College Accounting

Chapter 1

Accounting: The Language of Business

Google

www.google.com

There are so many careers out there for students to be curious about. How do you find out about them? Most of us turn to the Internet—We get directions, check the local weather, and research news using *Google*.

Google's features and performance have grown over the years and attracted new users at an astounding rate. By 2000, *Google* officially became the world's largest search engine with its introduction of a billion-page index. As a publicly owned global Internet communications, commerce, and media company, *Google* hires a lot of accountants to record its business transactions.

You might be curious about a career in accounting. Maybe you're wondering what accountants do every day at companies like *Google* and who looks at the reports generated by their efforts. This information is not only essential to *Google's* management team, but many other groups rely on it as well. A final question, you may want to *Google*, is why can users trust the information that accountants have prepared?

thinking critically

Can you think of any of the organizations that would be interested in how *Google* is performing?

LEARNING OBJECTIVES

1-1. Define accounting.
1-2. Identify and discuss career opportunities in accounting.
1-3. Identify the users of financial information.
1-4. Compare and contrast the three types of business entities.
1-5. Describe the process used to develop generally accepted accounting principles.
1-6. Define the accounting terms new to this chapter.

NEW TERMS

- accounting
- Accounting Standards Codification
- Accounting Standards Update
- accounting system
- auditing
- auditor's report
- certified public accountant (CPA)
- corporation
- creditor
- discussion memorandum
- economic entity
- entity
- exposure draft
- financial statements
- generally accepted accounting principles (GAAP)
- governmental accounting
- international accounting
- management advisory services
- managerial accounting
- partnership
- public accountants
- separate entity assumption
- social entity
- sole proprietorship
- Statements of Financial Accounting Standards
- stock
- stockholders
- tax accounting

Section 1

SECTION OBJECTIVES	TERMS TO LEARN
>> 1-1. Define accounting. WHY IT'S IMPORTANT Business transactions affect many aspects of our lives. >> 1-2. Identify and discuss career opportunities in accounting. WHY IT'S IMPORTANT There's something for everyone in the field of accounting. Accounting professionals are found in every workplace from public accounting firms to government agencies, from corporations to nonprofit organizations. >> 1-3. Identify the users of financial information. WHY IT'S IMPORTANT A wide variety of individuals and businesses depend on financial information to make decisions.	accounting accounting system auditing certified public accountant (CPA) financial statements governmental accounting management advisory services managerial accounting public accountants tax accounting

What Is Accounting?

Accounting provides financial information about a business or a nonprofit organization. Owners, managers, investors, and other interested parties need financial information in order to make decisions. Because accounting is used to communicate financial information, it is often called the "language of business."

The Need for Financial Information

Suppose a relative leaves you a substantial sum of money and you decide to carry out your lifelong dream of opening a small sportswear shop. You rent space in a local shopping center, purchase fixtures and equipment, purchase goods to sell, hire salespeople, and open the store to customers. Before long you realize that, to run your business successfully, you need financial information about the business. You probably need information that provides answers to the following questions:

- How much cash does the business have?
- How much money do customers owe the business?
- What is the cost of the merchandise sold?
- What is the change in sales volume?
- How much money is owed to suppliers?
- What is the profit or loss?

As your business grows, you will need even more financial information to evaluate the firm's performance and make decisions about the future. An efficient accounting system allows owners and managers to quickly obtain a wide range of useful information. The need for timely information is one reason that businesses have an accounting system directed by a professional staff.

>>1-1. OBJECTIVE
Define accounting.

Accounting Defined

Accounting is the process by which financial information about a business is recorded, classified, summarized, interpreted, and communicated to owners, managers, and other interested parties. An **accounting system** is designed to accumulate data about a firm's financial affairs, classify the data in a meaningful way, and summarize it in periodic reports called **financial statements.** Owners and managers obtain a lot of information from financial statements. The accountant:

- establishes the records and procedures that make up the accounting system,
- supervises the operations of the system,
- interprets the resulting financial information.

Most owners and managers rely heavily on the accountant's judgment and knowledge when making financial decisions.

Accounting Careers

>>1-2. OBJECTIVE
Identify and discuss career opportunities in accounting.

Many jobs are available in the accounting profession, and they require varying amounts of education and experience. Bookkeepers and accountants are responsible for keeping records and providing financial information about the business. Generally, bookkeepers are responsible for recording business transactions. In large firms, bookkeepers may also supervise the work of accounting clerks. Accounting clerks are responsible for recordkeeping for a part of the accounting system—perhaps payroll, accounts receivable, or accounts payable. Accountants usually supervise bookkeepers and prepare the financial statements and reports of the business.

Newspapers and websites often have job listings for accounting clerks, bookkeepers, and accountants:

- Accounting clerk positions usually require one to two accounting courses and little or no experience.
- Bookkeeper positions usually require one to two years of accounting education plus experience as an accounting clerk.
- Accountant positions usually require a bachelor's degree but are sometimes filled by experienced bookkeepers or individuals with a two-year college degree. Most entry-level accountant positions do not have an experience requirement. Both the education and experience requirements for accountant positions vary according to the size of the firm.

Accountants usually choose to practice in one of three areas:

- public accounting
- managerial accounting
- governmental accounting

Table 1.1 on page 6 shows a list of occupations with job duties that are similar to those of accountants and auditors.

