# financial accounting




# LEARNING OBJECTIVES

**AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:**

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

**LO2** Discuss the significance of accounting systems in generating reliable accounting information and understand the five components of internal control.

**LO3** 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.

**LO4** Explain the importance of accounting information for internal parties—primarily management—in terms of the objectives and the characteristics of that information.

**LO5** Discuss elements of the system of external and internal financial reporting that create integrity in the reported information.

**LO6** Identify and discuss several professional organizations that play important roles in preparing and communicating accounting information.

**LO7** Discuss the importance of personal competence, professional judgment, and ethical behavior on the part of accounting professionals.

**LO8** Describe various career opportunities in accounting.

# Accounting

## Information for Decision Making

1

## HSBC HOLDINGS

**HSBC Holdings**, or simply **HSBC**, is one of the largest banking institutions in the world by market capitalization. It is present in 86 countries worldwide, and has 335,000 employees serving over 100 million customers. Named after its founding member, The Hongkong and Shanghai Banking Corporation Limited was founded in 1865 in Hong Kong with an initial capital of HK$5 million. Now, **HSBC** becomes one of the largest banking institutions in the world by market capitalization. By 2006, the firm had assets worth more than US$1.86 trillion. Its profit grew from less than HK$0.5 million in 1875 to more than US$15.7 billion in 2006.

In 2008, however, the subprime mortgage crisis in the United States resulted in a global financial tsunami, which affected nearly all financial institutions, including **HSBC**. The latter was forced to restructure its loss-making North American operation, which was mainly based on its acquisition, in 2003, of Illinois-based subprime lender, Household International. In addition, **HSBC** had announced a rights issue to strengthen its financial position, and the action caused substantial volatility on its share price in March 2009. The share price of **HSBC** was trading as high as HK$150 per share in October 2007, but fell to HK$33 per share in March 2009—a drop of 78 percent.

How did a bank with such a strong presence around the world suffer such a huge setback? Group chairman Stephen Green said to reporters in a conference call in March 2009 about the acquisition of Household International: "It's an acquisition we wish we hadn't done with the benefit of hindsight, and there are lessons to be learned." Of course, **HSBC**'s management had failed to anticipate the dramatic decline in property price during the financial tsunami and adequately protected the bank from such decline.

SOURCES: **www.hsbc.com**, Bloomberg, and Wikipedia

Understanding and using accounting information is an important ingredient of any business undertaking. Terms such as sales revenue, profit or loss, 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, to become an active participant in the business world, you must gain a basic understanding of these and other accounting concepts. Our objective in this book is to provide those who both use and prepare accounting information with that basic understanding.

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 profit or loss 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 business faces on a day-to-day basis and which 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 financial 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

The primary objective of accounting is to provide information that is useful for decision-making purposes. 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.

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

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 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 how economic activities flow into the accounting process. The accounting process produces accounting information used by decision makers in making economic decisions and taking specific actions. These decisions and actions result in economic activities that continue the cycle.

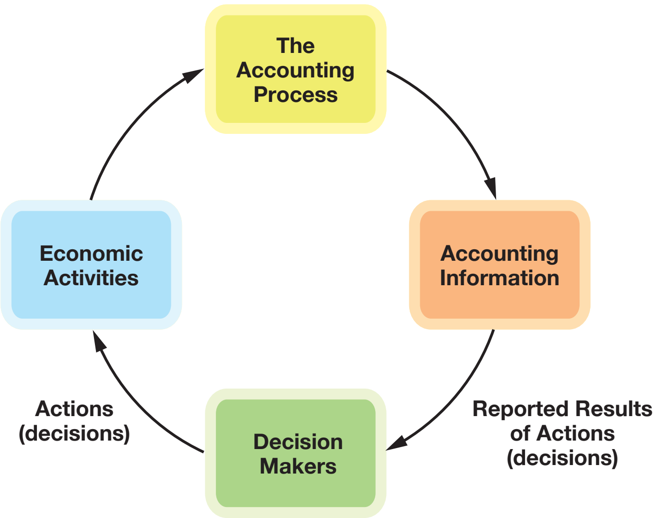



**Exhibit 1–1**

**THE ACCOUNTING PROCESS**

**Accounting links decision makers with economic activities—and with the results of their decisions**

## 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 2013 financial statements to owners, financial position is presented as consisting of ¥14,206 billion in assets (including cash, inventories, property, and equipment), with obligations against those assets of ¥11,525 billion. This leaves ¥2,681 billion as the owners' interest in those assets. In the same report, results of operations indicated that **Sony** had a net income (revenue exceeded expenses) of ¥43 billion for the year ending 31 March 2013.

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.

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

**LO2** **Discuss the significance of accounting systems in generating reliable accounting information and understand the five components of internal control.**

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*.

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 undertake 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—performance evaluation and resource allocation, among others. These relationships are consistent with what we have already learned—namely, that accounting information is intended to be useful for decision-making purposes.

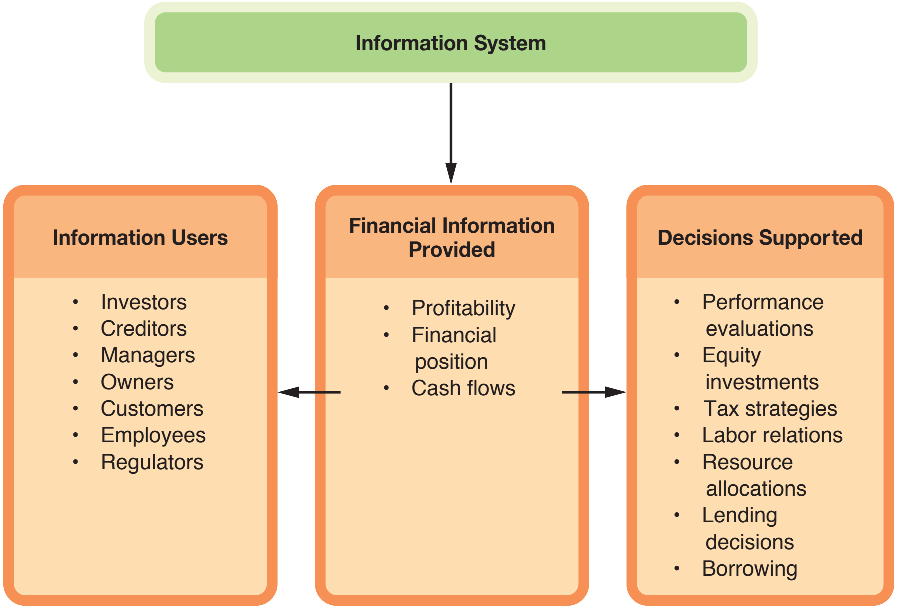



Exhibit 1–2

**ACCOUNTING AS AN INFORMATION SYSTEM**

## 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. Exchange or securities laws require publicly owned companies to prepare financial statements in conformity with international financial reporting standards. These statements must be filed with the relevant regulators and authorities, distributed to shareholders, 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-sized 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[1]

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* (Committee of Sponsoring Organizations of the Treadway Commission), are the *control environment*, *risk assessment*, *control activities*, *information and communication*, and *monitoring*.

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 integrity, ethical values, and competence of the company's personnel, (2) management's philosophy and operating style, (3) management's assignment of authority and responsibility, (4) procedures for the hiring and training of personnel, and (5) oversight by the board of directors. 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.

**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

[1] The information in this section is taken from *Internal Control–Integrated Framework*, Committee of Sponsoring Organizations of the Treadway Commission, September 1992.

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** enables the company to evaluate the effectiveness of its system of internal control over time. Monitoring is 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.

As a result of the large financial frauds at **Enron** and **WorldCom** in the United States, the U.S. Congress passed, and President George W. Bush signed, the **Sarbanes-Oxley Act** (SOX) of 2002. SOX has been described as the most far-reaching securities law since the 1930s. One of the SOX requirements is that public companies must issue a yearly report indicating whether they have an effective system of internal control over financial reporting. In essence, management must indicate whether the entity's internal control system provides reasonable assurance that financial statements will be prepared in accordance with laws and regulations governing financial reporting. In addition, the company's external auditor must issue its own report as to whether the auditor believes that the company's internal control system is effective. These requirements are contained in Section 404 of SOX; therefore, many businesspeople describe the above process as the 404 certification and the audit under Section 404. This certification process has been extremely expensive and time-consuming and some businesspeople believe that the costs associated with this certification requirement exceed the benefits.

# Financial Accounting Information

**LO3** **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.**

*Financial accounting* is an important subject for students who need only an introduction to the field of accounting, as well as for students who will pursue accounting as a major and take many additional accounting courses. Financial accounting provides information about the financial resources, obligations, and activities of an enterprise that is intended for use primarily by external decision makers—investors and creditors.

## EXTERNAL USERS OF ACCOUNTING INFORMATION

What do we mean by *external users* and who are they? **External users** of accounting information are individuals and other enterprises that have a current or potential financial interest in the reporting enterprise, but that are not involved in the day-to-day operations of that enterprise. External users of financial information may include the following:

- Owners
- Creditors
- Potential investors
- Labor unions
- Governmental agencies
- Suppliers
- Customers
- Trade associations
- General public

Each of these groups of external decision makers requires unique information to be able to make decisions about the reporting enterprise. For example, customers who purchase from the enterprise need information to allow them to assess the quality of the products they buy and the faithfulness of the enterprise in fulfilling warranty obligations. Governmental agencies such as relevant trade regulation departments or labor departments may have an interest in whether the enterprise meets certain governmental regulations that apply. The general public may be interested in the extent to which the reporting enterprise is socially responsible (for example, does not pollute the environment).

Providing information that meets the needs of such a large set of diverse users is difficult, if not impossible, in a single set of financial information. Therefore, external financial reporting is primarily used by two groups—investors and creditors. As you will soon see, investors are individuals and other enterprises that own the reporting enterprise. Creditors, on the other hand, are individuals and other enterprises to whom the reporting entity owes money, goods, or services. For example, a commercial bank may have loaned money to the reporting enterprise, or a supplier may have permitted the reporting enterprise to purchase goods and to pay for those goods later. Our assumption is that by meeting the financial information needs of investors and creditors, we provide information that is also useful to many other users of financial information.

For these reasons, we sometimes refer to investors and creditors as the primary external financial information users. When you see references like these, keep in mind that we are talking about both current investors and creditors and those individuals and other enterprises that may become investors and creditors in the future.

## OBJECTIVES OF EXTERNAL FINANCIAL REPORTING

If you had invested in a company, or if you had loaned money to a company, what would be your primary financial interest in the company? You probably would be interested in two things, both of which make up the company's **cash flow prospects**. You would be interested in the return to you at some future date of the amount you had invested or loaned. We refer to this as the **return *of* your investment**. In addition, you would expect the company to pay you something for the use of your funds, either as an owner or a creditor. We refer to this as the **return *on* your investment**. Information that is useful to you in making judgments about the company's ability to provide you with what you expect in terms of the return *of* your funds as well as a return *on* your funds while you do not have use of them is what we mean by information about *cash flow prospects*.

