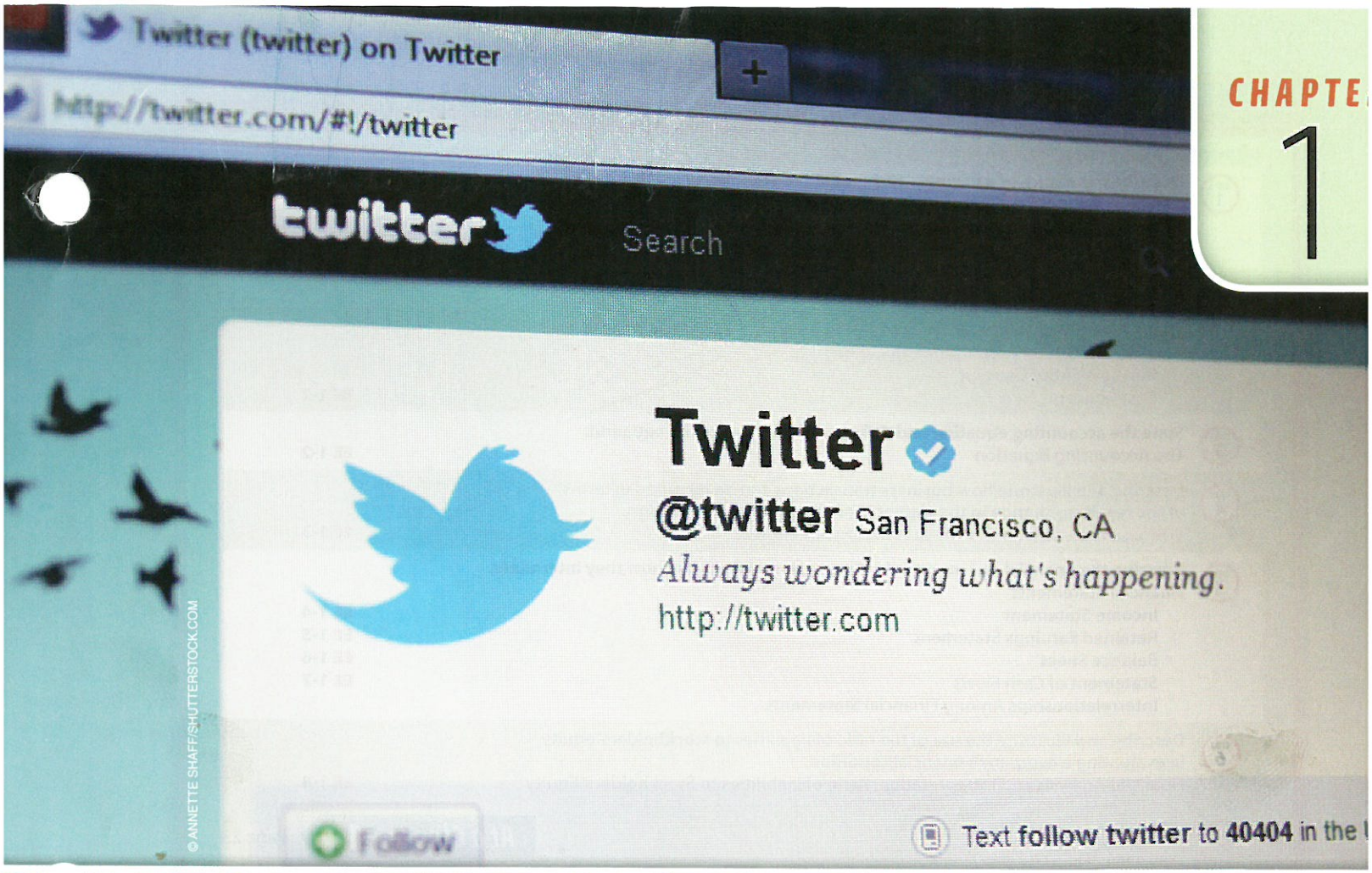

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CHAPTER 1

Introduction to Accounting and Business

Twitter

When two teams pair up for a game of football, there is often a lot of noise. The band plays, the fans cheer, and fireworks light up the scoreboard. Obviously, the fans are committed and care about the outcome of the game. Just like fans at a football game, the owners of a business want their business to "win" against their competitors in the marketplace. While having your football team win can be a source of pride, winning in the marketplace goes beyond pride and has many tangible benefits. Companies that are winners are better able to serve customers, provide good jobs for employees, and make money for their owners.

