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# ACCOUNTING PRINCIPLES

11e

| 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 |
| 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 Assets | 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 |
| 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 |
| **O** | | | |
| Owner's Capital | Owner's Equity | Owner's Equity and Balance Sheet | Credit |
| Owner's Drawings | Temporary account closed to Owner's Capital | Owner's Equity | Debit |
| **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 | Balance Sheet | Credit |
| Prepaid Insurance | Current Asset | Balance Sheet | Debit |
| Prepaid Rent | 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 |
| 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—Contra | 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 | Owner's and Stockholders' Equity | Revenues | Expenses |
|---|---|---|---|---|
| Cash | Notes Payable | Owner's Capital | Service Revenue | Advertising Expense |
| Accounts Receivable | Accounts Payable | Owner's Drawings | Sales Revenue | Amortization Expense |
| Allowance for Doubtful Accounts | Unearned Service Revenue | Common Stock | Sales Discounts | Bad Debt Expense |
| Interest Receivable | Salaries and Wages Payable | Paid-in Capital in Excess of Par—Common Stock | Sales Returns and Allowances | Cost of Goods Sold |
| Inventory | Unearned Rent Revenue | Preferred Stock | Interest Revenue | Depreciation Expense |
| Supplies | Interest Payable | Paid-in Capital in Excess of Par—Preferred Stock | Gain on Disposal of Plant Assets | Freight-Out |
| Prepaid Insurance | Dividends Payable | Treasury Stock | | Income Tax Expense |
| Prepaid Rent | Income Taxes Payable | Retained Earnings | | Insurance Expense |
| Land | Bonds Payable | Dividends | | Interest Expense |
| Equipment | Discount on Bonds Payable | Income Summary | | Loss on Disposal of Plant Assets |
| Accumulated Depreciation—Equipment | Premium on Bonds Payable | | | Maintenance and Repairs Expense |
| Buildings | Mortgage Payable | | | Rent Expense |
| Accumulated Depreciation—Buildings | | | | Salaries and Wages Expense |
| Copyrights | | | | Supplies Expense |
| Goodwill | | | | Utilities Expense |
| Patents | | | | |

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# ACCOUNTING PRINCIPLES

11e


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# Brief Contents



## APPENDICES



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

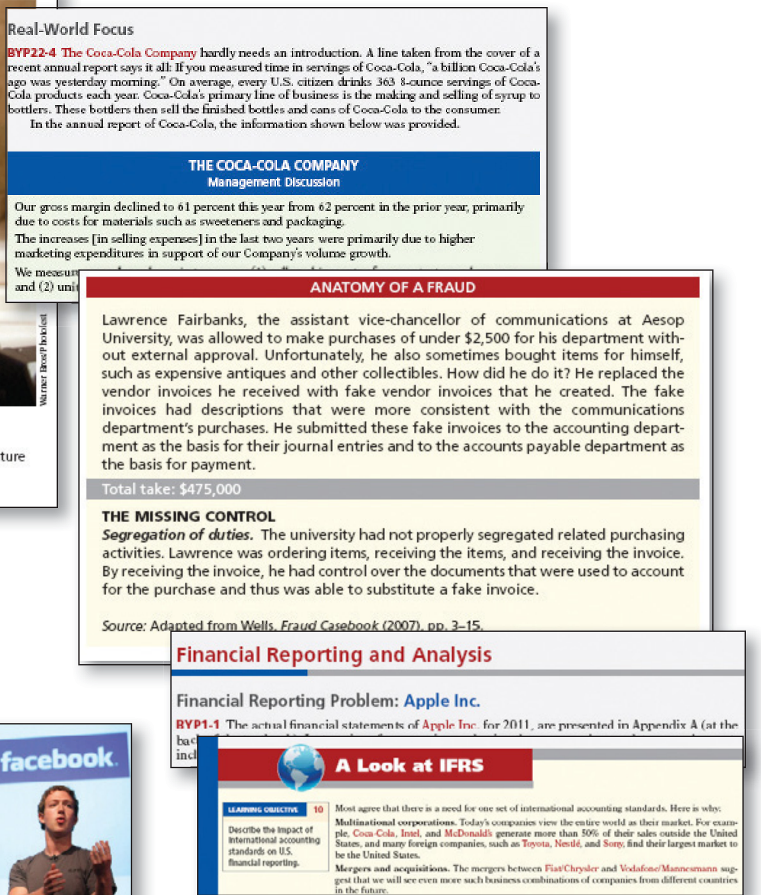
# read it!