PUBLIC ACCOUNTING

Public accountants work for public accounting firms. Public accounting firms provide accounting services for other companies. Usually they offer three services:

- auditing
- tax accounting
- management advisory services

The largest public accounting firms in the United States are called the "Big Four." The "Big Four" are Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers.

Many public accountants are **certified public accountants (CPAs).** To become a CPA, an individual must have a certain number of college credits in accounting courses, demonstrate good personal character, pass the Uniform CPA Examination, and fulfill the experience requirements of the state of practice. CPAs must follow the professional code of ethics.

Auditing is the review of financial statements to assess their fairness and adherence to generally accepted accounting principles. Accountants who are CPAs perform financial audits.

ABOUT ACCOUNTING

Accounting Services

The role of the CPA is expanding. In the past, accounting firms handled audits and taxes. Today accountants provide a wide range of services, including financial planning, investment advice, accounting and tax software advice, and profitability consulting. Accountants provide clients with information and advice on electronic business, health care performance measurement, risk assessment, business performance measurement, and information system reliability.

TABLE 1.1 Occupations with Similar Job Duties to Accountants and Auditors

Occupation	Job Duties	Entry-Level Education
Bookkeeping, Accounting, and Auditing Clerks	Bookkeeping, accounting, and auditing clerks produce financial records for organizations. They record financial transactions, update statements, and check financial records for accuracy.	High school diploma or equivalent
Budget Analysts	Budget analysts help public and private institutions organize their finances. They prepare budget reports and monitor institutional spending.	Bachelor's degree
Cost Estimators	Cost estimators collect and analyze data to estimate the time, money, resources, and labor required for product manufacturing, construction projects, or services. Some specialize in a particular industry or product type.	Bachelor's degree
Financial Analysts	Financial analysts provide guidance to businesses and individuals making investment decisions. They assess the performance of stocks, bonds, and other types of investments.	Bachelor's degree
Financial Examiners	Financial examiners ensure compliance with laws governing financial institutions and transactions. They review balance sheets, evaluate the risk level of loans, and assess bank management.	Bachelor's degree
Financial Managers	Financial managers are responsible for the financial health of an organization. They produce financial reports, direct investment activities, and develop strategies and plans for the long-term financial goals of their organization.	Bachelor's degree
Management Analysts	Management analysts, often called management consultants, propose ways to improve an organization's efficiency. They advise managers on how to make organizations more profitable through reduced costs and increased revenues.	Bachelor's degree
Personal Financial Advisors	Personal financial advisors give financial advice to people. They help with investments, taxes, and insurance decisions.	Bachelor's degree
Postsecondary Teachers	Postsecondary teachers instruct students in a wide variety of academic and vocational subjects beyond the high school level. They also conduct research and publish scholarly papers and books.	Doctoral or professional degree
Tax Examiners and Collectors, and Revenue Agents	Tax examiners and collectors, and revenue agents ensure that governments get their tax money from businesses and citizens. They review tax returns, conduct audits, identify taxes owed, and collect overdue tax payments.	Bachelor's degree
Top Executives	Top executives devise strategies and policies to ensure that an organization meets its goals. They plan, direct, and coordinate operational activities of companies and public or private-sector organizations.	Bachelor's degree

Source: Bureau of Labor Statistics, U.S. Department of Labor, Occupational Outlook Handbook, 2012–13 Edition, Accountants and Auditors, on the Internet at http://www.bls.gov/ooh/business-and-financial/accountants-and-auditors.htm (visited March 25, 2013).

Tax accounting involves tax compliance and tax planning. *Tax compliance* deals with the preparation of tax returns and the audit of those returns. *Tax planning* involves giving advice to clients on how to structure their financial affairs in order to reduce their tax liability.

Management advisory services involve helping clients improve their information systems or their business performance.

MANAGERIAL ACCOUNTING

Managerial accounting, also referred to as *private accounting,* involves working for a single business in industry. Managerial accountants perform a wide range of activities, including:

- establishing accounting policies,
- managing the accounting system,
- preparing financial statements,
- interpreting financial information,
- providing financial advice to management,
- preparing tax forms,
- performing tax planning services,
- preparing internal reports for management.

GOVERNMENTAL ACCOUNTING

Governmental accounting involves keeping financial records and preparing financial reports as part of the staff of federal, state, or local governmental units. Governmental units do not earn profits. However, governmental units receive and pay out huge amounts of money and need procedures for recording and managing this money.

Some governmental agencies hire accountants to audit the financial statements and records of the businesses under their jurisdiction and to uncover possible violations of the law. The Securities and Exchange Commission, the Internal Revenue Service, the Federal Bureau of Investigation, and Homeland Security employ a large number of accountants.

Users of Financial Information

>>1-3. OBJECTIVE
Identify the users of financial information.

The results of the accounting process are communicated to many individuals and organizations. Who are these individuals and organizations, and why do they want financial information about a particular firm?

OWNERS AND MANAGERS

Assume your sportswear shop is in full operation. One user of financial information about the business is you, the owner. You need information that will help you evaluate the results of your operations and plan and make decisions for the future. Questions such as the following are difficult to answer without financial information:

- Should you drop the long-sleeved pullover that is not selling well from the product line, or should you just reduce the price?
- How much should you charge for the denim jacket that you are adding to the product line?
- How much should you spend on advertising?
- How does this month's profit compare with last month's profit?
- Should you open a new store?

