Chapter 1
Principles of Accounting

Uses of Accounting Information and the Financial Statements

What is Accounting?

The purpose of accounting is to:
1. identify, record, and communicate the economic events of an organization to interested users.

Accounting as an Information System

The accounting process includes the bookkeeping function.

Performance Measures

Indicate whether managers are achieving business goals and whether business activities are well managed.

Types of performance measures:
1. Earned income
2. Relationship of expenses to revenue
3. Cash flow
4. Relationship of money owed to total resources controlled

Users of Accounting Information

DECISION MAKERS

MANAGEMENT
Finance
Investment
Operations and Production
Marketing
Human Resources
Information Systems
Accounting

THOSE WITH DIRECT FINANCIAL INTEREST
Investors
Creditors

THOSE WITH INDIRECT FINANCIAL INTEREST
Tax Authorities
Regulatory Agencies
Labor Unions
Customers
Economic Planners
Chapter 1-7

Accounting and Capital Allocation

Resources are limited. Efficient use of resources often determines whether a business thrives.

Capital Allocation Process

<table>
<thead>
<tr>
<th>Financial Reporting</th>
<th>Users</th>
<th>Capital Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information to help users with capital allocation decisions.</td>
<td>Investors, creditors, and other users</td>
<td>The process of determining how and at what cost money is allocated among competing interests.</td>
</tr>
</tbody>
</table>

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Financial and Management Accounting

Accounting’s role is divided into two categories:
1. Management accounting
2. Financial accounting
Functions overlap.
Primary difference is the principal users of the information.

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Uses of Financial Information

Ethics In Financial Reporting

Standards of conduct by which one’s actions are judged as right or wrong, honest or dishonest, fair or not fair, are Ethics.

- Recent financial scandals include: Enron, WorldCom, HealthSouth, AIG, and others.
- Effective financial reporting depends on sound ethical behavior.

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Uses of Financial Information

Solving an Ethical Dilemma

1. Recognize an ethical situation and the ethical issues involved. Use your personal ethics to identify ethical situations and issues. Some businesses and professional organizations provide written codes of ethics for guidance in some business situations.
2. Identify and analyze the principal elements in the situation. Identify the stakeholders—persons or groups who may be harmed or benefited. Ask the question: What are the responsibilities and obligations of the parties involved?
3. Identify the alternatives, and weigh the impact of each alternative on various stakeholders. Select the most ethical alternative, considering all the consequences. Sometimes there will be one right answer. Other situations involve more than one right solution; these situations require you to evaluate each alternative and select the best one.

Chapter 1-12

Review Question

Ethics are the standards of conduct by which one’s actions are judged as:

a. right or wrong.
b. honest or dishonest.
c. fair or not fair.
d. all of these options.
**Accounting Measurement**

Four basic questions:
1. What is measured?
2. When should the measurement be made?
3. What value should be placed on what is measured?
4. How should what is measured be classified?

**Business Transaction**

Economic events that affect the financial position of a business entity.

1. An exchange of value between two or more parties.
   - Purchase, sale, payment, collection, etc.
2. A Nonexchange transaction.
   - Loss from fire, flood, theft.
   - Physical wear and tear on equipment.
   - Accumulation of interest.

**Forms of Business Organization**

<table>
<thead>
<tr>
<th>Proprietorship</th>
<th>Partnership</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Generally owned by one person.</td>
<td>Owned by two or more persons.</td>
<td>Ownership divided into shares of stock</td>
</tr>
<tr>
<td>Often small service-type businesses</td>
<td>Often retail and service-type businesses</td>
<td>Separate legal entity organized under state corporation law</td>
</tr>
<tr>
<td>Owner receives any profits, suffers any losses, and is personally liable for all debts.</td>
<td>Generally unlimited personal liability</td>
<td>Limited liability</td>
</tr>
<tr>
<td>Partnership agreement</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Financial Position and Accounting Equation**

- $A = L + OE$

**Financial Statements**

Companies prepare four financial statements from the summarized accounting data:
- Balance Sheet
- Income Statement
- Retained Earnings Statement
- Statement of Cash Flows

**Review Question**

Net income will result during a time period when:

a. assets exceed liabilities.

b. assets exceed revenues.

c. expenses exceed revenues.

d. revenues exceed expenses.
Financial Statements

Balance Sheet

- Reports the assets, liabilities, and stockholder's equity at a specific date.
- Assets listed at the top, followed by liabilities and stockholder's equity.
- Total assets must equal total liabilities and stockholder's equity.

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Financial Statements

Retained Earnings Statement

- Statement indicates the reasons why retained earnings has increased or decreased during the period.

Financial Statements

Income Statement

- Reports revenues and expenses for a specific period of time.
- Net income - revenues exceed expenses.
- Net loss - expenses exceed revenues.

Answers:

1. Where did cash come from during the period?
2. How was cash used during the period?
3. What was the change in the cash balance during the period?

Net income is needed to determine the ending balance in stockholder's equity.
**Financial Statements**

**Review Question**

Which of the following financial statements is prepared as of a specific date?

- b. Income statement.
- c. Owner’s equity statement.
- d. Statement of cash flows.

**Other Elements of an Annual Report**

U.S. companies that are publicly traded must provide shareholders with an annual report.

The annual report always includes:

- Financial statements.
- Management discussion and analysis.
- Notes to the financial statements.
- Independent auditor’s report.

**Auditor’s Report**

Standard unqualified opinion - auditor expresses the opinion that the financial statements are presented fairly, in all material respects, in conformity with GAAP.

**Generally Accepted Accounting Principles**

Generally Accepted Accounting Principles (GAAP)

The accounting profession has attempted to develop a set of standards that are generally accepted and universally practiced.

**Standard Setting in a Political Environment**

Accounting standards are as much a product of political action as they are of careful logic or empirical findings.
**Generally Accepted Accounting Principles**

Organizations:
- Securities and Exchange Commission (SEC).
- Financial Accounting Standards Board (FASB).
- Public Company Accounting Oversight Board (PCAOB).
- American Institute of Certified Public Accountants (AICPA).
- International Accounting Standards Board (IASB).

**Securities and Exchange Commission**

- Established by federal government
- Accounting and reporting for public companies

**Securities Act of 1933**
- Encouraged private standard-setting body
- SEC requires public companies to adhere to GAAP
- SEC Oversight
- Enforcement Authority

**Issues in Financial Reporting**

**International Accounting Standards**

Two sets of standards accepted for international use:
- U.S. GAAP, issued by the FASB
- International Financial Reporting Standards (IFRS), issued by the IASB

FASB and IASB recognize that global markets will best be served if only one set of GAAP is used.

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