Twitter is one of the most visible companies on the Internet. It provides a real-time information network where members can post messages, called Tweets, of up to 140 characters for free. Millions post Tweets every day throughout the world.

Do you think Twitter is a successful company? Does it make money? How would you know? Accounting helps to answer these questions.

This textbook introduces you to accounting, the language of business. Chapter 1 begins by discussing what a business is, how it operates, and the role that accounting plays.

- **Manufacturing businesses** change basic inputs into products that are sold to customers.
  - Ford Motor Co. (cars, trucks, vans)
  - Dell Inc. (personal computers)

Role of Accounting in Business

The role of accounting in business is to provide information for managers to use in operating the business. In addition, accounting provides information to other users in assessing the economic performance and condition of the business.

Thus, **accounting** can be defined as an information system that provides reports to users about the economic activities and condition of a business. You could think of accounting as the "language of business." This is because accounting is the means by which businesses' financial information is communicated to users.

Note:
Accounting is an information system that provides reports to users about the economic activities and condition of a business.

The process by which accounting provides information to users is as follows:

1. Identify users.
2. Assess users' information needs.
3. Design the accounting information system to meet users' needs.
4. Record economic data about business activities and events.
5. Prepare accounting reports for users.

As illustrated in Exhibit 1, users of accounting information can be divided into two groups: internal users and external users.

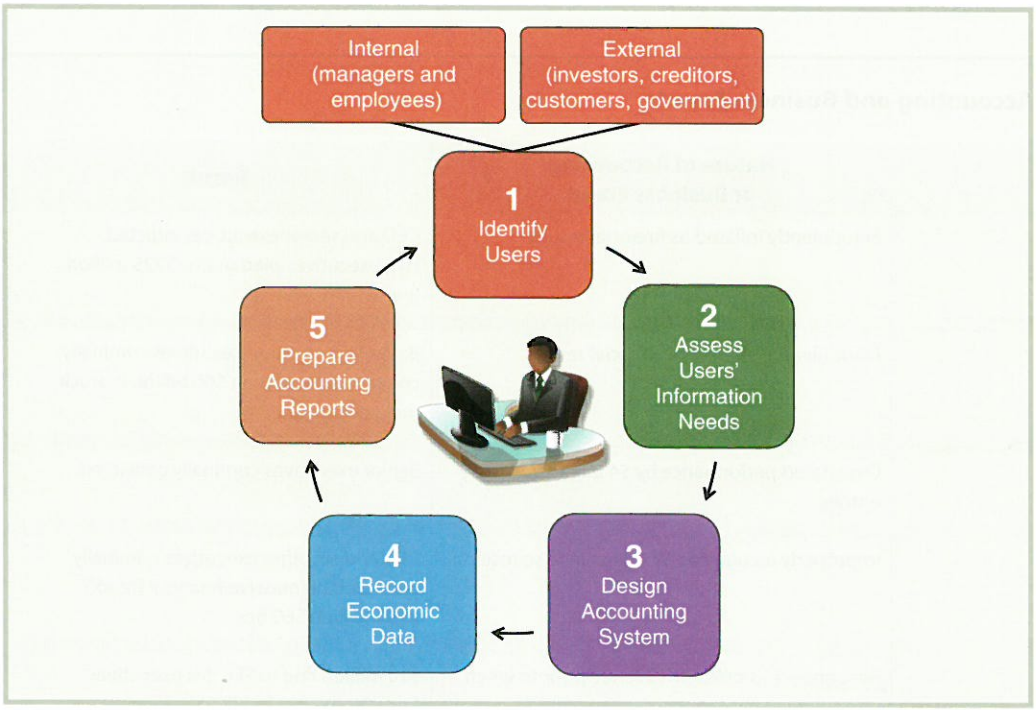

EXHIBIT 1
Accounting as an Information System

Managerial Accounting Internal users of accounting information include managers and employees. These users are directly involved in managing and operating the business. The area of accounting that provides internal users with information is called **managerial accounting**, or **management accounting**.