Assume that you have a friend who wants to start a business and needs some help getting the money required to rent space and acquire the needed assets to operate the business (for

**YOUR TURN** **You as a Creditor**

You are a loan officer at a bank that makes small loans to individuals to help finance purchases such as automobiles and appliances. You are considering an application from a young woman who needs to purchase a new car. She is requesting a loan of $10,000 which, when combined with the trade-in value of her old car, will allow her to meet her needs. What are your expectations with regard to repayment of the loan, and what information would help you decide whether she is a good credit risk for your bank?

(See our comments on the Online Learning Center Web site.)

example, delivery truck, display fixtures) and pay employees for their work before the doors open and customers begin paying for the products the company plans to sell. You are in a financially strong position and agree to loan your friend $100,000. Your intent is not to be a long-term investor or co-owner of the business, but rather to help your friend start his company and at the same time earn a return on the funds you have loaned him. Assume further that you agree to let your friend have the use of your $100,000 for one year and, if you had not loaned this amount to him, you could have earned an 8 percent return by placing your money in another investment.

In addition to wanting to help a friend, you are interested in knowing how much risk you are taking with regard to your $100,000. You expect your friend to pay that $100,000 back, and to also pay you an additional amount of $8,000 ($100,000 $\times$ 8%) for his use of your money. The total return of your investment ($100,000) back to you one year later, added to the amount you expect to receive for his having used your money for a year ($8,000), is shown in Exhibit 1–3.

Providing information for you to assess your friend's ability to meet his cash flow commitment to you is essentially what financial reporting is about. You need information to

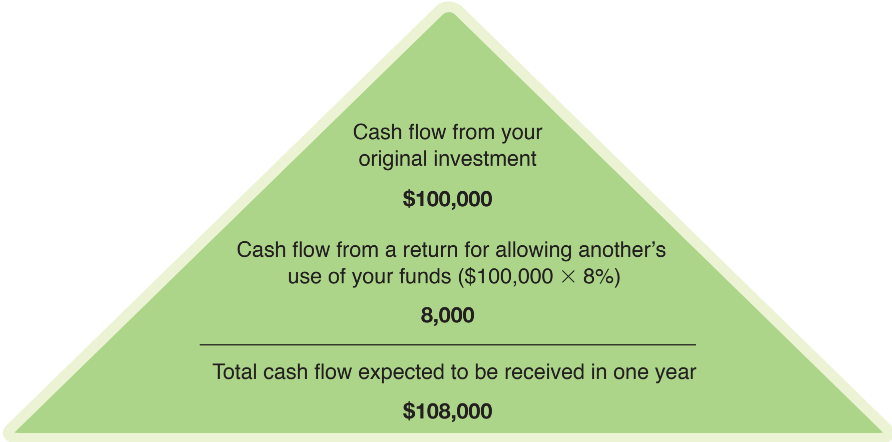



**Exhibit 1–3**
**INVESTMENT ANALYSIS**

assess the risk you are taking and the prospects that your friend will be able to deliver $108,000 to you one year from the time you loan him the $100,000. While this is a relatively simple example, it sets the stage for your understanding of the kinds of information that will help you make this important investment decision.

The accounting profession has identified certain objectives of external financial reporting to guide its efforts to refine and improve the reporting of information to external decision makers. These general objectives are displayed in Exhibit 1–4 and are best understood if studied from the bottom up—from general to specific.[2]

The first objective is the most general and is to provide information that is useful in making economic decisions. As we indicated earlier, investors and creditors are the primary focus of external financial reporting. We believe that, by meeting the information needs of investors and creditors, we provide general information that is also useful to many other important financial statement users.

The second objective, which is more specific than the first, is to provide information that is useful for predicting the amount, timing, and uncertainty of future cash flows. As we discussed earlier, investors and creditors are interested in future cash flows to them, so an important objective of financial reporting is to provide general information that permits that kind of analysis.

The most specific objective of external financial reporting is to provide information about the enterprise's assets, liabilities, equity, income and expenses, including gains and losses, contributions by and distributions to owners in their capacity as owners, and cash flows.

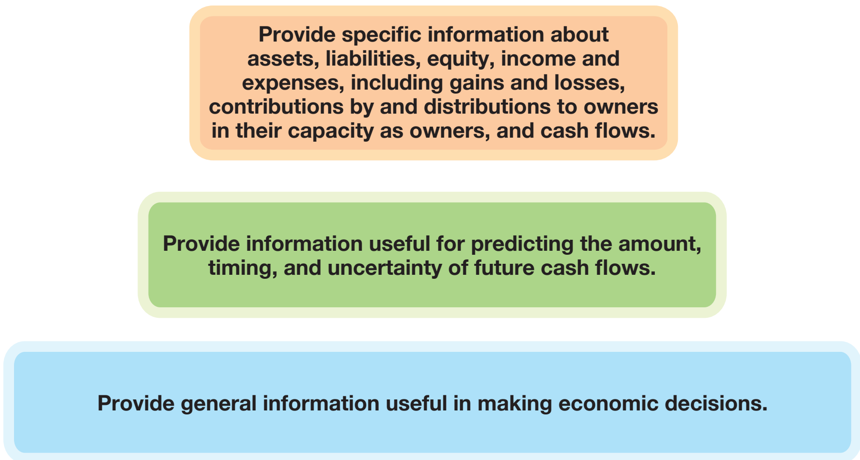



**Exhibit 1–4**
**OBJECTIVES OF FINANCIAL REPORTING: BUILDING FROM THE GENERAL TO THE SPECIFIC**

[2] IASB *International Accounting Standard No. 1* "Presentation of Financial Statements" (London, 2011), para. 9.

One of the primary ways investors and creditors assess whether an enterprise will be able to make future cash payments is to examine and analyze the enterprise's financial statements. In the general sense of the word, a statement is simply a declaration of something believed to be true. A **financial statement**, therefore, is simply a monetary declaration of what is believed to be true about an enterprise. When accountants prepare financial statements, they are describing in financial terms certain attributes of the enterprise that they believe fairly represent its financial activities.

Financial statements prepared for periods of time shorter than one year (for example, for three months or one month) are referred to as *interim financial statements*. Throughout this text, we use both annual and interim financial statements. As you approach a company's financial statements—either as a user or as a preparer—it is important to establish the time period those statements are intended to cover.

The primary financial statements are the following:

- *Statement of financial position (balance sheet)*. The **balance sheet** is a position statement that shows where the company stands in financial terms at a specific date.
- *Income statement*. The **income statement** is an activity statement that shows details and results of the company's profit-related activities for a period of time (for example, a month, quarter [three months], or year).
- *Statement of cash flows*. The **statement of cash flows** is an activity statement that shows the details of the company's activities involving cash during a period of time.

The names of the three primary financial statements are descriptive of the information you find in each. The **statement of financial position**, or balance sheet, for example, is sometimes described as a snapshot of the business in financial or dollar terms (that is, what the enterprise looks like at a specific date). An income statement is an activity statement that depicts the profitability of an enterprise for a designated period of time. The statement of cash flows is particularly important in understanding an enterprise for purposes of investment and credit decisions. As its name implies, the statement of cash flows depicts the ways cash has changed during a designated period. While the interest of investors and creditors is in cash flows to themselves rather than to the enterprise, information about cash activity of the enterprise is considered to be an important signal to investors and creditors.

At this early stage in your study of accounting, you are not expected to understand these financial statements or how they precisely help you assess the cash flow prospects of a company. The statement of financial position (balance sheet), income statement, and statement of cash flows are introduced more fully to you in the next chapter. Thereafter, you will learn a great deal about how these statements are prepared and how the information contained in them can be used to help you understand the underlying business activities they represent.

## CHARACTERISTICS OF EXTERNALLY REPORTED INFORMATION

Financial information that is reported to investors, creditors, and others external to the reporting enterprise has certain qualities that must be understood for the information to have maximum usefulness. Some of these qualities are discussed in the following paragraphs.

**Financial Reporting—A Means** As we learned in the introduction to this chapter, financial information is a means to an end, not an end in and of itself. The ultimate outcome of providing financial information is to improve the quality of decision making by external parties. Financial statements themselves are simply a means by which that end is achieved.

**Financial Reporting versus Financial Statements** Financial reporting is broader than financial statements. Stated another way, financial statements are a subset of the total information encompassed by financial reporting. Investors, creditors, and other external users of financial information learn about an enterprise in a variety of ways in addition to its formal financial statements (for example, press releases sent directly to investors and creditors, articles in *The Wall Street Journal* or the *Financial Times*, and more recently open communications via the Internet). Serious investors, creditors, and other external users take advantage of many sources of information that are available to support their economic decisions about an enterprise.

**Historical in Nature** Externally reported financial information is generally historical in nature. It looks back in time and reports the results of events and transactions that already have occurred. While historical information is very useful in assessing the future, the information itself is more about the past than it is about the future. However, in recent years, accounting standard setters are requiring greater use of fair values, rather than historical costs, in measuring assets and liabilities.

**Inexact and Approximate Measures** Externally reported financial information may have a look of great precision, but in fact much of it is based on estimates, judgments, and assumptions that must be made about both the past and the future. For example, assume a company purchases a piece of equipment for use in its business. To account for that asset and to incorporate the impact of it into the company's externally reported financial information, some assumptions must be made about how long it will be used by the company—how many years it will be used, how many machine-hours it will provide, and so on. The fact that a great deal of judgment underlies most accounting information is a limitation that is sometimes misunderstood.

**General-Purpose Assumption** As we have already mentioned, we assume that, by providing information that meets the needs of investors and creditors, we also meet the information needs of other external parties. We might be able to provide superior information if we were to treat each potential group of external users separately and prepare different information for each group. This approach is impractical, however, and we instead opt for preparing what is referred to as **general-purpose information** that we believe is useful to multiple user groups (that is, "one size fits all").

**Usefulness Enhanced via Explanation** The accounting profession believes that the value of externally reported financial information is enhanced by including explanations from management. This information is often nonquantitative and helps to interpret the financial numbers that are presented. For this reason, financial information, including financial statements, is accompanied by a number of notes and other explanations that help explain and interpret the numerical information.

# Management Accounting Information

**LO4** **Explain the importance of accounting information for internal parties—primarily management—in terms of the objectives and the characteristics of that information.**

Internal decision makers employed by the enterprise, often referred to as management, create and use internal accounting information not only for exclusive use inside the organization but also to share with external decision makers. For example, in order to meet a production schedule, a producer may design an accounting information system for suppliers detailing its production plans. The producer shares this information with its supplier companies so that they can help the producer meet its objectives. Thus, although the creator and distributor of the accounting information is an internal decision maker, the recipient of the information is, in this case, an external decision maker. Other types of accounting information, however, are not made available to external decision makers. Long-range plans, research and development results, capital budget details, and competitive strategies typically are closely guarded corporate secrets.

