Survey of Accounting, 9e

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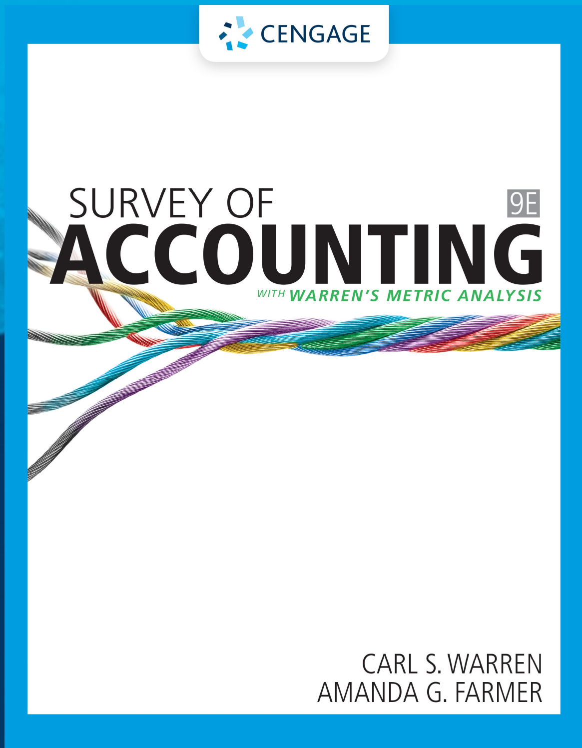


Chapter 1

The Role of Accounting in Business

Learning Objectives

- Describe the types and forms of businesses, how businesses make money, and business stakeholders
- Describe the three business activities of financing, investing, and operating
- Define accounting and describe its role in business
- Describe and illustrate the basic financial statements and how they are integrated
- Describe eight accounting concepts underlying financial reporting
- Describe types of metrics and analyze a company's performance using return on assets

Learning Objective 1

Describe the types and forms of businesses, how businesses make money, and business stakeholders

Types of Businesses

Service business

- Provides services rather than products to customers

Merchandising business

- Sells products purchased from other businesses to customers

Manufacturing business

- Changes basic inputs into products that are sold to customers

Forms of Business

Proprietorship	Partnership
Corporation	Limited liability company (LLC)

Characteristics of Different Forms of Business

Organizational Form	Ease of Formation	Legal Liability	Taxation	Limitation on Life of Entity	Access to Capital
Proprietorship	Simple	No limitation	Nontaxable (pass-through) entity	Yes	Limited
Partnership	Simple	No limitation	Nontaxable (pass-through) entity	Yes	Average
Corporation	Complex	Limited liability	Taxable entity	No	Extensive
Limited liability company	Moderate	Limited liability	Nontaxable (pass-through) entity by election	Yes	Average

How Do Businesses Make Money?

- Businesses earn a profit by providing goods and services to customers
- Strategies used by businesses to gain an advantage over their competitors
  - **Low-cost strategy**
  - **Premium-price strategy**

Exhibit 1: Business Strategies and Industries

Business Strategy	Industry					
	Airline	Freight	Automotive	Retail	Financial Services	Hotel
Low cost	Southwest	Union Pacific	Hyundai	Sam's Club	Ameritrade	Super 8
Premium price	Virgin Atlantic	FedEx	BMW	Talbot's	Morgan Stanley	Ritz-Carlton

