



Financial Accounting

SIXTH EDITION

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University of Memphis

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University of Oklahoma

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Oklahoma State University

**Mc
Graw
Hill**





FINANCIAL ACCOUNTING, SIXTH EDITION

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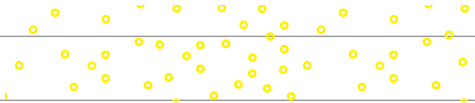
Dedicated to

David's wife Charlene, daughters Denise and Jessica, and three sons Mike, Michael, and David

Wayne's wife Julee, daughter Olivia and her husband Corbin, son Jake and his wife Bekah, and other sons Eli and Luke.

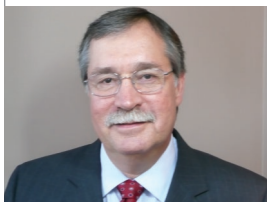
Don's wife Mary, daughter Rachel, and three sons David, Nathan, and Micah

In addition, David and Wayne would like to dedicate the sixth edition of Financial Accounting to Don Herrmann, who lost his battle with brain cancer on May 8, 2018. Don was a true friend, and his lasting impact on us will never be forgotten.



About the Authors

DAVID SPICELAND



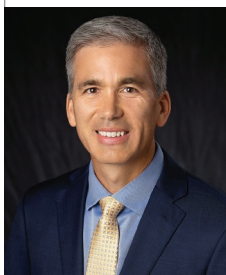
Courtesy of David Spiceland

David Spiceland is Accounting Professor Emeritus at the University of Memphis. He received his BS degree in finance from the University of Tennessee, his MBA from Southern Illinois University, and his PhD in accounting from the University of Arkansas.

Professor Spiceland's primary research interests are in earnings management and educational research. He has published articles in a variety of journals, including *The Accounting Review*, *Accounting and Business Research*, *Journal of Financial Research*, *Advances in Quantitative Analysis of Finance and Accounting*, and most accounting education journals: *Issues in Accounting Education*, *Journal of Accounting Education*, *Advances in Accounting Education*, *The Accounting Educators' Journal*, *Accounting Education*, *The Journal of Asynchronous Learning Networks*, and *Journal of Business Education*. David has received university and college awards and recognition for his teaching, research, and technological innovations in the classroom. David is a co-author on McGraw Hill's best-selling *Intermediate Accounting* text, with Mark Nelson, and Wayne Thomas.

David enjoys playing basketball, is a former all-state line-backer, and an avid fisherman. Cooking is a passion for David, who served as sous chef for Paula Deen at a Mid-South Fair cooking demonstration.

WAYNE THOMAS



Shevaun Williams & Associates

Wayne Thomas is the Senior Associate Dean for Faculty and Research Innovation, and the David C. Steed Chair of Accounting at the University of Oklahoma, where he teaches introductory financial accounting, intermediate accounting, and MBAs. He received his bachelor's degree in accounting from Southwestern Oklahoma State University, and his master's and PhD in accounting from Oklahoma State University.

Wayne has won teaching awards at the university, college, and departmental levels, and has received the Outstanding Educator Award from the Oklahoma Society of CPAs. In addition to *Financial Accounting*, he also co-authors McGraw Hill's best-selling *Intermediate Accounting*, with David Spiceland, Mark Nelson, and Jennifer Winchel. He also co-authors McGraw Hill's *Financial Accounting for Managers* with Michael Drake, Jake Thornock, and David Spiceland.

His primary research interests include accounting information in capital markets, techniques used by managers to manipulate earnings, the importance of financial disclosures, and financial statement analysis. He previously served as an editor of *The Accounting Review* and has published articles in a variety of journals, including *The Accounting Review*, *Journal of Accounting and Economics*, *Journal of Accounting Research*, *Review of Accounting Studies*, and *Contemporary Accounting Research*. He has won several research awards, including the American Accounting Association's Competitive Manuscript Award and the University of Oklahoma's highest research award, being named a George Lynn Cross Research Professor.

Wayne is married to Julee and they have four kids, Olivia, Jake, Eli, and Luke. He enjoys sports (basketball, tennis, golf, biking and ping pong), crossword puzzles, the outdoors, and spending time with his family.

DON HERRMANN



Courtesy of Don Herrmann

Don Herrmann passed away on May 8, 2018, after a 14-month battle with brain cancer. He was the Deloitte Professor of Accounting at Oklahoma State University, where he had been on the faculty since 2005.

Don won several teaching awards and enjoyed teaching financial accounting, intermediate accounting, and doctoral students. He received his bachelor's degree in business from John Brown University, his master's degree in accounting from Kansas State University, and his PhD in accounting from Oklahoma State University. He was active in the AAA and served as president of the International Accounting Section.