## USERS OF INTERNAL ACCOUNTING INFORMATION

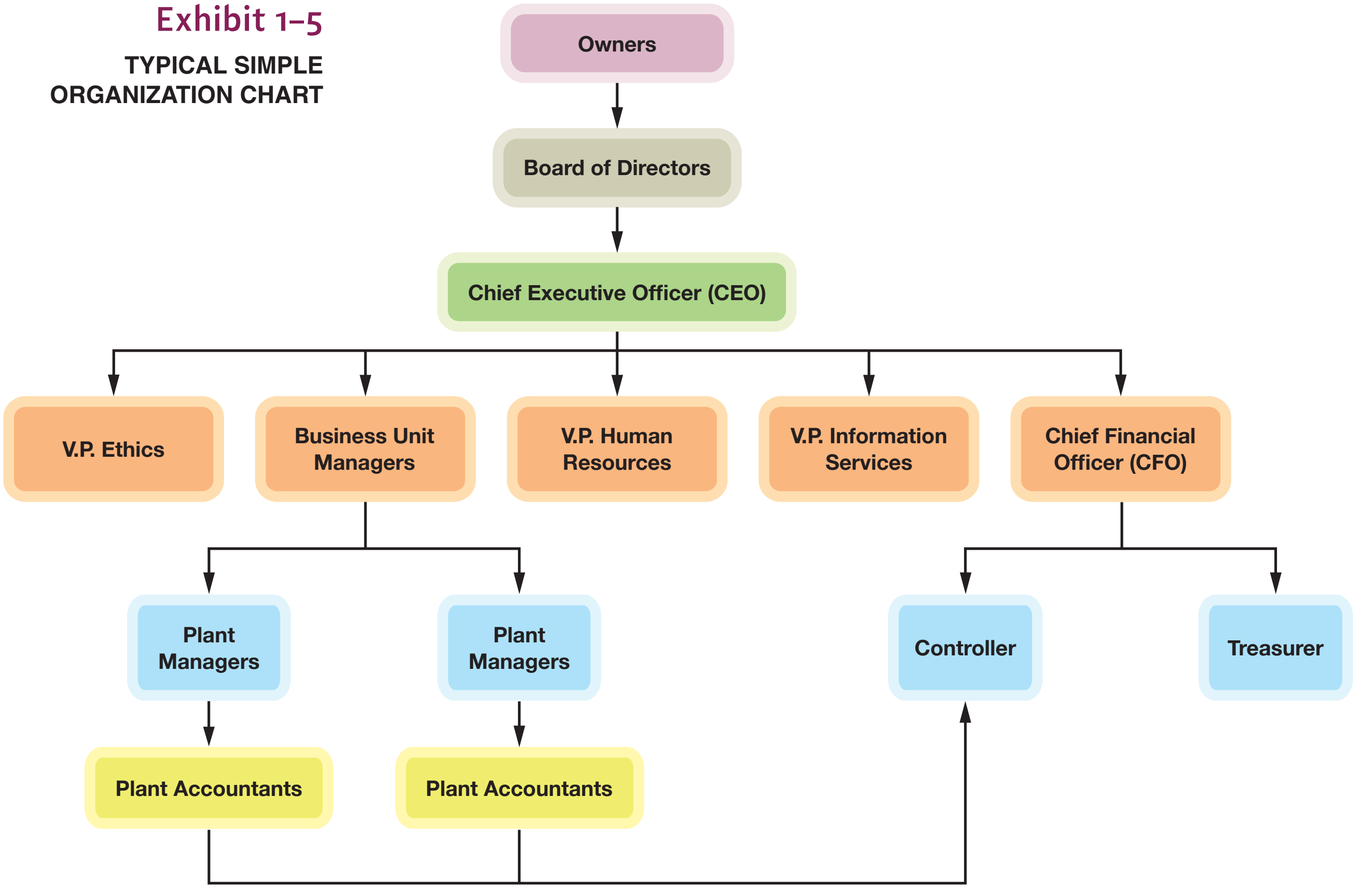
Every employee of the enterprise uses internal accounting information. From basic labor categories to the chief executive officer (CEO), all employees are paid, and their paychecks are generated by the accounting information system. However, the amount of use and, in particular, the involvement in the design of accounting information systems vary considerably. Examples of **internal users** of accounting information systems are as follows:

- Board of directors
- Chief executive officer (CEO)
- Chief financial officer (CFO)
- Vice presidents (information services, human resources, ethics, and so forth)
- Business unit managers
- Plant managers
- Store managers
- Line supervisors

Employees have different specific goals and objectives that are designed to help the enterprise achieve its overall strategies and mission. Looking at the typical, simple organization chart in Exhibit 1–5 you can see that the information created and used by

Exhibit 1–5

TYPICAL SIMPLE ORGANIZATION CHART




various employees will differ widely. All enterprises follow rules about the design of their accounting information systems to ensure the integrity of accounting information and to protect the enterprise's assets. There are no rules, however, about the type of internal reports or the kind of accounting information that can be generated. A snapshot look inside a firm will demonstrate the diversity of accounting information generated and used in the decision-making processes of employees.

Many enterprises use a database warehousing approach for the creation of accounting information systems. This approach, coupled with user-friendly software, allows management and other designated employees access to information to create a variety of accounting reports, including required external financial reports. For example, detailed cost information about a production process is used by the production line supervisor to help control production costs. A process design engineer, when considering the best configuration of equipment and employees, uses the same information to reduce costs or to increase efficiency. Finally, production-related cost information appears in the external financial statements used by investors and creditors.

## OBJECTIVES OF MANAGEMENT ACCOUNTING INFORMATION

Each enterprise has implicit and explicit goals and objectives. Many enterprises have a mission statement that describes their goals. These goals can vary widely among enterprises ranging from nonprofit organizations, where goals are aimed at serving specified constituents, to for-profit organizations, where goals are directed toward maximizing the owners' objectives. For example, the **Médecins Sans Frontières**, a nonprofit organization, has the following objective:

> **Médecins Sans Frontières** (**MSF**) is an international, independent, medical humanitarian organization that delivers emergency aid to people affected by armed conflicts, epidemics, natural disasters, and exclusion from healthcare. **MSF** offers assistance to people based on need, irrespective of race, religion, gender, or political affiliation.[3]

**Tesco plc**, a for-profit, food, and drug store operator, has the following core purpose and values:

> Our Core Purpose is a clear and simple statement of what we do and what we stand for: "We make what matters better, together." Our Values help us to understand how to put our Core Purpose into practice. Our Values are: No one tries harder for customers, We treat everyone how we like to be treated, and We use our scale for good.[4]

**Tesco**'s annual report to shareholders provides more detail on how the company will achieve its purpose. **Tesco**'s design for growth was explained in its annual report to its shareholders and its seven-part, long-term strategy (outlined below) aims to broaden the scope of the business to enable it to deliver strong, sustainable long-term growth for all its stakeholders:

1. To grow the U.K. core.
2. To be an outstanding international retailer in stores and online.
3. To be as strong in everything we sell as we are in food.
4. To grow retail services in all our markets.
5. To put our responsibilities to the communities we serve at the heart of what we do.
6. To be a creator of highly valued brands.
7. To build our team so that we create more value.[5]


© fotoVoyager/iStockphoto.com

The constituents of these organizations receive external financial information that helps them assess the progress being made in achieving these goals and objectives. In the case of **Tesco**, quarterly and annual information is provided to shareholders. **Médecins Sans Frontières** is required to report its activities and financial condition to stakeholders. Providing constituents evaluative information is only one objective of accounting systems.

Enterprises design and use their internal accounting information systems to help them achieve their stated goals and missions. Multiple reports, some as part of the normal reporting process and some that are specially constructed and designed, are produced and distributed regularly. To motivate managers to achieve organizational goals, the internal accounting system is also used to evaluate and reward decision-making performance. When the accounting system compares the plan or budget to the actual outcomes for a period, it creates a signal about the performance of the employee responsible for that part of the budget. In many enterprises management creates a reward system linked to performance as measured by the accounting system.

Thus the objectives of accounting systems begin at the most general level with the objectives and mission of the enterprise. These general organizational goals create a need for information. The enterprise gathers historical and future information from both inside the enterprise and external sources. This information is used by the decision makers who have authority over the firm's resources and who will be evaluated and rewarded based on their decision outcomes.

## CHARACTERISTICS OF MANAGEMENT ACCOUNTING INFORMATION

The accounting information created and used by management is intended primarily for planning and control decisions. Because the goal of creating and using management accounting information differs from the reasons for producing externally reported financial information, its characteristics are different.

Both the processes used to create financial accounting reports and the structure of those reports significantly impact management strategy. For example, because external financial

[3] www.msf.org

[4] www.tesco.com

[5] Tesco plc, Annual Report and Financial Statements 2013.

reporting standards require companies to include pension-related obligations on their financial statements, management monitors those obligations closely. These pension-related obligations impact labor negotiations and labor-related corporate strategies.

Another example is that the processes necessary to create required external financial reports have historically determined the type of accounting information available inside of companies for internal decision making. Most plants within companies are organized as profit centers where plant-related financial statements mirror those necessary for external reporting purposes.

As you read the chapters of this book, we will remind you about how financial reporting has an impact on and is impacted by management strategies. The following paragraphs identify internal accounting information characteristics.

**Importance of Timeliness** In order to plan for and control ongoing business processes, accounting information needs to be timely. The competitive environment faced by many enterprises demands immediate access to information. Enterprises are responding to this demand by creating computerized databases that link to external forecasts of industry associations, to their suppliers and buyers, and to their constituents. Time lines for the development and launch of new products and services are becoming shorter and shorter, making quick access to information a priority.

In addition to needing timely information for planning purposes, enterprises are constantly monitoring and controlling ongoing activities. If a process or activity goes out of control, the enterprise can incur significant costs. For example, recalls of products can be very expensive for a company. If the company can monitor processes and prevent low-quality or defective products from reaching its customers, it can experience significant savings.

**Identity of Decision Maker** Information that is produced to monitor and control processes needs to be provided to those who have decision-making authority to correct problems. Reporting scrap and rework information to line workers without providing them the responsibility for fixing the process is counterproductive. However, a self-directed work team that has been assigned decision-making responsibility over equipment and work-related activities can have a significant impact on rework and scrap if team members control the process causing the problems.

**Oriented toward the Future** Although some accounting information, like financial accounting information, is historical in nature, the purpose in creating and generating it is to affect the future. The objective is to motivate management to make future decisions that are in the best interest of the enterprise, consistent with its goals, objectives, and mission.

**Measures of Efficiency and Effectiveness** Accounting information measures the efficiency and effectiveness of resource usage. By comparing the enterprise's resource inputs and outputs with measures of competitors' effectiveness and efficiency, an assessment can be made of how effective management is in achieving the organization's mission. The accounting system uses money as a common unit to achieve these types of comparisons.

**Management Accounting Information—A Means** As with financial accounting information, management accounting information is a means to an end, not an end in and of itself. The ultimate objective is to design and use an accounting system that helps management achieve the goals and objectives of the enterprise.

## Integrity of Accounting Information

What enables investors and creditors to rely on financial accounting information without fear that the management of the reporting enterprise has altered the information to make the company's performance look better than it actually was? How can management be sure that internally generated information is free from bias that might favor one outcome over another? The word **integrity** refers to the following qualities: complete, unbroken, unimpaired, sound, honest, and sincere. Accounting information must have these qualities because of the significance of the information to individuals who rely on it in making important financial decisions.

