccaro, Clarke University; Teressa Farough; and the teams at Agate Development and ANSR Source.

We appreciate the expert attention given to this project by the staff at McGraw-Hill Education, especially Tim Vertovec, Managing Director; Steve Schuetz, Executive Brand Manager; Rebecca Mann, Product Developer; Kris Tibbets, Lead Product Developer; Peggy Hussey, Director of Digital Conent; Xin Lin, Digital Product Analyst; Michelle Nolte, Senior Marketing Manager; Erin Chomat, Senior Market Development Manager; Sarah Wood and Christina Sanders (Agate Development), Freelance Product Developer; Daryl Horrocks, Program Manager; Pat Frederickson, Lead Content Project Manager (Core); Brian Nacik, Lead Content Project Manager (Assessment); Laura Fuller, Buyer; Matt Diamond, Senior Designer; Melissa Homer, Content Licensing Specialist (Image); and Melissa Seegmiller, Content Licensing Specialist (Text).

Sincerely,

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

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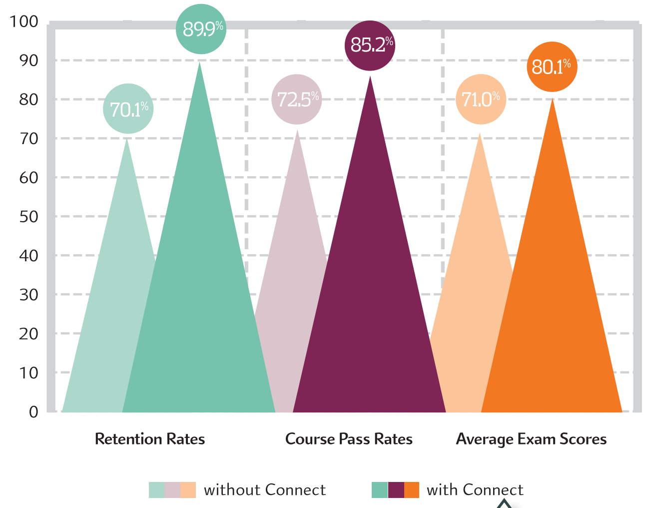

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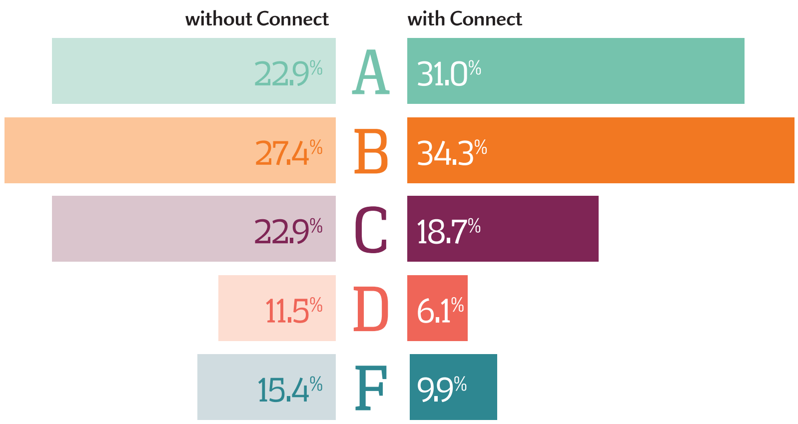
Impact on Final Course Grade Distribution



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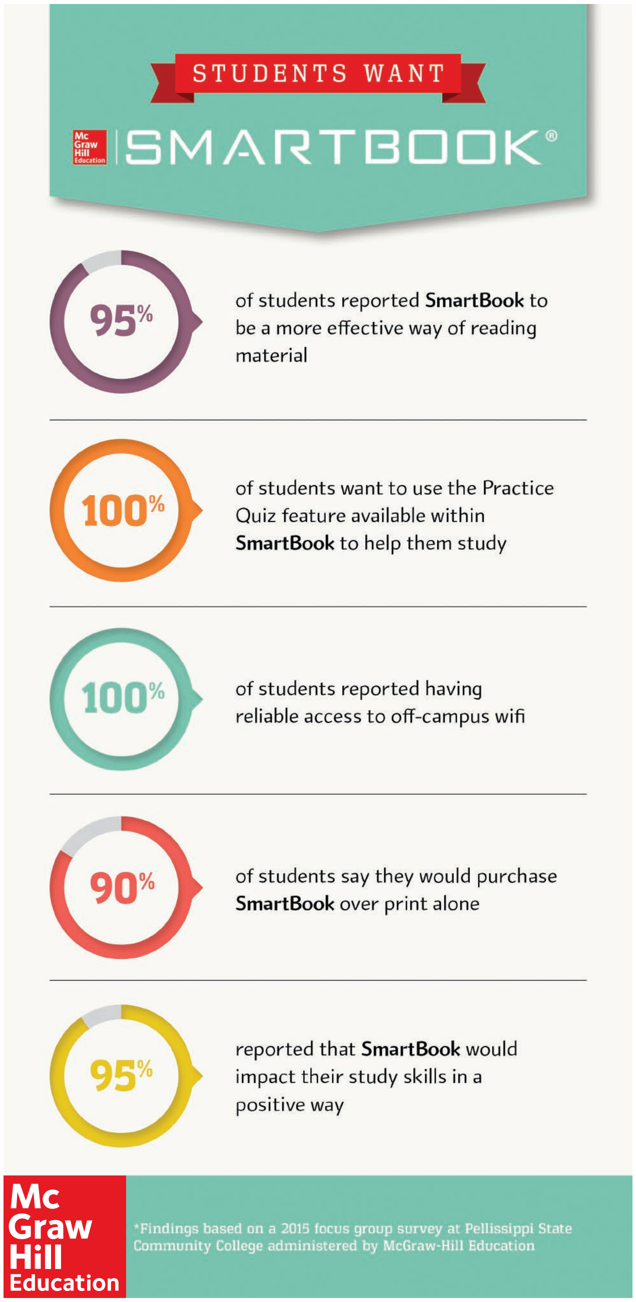