SUPPLIERS

A number of other people are interested in the financial information about your business. For example, businesses that supply you with sportswear need to assess the ability of your firm to pay its bills. They also need to set a credit limit for your firm.

BANKS

What if you decide to ask your bank for a loan so that you can open a new store? The bank needs to be sure that your firm will repay the loan on time. The bank will ask for financial information prepared by your accountant. Based on this information, the bank will decide whether to make the loan and the terms of the loan.

TAX AUTHORITIES

The Internal Revenue Service (IRS) and other state and local tax authorities are interested in financial information about your firm. This information is used to determine the tax base:

- Income taxes are based on taxable income.
- Sales taxes are based on sales income.
- Property taxes are based on the assessed value of buildings, equipment, and inventory (the goods available for sale).

The accounting process provides all of this information.

REGULATORY AGENCIES AND INVESTORS

If an industry is regulated by a governmental agency, businesses in that industry have to supply financial information to the regulating agency. For example, the Federal Communications Commission receives financial information from radio and television stations. The Securities and Exchange Commission (SEC) oversees the financial information provided by publicly owned corporations to their investors and potential investors. Publicly owned corporations trade their shares on stock exchanges and in over-the-counter markets. Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934 in order to protect those who invest in publicly owned corporations.

The SEC is responsible for reviewing the accounting methods used by publicly owned corporations. The SEC has delegated this review to the accounting profession but still has the final say on any financial accounting issue faced by publicly owned corporations. If the SEC does not agree with the reporting that results from an accounting method, the SEC can suspend trading of a company's shares on the stock exchanges.

> Major changes were made to the regulatory environment in the accounting profession with the passage of the Public Company Accounting Reform and Investor Protection Act of 2002 (also known as the Sarbanes-Oxley Act) that was signed into law by President Bush on August 2, 2002. The Act was the most far-reaching regulatory crackdown on corporate fraud and corruption since the creation of the Securities and Exchange Commission in 1934.

The Sarbanes-Oxley Act was passed in response to the wave of corporate accounting scandals starting with the demise of Enron Corporation in 2001, the arrest of top executives at WorldCom and Adelphia Communications Corporation, and ultimately the demise of Arthur Andersen, an international public accounting firm formerly a member of the "Big Five." Arthur Andersen was found guilty of an obstruction of justice charge after admitting that the firm destroyed thousands of documents and electronic files related to the Enron audit engagement. Although on May 31, 2008, the Supreme Court of the United States reversed the Andersen guilty verdict, Arthur Andersen has not returned as a viable business. As a result of the demise of Arthur Andersen, the "Big Five" are now the "Big Four."

The Act significantly tightens regulation of financial reporting by publicly held companies and their accountants and auditors. The Sarbanes-Oxley Act creates a five-member Public Company Accounting Oversight Board. The Board will have investigative and enforcement powers to oversee the accounting profession and to discipline corrupt accountants and auditors. The Securities and Exchange Commission will oversee the Board. Two members of the Board will be certified public accountants, to regulate the accountants who audit public companies, and the remaining three must not be and cannot have been CPAs. The chair of the Board may be held by one of the CPA members, provided that the individual has not been engaged as a practicing CPA for five years.

Major provisions of the bill include rules on consulting services, auditor rotation, criminal penalties, corporate governance, and securities regulation. The Act prohibits accountants from offering a broad range of consulting services to publicly traded companies that they audit and requires accounting firms to change the lead audit or coordinating partner and the reviewing partner for a company every five years. Additionally, it is a felony to "knowingly" destroy or create documents to "impede, obstruct or influence" any existing or contemplated federal investigation. Auditors are also required to maintain all audit or review work papers for seven years. Criminal penalties, up to 20 years in prison, are imposed for obstruction of justice and the Act raises the maximum sentence for defrauding pension funds to 10 years.

Chief executives and chief financial officers of publicly traded corporations are now required to certify their financial statements and these executives will face up to 20 years in prison if they "knowingly or willfully" allow materially misleading information into their financial statements. Companies must also disclose, as quickly as possible, material changes in their financial position. Wall Street investment firms are prohibited from retaliating against analysts who criticize investment-banking clients of the firm. The Act contains a provision with broad new protection for whistle-blowers and lengthens the time that investors have to file lawsuits against corporations for securities fraud.

By narrowing the type of consulting services that accountants can provide to companies that they audit, requiring auditor rotation, and imposing stiff criminal penalties for violation of the Act, it appears that this new legislation will significantly help to restore public confidence in financial statements and markets and change the regulatory environment in which accountants operate.