**LO5** **Discuss elements of the system of external and internal financial reporting that create integrity in the reported information.**

The integrity of accounting information is enhanced in three primary ways. First, certain institutional features add significantly to the integrity of accounting information. These features include standards for the preparation of accounting information, an internal control structure, and audits of financial statements. Second, several professional accounting organizations play unique roles in adding to the integrity of accounting information. Finally, and perhaps most important, is the personal competence, judgment, and ethical behavior of professional accountants. These three elements of the accounting profession come together to ensure that users of accounting information—investors, creditors, managers, and others—can rely on the information to be a fair representation of what it purports to represent.

## INSTITUTIONAL FEATURES

### Standards for the Preparation of Accounting Information

Accounting information that is communicated externally to investors, creditors, and other users must be prepared in accordance with standards that are understood by both the preparers and users of that information. We call these standards **international financial reporting standards**, often shortened to IFRS. These principles provide the general framework for determining what information is included in financial statements and how this information is to be prepared and presented. IFRS includes broad principles of measurement and presentation, as well as detailed rules that are used by professional accountants in preparing accounting information and reports.

Accounting principles are not like physical laws; they do not exist in nature waiting to be discovered. Rather, they are developed by people, in light of what we consider to be the most important objectives of financial reporting. In many ways accounting principles are similar to the rules established for an organized sport, such as baseball or basketball. For example, accounting principles, like sports rules:

- Originate from a combination of tradition, experience, and official decree.
- Require authoritative support and some means of enforcement.
- Are sometimes arbitrary.
- May change over time as shortcomings in the existing rules come to light.
- Must be clearly understood and observed by all participants in the process.

Accounting principles vary somewhat from country to country. The phrase "generally accepted accounting principles (GAAP)" refers to the accounting concepts in use in a country or a place. The International Accounting Standards Board (IASB) is currently attempting to establish greater uniformity among the accounting principles in use around the world in order to facilitate business activity that increasingly is carried out in more than one country.

### International Accounting Standards Board

When an enterprise operates beyond the borders of its own country, differences in financial reporting practices between countries can pose significant problems. For example, when a company buys or sells products in another country, the lack of comparability of accounting information can create uncertainties. Similarly, cross-border financing, where companies sell their securities in the capital markets of another country, is increasingly popular. Business activities that cross borders create the need for more comparable information between companies that reside in different countries.

As a result of increasing cross-border activities, efforts are under way to harmonize accounting standards around the world. The **International Accounting Standards Board (IASB)** is playing a leading role in the harmonization process. The London-based IASB is an elite panel of professionals with deep knowledge of accounting methods used in the most vibrant capital markets.

The IASB issues *International Financial Reporting Standards* (IFRSs). The European Union requires listed companies in its member states to follow IASB standards. Many other countries, including Australia and Canada, either require the use of IASB standards or have plans to require their use in the future. In the United States, the Securities and Exchange Commission (SEC) accepts financial statements prepared using IASB standards from foreign companies that are cross-listed on a U.S. stock exchange, and is considering allowing U.S. companies to prepare their financial statements using either IFRS or IASB standards. In addition, the American Institute of CPAs (AICPA), which essentially has jurisdiction over private company reporting, accepts either IFRS or IASB standards as authoritative sources of accounting principles.

**CASE IN POINT**

In 2001, Sir David Tweedie was appointed chairman of the International Accounting Standards Board (IASB). He was succeeded by Hans Hoogervorst in 2011. Over the last decade, Sir David and other board members have worked tirelessly promoting and engaging the world community with International Financial Reporting Standards (IFRS). Their goal is the creation of a globally accepted, single set of high-quality financial reporting standards. In fulfilling its standard-setting duties, the IASB engages stakeholders from around the world including investors, analysts, regulators, business leaders, accounting standard setters, and the accountancy profession. In determining the standards, it is paramount that board members understand the diversity of businesses, cultures, economic conditions, political and legal structures, and infrastructures around the world. Recent interest in IFRS from the G-20 leaders demonstrates the importance of considering the global political and economic ramifications of creating and changing IFRS.[6]

[6]The Group of Twenty (G-20) was established in 1999 to bring together systemically important industrialized and developing economies to discuss key issues in the global economy. The G-20 comprises 19 countries plus the European Union and account for 85 percent of global gross national product, 80 percent of world trade, and two-thirds of the world population.

In the United States two other organizations are particularly important in establishing accounting principles—the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB).

In early 2010, the SEC issued a Statement in Support of Convergence and Global Accounting Standards. This SEC statement reaffirms the SEC's belief that a single set of high-quality global accounting standards is in the best interests of investors, and also reaffirms the SEC's belief that IFRS as issued by the IASB is the set of standards best positioned to fill this role. However, the SEC indicates that there are obstacles to the adoption of IFRS in the United States and until these obstacles are addressed, the SEC is reserving its judgment as to whether to require U.S. public companies to prepare their financial statements using IFRS. If the SEC decides to require U.S. public companies to use IFRS, this would be a major development because IASB standards are less detailed and prescriptive than existing FASB standards. The SEC indicated that if IFRS were to be adopted in the United States, it would not occur before 2015.

**CASE IN POINT**

A movement to IFRS is likely to require significant changes to accounting systems, controls, and procedures. For example, IFRS requires that an entity account for similar transactions in an identical manner regardless of where the transaction occurs in the entity, a requirement that does not exist under U.S. GAAP. Therefore, if IFRS becomes mandatory for U.S. public companies, companies would have to inventory all of their transactions and how they are accounted for throughout the entity.

**Securities and Exchange Commission** The **Securities and Exchange Commission** is a governmental agency with the *legal power* to establish accounting principles and financial reporting requirements for publicly owned corporations in the United States. In the past, the SEC has generally adopted the recommendations of the FASB (discussed below), rather than develop its own set of accounting principles. Thus accounting principles continue to be developed in the private sector but are given the *force of law* when they are adopted by the SEC.

To ensure widespread acceptance of new accounting standards, the FASB *needs the support* of the SEC. Therefore, the two organizations work closely together in developing new accounting standards. The SEC also reviews the financial statements of publicly owned corporations to ensure compliance with its reporting requirements. In the event that a publicly owned corporation fails to comply with these requirements, the SEC may initiate legal action against the company and the responsible individuals. Thus the SEC enforces compliance with generally accepted accounting principles that are established primarily by the FASB.

**Financial Accounting Standards Board** Today, the most authoritative source of generally accepted accounting principles is the **Financial Accounting Standards Board**. The FASB is an independent rule-making body, consisting of seven members from the accounting profession, industry, government, and accounting education. Lending support to these members are an advisory council and a large research staff.

The FASB has compiled all of its standards, and those of its predecessors, in an Accounting Standards Codification. The FASB periodically issues updates to its codification. The codification represents official expressions of generally accepted accounting principles.

In addition to maintaining the Accounting Standards Codification, the FASB has completed a project describing a *conceptual framework* for financial reporting. This conceptual framework sets forth the FASB's views as to the:

- Objectives of financial reporting.
- Desired characteristics of accounting information (such as relevance, reliability, and understandability).
- Elements of financial statements.
- Criteria for deciding what information to include in financial statements.
- Valuation concepts relating to financial statement amounts.

The primary purpose of the conceptual framework is to provide guidance to the FASB in developing new accounting standards, which are issued as updates to the codification. By making each new standard consistent with this framework, the FASB believes that the Accounting Standards Codification resolves accounting problems in a logical and consistent manner.

The FASB is part of the private sector of the economy—*it is not a governmental agency*. The development of accounting principles in the United States traditionally has been carried out in the private sector, although the government, acting through the SEC, exercises considerable influence.

**International Federation of Accountants (IFAC)** As the global organization for the accounting profession, the **International Federation of Accountants** works with its 172 members and associates in 129 countries and jurisdictions to protect the public interest by encouraging high quality practices by the world's accountants. IFAC members and associates, which are primarily national professional accountancy bodies, represent 2.5 million accountants employed in public practice, industry and commerce, government, and academia. To serve the public interest, IFAC continues to strengthen the worldwide accounting profession and contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues where the profession's expertise is most relevant. The IFAC has several standard-setting boards, including the International Auditing and Assurance Standards Board issuing standards dealing with auditing, review, other assurance and quality control, and the International Ethics Standards Board for Accountants issuing ethical standards and guidance for use by professional accountants.

**Public Company Accounting Oversight Board** The **Public Company Accounting Oversight Board (PCAOB)** is a quasi-governmental body in the United States charged with oversight of the public accounting profession. The Board was created as a result of the Sarbanes-Oxley Act of 2002 and began operations in the spring of 2003.

The PCAOB has extensive powers in overseeing the accounting profession. Any accounting firm wishing to audit a public company must register with the PCAOB. The PCAOB sets auditing standards for audits of publicly traded companies, an activity that previously was performed by the accounting profession. The Board also inspects the quality of audits performed by public accounting firms and conducts investigations and administers penalties when substandard audit work is alleged.

The PCAOB is headquartered in Washington, D.C., and has regional offices in major cities throughout the United States. The PCAOB has five members who serve a five-year term and are eligible to be reappointed once. No more than two members of the Board can be certified public accountants. The Board also maintains a large and well-qualified staff. The PCAOB is funded by a mandatory assessment on publicly traded companies. The assessment is a function of the company's market value relative to overall stock market value in the United States.

**Audits of Financial Statements** What assurance do outsiders have that the financial statements issued by management provide a complete and reliable picture of the company's financial position and operating results? In large part, this assurance is provided by an *audit* of the company's financial statements, performed by a firm of *certified public accountants (CPAs)*. These auditors are experts in the field of financial reporting and are *independent* of the company issuing the financial statements.

An **audit** is an *investigation* of a company's financial statements, designed to determine the fairness of these statements. Accountants and auditors use the term *fair* in describing financial statements that are reliable and complete, conform to generally accepted accounting principles, and are *not misleading*.

In auditing financial statements, generally accepted accounting principles are the standard by which those statements are judged. For the auditor to reach the conclusion that the financial statements are fair representations of a company's financial position, results of operations, and cash flows, the statements must comply in all important ways with generally accepted accounting principles.

**Legislation** All businesses must comply with rules and regulations. The directors, chief executive officer, and chief financial officers have respective responsibilities to meet the requirements imposed by such rules and regulations. The rules and regulations range from basic financial reporting requirements, audit requirements to corporate governance and internal control requirements, for example, as discussed previously, the U.S. Sarbanes-Oxley Act 2002.

## PROFESSIONAL ORGANIZATIONS

**LO6** **Identify and discuss several professional organizations that play important roles in preparing and communicating accounting information.**

Several professional accounting organizations around the world play an active role in improving the quality of accounting information that is used by investors, creditors, management, and others. In addition to International Accounting Standards Board, the Securities and Exchange Commission, and Financial Accounting Standards Board, the International Federation of Accountants, the American Institute of CPAs, the Institute of Management Accountants, the Institute of Internal Auditors, the American Accounting Association, and the Committee of Sponsoring Organizations of the Treadway Commission are particularly important.