## REAL-WORLD CONTEXT

Real-world companies and business situations give you glimpses into how real companies use accounting.

**Feature Stories** introduce chapter topics in fun ways using real-world companies that are engaging.


**Issues** that affect today's business world are highlighted in the textbook.



Real-World Focus

BYP22-4 The Coca-Cola Company hardly needs an introduction. A line taken from the cover of a recent annual report says it all: If you measured time in servings of Coca-Cola, "a billion Coca-Cola's ago was yesterday morning." On average, every U.S. citizen drinks 363 8-ounce servings of Coca-Cola products each year. Coca-Cola's primary line of business is the making and selling of syrup to bottlers. These bottlers then sell the finished bottles and cans of Coca-Cola to the consumer.

In the annual report of Coca-Cola, the information shown below was provided.

THE COCA-COLA COMPANY
Management Discussion

Our gross margin declined to 61 percent this year from 62 percent in the prior year, primarily due to costs for materials such as sweeteners and packaging.

The increases [in selling expenses] in the last two years were primarily due to higher marketing expenditures in support of our Company's volume growth.

We measur... and (2) uni...

ANATOMY OF A FRAUD

Lawrence Fairbanks, the assistant vice-chancellor of communications at Aesop University, was allowed to make purchases of under $2,500 for his department without external approval. Unfortunately, he also sometimes bought items for himself, such as expensive antiques and other collectibles. How did he do it? He replaced the vendor invoices he received with fake vendor invoices that he created. The fake invoices had descriptions that were more consistent with the communications department's purchases. He submitted these fake invoices to the accounting department as the basis for their journal entries and to the accounts payable department as the basis for payment.

Total take: $475,000

THE MISSING CONTROL

*Segregation of duties.* The university had not properly segregated related purchasing activities. Lawrence was ordering items, receiving the items, and receiving the invoice. By receiving the invoice, he had control over the documents that were used to account for the purchase and thus was able to substitute a fake invoice.

*Source:* Adapted from Wells, *Fraud Casebook* (2007), pp. 3–15.

Financial Reporting and Analysis

Financial Reporting Problem: Apple Inc.

BYP1-1 The actual financial statements of Apple Inc. for 2011, are presented in Appendix A (at the bac... inc...

A Look at IFRS

LEARNING OBJECTIVE 10
Describe the impact of international accounting standards on U.S. financial reporting.

Most agree that there is a need for one set of international accounting standards. Here is why:

**Multinational corporations.** Today's companies view the entire world as their market. For example, Coca-Cola, Intel, and McDonald's generate more than 50% of their sales outside the United States, and many foreign companies, such as Toyota, Nestlé, and Sony, find their largest market to be the United States.

**Mergers and acquisitions.** The mergers between Fiat/Chrysler and Vodafone/Mannesmann suggest that we will see even more such business combinations of companies from different countries in the future.

**Insight Boxes** frame real-world company issues through international, ethical, and other perspectives.

ACCOUNTING ACROSS THE ORGANIZATION

**A Thousand Millionaires!**

Traveling to space or embarking on an expedition to excavate lost Mayan ruins are normally the stuff of adventure novels. But for employees of Facebook, these and other lavish dreams moved closer to reality when the world's No. 1 online social network went public through an initial public offering (IPO) that may have created at least a thousand millionaires. The IPO was the largest in Internet history, valuing Facebook at over $104 billion.