CUSTOMERS

Customers pay special attention to financial information about the firms with which they do business. For example, before a business spends a lot of money on a new computer system, the business wants to know that the computer manufacturer will be around for the

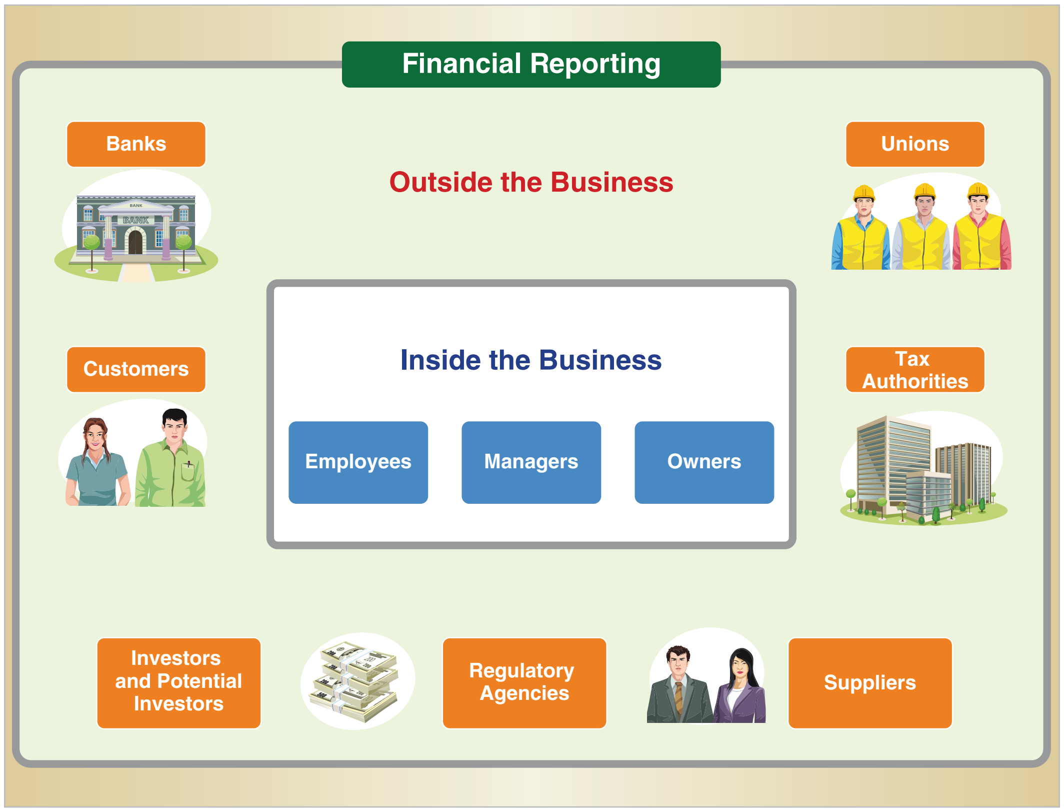

FIGURE 1.1

Users of Financial Information

next several years in order to service the computer, replace parts, and provide additional components. The business analyzes the financial information about the computer manufacturer in order to determine its economic health and the likelihood that it will remain in business.

EMPLOYEES AND UNIONS

Often employees are interested in the financial information of the business that employs them. Employees who are members of a profit-sharing plan pay close attention to the financial results because they affect employee income. Employees who are members of a labor union use financial information about the firm to negotiate wages and benefits.

Figure 1.1 on page 9 illustrates different financial information users. As you learn about the accounting process, you will appreciate why financial information is so important to these individuals and organizations. You will learn how financial information meets users' needs.

Section 1 Self Review

QUESTIONS

1. Why is accounting called the "language of business"?
2. What are financial statements?
3. What are the names of three accounting job positions?

EXERCISES

4. One requirement for becoming a CPA is to pass the:
   a. Final CPA Examination
   b. SEC Accounting Examination
   c. Uniform CPA Examination
   d. State Board Examination
5. Which organization has the final say on financial accounting issues faced by publicly owned corporations?
   a. Securities and Exchange Commission
   b. Federal Trade Commission
   c. U.S. Treasury Department
   d. Internal Revenue Service

ANALYSIS

6. The owner of the sporting goods store where you work has decided to expand the store. She has decided to apply for a loan. What type of information will she need to give to the bank?

(Answers to Section 1 Self Review are on page 20.)

Section 2

SECTION OBJECTIVES	TERMS TO LEARN
>> 1-4. Compare and contrast the three types of business entities. WHY IT'S IMPORTANT Each type of business entity requires unique legal and accounting considerations. >> 1-5. Describe the process used to develop generally accepted accounting principles. WHY IT'S IMPORTANT Accounting professionals are required to use common standards and principles in order to produce reliable financial information.	Accounting Standards Codification Accounting Standards Update auditor's report corporation creditor discussion memorandum economic entity entity exposure draft generally accepted accounting principles (GAAP) international accounting partnership separate entity assumption social entity sole proprietorship Statements of Financial Accounting Standards stock stockholders

Business and Accounting

The accounting process involves recording, classifying, summarizing, interpreting, and communicating financial information about an economic or social entity. An **entity** is recognized as having its own separate identity. An entity may be an individual, a town, a university, or a business. The term **economic entity** usually refers to a business or organization whose major purpose is to produce a profit for its owners. **Social entities** are nonprofit organizations, such as cities, public schools, and public hospitals. This book focuses on the accounting process for businesses, but keep in mind that nonprofit organizations also need financial information.

Types of Business Entities

>>1-4. OBJECTIVE
Compare and contrast the three types of business entities.

The three major legal forms of business entity are the sole proprietorship, the partnership, and the corporation. In general, the accounting process is the same for all three forms of business. Later in the book you will study the different ways certain transactions are handled depending on the type of business entity. For now, however, you will learn about the different types of business entities.

SOLE PROPRIETORSHIPS

A **sole proprietorship** is a business entity owned by one person. The life of the business ends when the owner is no longer willing or able to keep the business going. Many small businesses are operated as sole proprietorships.