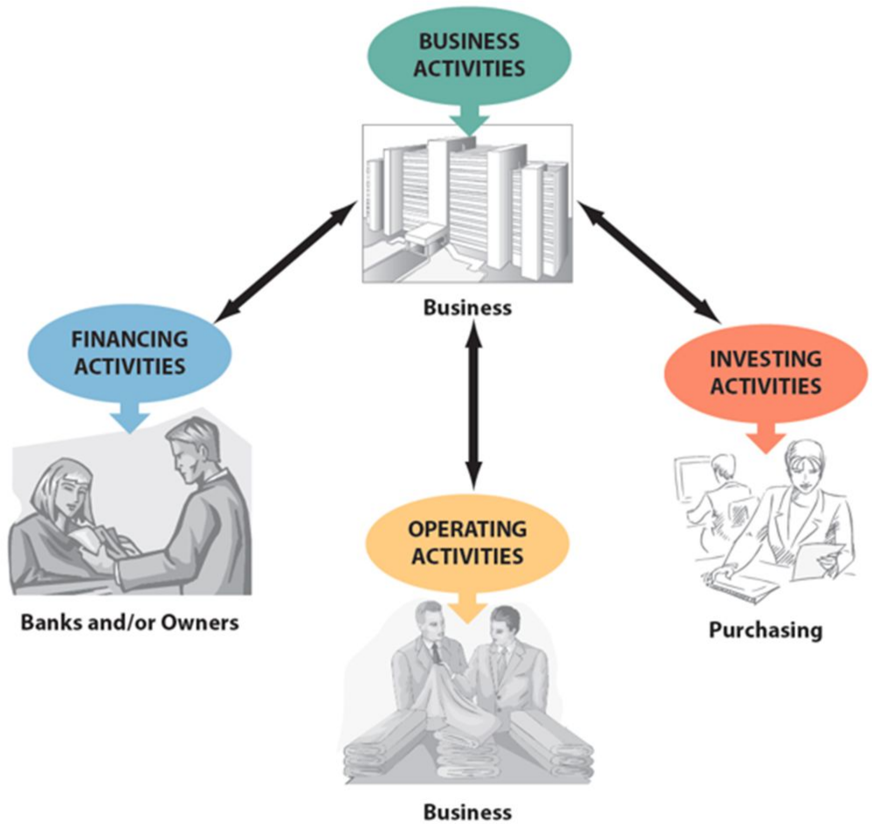
Exhibit 2: Business Stakeholders

Business Stakeholder	Interest in the Business	Examples
Capital market stakeholders	Providers of major financing for the business	Banks, owners, stockholders
Product or service market stakeholders	Buyers of products or services and vendors to the business	Customers and suppliers
Government stakeholders	Collect taxes and fees from the business and its employees	Federal, state, and city governments
Internal stakeholders	Individuals employed by the business	Employees and managers

Learning Objective 2

Describe the three business activities of financing, investing, and operating

Exhibit 4: Business Activities



Financing Activities: Forms of Liability

- **Account payable:** Liability when a company borrows from a vendor or supplier
- **Bonds payable:** Any bond obligations
  - Any interest due is reported as interest payable
- **Note payable:** Payment of the amount borrowed plus interest
  - Issued on a short-term or long-term basis
- Shares of ownership issued in the form of shares of stock
  - Include **common stock**

Investing Activities: Types of Assets

- **Tangible assets**
  - Assets that have physical characteristics
- **Intangible assets**
  - Include assets such as patents, goodwill, and copyrights
- **Prepaid expenses** are considered as assets until consumed
- **Accounts receivable** include rights to payments from customers who purchase merchandise or services on credit

Operating Activities: Revenues and Expenses

- **Sources of revenue**
  - Sales
  - Fees earned
- **Expenses**
  - Cost of goods sold, cost of merchandise sold, or cost of sales
  - Selling expenses
  - Administrative expenses

Learning Objective 3

Define accounting and describe its role in business

Accounting

- Information system that provides reports to stakeholders about the economic activities and condition of a business
- Summarizes the financial performance of a business for external stakeholders