With all these riches to be had, why did Mark Zuckerberg, the founder of Facebook, delay taking his company public? Consider that the main motivation for issuing shares to the public is to raise money so you can grow your business. However, unlike a manufacturer or even an online retailer, Facebook doesn't need major physical resources, it doesn't have inventory, and it doesn't really need much money for marketing. So in the past, the company hasn't had much need for additional cash beyond what it was already generating on its own. Finally, as head of a closely held, nonpublic company, Zuckerberg was subject to far fewer regulations than a public company.

Source: "Status Update: I'm Rich: Facebook Flotation to Create 1,000 Millionaires Among Company's Rank and File," *Daily Mail Reporter* (February 1, 2012).

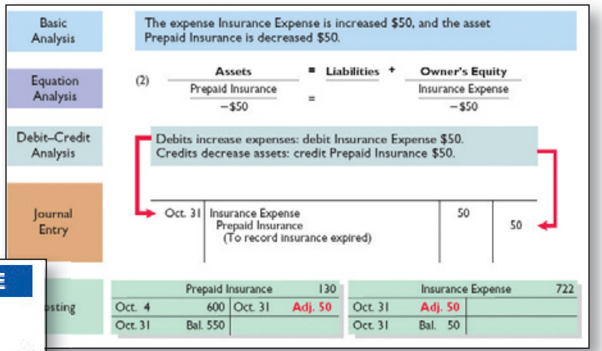
? Why did Mark Zuckerberg, the CEO and founder of Facebook, delay taking his company's shares public through an initial public offering (IPO)? (See page 642.)

# see!it

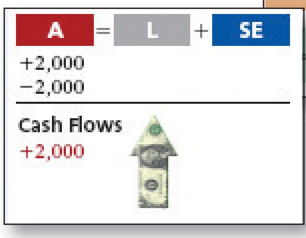
## CONTENT FOR ALL LEARNING STYLES

In addition to a textbook consistently reviewed as very readable, over 50% of the textbook provides visual presentations and interpretations of content.

**Equation Analysis Illustrations** visually walk you through the steps of journal transactions.



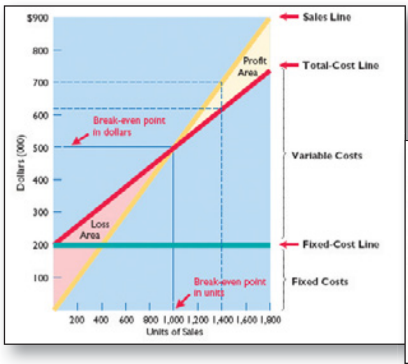

**Cash Flow Analyses** visually summarize the effects of transactions on cash flows.

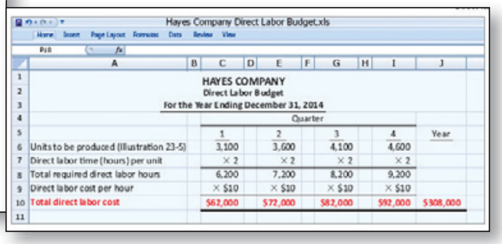




**Infographics** reinforce important textual concepts. All infographics were revised in the Eleventh Edition.

**Illustrations** are clearly identified and often present data in a real-world format.





Hayes Company Direct Labor Budget.xls

HAYES COMPANY
Direct Labor Budget
For the Year Ending December 31, 2014

| | Quarter 1 | Quarter 2 | Quarter 3 | Quarter 4 | Year |
|---|---|---|---|---|---|
| Units to be produced (Illustration 23-5) | 3,100 | 3,600 | 4,100 | 4,600 | |
| Direct labor time (hours) per unit | × 2 | × 2 | × 2 | × 2 | |
| Total required direct labor hours | 6,200 | 7,200 | 8,200 | 9,200 | |
| Direct labor cost per hour | × $10 | × $10 | × $10 | × $10 | |
| Total direct labor cost | $62,000 | $72,000 | $82,000 | $92,000 | $308,000 |

# do!it

## KNOW THE FUNDAMENTALS

Knowing the fundamentals of accounting will help you understand what is happening in all areas of a business. **DO IT!** exercises throughout the textbook will help you practice your understanding of accounting.