The objective of managerial accounting is to provide relevant and timely information for managers' and employees' decision-making needs. Oftentimes, such information is sensitive and is not distributed outside the business. Examples of sensitive information might include information about customers, prices, and plans to expand the business. Managerial accountants employed by a business are employed in **private accounting**.

- ***Culture of Greed and Ethical Indifference.*** By their behavior and attitude, senior managers set the company culture. In most of the companies listed in Exhibit 2, the senior managers created a culture of greed and indifference to the truth.

As a result of the accounting and business frauds shown in Exhibit 2, Congress passed laws to monitor the behavior of accounting and business. For example, the **Sarbanes-Oxley Act (SOX)** was enacted. SOX established a new oversight body for the accounting profession called the **Public Company Accounting Oversight Board (PCAOB)**. In addition, SOX established standards for independence, corporate responsibility, and disclosure.

How does one behave ethically when faced with financial or other types of pressure? Guidelines for behaving ethically follow:[2]

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

Integrity, Objectivity, and Ethics in Business

BERNIE MADOFF

In June 2009, Bernard L. "Bernie" Madoff was sentenced to 150 years in prison for defrauding thousands of investors in one of the biggest frauds in American history. Madoff's fraud started several decades earlier when he began a "Ponzi scheme" in his investment management firm, Bernard L. Madoff Investment Securities LLC.

In a Ponzi scheme, the investment manager uses funds received from new investors to pay a return to existing investors, rather than basing investment returns on the fund's actual performance. As long as the investment manager is able to attract new investors, he or she will have new funds to pay existing investors and continue the fraud. While most Ponzi schemes collapse quickly when the investment manager runs out of new investors, Madoff's reputation, popularity, and personal contacts provided a steady stream of investors, which allowed the fraud to survive for decades.

Opportunities for Accountants

Numerous career opportunities are available for students majoring in accounting. Currently, the demand for accountants exceeds the number of new graduates entering the job market. This is partly due to the increased regulation of business caused by the accounting and business frauds shown in Exhibit 2. Also, more and more businesses have come to recognize the importance and value of accounting information.

As indicated earlier, accountants employed by a business are employed in private accounting. Private accountants have a variety of possible career options within a company. Some of these career options are shown in Exhibit 3 along with their starting salaries. Accountants who provide audit services, called *auditors*, verify the accuracy of financial records, accounts, and systems. As shown in Exhibit 3, several private accounting careers have certification options.

Accountants and their staff who provide services on a fee basis are said to be employed in **public accounting**. In public accounting, an accountant may practice as an individual or as a member of a public accounting firm. Public accountants who have met a state's education, experience, and examination requirements may become **Certified Public Accountants (CPAs)**. CPAs typically perform general accounting,

[2] Many companies have ethical standards of conduct for managers and employees. In addition, the Institute of Management Accountants and the American Institute of Certified Public Accountants have professional codes of conduct, which can be obtained from their Web sites at www.imanet.org and www.aicpa.org, respectively.

Generally Accepted Accounting Principles

OBJ 2 Summarize the development of accounting principles and relate them to practice.

If a company's management could record and report financial data as it saw fit, comparisons among companies would be difficult, if not impossible. Thus, financial accountants follow **generally accepted accounting principles (GAAP)** in preparing reports. These reports allow investors and other users to compare one company to another.

Accounting principles and concepts develop from research, accepted accounting practices, and pronouncements of regulators. Within the United States, the **Financial Accounting Standards Board (FASB)** has the primary responsibility for developing accounting principles. The FASB publishes *Statements of Financial Accounting Standards* as well as *Interpretations* of these Standards. In addition, the **Securities and Exchange Commission (SEC),** an agency of the U.S. government, has authority over the accounting and financial disclosures for companies whose shares of ownership (stock) are traded and sold to the public. The SEC normally accepts the accounting principles set forth by the FASB. However, the SEC may issue *Staff Accounting Bulletins* on accounting matters that may not have been addressed by the FASB.

Many countries outside the United States use generally accepted accounting principles adopted by the **International Accounting Standards Board (IASB)**. The IASB issues *International Financial Reporting Standards (IFRSs)*. Differences currently exist between FASB and IASB accounting principles. However, the FASB and IASB are working together to reduce and eliminate these differences into a single set of accounting principles. Such a set of worldwide accounting principles would help facilitate investment and business in an increasingly global economy.

IFRS

See Appendix C for more information.