**American Institute of CPAs (AICPA)** The **American Institute of CPAs** is a professional association of certified public accountants in the United States. Its mission is to provide members with the resources, information, and leadership to enable them to provide valuable services in the highest professional manner to benefit the public, employers, and clients. The AICPA participates in many aspects of the accounting profession. The AICPA conducts accounting research and works closely with the FASB in the establishment and interpretation of generally accepted accounting principles. In fact, prior to the establishment of the FASB, the AICPA had primary responsibility for the establishment of accounting principles. The AICPA's Auditing Standards Board has developed the standards by which audits of private companies are conducted, and the PCAOB has accepted many of these standards for audits of public companies. The AICPA also issues standards for the conduct of other professional services. Finally, the AICPA is responsible for the preparation and grading of the CPA examination, which is discussed later in this chapter.

**Institute of Management Accountants (IMA)** The mission of the **Institute of Management Accountants** is to provide members personal and professional development opportunities through education, association with business professionals, and certification. The IMA is recognized by the financial community as a respected organization that influences the concepts and ethical practice of management accounting and financial management. The IMA sponsors a number of educational activities for its members, including national seminars and conferences, regional and local programs, self-study courses, and in-house and online programs. The IMA offers a certification program—the Certified Management Accountant (CMA). This designation testifies to the individual's competence and expertise in management accounting and financial management.

**Institute of Internal Auditors (IIA)** With more than 170,000 members in over 100 countries, the **Institute of Internal Auditors** is the primary international professional association dedicated to the promotion and development of the practice of internal auditing. It provides professional development through the Certified Internal Auditor® Program and leading-edge conferences and seminars; research through the IIA Research Foundation on trends, best practices, and other internal auditing issues; guidance through the *Standards for the Professional Practice of Internal Auditing*; and educational products on virtually all aspects of the profession. The IIA also provides audit specialty services and industry-specific auditing programs, as well as quality assurance reviews and benchmarking services.

**American Accounting Association (AAA)** Membership in the **American Accounting Association** is made up primarily of accounting educators, although many practicing accountants are members as well. The mission of the AAA includes advancing accounting education and research, as well as influencing accounting practice. The focus of many of the AAA's activities is on improving accounting education by better preparing accounting professors and on advancing knowledge in the accounting discipline through research and publication. An important contribution of the AAA to the integrity of accounting information is its impact through accounting faculty on the many students who study accounting in college and subsequently become professional accountants.

**Committee of Sponsoring Organizations of the Treadway Commission (COSO)** **COSO** is a voluntary private-sector organization in the United States dedicated to improving the quality of financial reporting through business ethics, effective internal controls, corporate governance, and enterprise risk management. COSO was originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting (chaired by former SEC Commissioner James C. Treadway, Jr.). The National Commission on Fraudulent Financial Reporting studied the causal factors that lead to fraudulent financial reporting and made a series of recommendations for improving financial reporting, auditing, and accounting education. The original sponsors of the National Commission on Fraudulent Financial Reporting, and the current sponsors of COSO, are the AAA, the AICPA, Financial Executives International (FEI), the IIA, and the IMA.

COSO is best known for its work in developing the standards for evaluating internal control—particularly internal control over financial reporting. As a result of the Sarbanes-Oxley Act, public companies now need to evaluate the effectiveness of their internal control over financial reporting on a yearly basis, as well as have their auditors separately report on the auditors' evaluation of the effectiveness of internal control over financial reporting. The standard for evaluating the effectiveness of internal control over financial reporting is contained in COSO's 1992 publication, *Internal Control–Integrated Framework*. COSO has also issued a document, *Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting*, that seeks to provide implementation guidance to smaller businesses in applying the original COSO internal control framework.

## COMPETENCE, JUDGMENT, AND ETHICAL BEHAVIOR

**LO7 Discuss the importance of personal competence, professional judgment, and ethical behavior on the part of accounting professionals.**

Preparing and presenting accounting information is not a mechanical task that can be performed entirely by a computer or even by well-trained clerical personnel. A characteristic common to all recognized professions, including medicine, law, and accounting, is the need for competent individual practitioners to solve problems using their professional judgment and applying strong ethical standards. The problems encountered in the practice of a profession are often complex, and the specific circumstances unique. In many cases, the well-being of others is directly affected by the work of a professional.

To illustrate the importance of competence, professional judgment, and ethical behavior in the preparation of financial statements, consider the following complex issues that must be addressed by the accountant:

- At what point should an enterprise account for transactions that continue over a long period of time, such as a long-term contract to construct a cross-border highway?
- What constitutes adequate disclosure of information that would be expected by a reasonably informed user of financial statements?
- At what point are a company's financial problems sufficient to question whether it will be able to remain in business for the foreseeable future, and when should that information be communicated to users of its financial statements?
- When have efforts by management to improve (that is, "window dress") its financial statements crossed a line that is inappropriate, making the financial statements actually misleading to investors and creditors?

Judgment always involves some risk of error. Some errors in judgment result from carelessness or inexperience on the part of the preparer of financial information or the decision maker who uses that information. Others occur simply because future events are uncertain and do not work out as expected when the information was prepared.

If the public is to have confidence in the judgment of professional accountants, these accountants first must demonstrate that they possess the characteristic of *competence*. Both the accounting profession and governments have taken steps to assure the public of the technical competence of **certified public accountants** (CPAs). CPAs are licensed by different countries by their relevant rules and regulations. The licensing requirements vary somewhat from country to country, but in general, an individual must be of good character, have completed adequate semester hours of college work with a major in accounting, pass a rigorous examination, and have accounting experience. In addition, most countries require all CPAs to spend at least adequate hours per year in continuing professional education throughout their careers.

Management accountants are not required to be licensed as CPAs. However, they voluntarily may earn a **Certified Management Accountant** (CMA) or a **Certified Internal Auditor** (CIA) as evidence of their professional competence. These certifications are issued by the IMA and the IIA, and signify competence in management accounting and internal auditing, respectively. The requirements for becoming a CMA and CIA are similar to those for becoming a CPA.

Integrity in accounting requires honesty and a strong commitment to ethical conduct—doing the right thing. For a professional accountant, ethical behavior is just as important as competence. However, it is far more difficult to test or enforce.

Many professional organizations have codes of ethics or professional conduct that direct the activities of their members. The AICPA, for example, has a code of professional conduct that expresses the accounting profession's recognition of its responsibilities to the public, to clients, and to colleagues. The principles included in the code guide AICPA members in the performance of their professional responsibilities. This code expresses the basic tenets of ethical and professional behavior and is enforced in conjunction with professional societies of CPAs, although regulatory boards take precedence in regulating the CPA license.

**YOUR TURN** **You as a Professional Accountant**

You are a professional accountant working for a public accounting firm and find yourself in a difficult situation. You have discovered some irregularities in the financial records of your firm's client. You are uncertain whether these irregularities are the result of carelessness on the part of the company's employees or represent intentional steps taken to cover up questionable activities. You approach your superior about this and she indicates that you should ignore it. Her response is, "These things happen all of the time and usually are pretty minor. We are on a very tight time schedule to complete this engagement, so let's just keep our eyes on our goal of finishing our work by the end of the month." What would you do?

(See our comments on the Online Learning Center Web site.)

Exhibit 1–6 contains excerpts from the AICPA code of professional conduct. One of the principles expressed in the AICPA's code of professional conduct is the commitment of CPAs to the public interest, shown in Article II. The public interest is defined as the collective well-being of the community of people and institutions the profession serves. Other principles emphasize the importance of integrity, objectivity, independence, and due care in the performance of one's duties.

## Exhibit 1–6

**EXCERPTS FROM THE AICPA CODE OF PROFESSIONAL CONDUCT**

**Preamble**

These Principles of the Code of Professional Conduct of the American Institute of Certified Public Accountants express the profession's recognition of its responsibilities to the public, to clients, and to colleagues. They guide members in the performance of their professional responsibilities and express the basic tenets of ethical and professional conduct. The Principles call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage.

**Articles**

**I. Responsibilities**

*In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.*

**II. The Public Interest**

*Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.*

**III. Integrity**

*To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.*

**IV. Objectivity and Independence**

*A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.*

**V. Due Care**

*A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of service, and discharge professional responsibility to the best of the member's ability.*

**VI. Scope and Nature of Services**

*A member in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.*

The IFAC also develops ethical standards and guidance for use by professional accountants. It encourages member bodies to adopt high standards of ethics for their members and promotes good ethical practices globally. Exhibit 1-7 contains excerpts from IFAC Code of Ethics for Professional Accountants (2013 Edition).

**Exhibit 1–7**

**EXCERPTS FROM THE IFAC CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS**

**The Code of Ethics**
**Introduction**

A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. Therefore, a professional accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer. In acting in the public interest a professional accountant should observe and comply with this Code. If a professional accountant is prohibited from complying with certain parts of this Code by law or regulation, the professional accountant shall comply with all other parts of this Code.

**Fundamental Principles**

A professional accountant shall comply with the following fundamental principles:

- Integrity: To be straightforward and honest in performing professional services.
- Objectivity: To not allow bias, conflict of interest, or undue influence of others to override professional or business judgments.
- Professional Competence and Due Care: To maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.
- Confidentiality: To respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.
- Professional Behavior: To comply with relevant laws and regulations and avoid any action that discredits the profession.

Expectations of ethical conduct are also important for other accountants. The IMA has a code of conduct for management accountants, as does the IIA for internal auditors.

Users of accounting information—both external and internal—recognize that the reliability of the information is affected by the competence, professional judgment, and ethical standards of accountants. While the institutional features and professional organizations that were discussed earlier are important parts of the financial reporting system, the personal attributes of competence, professional judgment, and ethical behavior ultimately ensure the quality and reliability of accounting information.

In this text, we address the topic of ethical conduct primarily through questions, exercises, problems, and cases that emphasize the general concepts of honesty, fairness, and adequate disclosure. Most chapters include assignment material in which you are asked to make judgment calls in applying these concepts. (These assignments are identified by the scales of justice logo appearing in the margin.)

## Careers in Accounting

**LO8** Describe various career opportunities in accounting.

Accounting—along with such fields as architecture, engineering, law, medicine, and theology—is recognized as a profession. What distinguishes a profession from other disciplines? There is no single recognized definition of a profession, but all of these fields have several characteristics in common.

First, all professions involve a complex and evolving body of knowledge. In accounting, the complexity and the ever-changing nature of the business world, financial reporting requirements, management's demands for increasingly complex information, and income tax laws certainly meet this criterion.

Second, in all professions, practitioners must use their professional judgment to resolve problems and dilemmas. Throughout this text, we will point out situations requiring accountants to exercise professional judgment.

Of greatest importance, however, is the unique responsibility of professionals *to serve the public's best interest, even at the sacrifice of personal advantage*. This responsibility stems from the fact that the public has little technical knowledge in the professions, yet fair and competent performance by professionals is vital to the public's health, safety, or well-being. The practice of medicine, for example, directly affects public health, while engineering affects public safety. Accounting affects the public's well-being in many ways, because accounting information is used in the allocation of economic resources throughout society. Thus accountants have a basic social contract to avoid being associated with misleading information.