> **DO IT!**
>
> **Break-Even Analysis**
>
> Lombardi Company has a unit selling price of $400, variable costs per unit of $240, and fixed costs of $180,000. Compute the break-even point in units using (a) a mathematical equation and (b) contribution margin per unit.
>
> **Action Plan**
>
> ✔ Apply the formula: Sales = Variable costs + Fixed costs + Net income.
>
> ✔ Apply the formula: Fixed costs ÷ Contribution margin per unit = Break-even point in units.
>
> **Solution**
>
> (a) The equation is $400Q − $240Q − $180,000 = $0; ($400Q − $240Q) = $180,000. The break-even point in units is 1,125. (b) The contribution margin per unit is $160 ($400 − $240). The formula therefore is $180,000 ÷ $160, and the break-even point in units is 1,125.
>
> Related exercise material: BE22-6, BE22-7, BE22-8, BE22-9, E22-8, E22-9, E22-10, E22-11, E22-12, E22-13, and DO IT! 22-3.
>
> ✔ The Navigator

Clear **DO IT! exercises** in the textbook narrative provide step-by-step applications of a concept at the precise moment you acquire the knowledge. Each **DO IT!** in the textbook narrative includes a solution, an Action Plan, and a path of related homework exercises.

**Comprehensive DO IT!'s** at the end of each chapter apply the **DO IT!** exercises and address **multiple** topics.

> **Comprehensive DO IT!**
>
> B.T. Hernandez Company, maker of high-quality flashlights, has experienced steady growth over the last 6 years. However, increased competition has led Mr. Hernandez, the president, to believe that an aggressive campaign is needed next year to maintain the company's present growth. The company's accountant has presented Mr. Hernandez with the data on the next page for the current year, 2014, for use in preparing next year's advertising campaign.

> **DO IT! Review**
>
> **DO IT! 22-1** Helena Company reports the following total costs at two levels of production. *Classify types of costs.* (LO 1, 3), C

| | 5,000 Units | 10,000 Units |
|---|---|---|
| Indirect labor | $ 3,000 | $ 6,000 |
| Property taxes | 7,000 | 7,000 |
| Direct labor | 28,000 | 56,000 |
| Direct materials | 22,000 | 44,000 |
| Depreciation | 4,000 | 4,000 |
| Utilities | 5,000 | 7,000 |
| Maintenance | 9,000 | 11,000 |

> Classify each cost as variable, fixed, or mixed.
>
> **DO IT! 22-2** Westerville Company accumulates the following data concerning a mixed cost, using units produced as the activity level. *Compute costs using high-low method and estimate total cost.* (LO 3), AP

| | Units Produced | Total Cost |
|---|---|---|
| March | 10,000 | $18,000 |
| April | 9,000 | 16,650 |
| May | 10,500 | 18,580 |
| June | 8,800 | 16,200 |
| July | 9,500 | 17,100 |

> (a) Compute the variable- and fixed-cost elements using the high-low method.
>
> (b) Estimate the total cost if the company produces 9,200 units.