The owner of a sole proprietorship is legally responsible for the debts and taxes of the business. If the business is unable to pay its debts, the **creditors** (those people, companies, or government agencies to whom the business owes money) can turn to the owner for payment. The owner may have to pay the debts of the business from personal resources, including personal savings. When the time comes to pay income taxes, the owner's income and the income of the business are combined to compute the total tax responsibility of the owner.

It is important that the business transactions be kept separate from the owner's personal transactions. If the owner's personal transactions are mixed with those of the business, it will be difficult to measure the performance of the business. The term **separate entity assumption** describes the concept of keeping the firm's financial records separate from the owner's personal financial records.

PARTNERSHIPS

A **partnership** is a business entity owned by two or more people. The partnership structure is common in businesses that offer professional services, such as law firms, accounting firms, architectural firms, medical practices, and dental practices. At the beginning of the partnership, two or more individuals enter into a contract that details the rights, obligations, and limitations of each partner, including:

- the amount each partner will contribute to the business,
- each partner's percentage of ownership,
- each partner's share of the profits,
- the duties each partner will perform,
- the responsibility each partner has for the amounts owed by the business to creditors and tax authorities.

The partners choose how to share the ownership and profits of the business. They may share equally or in any proportion agreed upon in the contract. When a partner leaves, the partnership is dissolved and a new partnership may be formed with the remaining partners.

Partners are individually, and as a group, responsible for the debts and taxes of the partnership. If the partnership is unable to pay its debts or taxes, the partners' personal property, including personal bank accounts, may be used to provide payment. It is important that partnership transactions be kept separate from the personal financial transactions of the partners.

> Under the Limited Liability Partnership Act of most states, a Limited Liability Partnership (LLP) may be formed. An LLP is a general partnership that provides some limited liability for all partners. LLP partners are responsible and have liability for their own actions and the actions of those under their control or supervision. They are not liable for the actions or malfeasance of another partner. Except for the limited liability aspect, LLPs generally have the same characteristics, advantages, and disadvantages as any other partnership.

CORPORATIONS

A **corporation** is a business entity that is separate from its owners. A corporation has a legal right to own property and do business in its own name. Corporations are very different from sole proprietorships and partnerships.

Stock, issued in the form of stock certificates, represents the ownership of the corporation. Corporations may be *privately* or *publicly* owned. Privately owned corporations are also called *closely held* corporations. The ownership of privately owned corporations is limited to specific individuals, usually family members. Stock of closely held corporations is not traded on an exchange. In contrast, stock of publicly owned corporations is bought and sold on stock exchanges and in over-the-counter markets. Most large corporations have issued (sold) thousands of shares of stock.

important!

Separate Entity Assumption

For *accounting* purposes, all forms of business are considered separate entities from their owners. However, the corporation is the only form of business that is a separate *legal* entity.

An owner's share of the corporation is determined by the number of shares of stock held by the owner compared to the total number of shares issued by the corporation. Assume that Hector Flores owns 600 shares of Sample Corporation. If Sample Corporation has issued 2,000 shares of stock, Flores owns 30 percent of the corporation (600 shares ÷ 2,000 shares = 0.30 or 30%). Some corporate decisions require a vote by the owners. For Sample Corporation, Flores has 600 votes, one for each share of stock that he owns. The other owners have 1,400 votes.

Subchapter S Corporations, also known as S corporations, are entities formed as corporations which meet the requirements of Subchapter S of the Internal Revenue Code to be treated essentially as a partnership so the corporation pays no income tax. Instead, shareholders include their share of corporate profits, and any items that require special tax treatment, on their individual income tax returns. Otherwise, S corporations have all of the characteristics of regular corporations. The advantage of the S corporation is that the owners have limited liability and avoid double taxation.

One of the advantages of the corporate form of business is the indefinite life of the corporation. A sole proprietorship ends when the owner dies or discontinues the business. A partnership ends on the death or withdrawal of a partner. In contrast, a corporation does not end when ownership changes. Some corporations have new owners daily because their shares are actively traded (sold) on stock exchanges.

Corporate owners, called **stockholders** or *shareholders,* are not personally responsible for the debts or taxes of the corporation. If the corporation is unable to pay its bills, the most stockholders can lose is their investment in the corporation. In other words, the stockholders will not lose more than the cost of the shares of stock.

The accounting process for the corporate entity, like that of the sole proprietorship and the partnership, is separate from the financial affairs of its owners. Usually this separation is easy to maintain. Most stockholders do not participate in the day-to-day operations of the business.

Table 1.2 summarizes the business characteristics for sole proprietorships, partnerships, and corporations.

Generally Accepted Accounting Principles

The Securities and Exchange Commission has the final say on matters of financial reporting by publicly owned corporations. The SEC has delegated the job of determining proper accounting standards to the accounting profession. However, the SEC sometimes overrides decisions the

TABLE 1.2

Major Characteristics of Business Entities

Characteristic	Type of Business Entity		
	Sole Proprietorship	Partnership	Corporation
Ownership	One owner	Two or more owners	One or more owners, even thousands
Life of the business	Ends when the owner dies, is unable to carry on operations, or decides to close the firm	Ends when one or more partners withdraw, when a partner dies, or when the partners decide to close the firm	Can continue indefinitely; ends only when the business goes bankrupt or when the stockholders vote to liquidate
Responsibility for debts of the business	Owner is responsible for firm's debt when the firm is unable to pay	Partners are responsible individually and jointly for firm's debts when the firm is unable to pay	Stockholders are not responsible for firm's debts; they can lose only the amount they invested

accounting profession makes. To fulfill its responsibility, the accounting profession has developed, and continues to develop, **generally accepted accounting principles (GAAP).** Generally accepted accounting principles must be followed by publicly owned companies unless they can show that doing so would produce information which is misleading.