Accountants tend to specialize in specific fields, as do the members of other professions. Career opportunities in accounting may be divided into four broad areas: (1) public accounting, (2) management accounting, (3) governmental accounting, and (4) accounting education.

## PUBLIC ACCOUNTING

Certified public accountants offer a variety of accounting services to the public. These individuals may work in a CPA firm or as sole practitioners.

The work of public accountants consists primarily of auditing financial statements, income tax work, and management advisory services (management consulting).

Management advisory services extend well beyond tax planning and accounting matters; CPAs advise management on such diverse issues as international mergers, manufacturing processes, and the introduction of new products. CPAs assist management because *financial considerations enter into almost every business decision*.

A great many CPAs move from public accounting into managerial positions with organizations. These "alumni" from public accounting often move directly into such top management positions as controller, treasurer, or chief financial officer.

**The CPA Examination** To become a CPA, a person must meet several criteria, including an extensive university education requirement, passing the relevant CPA or professional examination, and meeting a practice experience requirement. The CPA examination is a rigorous examination that covers a variety of accounting and business subjects that allow candidates to demonstrate their knowledge and skills in areas believed important for protecting the public.

## MANAGEMENT ACCOUNTING

In contrast to the public accountant who serves many clients, the management accountant works for one enterprise. Management accountants develop and interpret accounting information designed specifically to meet the various needs of management.

The chief accounting officer of an organization usually is called the *chief accounting officer (CAO)*, *chief accountant* or *controller*. The term *controller* has been used to emphasize the fact that one basic purpose of accounting data is to aid in controlling business operations. The CAO or controller is part of the top management team, which is responsible for running the business, setting its objectives, and seeing that these objectives are met.

In addition to developing information to assist managers, management accountants are responsible for operating the company's accounting system, including the recording of transactions and the preparation of financial statements, tax returns, and other accounting reports. Because the responsibilities of management accountants are so broad, many areas of specialization have developed. Among the more important are financial forecasting, cost accounting, and internal auditing.

## GOVERNMENTAL ACCOUNTING

Governmental agencies use accounting information in allocating their resources and in controlling their operations. Therefore, the need for management accountants in governmental agencies is similar to that in business organizations.

## ACCOUNTING EDUCATION

Some accountants, including your instructor and the authors of this textbook, have chosen to pursue careers in accounting education. A position as an accounting faculty member offers opportunities for teaching, research, consulting, and an unusual degree of freedom in developing individual skills. Accounting educators contribute to the accounting profession in many ways. One, of course, lies in effective teaching; second, in publishing significant research findings; and third, in influencing top students to pursue careers in accounting.

## WHAT ABOUT BOOKKEEPING?

Some people think that the work of professional accountants consists primarily of bookkeeping. Actually, it doesn't. In fact, many professional accountants do *little or no* bookkeeping.

**Bookkeeping** is the clerical side of accounting—the recording of routine transactions and day-to-day record keeping. Today such tasks are performed primarily by computers and skilled clerical personnel, not by accountants.

Professional accountants are involved more with the *interpretation and use* of accounting information than with its actual preparation. Their work includes evaluating the efficiency of operations, resolving complex financial reporting issues, forecasting the results of future operations, auditing, tax planning, and designing efficient accounting systems. There is very little that is "routine" about the work of a professional accountant.

A person might become a proficient bookkeeper in a few weeks or months. To become a professional accountant, however, is a far greater challenge because this requires more than understanding the bookkeeping systems. It requires years of study, experience, and an ongoing commitment to keeping current.

We will illustrate and explain a number of bookkeeping procedures in this text, particularly in the next several chapters. But teaching bookkeeping skills is *not* our goal; the primary purpose of this text is to develop your abilities to *understand and use* accounting information in today's business world.

## ACCOUNTING AS A STEPPING-STONE

We have mentioned that many professional accountants leave their accounting careers for key positions in management or administration. An accounting background is invaluable in such positions, because top management works continuously with issues defined and described in accounting terms and concepts.

An especially useful stepping-stone is experience in public accounting. Public accountants have the unusual opportunity of getting an inside look at many different business organizations, which makes them particularly well suited for top management positions in other organizations.

## BUT WHAT ABOUT ME? I'M NOT AN ACCOUNTING MAJOR

Most students who use this book are not accounting majors. However, the study of accounting is still important to you. You need to understand accounting concepts, both for your professional careers and for many aspects of your personal life. Finance students need to understand accounting concepts if they seek positions in investment banking, consulting, or in corporate America as a financial analyst. Approximately 50 percent of the chief financial officers of large U.S. corporations have a background in accounting. A management student seeking a career as a management trainee—with the ultimate goal of running a corporation or a corporate division—needs to understand accounting in order to be able to run, control, and evaluate the performance of a business unit. Accounting is the language of business, and trying to run a business without understanding accounting information is analogous to trying to play sports without understanding the rules. Marketing students often take positions in sales. It is imperative that marketing students understand the principles of revenue recognition, as well as the obligations of a public company under the relevant securities laws. A lack of this understanding has led many a marketing/sales executive to become involved in improper revenue recognition schemes. Many of these executives have been subject to civil and criminal prosecution.

Finally, accounting knowledge is helpful in many aspects of your personal lives. Accounting concepts are integral to such everyday decisions as personal budgeting, retirement and college planning, lease versus buy decisions, evaluation of loan terms, and evaluation of investment opportunities. Since accounting skills are designed to help you make better economic decisions, you will be using these skills for the rest of your life. The only question is the degree of skill with which you will apply these concepts.

## Ethics, Fraud, & Corporate Governance

The early 2000s was a time of unprecedented business failures amid allegations of fraudulent financial reporting that include corporations that have now become household names—**Enron**, **WorldCom**, **HealthSouth**, **Adelphia Communications**, **Tyco**, and **Qwest**, among others. These problems are not exclusively a problem with financial reporting in the United States, as evidenced by fraud allegations at **Parmalat**, a large Italian company.

Fraud typically is perpetrated by senior management; for example, a 2010 study indicates that the company's chief executive officer and/or chief financial officer is involved in 89 percent of the fraud-related enforcement actions brought by the Securities and Exchange Commission. Committing fraud, an illegal act, obviously suggests a serious lack of ethical awareness and ethical sensitivity on the part of the perpetrators. Another feature of many frauds is that the company where the fraud occurred had a weak corporate governance environment. **Corporate governance** entails corporate structures and processes for overseeing the company's affairs, including oversight by the board of directors of the actions of top management to ensure that the company is being managed with the best interests of shareholders in mind.

In each chapter, we will discuss common fraud-related schemes relevant to the material covered in that chapter, ethical quandaries and challenges faced by businesspeople, or efforts to improve corporate governance and by extension the quality of accounting information.

## Concluding Remarks

In this chapter we have established a framework for your study of accounting. You have learned how financial accounting provides information for external users, primarily investors and creditors, and how accounting provides information for internal management. We have established the importance of integrity in accounting information and have learned about several things that build integrity. Looking ahead, in Chapter 2 we begin to look in greater depth at financial accounting and, more specifically, financial statements. You will be introduced to the details of the three primary financial statements that provide information for investors and creditors. As the text progresses, you will learn more about the important information that these financial statements provide and how that information is used to make important financial decisions.

## SUMMARY OF LEARNING OBJECTIVES

**LO1 Discuss accounting as the language of business and the role of accounting information in making economic decisions.** Accounting is the means by which information about an enterprise is communicated and, thus, is sometimes called the language of business. Many different users have need for accounting information in order to make important decisions. These users include investors, creditors, management, governmental agencies, labor unions, and others. Because the primary role of accounting information is to provide useful information for decision-making purposes, it is sometimes referred to as a means to an end, with the end being the decision that is helped by the availability of accounting information.

**LO2 Discuss the significance of accounting systems in generating reliable accounting information and understand the five components of internal control.** Information systems are critical to the production of quality accounting information on a timely basis and the communication of that information to decision makers. While there are different types of information systems, they all have one characteristic in common—to meet the organization's needs for accounting information as efficiently as possible. Per the COSO framework, the five elements of internal control are: (1) control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring.

**LO3 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.** The primary objectives of financial accounting are to provide information that is useful in making investment and credit decisions; in assessing the amount, timing, and uncertainty of future cash flows; and in learning about the enterprise's economic resources, claims to resources, and changes in claims to resources. Some of the most important characteristics of financial accounting information are: it is a means to an end, it is historical in nature, it results from inexact and approximate measures of business activity, and it is based on a general-purpose assumption.

**LO4 Explain the importance of accounting information for internal parties—primarily management—in terms of the objectives and the characteristics of that information.** Accounting information is useful to the enterprise in achieving its goals, objectives, and mission; assessing past performance and future directions; and evaluating and rewarding decision-making performance. Some of the important characteristics of internal accounting information are its timeliness, its relationship to decision-making authority, its future orientation, its relationship to measuring efficiency and effectiveness, and the fact that it is a means to an end.

**LO5 Discuss elements of the system of external and internal financial reporting that create integrity in the reported information.** Integrity of financial reporting is important because of the reliance that is placed on financial information by users both outside and inside the reporting organization. Important dimensions of financial reporting that work together to ensure integrity in information are institutional features (accounting principles, internal structure, audits, and legislation); professional organizations (the AICPA, IMA, IIA, AAA); and the competence, judgment, and ethical behavior of individual accountants.

**LO6 Identify and discuss several professional organizations that play important roles in preparing and communicating accounting information.** The IASB, FASB, and SEC are important organizations in terms of standard setting in the world and in the United States. The IASB and FASB are private-sector organizations that establish accounting standards for public and private companies. The IFAC and PCAOB set auditing standards. Professional organizations that provide services to individual accountants in various segments of the accounting profession are the IFAC, AICPA, IMA, IIA, AAA, and COSO.

**LO7 Discuss the importance of personal competence, professional judgment, and ethical behavior on the part of accounting professionals.** Personal competence and professional judgment are, perhaps, the most important factors in ensuring the integrity of financial information. Competence is demonstrated by one's education and professional certification (CPA, CMA, CIA). Professional judgment is important because accounting information is often based on inexact measurements, and assumptions are required. Ethical behavior refers to the quality of accountants being motivated to "do the right thing."

**LO8 Describe various career opportunities in accounting.** Accounting opens the door to many career opportunities. Public accounting is the segment of the profession where professionals offer audit, tax, and consulting services. Management, or managerial, accounting refers to that segment of the accounting profession where professional accountants work for individual companies in a wide variety of capacities. Many accountants work for governmental agencies. Some accountants choose education as a career and work to prepare students for future careers in one of the other segments of the accounting profession. While keeping detailed records (that is, bookkeeping) is a part of accounting, it is not a distinguishing characteristic of a career in accounting; in fact, many accounting careers involve little or no bookkeeping. Accounting skills are important to nonaccounting majors and to all students in their personal lives.

## KEY TERMS

**accounting system** (p. 6) The personnel, procedures, devices, and records used by an organization to develop accounting information and communicate that information to decision makers.

**American Accounting Association** (p. 21) A professional accounting organization consisting primarily of accounting educators that is dedicated to improving accounting education, research, and practice.