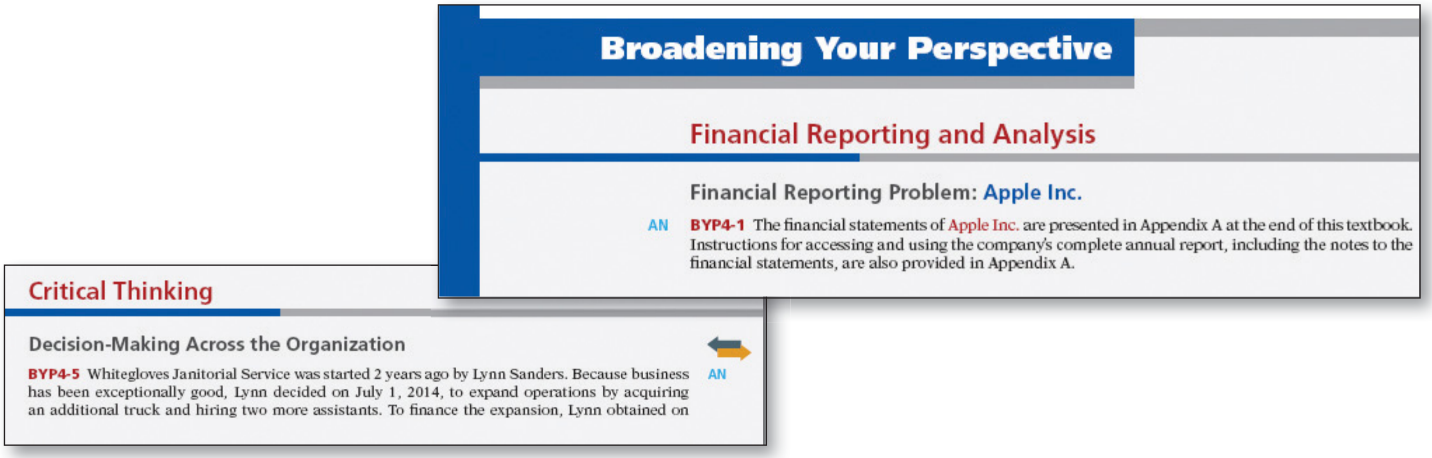
**End-of-Chapter DO IT!** exercises provide further practice with alternate versions of the in-chapter **DO IT!** exercises.

# get!it

## IMPROVE DECISION-MAKING SKILLS

As an employee, manager, or even a director of your own personal finances, you will make better decisions by learning how to analyze and solve business problems using materials provided at the end of each chapter.

**Broadening Your Perspective** questions help you pull together concepts from a particular chapter and apply them to real-world business situations. Critical thinking, communication, ethics, and other questions are included in this section at the end of each textbook chapter.



Broadening Your Perspective

Financial Reporting and Analysis

Financial Reporting Problem: Apple Inc.

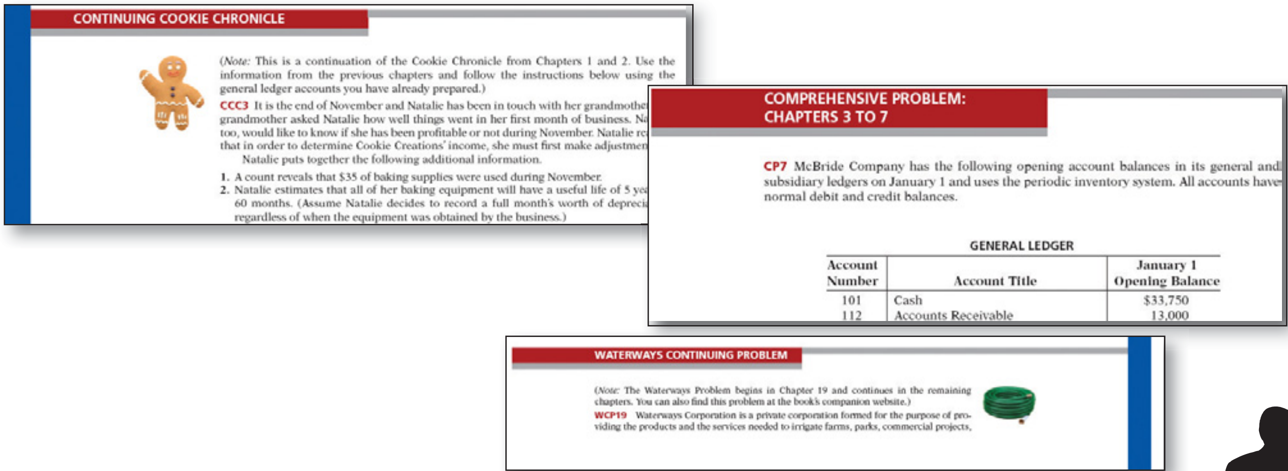
AN **BYP4-1** The financial statements of Apple Inc. are presented in Appendix A at the end of this textbook. Instructions for accessing and using the company's complete annual report, including the notes to the financial statements, are also provided in Appendix A.