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Acknowledgments

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

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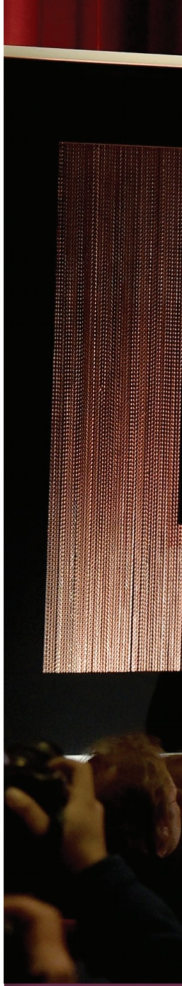
CHAPTER 1

Accounting

Information for Decision Making



After studying this chapter, you should be able to:

Learning Objectives

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

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

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

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

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

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

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

LO1-8 Describe various career opportunities in accounting.

THE WALT DISNEY COMPANY

The Walt Disney Company (Disney) was founded in 1923 by Walt and Roy Disney. Over the last 90 years, Disney has grown to become one of the largest entertainment companies in the world, with revenues and assets well above $50 billion. Disney operates five business segments: media networks, parks and resorts, studio entertainment, consumer products, and interactive media. Disney has grown over the years both by expanding its existing business, and by successfully acquiring other companies and integrating them into Disney.

Just as individuals need reliable financial information when making investment decisions, it is equally important when one company is considering buying another. Over the years, Disney has acquired ESPN, Pixar, Marvel, and Lucasfilm, among many other companies. Before making these acquisitions, Disney assessed the target company's profitability by examining its income statement, cash flows reflected in its statement of cash flows, and liquidity and solvency by examining its balance sheet. Although nonfinancial considerations play an important role in deciding whether or not to buy another company, and in deciding on the price to pay, financial considerations are integral in evaluating a company before making an acquisition attempt.

Successful acquisitions have been key to Disney's success in recent years. ESPN is a highly profitable

(contiuned)

unit, and movies from Pixar, Marvel, and Lucasfilm have been highly successful. Movie success not only contributes to the success of the studio entertainment segment, but often leads to rides and attractions that contribute to the success of the parks and resorts segment. In addition, successful movies and their characters spawn merchandise that contributes to the success of the consumer products segment as well as games that contribute to the success of the interactive segment. Content derived from successful movies often serves as an engine of growth for the entire Disney company. ■

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

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

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

Accounting Information: A Means to an End

LO1-1

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

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

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

ACCOUNTING FROM A USER'S PERSPECTIVE

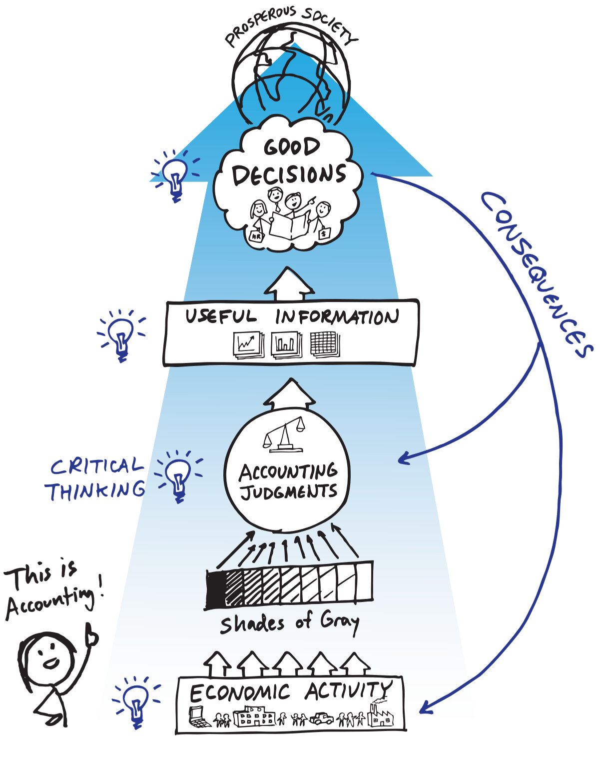
Many people think of accounting as simply a highly technical field with black and white rules, and as a field practiced only by professional accountants. In reality, nearly everyone uses accounting information daily. Accounting information is the means by which we measure and communicate economic events.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