**American Institute of CPAs** (p. 20) A professional accounting organization of certified public accountants that engages in a variety of professional activities, including establishing auditing standards for private companies, conducting research, and establishing industry-specific financial reporting standards.

**audit** (p. 20) An investigation of financial statements designed to determine their fairness in relation to generally accepted accounting principles.

**balance sheet** (p. 12) A position statement that shows where the company stands in financial terms at a specific date. (Also called the statement of financial position.)

**bookkeeping** (p. 26) The clerical dimension of accounting that includes recording the routine transactions and day-to-day record keeping of an enterprise.

**cash flow prospects** (p. 10) The likelihood that an enterprise will be able to provide an investor with both a return on the investor's investment and the return of that investment.

**Certified Internal Auditor** (p. 22) A professional designation issued by the Institute of Internal Auditors signifying expertise in internal auditing.

**Certified Management Accountant** (p. 22) A professional designation issued by the Institute of Management Accountants signifying expertise in management accounting.

**certified public accountant** (p. 22) An accountant who is licensed by a state after meeting rigorous education, experience, and examination requirements.

**Committee of Sponsoring Organizations of the Treadway Commission (COSO)** (p. 21) A voluntary private-sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, corporate governance, and enterprise risk management.

**control activities** (p. 8) Policies and procedures that management puts in place to address the risks identified during the risk assessment process.

**control environment** (p. 8) The foundation for all the other elements of internal control, setting the overall tone for the organization.

**corporate governance** (p. 27) Includes the corporate structures and processes for overseeing a company's affairs, for example, the board of directors and the company's internal control processes.

**external users** (p. 9) Individuals and other enterprises that have a financial interest in the reporting enterprise but that are not involved in the day-to-day operations of that enterprise (for example, owners, creditors, labor unions, suppliers, customers).

**financial accounting** (p. 5) Providing information about the financial resources, obligations, and activities of an economic entity that is intended for use primarily by external decision makers—investors and creditors.

**Financial Accounting Standards Board (FASB)** (p. 19) A private-sector organization that is responsible for determining generally accepted accounting principles in the United States.

**financial statement** (p. 12) A monetary declaration of what is believed to be true about an enterprise.

**general-purpose information** (p. 13) Information that is intended to meet the needs of multiple users that have an interest in the financial activities of an enterprise rather than tailored to the specific information needs of one user.

**income statement** (p. 12) An activity statement that shows details and results of the company's profit-related activities for a period of time.

**information and communication** (p. 8) The organization's process for capturing operational, financial, and compliance-related information necessary to run the business, and communicating that information downstream (from management to employees), upstream (from employees to management), and across the organization.

**Institute of Internal Auditors** (p. 21) A professional accounting organization that is dedicated to the promotion and development of the practice of internal auditing.

**Institute of Management Accountants** (p. 21) A professional accounting organization that intends to influence the concepts and ethical practice of management accounting and financial management.

**integrity** (p. 16) The qualities of being complete, unbroken, unimpaired, sound, honest, and sincere.

**internal control** (p. 8) 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.

**internal users** (p. 13) Individuals who use accounting information from within an organization (for example, board of directors, chief financial officer, plant managers, store managers).

**International Accounting Standards Board (IASB)** (p. 17) The group responsible for creating and promoting *International Financial Reporting Standards (IFRSs).*

**International Federation of Accountants (IFAC)** (p. 19) A global organization for the accounting profession, with 172 members and associates in 129 countries and jurisdictions.

**International financial reporting standards** (p. 17) Principles that provide the framework for determining what information is to be included in financial statements and how that information is to be presented.

**management accounting** (p. 6) Providing information that is intended primarily for use by internal management in decision making required to run the business.

**monitoring** (p. 9) The process of evaluating the effectiveness of an organization's system of internal control over time, including both ongoing management and supervisory activities and periodic separate evaluations.

**Public Company Accounting Oversight Board (PCAOB)** (p. 20) A quasi-governmental body charged with oversight of the public accounting profession. The PCAOB sets auditing standards for audits of publicly traded companies in the United States.

**return of investment** (p. 10) The repayment to an investor of the amount originally invested in another enterprise.

**return on investment** (p. 10) The payment of an amount (interest, dividends) for using another's money.

**risk assessment** (p. 8) A process of identifying, analyzing, and managing those risks that pose a threat to the achievement of the organization's objectives.

**Sarbanes-Oxley Act** (p. 9) A landmark piece of securities law, designed to improve the effectiveness of corporate financial reporting through enhanced accountability of auditors, boards of directors, and management.

**Securities and Exchange Commission (SEC)** (p. 18) A governmental organization that has the legal power to establish accounting principles and financial reporting requirements for publicly held companies in the United States.

**statement of cash flows** (p. 12) An activity statement that shows the details of the company's activities involving cash during a period of time.

**statement of financial position** (p. 12) Also called the balance sheet.

## Demonstration Problem

Find the **Nokia Corporation** annual account 2012 at the following Internet address (**http://investors.nokia.com**) to answer the following questions:

**a.** Name the titles of the financial reports in the **Nokia Corp**. annual report that provide specific information about assets, liabilities, equity, income and expenses, and cash flows.

**b.** Name three other sections from **Nokia**'s 2012 annual accounts that provide information useful in assessing the amount, timing, and uncertainty of future cash flows.

**c.** Which main categories of other general information are useful in making investment and credit decisions?

### Solution to the Demonstration Problem

**a.**
- **Nokia Corporation**
  Consolidated Statements of Financial Position
- **Nokia Corporation**
  Consolidated Statements of Changes in Shareholders' Equity
- **Nokia Corporation**
  Consolidated Income Statements
- **Nokia Corporation**
  Consolidated Statements of Cash Flows

**b.**
- Review by the Board of Directors
- Calculation of Key Ratios
- Notes to the Consolidated Financial Statements

**c.**
- Critical Accounting Policies
- Auditors' Report

# Self-Test Questions

*The answers to these questions appear on page 37.*

1. Which of the following does *not* describe accounting?
   - **a.** Language of business.
   - **b.** Is an end rather than a means to an end.
   - **c.** Useful for decision making.
   - **d.** Used by business, government, nonprofit organizations, and individuals.

2. To understand and use accounting information in making economic decisions, you must understand:
   - **a.** The nature of economic activities that accounting information describes.
   - **b.** The assumptions and measurement techniques involved in developing accounting information.
   - **c.** Which information is relevant for a particular type of decision that is being made.
   - **d.** All of the above.

3. Purposes of an accounting system include all of the following *except:*
   - **a.** Interpret and record the effects of business transactions.
   - **b.** Classify the effects of transactions to facilitate the preparation of reports.
   - **c.** Summarize and communicate information to decision makers.
   - **d.** Dictate the specific types of business transactions that the enterprise may engage in.

4. External users of financial accounting information include all of the following *except:*
   - **a.** Investors.
   - **b.** Labor unions.
   - **c.** Line managers.
   - **d.** General public.

5. Objectives of financial reporting to external investors and creditors include preparing information about all of the following *except:*
   - **a.** Information used to determine which products to produce.
   - **b.** Information about economic resources, claims to those resources, and changes in both resources and claims.
   - **c.** Information that is useful in assessing the amount, timing, and uncertainty of future cash flows.
   - **d.** Information that is useful in making investment and credit decisions.

6. Financial accounting information is characterized by all of the following *except:*
   - **a.** It is historical in nature.
   - **b.** It sometimes results from inexact and approximate measures.
   - **c.** It is factual, so it does not require judgment to prepare.
   - **d.** It is enhanced by management's explanation.

7. Which of the following is *not* a user of internal accounting information?
   - **a.** Store manager.
   - **b.** Chief executive officer.
   - **c.** Creditor.
   - **d.** Chief financial officer.

8. Characteristics of internal accounting information include all of the following *except:*
   - **a.** It is audited by a CPA.
   - **b.** It must be timely.
   - **c.** It is oriented toward the future.
   - **d.** It measures efficiency and effectiveness.

9. Which of the following are important factors in ensuring the integrity of accounting information?
   - **a.** Institutional factors, such as standards for preparing information.
   - **b.** Professional organizations, such as the American Institute of CPAs.
   - **c.** Competence, judgment, and ethical behavior of individual accountants.
   - **d.** All of the above.

10. The code of conduct of the American Institute of Certified Public Accountants includes requirements in which of the following areas?
    - **a.** The Public Interest.
    - **b.** Objectivity.
    - **c.** Independence.
    - **d.** All of the above.

# ASSIGNMENT MATERIAL Discussion Questions

1. Accounting is sometimes described as the language of business. What is meant by this description?
2. When you invest your savings in a company, what is the difference between the return *on* your investment and the return *of* your investment?
3. Going from general to specific, what are the three primary objectives of financial accounting information?
4. What are the three primary financial statements with which we communicate financial accounting information?

**5.** Is externally reported financial information always precise and accurate?

**6.** Is internal accounting information primarily historical or future-oriented? How does that compare with financial accounting information?

**7.** What is meant by *generally accepted accounting principles,* and how do these principles add to the integrity of financial accounting information?

**8.** What is the definition of *internal control,* and what are the five components of COSO's internal control framework?

**9.** What is an *audit,* and how does it add to the integrity of accounting information?

**10.** What is meant by the professional designations *CPA, CMA,* and *CIA,* and how do these designations add to the integrity of accounting information?

**11.** Why was the Sarbanes-Oxley legislation passed in 2002, and what are its implications for the accounting profession?

**12.** What is the Financial Accounting Standards Board (FASB), and what is its role in external financial reporting?

**13.** What is the Securities and Exchange Commission (SEC), and what is its role in external financial reporting?

**14.** What is the role of the Public Company Accounting Oversight Board in the audit of financial statements?

**15.** What is the International Accounting Standards Board (IASB), and what are its objectives?

connect ACCOUNTING

## Brief Exercises

Users of Information

**BRIEF EXERCISE 1.1** List four external users of accounting information.

Components of Internal Control

**BRIEF EXERCISE 1.2** Match the terms on the left with the descriptions on the right. Each description should be used only once.

| Term | Description |
|---|---|
| ______ Control environment | a. Identifying, analyzing, and managing those risks that pose a threat to the achievement of the organization's objectives. |
| ______ Risk assessment | b. A process, involving both ongoing activities and separate evaluations, that enables an organization to evaluate the effectiveness of its system of internal control over time. |
| ______ Control activities | c. The process of capturing and communicating operational, financial, and compliance-related information. |
| ______ Information and communication | d. The foundation for all the other elements of internal control, setting the overall tone for the organization. |
| ______ Monitoring | e. Policies and procedures put in place by management to address the risks identified during the risk assessment process. |

Inexact or Approximate Measures

**BRIEF EXERCISE 1.3** Why does accounting rely on inexact or approximate measures?

Standards for the Preparation of Accounting Information

**BRIEF EXERCISE 1.4** What are the two primary organizations in the U.S. that are responsible for setting standards related to the preparation of accounting information?

FASB Conceptual Framework

**BRIEF EXERCISE 1.5** The FASB's conceptual framework sets forth the Board's views on which topics?

Public Company Accounting Oversight Board (PCAOB)

**BRIEF EXERCISE 1.6** Use the Web to find the home page of the PCAOB. What are the four primary activities of the PCAOB?