Critical Thinking

Decision-Making Across the Organization

**BYP4-5** Whitegloves Janitorial Service was started 2 years ago by Lynn Sanders. Because business has been exceptionally good, Lynn decided on July 1, 2014, to expand operations by acquiring an additional truck and hiring two more assistants. To finance the expansion, Lynn obtained on AN

**Continuing Cookie Chronicle, Waterways Continuing Problem, and Comprehensive Problems** pull together concepts from multiple chapters and provide a macro perspective of accounting in action.



CONTINUING COOKIE CHRONICLE

(*Note:* This is a continuation of the Cookie Chronicle from Chapters 1 and 2. Use the information from the previous chapters and follow the instructions below using the general ledger accounts you have already prepared.)

**CCC3** It is the end of November and Natalie has been in touch with her grandmother grandmother asked Natalie how well things went in her first month of business. Na too, would like to know if she has been profitable or not during November. Natalie re that in order to determine Cookie Creations' income, she must first make adjustmen

Natalie puts together the following additional information.

1. A count reveals that $35 of baking supplies were used during November.
2. Natalie estimates that all of her baking equipment will have a useful life of 5 yea 60 months. (Assume Natalie decides to record a full month's worth of depreci regardless of when the equipment was obtained by the business.)

COMPREHENSIVE PROBLEM: CHAPTERS 3 TO 7

**CP7** McBride Company has the following opening account balances in its general and subsidiary ledgers on January 1 and uses the periodic inventory system. All accounts have normal debit and credit balances.

GENERAL LEDGER

| Account Number | Account Title | January 1 Opening Balance |
|---|---|---|
| 101 | Cash | $33,750 |
| 112 | Accounts Receivable | 13,000 |

WATERWAYS CONTINUING PROBLEM

(*Note:* The Waterways Problem begins in Chapter 19 and continues in the remaining chapters. You can also find this problem at the book's companion website.)

**WCP19** Waterways Corporation is a private corporation formed for the purpose of providing the products and the services needed to irrigate farms, parks, commercial projects,

# Contents

# 1 Accounting in Action

## Feature Story

*The **Feature Story** helps you picture how the chapter topic relates to the real world of accounting and business. You will find references to the story throughout the chapter.*

✔ The Navigator

### 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 after six months of experimentation by Gary Erickson and his mother in her kitchen. Today, the company has almost 300 employees and is considered one of the leading Landor's Breakaway Brands®.

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. Even in companies that do not practice

*__The Navigator__ is a learning system designed to prompt you to use the learning aids in the chapter and set priorities as you study.*

*__Learning Objectives__ give you a framework for learning the specific concepts covered in the chapter.*

✔ The Navigator

- ■ Scan Learning Objectives
- ■ Read Feature Story
- ■ Read Preview
- ■ Read text and answer **DO IT!** p. 11 ■ p. 14 ■ p. 21 ■ p. 25
- ■ Work Comprehensive **DO IT!** p. 26
- ■ Review Summary of Learning Objectives
- ■ Answer Self-Test Questions
- ■ Complete Assignments
- ■ Go to *WileyPLUS* for practice and tutorials
- **Read A Look at IFRS** p. 48

## Learning Objectives

✔ The Navigator

*After studying this chapter, you should be able to:*

[1] Explain what accounting is.

[2] Identify the users and uses of accounting.

[3] Understand why ethics is a fundamental business concept.

[4] Explain generally accepted accounting principles.

[5] Explain the monetary unit assumption and the economic entity assumption.

[6] State the accounting equation, and define its components.

[7] Analyze the effects of business transactions on the accounting equation.

[8] Understand the four financial statements and how they are prepared.

© Dan Moore/iStockphoto

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.