>>1-5. OBJECTIVE

Describe the process used to develop generally accepted accounting principles.

THE DEVELOPMENT OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Generally accepted accounting principles are developed by the Financial Accounting Standards Board (FASB), which is composed of five full-time members. Prior to 2009, the FASB issued 168 **Statements of Financial Accounting Standards.** The FASB developed these statements and, before issuing them, obtained feedback from interested people and organizations.

First, the FASB wrote a **discussion memorandum** to explain the topic being considered. Then public hearings were held where interested parties could express their opinions, either orally or in writing. The groups that consistently expressed opinions about proposed FASB statements were the SEC, the American Institute of Certified Public Accountants (AICPA), public accounting firms, the American Accounting Association (AAA), and businesses with a direct interest in a particular statement.

The AICPA is a national association for certified public accountants. The AAA is a group of accounting educators. AAA members research possible effects of a proposed FASB statement and offer their opinions to the FASB.

important!

GAAP

The SEC requires all publicly owned companies to follow generally accepted accounting principles. As new standards are developed or refined, accountants interpret the standards and adapt accounting practices to the new standards.

After public hearings, the FASB released an **exposure draft,** which described the proposed statement. Then the FASB received and evaluated public comment about the exposure draft. Finally, FASB members voted on the statement. If at least four members approved, the statement was issued.

The above process was used until 2009. Effective July 1, 2009, the source of authoritative U.S. GAAP is the FASB **Accounting Standards Codification,** which are communicated through an **Accounting Standards Update** **(Update).** The Codification reorganizes U.S. GAAP pronouncements into approximately 90 accounting topics. It also includes relevant U.S. Securities and Exchange Commission (SEC) guidance that follows the same topical structure in separate sections in the Codification.

Updates are now published on these accounting topics for all authoritative U.S. GAAP promulgated by the FASB, regardless of the form in which such guidance may have been issued prior to the release of the FASB Codification. An Update summarizes the key provisions of the project that led to the Update, details the specific amendments to the FASB Codification, and explains the basis for the Board's decision.

Accounting principles vary from country to country. **International accounting** is the study of the accounting principles used by different countries. In 1973, the International Accounting Standards Committee (IASC) was formed. Recently, the IASC's name was changed to the International Accounting Standards Board (IASB). The ISAB deals with issues caused by the lack of uniform accounting principles. The IASB also makes recommendations to enhance comparability of reporting practices.

THE USE OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Every year, publicly traded companies submit financial statements to the SEC. The financial statements are audited by independent certified public accountants (CPAs). The CPAs are called *independent* because they are not employees of the company being audited and they do not have a financial interest in the company. The financial statements include the auditor's report. The **auditor's report** contains the auditor's opinion about the fair presentation of the operating results and financial position of the business. The auditor's report also confirms that the financial information is prepared in conformity with generally accepted accounting principles. The financial statements and the auditor's report are made available to the public, including existing and potential stockholders.

MANAGERIAL IMPLICATIONS <<

FINANCIAL INFORMATION

- Managers of a business make sure that the firm's accounting system produces financial information that is timely, accurate, and fair.
- Financial statements should be based on generally accepted accounting principles.
- Each year a publicly traded company must submit financial statements, including an independent auditor's report, to the SEC.
- Internal reports for management need not follow generally accepted accounting principles but should provide useful information that will aid in monitoring and controlling operations.
- Financial information can help managers to control present operations, make decisions, and plan for the future.
- The sound use of financial information is essential to good management.

THINKING CRITICALLY

If you were a manager, how would you use financial information to make decisions?

Businesses and the environment in which they operate are constantly changing. The economy, technology, and laws change. Generally accepted accounting principles are changed and refined as accountants respond to the changing environment.

Section 2 Self Review

QUESTIONS

1. What are generally accepted accounting principles?
2. Why are generally accepted accounting principles needed?
3. How are generally accepted accounting principles developed?

EXERCISES

4. An organization that has two or more owners who are legally responsible for the debts and taxes of the business is a:
   a. social entity
   b. partnership
   c. sole proprietorship
   d. corporation
5. A nonprofit organization such as a public school is a(n):
   a. social unit
   b. economic unit
   c. social entity
   d. economic entity
6. You plan to open a business with two of your friends. You would like to form a corporation, but your friends prefer the partnership form of business. What are some of the advantages of the corporate form of business?

(Answers to Section 2 Self Review are on page 20.)

1 Chapter REVIEW Chapter Summary

Accounting is often called the "language of business." The financial information about a business is communicated to interested parties in financial statements.

Learning Objectives

1-1 Define accounting.

Accounting is the process by which financial information about a business is recorded, classified, summarized, interpreted, and communicated to owners, managers, and other interested parties. Accurate accounting information is essential for making business decisions.

1-2 Identify and discuss career opportunities in accounting.