**BRIEF EXERCISE 1.7** Who are the sponsoring organizations of COSO, and what is COSO best known for doing?

Committee of Sponsoring Organizations (COSO)

**BRIEF EXERCISE 1.8** List three professional certifications offered in accounting and the organizations that offer them.

Professional Certifications in Accounting

**BRIEF EXERCISE 1.9** Match the terms on the left with the descriptions on the right. Each description should be used only once.

AICPA Code of Professional Conduct

| Term | Description |
|---|---|
| ______ Responsibilities | a. A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of service, and discharge professional responsibility to the best of the member's ability. |
| ______ The Public Interest | b. In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities. |
| ______ Integrity | c. A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services. |
| ______ Objectivity and Independence | d. A member in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services to be provided. |
| ______ Due Care | e. Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism. |
| ______ Scope and Nature of Services | f. To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity. |

**BRIEF EXERCISE 1.10** List three accounting-related skills that are useful to many people in their personal lives.

Personal Benefits of Accounting Skills

## Exercises

**EXERCISE 1.1** Identify several ways in which *you* currently use accounting information in your life as a student. Also identify several situations in which, while you are still a student, you might be required to supply financial information about yourself to others.

You as a User of Accounting Information
LO1

**EXERCISE 1.2** **Boeing Company** is the largest manufacturer of commercial aircraft in the United States and is a major employer in Seattle, Washington. Explain why each of the following individuals or organizations would be interested in financial information about the company.

Users of Accounting Information
LO3, LO4

**a.** **California Public Employees Retirement System**, one of the world's largest pension funds.
**b.** **China Airlines**, a rapidly growing airline serving the Pacific Rim.
**c.** Henry James, a real estate investor considering building apartments in the Seattle area.
**d.** **Boeing**'s management.
**e.** **International Aerospace Machinists**, a labor union representing many **Boeing** employees.

What Is Financial Reporting?
LO3

**EXERCISE 1.3** A major focus of this course is the process of financial reporting.

**a.** What is meant by the term *financial reporting*?
**b.** What are the principal accounting reports involved in the financial reporting process? In general terms, what is the purpose of these reports?
**c.** Do all business entities engage in financial reporting? Explain.
**d.** How does society benefit from the financial reporting process?

Generally Accepted Accounting Principles
LO6

**EXERCISE 1.4** Generally accepted accounting principles play an important role in financial reporting.

**a.** What is meant by the phrase *generally accepted accounting principles*?
**b.** What are the major sources of these principles?
**c.** Is there a single comprehensive list of generally accepted accounting principles? Explain.
**d.** What types of accounting reports are prepared in conformity with generally accepted accounting principles?

Accounting Organizations
LO6

**EXERCISE 1.5** Describe the roles of the following organizations in establishing generally accepted accounting principles:

**a.** The FASB
**b.** The AICPA
**c.** The SEC

From which of these organizations can you most easily obtain financial information about publicly owned companies?

Investment Return
LO3

**EXERCISE 1.6** You recently invested $12,000 of your savings in a security issued by a large company. The security agreement pays you 7 percent per year and has a maturity two years from the day you purchased it. What is the total cash flow you expect to receive from this investment, separated into the return on your investment and the return of your investment?

Accounting Terminology
LO3, LO4, LO5, LO7

**EXERCISE 1.7** Match the terms on the left with the descriptions on the right. Each description should be used only once.

| Term | Description |
|---|---|
| ______ Financial accounting | a. The procedural aspect of accounting that involves keeping detailed records of business transactions, much of which is done today by computers. |
| ______ Management accounting | b. A broad term that describes all information provided to external users, including but not limited to financial statements. |
| ______ Financial reporting | c. An important quality of accounting information that allows investors, creditors, management, and other users to rely on the information. |
| ______ Financial statements | d. The segment of the accounting profession that relates to providing audit, tax, and consulting services to clients. |
| ______ General-purpose assumption | e. Procedures and processes within an organization that ensure the integrity of accounting information. |
| ______ Integrity | f. Statement of financial position (balance sheet), income statement, statement of cash flows. |
| ______ Internal control | g. The fact that the same information is provided to various external users, including investors and creditors. |
| ______ Public accounting | h. The area of accounting that refers to providing information to support internal management decisions. |
| ______ Bookkeeping | i. The area of accounting that refers to providing information to support external investment and credit decisions. |

**EXERCISE 1.8** Match the organizations on the left with the functions on the right. Each function should be used only once.

Accounting Organizations
LO6

| Organization | Function |
|---|---|
| _____ Institute of Internal Auditors | a. Government agency responsible for financial reporting by publicly held companies. |
| _____ Securities and Exchange Commission | b. International organization dedicated to the advancement of internal auditing. |
| _____ American Institute of CPAs | c. Organization dedicated to providing members personal and professional development opportunities in the area of management accounting. |
| _____ Institute of Management Accountants | d. The body charged with setting auditing standards for audits of public companies. |
| _____ Financial Accounting Standards Board | e. Organization consisting primarily of accounting educators that encourages improvements in teaching and research. |
| _____ American Accounting Association | f. The group that creates and promotes International Financial Reporting Standards (IFRSs). |
| _____ Public Company Accounting Oversight Board | g. Professional association of Certified Public Accountants. |
| _____ International Accounting Standards Board | h. Private-sector organization that establishes accounting standards. |

**EXERCISE 1.9** The major focus of accounting information is to facilitate decision making.

Financial and Management Accounting
LO3, LO4

**a.** As an investor in a company, what would be your primary objective?
**b.** As a manager of a company, what would be your primary objective?
**c.** Is the same accounting information likely to be equally useful to you in these two different roles?

**EXERCISE 1.10** Internal accounting information is used primarily for internal decision making by an enterprise's management.

Management Accounting Information
LO4

**a.** What are the three primary purposes of internal accounting information?
**b.** Which of these is the most general and which is the most specific?
**c.** Give several examples of the kinds of decisions that internal accounting information supports.

**EXERCISE 1.11** Describe which professional organization(s) would most likely be of greatest value to you if your position involved each of the following independent roles:

Accounting Organizations
LO6

**a.** Accounting educator.
**b.** Management accountant.
**c.** Certified public accountant.

**EXERCISE 1.12** Audits of financial statements are an important part of the accounting process to ensure integrity in financial reporting.

Purpose of an Audit
LO5

**a.** What is the purpose of an audit?
**b.** As an external user of accounting information, what meaning would you attach to an audit that concludes that the financial statements are fairly presented in conformity with generally accepted accounting principles?
**c.** Would your interest in investing in this same company be affected by an auditor's report that concluded the financial statements were *not* fairly presented? Why or why not?

**EXERCISE 1.13** The annual financial statements of all large, publicly owned corporations are audited.

Audits of Financial Statements
LO5

**a.** What is an audit of financial statements?
**b.** Who performs audits?
**c.** What is the purpose of an audit?

Ethics and Professional Judgment
LO7

**EXERCISE 1.14** Ethical conduct and professional judgment each play important roles in the accounting process.

**a.** In general terms, explain why it is important to society that people who prepare accounting information act in an ethical manner.
**b.** Identify at least three areas in which accountants must exercise *professional judgment*, rather than merely relying on written rules.

Careers in Accounting
LO8

**EXERCISE 1.15** Four accounting majors, Maria Acosta, Kenzo Nakao, Helen Martin, and Anthony Mandella, recently graduated from Central University and began professional accounting careers. Acosta entered public accounting, Nakao became a management accountant, Martin joined a governmental agency, and Mandella (who had completed a graduate program) became an accounting faculty member.

Assume that each of the four graduates was successful in his or her chosen career. Identify the types of accounting *activities* in which each of these graduates might find themselves specializing several years after graduation.

adidas AG, Herzogenaurach General and Specific Information
LO1, LO3, LO5

**EXERCISE 1.16** Locate the **adidas AG, Herzogenaurach** 2012 financial statements in Appendix A of this text. Briefly peruse the financial statements and answer the following questions:

**a.** Name the titles of each of **adidas**' financial statements that provide specific information about economic resources, claims to resources, and changes in resources and claims.
**b.** Name three other sections from **adidas**' 2012 financial statements that might be useful to a potential investor or creditor.

*Due to the introductory nature of this chapter and the conceptual nature of its contents, no items labeled **Problems** are included. In all future chapters you will find two problem sets, A and B, that generally include computations, are more complex, and generally require more time to complete than the Exercises.*

## Critical Thinking Cases

Reliability of Financial Statements
LO5

**CASE 1.1** In November 2009, **Dubai World** was in severe financial difficulty and desperately needed large loans for the company to survive. What factors prevented **Dubai** from simply providing potential lenders with misleading financial statements to make the company look like a risk-free investment?

Objectives of Financial Accounting
LO3

**CASE 1.2** Divide into groups as instructed by your professor and discuss the following:

**a.** How does the description of accounting as the "language of business" relate to accounting as being useful for investors and creditors?
**b.** Explain how the decisions you would make might differ if you were an external investor or a member of an enterprise's management team.

Accounting Systems
LO2

**CASE 1.3** You are employed by a business consulting firm as an information systems specialist. You have just begun an assignment with a startup company and are discussing with the owner her need for an accounting system. How would you respond to the following questions from the owner?

**a.** What is the meaning of the term *accounting system*?
**b.** What is the purpose of an accounting system and what are its basic functions?
**c.** Who is responsible for designing and implementing an accounting system?

Codes of Ethics
LO7

**CASE 1.4** Assume you have recently completed your college degree with a major in accounting and have accepted a position on the accounting staff of a large corporation. Your supervisor suggests that in preparing for your first day on the job, you become familiar with the basic principles included in the code of ethics of the Institute of Management Accountants. Briefly explain what you learn as you study the code and how it might affect your behavior on your new job. (Use the IMA's Web site to obtain access to the IMA's Code of Ethics.)

Accessing Information on the Internet

LO6, LO7

**INTERNET CASE 1.5** The Internet is a good place to get information that is useful to you in your study of accounting. For example, you can find information about accounting firms, standards setters, and regulators.

### Instructions

**a.** The largest accounting firms around the world are referred to as the Big Four—Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers. Access the Internet sites of these four firms and learn what you can about the type of services provided by each firm.

**b.** The Public Company Accounting Oversight Board (PCAOB) was created by the Sarbanes-Oxley Act to oversee auditors of public companies. Access the PCAOB's Internet site and learn what you can about its four major activities.

**c.** The Financial Accounting Standards Board (FASB) is the designated accounting standard setter in the United States. Access the FASB's Internet site and identify its board members, including a brief description of their backgrounds.

**d.** The International Accounting Standards Board (IASB) is the body that issues International Financial Reporting Standards (IFRSs). Access the IASB's Internet site and identify its board members, including a brief description of the backgrounds of five board members.

*Internet sites are time and date sensitive. It is the purpose of these exercises to have you explore the Internet. You may need to use the Yahoo! search engine* **www.yahoo.com** *(or another favorite search engine) to find a company's current Web address.*

## Answers to Self-Test Questions

1. b
2. d
3. d
4. c
5. a
6. c
7. c
8. a
9. d
10. d