## Preview of Chapter 1

✔ The Navigator

The opening story 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 content and organization of Chapter 1 are as follows.

*The **Preview** describes and outlines the major topics and subtopics you will see in the chapter.*

**ACCOUNTING IN ACTION**

| What Is Accounting? | The Building Blocks of Accounting | The Basic Accounting Equation | Using the Accounting Equation | Financial Statements |
|---|---|---|---|---|
| • Three activities<br>• Who uses accounting data | • Ethics in financial reporting<br>• Generally accepted accounting principles<br>• Measurement principles<br>• Assumptions | • Assets<br>• Liabilities<br>• Owner's equity | • Transaction analysis<br>• Summary of transactions | • Income statement<br>• Owner's equity statement<br>• Balance sheet<br>• Statement of cash flows |

## What Is Accounting?

**LEARNING OBJECTIVE 1**

**Explain what accounting is.**

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 Ford Motor Company.

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 U.K. company Zetar plc 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.

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

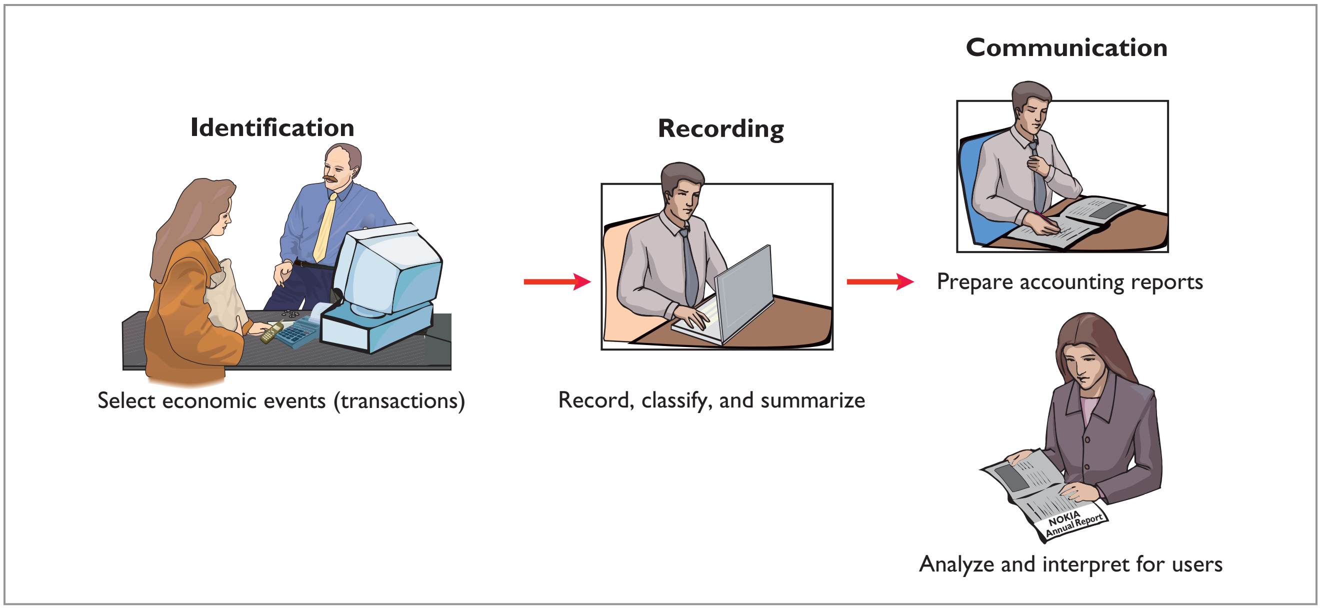


**Illustration 1-1**
The activities of the accounting process

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

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

**LEARNING OBJECTIVE 2**
**Identify the users and uses of accounting.**

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.