- There are many job opportunities in accounting.
- Accounting clerk positions, such as accounts receivable clerk, accounts payable clerk, and payroll clerk, require the least education and experience.
- Bookkeepers usually have experience as accounting clerks and a minimum of one to two years of accounting education.
- Most entry-level accounting positions require a college degree or significant experience as a bookkeeper.
- Accountants usually specialize in one of three major areas: public, managerial, or governmental accounting.
  - Some accountants work for public accounting firms and perform auditing, tax accounting, or management advisory functions.
  - Other accountants work in private industry where they set up and supervise accounting systems, prepare financial reports, prepare internal reports, or assist in determining the prices to charge for the firm's products.
  - Still other accountants work for government agencies. They keep track of public funds and expenditures, or they audit the financial records of businesses and individuals to determine whether the records are in compliance with regulatory laws, tax laws, and other laws. The Securities and Exchange Commission, the Internal Revenue Service, the Federal Bureau of Investigation, and Homeland Security employ many accountants.

1-3 Identify the users of financial information.

All types of businesses need and use financial information. Users of financial information include owners and managers, employees, suppliers, banks, tax authorities, regulatory agencies, and investors. Nonprofit organizations need similar financial information.

1-4 Compare and contrast the three types of business entities.

- A sole proprietorship is owned by one person. The owner is legally responsible for the debts and taxes of the business.
- A partnership is owned by two or more people. The owners are legally responsible for the debts and taxes of the business.
- A corporation is a separate legal entity from its owners.
- Note that all three types of business entities are considered separate entities for accounting purposes.

1-5 Describe the process used to develop generally accepted accounting principles.

- The SEC has delegated the authority to develop generally accepted accounting principles to the accounting profession. The Financial Accounting Standards Board handles this task. A series of steps used by the FASB includes issuing a discussion memorandum, an exposure draft, and a statement of principle.
- The SEC oversees the Public Company Accounting Oversight Board that was created by the Sarbanes-Oxley Act. The Board regulates financial reporting by accountants and auditors of publicly held companies.
- Each year, firms that sell stock on stock exchanges or in over-the-counter markets must publish audited financial reports that follow generally accepted accounting principles. They must submit their reports to the Securities and Exchange Commission. They must also make the reports available to stockholders.

1-6 Define the accounting terms new to this chapter.

Glossary

Accounting (p. 4) The process by which financial information about a business is recorded, classified, summarized, interpreted, and communicated to owners, managers, and other interested parties

Accounting Standards Codification (p. 14) The source of authoritative U.S. GAAP

Accounting Standards Update (p. 14) Changes to Accounting Standards Codification are communicated through Accounting Standards Update covering approximately 90 topics

Accounting system (p. 4) A process designed to accumulate, classify, and summarize financial data

Auditing (p. 5) The review of financial statements to assess their fairness and adherence to generally accepted accounting principles

Auditor's report (p. 14) An independent accountant's review of a firm's financial statements

Certified public accountant (CPA) (p. 5) An independent accountant who provides accounting services to the public for a fee

Corporation (p. 12) A publicly or privately owned business entity that is separate from its owners and has a legal right to own property and do business in its own name; stockholders are not responsible for the debts or taxes of the business

Creditor (p. 12) One to whom money is owed

Discussion memorandum (p. 14) An explanation of a topic under consideration by the Financial Accounting Standards Board

Economic entity (p. 11) A business or organization whose major purpose is to produce a profit for its owners

Entity (p. 11) Anything having its own separate identity, such as an individual, a town, a university, or a business

Exposure draft (p. 14) A proposed solution to a problem being considered by the Financial Accounting Standards Board

Financial statements (p. 5) Periodic reports of a firm's financial position or operating results

Generally accepted accounting principles (GAAP) (p. 14) Accounting standards developed and applied by professional accountants

Governmental accounting (p. 7) Accounting work performed for a federal, state, or local governmental unit

International accounting (p. 14) The study of accounting principles used by different countries

Management advisory services (p. 7) Services designed to help clients improve their information systems or their business performance

Managerial accounting (p. 7) Accounting work carried on by an accountant employed by a single business in industry

Partnership (p. 12) A business entity owned by two or more people who are legally responsible for the debts and taxes of the business

Public accountants (p. 5) Members of firms that perform accounting services for other companies

Separate entity assumption (p. 12) The concept of keeping a firm's financial records separate from the owner's personal financial records

Social entity (p. 11) A nonprofit organization, such as a city, public school, or public hospital

Sole proprietorship (p. 11) A business entity owned by one person who is legally responsible for the debts and taxes of the business

Statements of Financial Accounting Standards (p. 14) Accounting principles established by the Financial Accounting Standards Board

Stock (p. 12) Certificates that represent ownership of a corporation

Stockholders (p. 13) The owners of a corporation; also called shareholders

Tax accounting (p. 7) A service that involves tax compliance and tax planning

Comprehensive **Self Review**

1. What are the three types of business entities?
2. How is the ownership of a corporation different from that of a sole proprietorship?
3. What is the purpose of accounting?
4. What does the accounting process involve?
5. What is the purpose of the auditor's report?

(Answers to Comprehensive Self Review are on page 20.)