Branches of Accounting

Financial accounting

- Associated with preparing reports for users external to a business

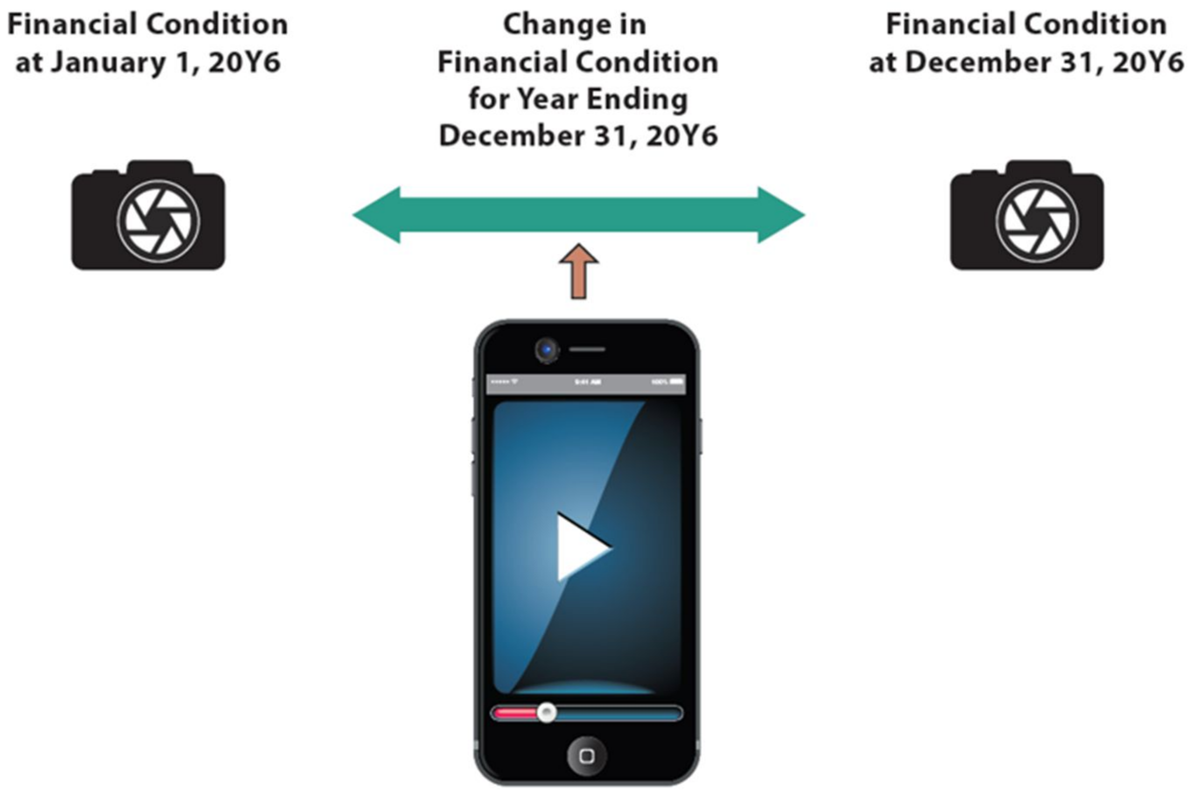
Managerial accounting

- Used to guide management in making financing, investing, and operations decisions for a company

Objectives of Financial Accounting

- To report the financial condition of a business at a point in time
- To report changes in the financial condition of a business over a period of time

Exhibit 5: Objectives of Financial Accounting



Learning Objective 4

Describe and illustrate the basic financial statements and how they are integrated

Financial Statements

Financial Statement	Financial Accounting Objective
Income Statement	Reports change in financial condition
Statement of Stockholders' Equity	Reports change in financial condition
Balance Sheet	Reports financial condition
Statement of Cash Flows	Reports change in financial condition

Exhibit 6: Income Statement—The Hershey Company

The Hershey Company Income Statement For the Year Ended December 31 (in millions)		
Revenues:		
Sales		$7,791
Expenses:		
Cost of sales	$4,216	
Selling and administrative expenses	1,875	
Interest expense	139	
Income taxes expense	239	
Other expenses	144	(6,613)
Net income		$ 1,178

- Summary of revenue and expenses for a specific period of time (month, quarter, or year)
- Reports the change in financial condition due to the operations of the company

Exhibit 7: Statement of Stockholders’ Equity

The Hershey Company
Statement of Stockholders’ Equity
For the Year Ended December 31 (in millions)

	Common Stock	Retained Earnings	Other Items	Total
Balances, January 1	$299	$6,371	$(5,738)	$ 932
Net income		1,178		1,178
Dividends		(564)		(564)
Other items		47	(186)	(139)
Balances, December 31	$299	$7,032	$(5,924)	$1,407

- Reports the changes in financial condition due to changes in stockholders’ equity for a period

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Exhibit 8 - Balance Sheet

The Hershey Company Balance Sheet December 31 (in millions)	
Assets	
Cash	$ 588
Accounts receivable	594
Inventories	785
Prepaid expenses	272
Property, plant, and equipment	2,130
Intangibles	3,080
Other assets	254
Total assets	$7,703
Liabilities	
Accounts payable	$ 502
Accrued liabilities	713
Notes and other debt	4,904
Income taxes payable	177
Total liabilities	$6,296
Stockholders' Equity	
Common stock	$ 299
Retained earnings	7,032
Repurchased capital stock and other equity items	(5,924)
Total stockholders' equity	$1,407
Total liabilities and stockholders' equity	$7,703