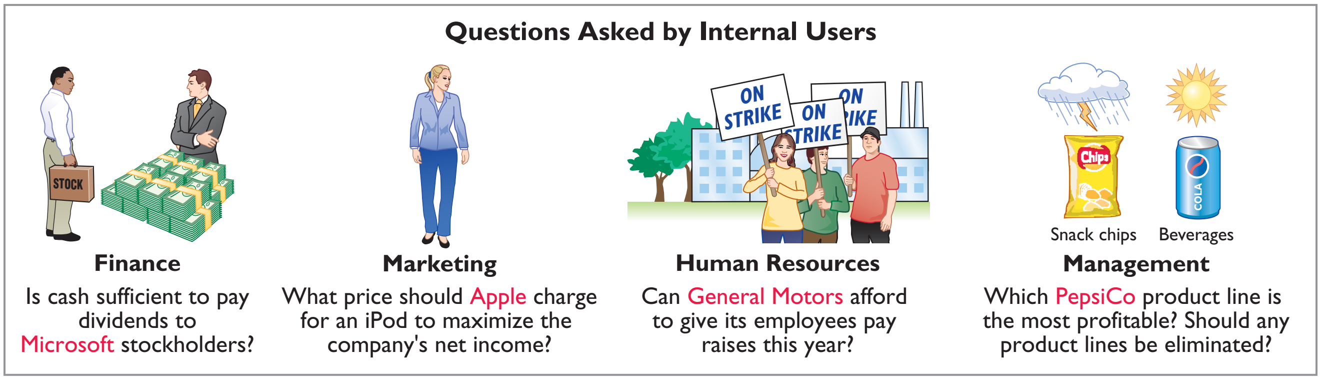


**Illustration 1-2**
Questions that internal users ask

[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.

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## ACCOUNTING ACROSS THE ORGANIZATION

### 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.*

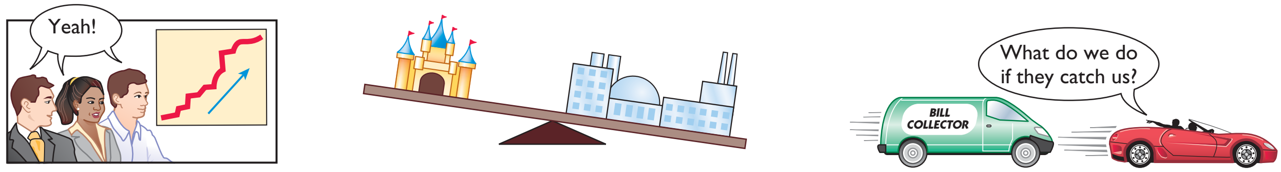
? What are the benefits to the company and to the employees of making the financial statements available to all employees? (See page 47.)

*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 General Motors 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 Building Blocks of Accounting

A doctor follows certain standards in treating a patient's illness. An architect follows certain standards in designing a building. An accountant follows certain standards in reporting financial information. For these standards to work, a fundamental business concept must be at work—ethical behavior.

**LEARNING OBJECTIVE 3**

**Understand why ethics is a fundamental business concept.**

### 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 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:

**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.

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

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.

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 are provided near the end of the chapter.*

Gemunu Amarasinghe/AP Photo

## ETHICS INSIGHT

### The Numbers Behind Not-for-Profit Organizations

Accounting plays an important role for a wide range of business organizations worldwide. Just as the integrity of the numbers matters for business, it matters at least as much at not-for-profit organizations. Proper control and reporting help ensure that money is used the way donors intended. Donors are less inclined to give to an organization if they think the organization is subject to waste or theft. The accounting challenges of some large international not-for-profits rival those of the world's largest businesses. For example, after the Haitian earthquake, the Haitian-born musician Wyclef Jean was criticized for the poor accounting controls in a relief fund that he founded. In response, he hired a new accountant and improved the transparency regarding money raised and spent.

? What benefits does a sound accounting system provide to a not-for-profit organization? (See page 47.)

## Generally Accepted Accounting Principles

LEARNING OBJECTIVE 4
Explain 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.

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.

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

## 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 \$300,000, the company initially reports it in its accounting records at \$300,000. 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 \$300,000.

### 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.