Discussion Questions

1. What are the three major areas of accounting?
2. What types of services do public accountants provide?
3. What is tax planning?
4. What are the major functions or activities performed by accountants in private industry?
5. What are the three types of business entities, and how do they differ?
6. Why is it important for business records to be separate from the records of the business's owner or owners? What is the term accountants use to describe this separation of personal and business records?
7. What types of people or organizations are interested in financial information about a firm, and why are they interested in this information?
8. What is the purpose of the Financial Accounting Standards Board?
9. What groups consistently offer opinions about proposed FASB statements?
10. What is the function of the Securities and Exchange Commission?
11. What led to the passage of the Public Company Accounting Reform and Investor Protection Act of 2002?
12. What is the purpose of the Public Company Accounting Oversight Board?

PROBLEM

Critical Thinking Problem

Which Type of Business Entity?

Since graduating from college six years ago, Heidi Cantu has worked for a national chain of shoe stores. She has held several positions within the company and is currently manager of a local branch store.

Over the past six years, Heidi has observed a pattern in women's shoe purchases. She informs you that a large majority of the shoes sold are white, black, blue, or gray and that almost every woman owns at least three pairs of each of these colors. Since she has always wanted to be in business for herself, Heidi's idea is to open a women's shoe store that sells only white, black, blue, or gray shoes. She has discussed her plan with a number of people in the industry, and they have encouraged her to pursue her dream of becoming an entrepreneur.

A new upscale shopping mall is opening nearby, and Heidi has decided that now is the time to take the plunge and go into business for herself. She plans to open a shop in the new mall called WBBG Shoes that will only sell white, black, blue, and gray shoes.

One of the things Heidi must decide in the process of transforming her idea into reality is the form of ownership for her new business. Should it be organized as a sole proprietorship, a partnership, or a corporation?

What advice would you give Heidi? What advantages or disadvantages are there to each choice? What do you think of the proposed name for the business, WBBG Shoes?

Business Entity	Advantages	Disadvantages
Sole Proprietorship		
Partnership		
Corporation		

BUSINESS CONNECTIONS

Managerial FOCUS

Know Accounting

1. As an owner or manager of a business, what questions would you ask to judge the firm's performance, control operations, make decisions, and plan for the future?
2. Why is financial information important?
3. Besides earning a profit, what other objectives might a business have? Can financial information play an important role in these objectives?
4. What kind of problems can you foresee if a business owner and/or manager does not have a basic knowledge of accounting?
5. What would you tell a small business owner who says he does not see a need for an accounting system in his business because he closely supervises the day-to-day operations and knows exactly what is happening with the business?
6. What is the role of the manager versus the accountant?
7. Does a business owner/manager need to worry about the separate entity assumption? Why or why not?
8. Why are international accounting standards important to management?

Ethical DILEMMA

To Tell or Not to Tell

You are employed as an accountant for Innovative Computing. Your company is in the process of signing a large contract with an electronics components supplier. You have a personal friend that works for the electronics components supplier, and you have personal knowledge that they have trouble paying their bills. Should you report this to your employer before the purchase?

Financial Statement ANALYSIS

Notes to Financial Statements

Within a company's annual report, a section called "Notes to Consolidated Financial Statements" offers general information about the company along with detailed notes related to its financial statements.

Analyze Online: On the American Eagle Outfitters, Inc., website (www.ae.com), click on About AE located at the bottom of the page. Then click on AE Investment Information.

Analyze:

1. What types of merchandise does this company sell?
2. Who are the potential users of the information presented? Why would this information be helpful to these users?
3. What age consumer does the company target?
4. Would American Eagle Outfitters, Inc. be considered an economic entity or a social entity? Why?

TEAMWORK

Determining Information

Restful Sleep Mattress Company is planning to expand into selling bedroom furniture. This expansion will require a loan from the bank. The bank has requested financial information. Discuss, in a group, the information the bank would require. What information, if any, would you not provide the bank?

Internet | CONNECTION

FASB—What is it?

Go to the FASB website at www.FASB.org. How many Accounting Standards Updates were issued in the current year? How are they cited?

Answers to **Self Reviews**

Answers to Section 1 Self Review

1. The results of the accounting process—financial statements—communicate essential information about a business to concerned individuals and organizations.

2. Periodic reports that summarize the financial affairs of a business.

3. Clerk, bookkeeper, and accountant.

4. **c.** Uniform CPA Examination

5. **a.** Securities and Exchange Commission

6. Current sales and expenses figures, anticipated sales and expenses, and the cost of the expansion.

Answers to Section 2 Self Review

1. Accounting standards that are changed and refined in response to changes in the environment in which businesses operate.

2. GAAP help to ensure that financial information fairly presents a firm's operating results and financial position.

3. The FASB develops proposed statements and solicits feedback from interested individuals, groups, and companies. The FASB evaluates the opinions received and votes on the statement.

4. **b.** partnership

5. **c.** social entity

6. The shareholders are not responsible for the debts and taxes of the corporation. Corporations can continue in existence indefinitely.

Answers to Comprehensive Self Review

1. Sole proprietorship, partnership, and corporation.

2. A sole proprietorship is a business entity owned by one person. A corporation is a separate legal entity that has a legal right to own property and do business in its own name.

3. To gather and communicate financial information about a business.

4. Recording, classifying, summarizing, interpreting, and communicating financial information about a business.

5. To obtain the objective opinion of a professional accountant from outside the company that the statements fairly present the operating results and financial position of the business and that the information was prepared according to GAAP.