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Balance Sheet: Preparation

Step 1	Each asset is listed and added to arrive at total assets
Step 2	Each liability is listed and added to arrive at total liabilities
Step 3	Each stockholders' equity item is listed and added to arrive at total stockholders' equity
Step 4	Total liabilities and total stockholders' equity are added to get total liabilities and stockholders' equity
Step 5	Total assets must equal total liabilities and stockholders' equity

Exhibit 9: Statement of Cash Flows

The Hershey Company Statement of Cash Flows For the Year Ended December 31 (in millions)		
Cash flows from (used for) operating activities:		
Net cash flows from operating activities		$1,600
Cash flows from (used for) investing activities:		
Investments in property, plant, equipment, and other long-term assets		(1,503)
Cash flows from (used for) financing activities:		
Cash receipts from financing activities, including debt	$1,846	
Dividends paid to stockholders	(564)	
Repurchase of stock	(248)	
Other, including repayment of debt	(923)	
Net cash flows from financing activities		111
Net increase in cash during year		$ 208
Cash as of January 1		380
Cash as of December 31		$ 588

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Statement of Cash Flows

- Reports the change in financial condition due to the changes in cash during a period
- Net cash flows from operating activities
  - Primary focus of a company's stakeholders
  - Concerns the employees, managers, suppliers, customers, and other stakeholders interested in the long-term success of the company
- Net cash flows from investing activities
  - Includes cash receipts from selling property, plant, and equipment
  - Cash used to purchase property, plant, and equipment is reported as cash payments

Statement of Cash Flows (continued 1)

- Net cash flows from financing activities
  - Includes any cash receipts from issuing debt or stock
  - Reports any cash payments of debt and dividends

Order of Preparing Financial Statements

1. Income statement

2. Statement of changes in stockholders' equity

3. Balance sheet

4. Statement of cash flows

Exhibit 10: Integrated Financial Statements

The Hershey Company
Balance Sheet
December 31

Assets		=	Liabilities	+	Stockholders' Equity	
Cash	$ 588					
	.		.		.	
	.		.		$7,032	Retained Earnings
	.		.		299	Common Stock
	$7,703	=	$6,296	+	$1,407	

$7,703
Total Liabilities + Stockholders' Equity

The Hershey Company
Statement of Cash Flows
For the Year Ended Dec. 31

Operating act.	$1,600
Investing act.	(1,503)
Financing act.	111
Increase in cash	$ 208
Cash, Jan. 1	380
Cash, Dec. 31	$ 588

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The Hershey Company
Income Statement
For the Year Ended Dec. 31

Revenues	$7,791
Expenses	(6,613)
Net income	$1,178

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The Hershey Company
Statement of Stockholders' Equity
For the Year Ended Dec. 31

	Common Stock	Retained Earnings	Other Items	Total
Bal. Jan. 1	$299	$6,371	$(5,378)	$ 932
Net income		1,178		1,178
Dividends		(564)		(564)
Other items		47	(186)	(139)
Bal. Dec. 31	$299	$7,032	$(5,924)	$1,407

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Integrated Financial Statements

- Integrations help analyze:
  - Financial statements
  - Impact of transactions on the financial statements

Learning Objective 5

Describe eight accounting concepts underlying financial reporting

Generally Accepted Accounting Principles (GAAP)

- Accounting rules
- Institutions that develop and regulate accounting principles and concepts
  - **Financial Accounting Standards Board (FASB)**
  - **Securities and Exchange Commission (SEC)**
  - **International Accounting Standards Board (IASB)**

Accounting Concepts: Basis of GAAP

- **Business entity:** Company is viewed as an entity separate from its owners, creditors, or other companies
- **Cost:** Assets in the accounting records should be initially recorded at their cost or purchase price
- **Going concern:** Assumption that a company will continue in business indefinitely

Accounting Concepts: Basis of GAAP (continued 1)

- **Matching:** Expenses are matched against the revenues they generate
  - Based on **revenue recognition** and **expense recognition principles**
- **Objectivity:** Entries in the accounting records and the data reported on financial statements should be based on verifiable or objective evidence
- **Unit of measure:** All economic data are to be recorded in dollars