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

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

Exhibit 1–1 illustrates a model developed by the Pathways Commission that describes accounting.[1] Businesses engage in economic activities, and converting these economic activities into useful information sometimes requires significant judgment because business

EXHIBIT 1–1
This is Accounting



[1] The Pathways Commission was a national initiative from 2010 to 2015 with a goal of making recommendations to engage and retain the strongest possible community of students, academics, practitioners, and other knowledgeable leaders in the practice and study of accounting.

transactions are often complex. Making these judgments requires the accountant to exercise effective critical thinking skills. The ultimate objective of useful information is to facilitate good decisions, and good decisions help bring about a prosperous society.

TYPES OF ACCOUNTING INFORMATION

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

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

CASE IN POINT

In Sony Corporation's 2015 financial statements to owners, financial position is presented as consisting of ¥15,834 trillion in assets (including cash and cash equivalents, inventories, buildings, and machinery and equipment), with obligations against those assets of ¥12,906 trillion. This leaves ¥2,928 trillion as the owners' interest in those assets. In the same report, results of operations indicate that Sony had a net loss (expenses exceeded revenues) of ¥126 billion for the year ending March 31, 2015.

Financial accounting information is designed primarily to assist investors and creditors in deciding where to place their scarce investment resources. Such decisions are important to society, because they determine which companies and industries will receive the financial resources necessary for growth. When capital, which is a scarce resource, is allocated wisely, the overall prosperity of society is maximized (refer to Exhibit 1–1, the Pathways Model of accounting).

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

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

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

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

Accounting Systems

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

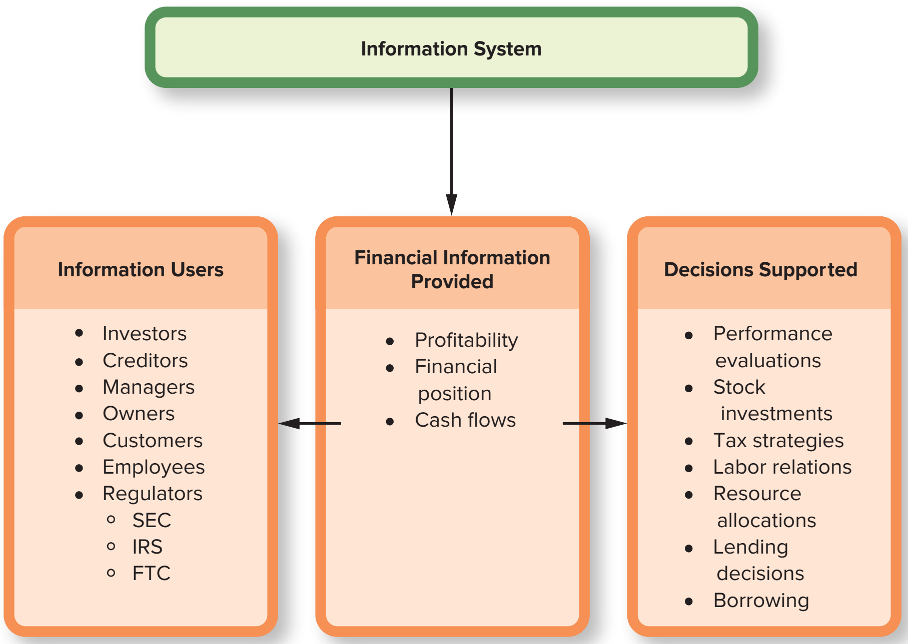
LO1-2

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

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

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

EXHIBIT 1–2
Accounting as an Information System



These relationships are consistent with what we have already learned—namely, that accounting information is intended to be useful for decision-making purposes.

DETERMINING INFORMATION NEEDS

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

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

THE COST OF PRODUCING ACCOUNTING INFORMATION

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

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

BASIC FUNCTIONS OF AN ACCOUNTING SYSTEM

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

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

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

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

WHO DESIGNS AND INSTALLS ACCOUNTING SYSTEMS?

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

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

COMPONENTS OF INTERNAL CONTROL[2]

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

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

Risk assessment involves identifying, analyzing, and managing those risks that pose a threat to the achievement of the organization's objectives. For example, a company should assess the risks that might prevent it from preparing reliable financial reports and then take steps to minimize those risks. When an entity commits fraud, its risk assessment procedures have likely failed.

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

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

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

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