In this chapter and text, accounting principles and concepts are emphasized. It is through this emphasis on the "why" as well as the "how" that you will gain an understanding of accounting.

International Connection

IFRS INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

IFRS are considered to be more "principles-based" than U.S. GAAP, which is considered to be more "rules-based." For example, U.S. GAAP consists of approximately 17,000 pages, which include numerous industry-specific accounting rules. In contrast, IFRS allow more judgment in deciding how business transactions are recorded. Many believe that the strong regulatory and litigation environment in the United States is the cause for the more rules-based GAAP approach. Regardless, IFRS and GAAP share many common principles.*

*Differences between U.S. GAAP and IFRS are further discussed and illustrated in Appendix C.

Business Entity Concept

The **business entity concept** limits the economic data in an accounting system to data related directly to the activities of the business. In other words, the business is viewed as an entity separate from its owners, creditors, or other businesses. For example, the accountant for a business with one owner would record the activities of the business only and would not record the personal activities, property, or debts of the owner.

Note:
Under the business entity concept, the activities of a business are recorded separately from the activities of its owners, creditors, or other businesses.

A business entity may take the form of a proprietorship, partnership, corporation, or limited liability company (LLC). Each of these forms and their major characteristics are listed in Exhibit 4.

The three types of businesses discussed earlier—service, merchandising, and manufacturing—may be organized as proprietorships, partnerships, corporations, or limited liability companies. Because of the large amount of resources required to operate a manufacturing business, most manufacturers such as Ford Motor Company are corporations. Most large retailers such as Walmart and Home Depot are also corporations.

Example Exercise 1-1 Cost Concept

OBJ 2

On August 25, Gallatin Repair Service extended an offer of $125,000 for land that had been priced for sale at $150,000. On September 3, Gallatin Repair Service accepted the seller's counteroffer of $137,000. On October 20, the land was assessed at a value of $98,000 for property tax purposes. On December 4, Gallatin Repair Service was offered $160,000 for the land by a national retail chain. At what value should the land be recorded in Gallatin Repair Service's records?

Follow My Example 1-1

$137,000. Under the cost concept, the land should be recorded at the cost to Gallatin Repair Service.

Practice Exercises: PE 1-1A, PE 1-1B

The Accounting Equation

OBJ 3 State the accounting equation and define each element of the equation.

The resources owned by a business are its **assets**. Examples of assets include cash, land, buildings, and equipment. The rights or claims to the assets are divided into two types: (1) the rights of creditors and (2) the rights of owners. The rights of creditors are the debts of the business and are called **liabilities**. The rights of the owners are called **stockholders' equity** for a corporation and **owner's equity** for a proprietorship, partnership, or limited liability company. Throughout this text, we use the corporate form of business. However, most of the concepts and principles described and illustrated also apply to proprietorships, partnerships, and limited liability companies.

The following equation shows the relationship among assets, liabilities, and stockholders' equity:

Assets = Liabilities + Stockholders' Equity

This equation is called the **accounting equation**. Liabilities usually are shown before stockholders' equity in the accounting equation because creditors have first rights to the assets.

Given any two amounts, the accounting equation may be solved for the third unknown amount. To illustrate, if the assets owned by a business amount to $100,000 and the liabilities amount to $30,000, the stockholders' equity is equal to $70,000, computed as follows:

Assets	−	Liabilities	=	Stockholders' Equity
$100,000	−	$30,000	=	$70,000

Business Connection

THE ACCOUNTING EQUATION

The accounting equation serves as the basic foundation for the accounting systems of all companies. From the smallest business, such as the local convenience store, to the largest business, such as The Coca-Cola Company, companies use the accounting equation. Some examples taken from recent financial reports of well-known companies follow:

Company	Assets*	=	Liabilities	+	Stockholders' Equity
The Coca-Cola Company	$79,974	=	$48,339	+	$31,635
DuPont	$49,736	=	$39,648	+	$10,088
eBay	$37,074	=	$16,209	+	$20,865
Google	$93,798	=	$22,083	+	$71,715
McDonald's	$32,990	=	$18,600	+	$14,390
Microsoft Corporation	$121,271	=	$54,908	+	$66,363
Southwest Airlines	$18,596	=	$11,604	+	$6,992
Walmart	$193,406	=	$122,091	+	$71,315

*Amounts are shown in millions of dollars.