Accounting Concepts: Basis of GAAP (continued 2)

- **Adequate disclosure:** The financial statements, including related notes, contain all relevant data a stakeholder needs to understand the financial condition and performance of the company
- **Accounting period:** Accounting data should be recorded and summarized in financial statements for periods of time

Exhibit 13: Accounting Frauds

Company	Concept Violated	Result
Adelphia	Business Entity Concept: Rigas family treated the company assets as their own.	Bankruptcy. Rigas family members convicted of fraud and lost their investment in the company.
AIG	Business Entity Concept: Compensation transactions with an offshore company that should have been disclosed on AIG's books.	CEO (Chief Executive Officer) resigned. AIG paid out $126 million in fines.
AOL and PurchasePro	Matching Concept: Back-dated contracts to inflate revenues.	Civil charges filed against senior executives of both companies. Fined $500 million.
Computer Associates	Matching Concept: Fraudulently inflating revenues.	CEO and senior executives indicted. Five executives pled guilty. Fined $225 million.

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Exhibit 13: Accounting Frauds (continued 1)

Company	Concept Violated	Result
Enron	Business Entity Concept: Treated transactions as revenue, when they should have been treated as debt.	Bankruptcy. Criminal charges against senior executives. Over $60 billion in stock market losses.
Fannie Mae	Accounting Period Concept: Managing earnings by shifting expenses between periods.	CEO and CFO fired. $9 billion in restated earnings.
HealthSouth	Matching Concept: $4 billion in false entries to overstate revenues.	Senior executives faced regulatory and civil charges.
Quest	Matching Concept: Improper recognition of $3 billion in revenue.	CEO and six other executives charged with “massive financial fraud.” Fined $250 million by SEC.

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Exhibit 13: Accounting Frauds (continued 2)

Company	Concept Violated	Result
Tyco	Adequate Disclosure Concept: Failure to disclose secret loans to executives that were subsequently forgiven.	CEO forced to resign and was convicted in criminal proceedings.
WorldCom	Matching Concept: Improperly treated expenses as assets.	Bankruptcy. Criminal conviction of CEO and CFO. Over $100 billion in stock market losses. Directors fined $18 million.
Xerox	Matching Concept: Recognized $3 billion in revenue in periods earlier than should have been recognized.	Fined $10 million by SEC. Six executives fined $22 million.

Factors That Promote Accounting Frauds

Failure of individual character

- Managers and accountants perform ethical violations to avoid pressures from supervisors

Culture of greed and ethical indifference

- Senior managers create a culture of greed and indifference to the truth

Guidelines for Ethical Conduct

- Identify an ethical decision by using your personal ethical standards of honesty and fairness
- Identify the consequences of the decision and its effect on others
- Consider your obligations and responsibilities to those that will be affected by your decision
- Make a decision that is ethical and fair to those affected by it

Learning Objective 6

Describe types of metrics and analyze a company's performance using return on assets

Metrics

- Any quantitative measures
- Types: Ratios and amounts
- **Metric-based analysis:** Use of metrics to assess financial condition, performance, and decisions
  - Level of application
    - Financial statement level
    - Transaction level
    - Managerial decision level

Return on Assets

- Measure of a company's profitability
  - Used to compare a company's performance over time and with its competitors

$$\text{Return on Assets} = \frac{\text{Net Income}}{\text{Average Total Assets}}$$

- Expressed as a percentage or as an amount per dollar invested
  - Example: 12% rate of return on assets could also be expressed as $0.12 return per $1 invested

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Rate of Return on Assets

	Apple Inc.	HP Inc.
Net income	$ 48,351	$ 2,526
Total assets at beginning of year	$321,686	$28,987
Total assets at end of year	$375,319	$32,913
Average total assets:		
Apple Inc. [($321,686 + $375,319) ÷ 2]	$348,503	
HP Inc. [($28,987 + $32,913) ÷ 2]		$30,950
Return on assets:*		
Apple Inc. ($48,351 ÷ $348,503)	13.9%	
HP Inc. ($2,526 ÷ $30,950)		8.2%

*Rounded to one decimal place.

- Apple Inc. is approximately 1.7 (13.9% ÷ 8.2%) times more profitable as measured by return on assets than is HP Inc.

End of Chapter 1