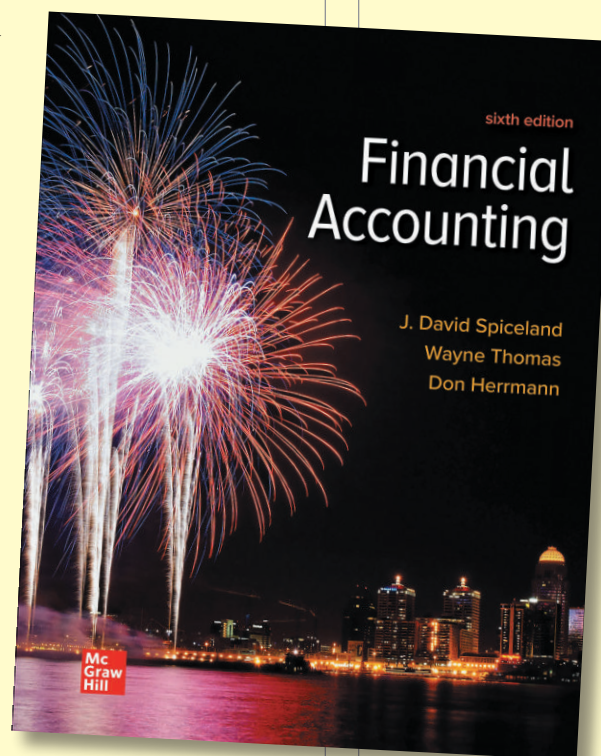
Don was best known for his warm and welcoming personality. He enjoyed serving in his local community and church, as well as hosting families and students in his home. His outgoing nature wasn't the type that filled a room with his presence, but it was the type that filled a one-on-one conversation with purpose.

Above all else, family was first to Don. Some of his favorite family activities included camping, going to amusement parks, and coaching little league sports. He is survived by his wonderful wife Mary and four amazing children Rachel, David, Nathan, and Micah. As he battled through the different stages of cancer, he often reflected on his family. He was so proud of them and talked about them with a humble thankfulness.

Those of us who knew Don were fortunate to share our lives with him. He lived with a sense of purpose and a solid foundation. That foundation continues through his family and the people he's touched. He will be missed by many.

CELEBRATING STUDENT SUCCESS

Don't you love those moments in your course when students are fully engaged? When the "Aha!" revelations are bursting like fireworks? David Spiceland, Wayne Thomas, and Don Herrmann have developed a unique set of materials based directly on their collective years in the classroom. They've brought together best practices by (1) building a Framework for Financial Accounting; (2) reinforcing the Framework in each chapter's text and end-of-chapter assignments; and (3) enriching that Framework using real-world companies, Excel assignments, General Ledger problems, data analytics tools, and a variety of auto-graded ethics, earnings management, and real-world cases. The material is communicated in a student-friendly conversational writing style. After the proven success of the first five editions of *Financial Accounting*, we are confident that the sixth edition will not only motivate, engage, and challenge students—it will illuminate the financial accounting course like never before.



Spiceland's Accounting Series

The Spiceland Accounting series includes:

- *Financial Accounting 6e*
- *Intermediate Accounting 11e*
- *Financial Accounting for Managers, 1e*

Financial Accounting and Intermediate Accounting have proven records of market-leading success by engaging a broad range of students, offering a wide array of resources necessary for building accounting concepts, and giving instructors the variety of tools they need to structure their unique courses.

The authors are proud to introduce a new book in the series, *Financial Accounting for Managers*, for which they are joined by authors Michael Drake and Jake Thornock. *Financial Accounting for Managers* brings the proven Spiceland approach to today's students, featuring modern companies, robust analysis sections, auto-graded cases, and a focus on helping students think critically about how accounting information fuels business decisions.

The Spiceland Accounting Series is fully integrated with McGraw Hill's Connect, an educational platform that seamlessly joins Spiceland's superior content with enhanced digital tools to deliver precisely what a student needs, when and how they need it.



CREATING FUTURE BUSINESS LEADERS

From the first edition of *Financial Accounting*, the authors have been talking with standard setters, auditors, and business leaders across the country to ensure their materials are consistent with what's being practiced in the business world and presented in such a way to help students be ready for business success. In keeping with this feedback, the authors have focused their approach on five key areas:

- Developing an organized learning framework
- Fostering decision-making and analysis skills
- Helping students become better problem solvers
- Developing real-world perspectives & career-ready students
- Using technology to enhance learning

The result? Better-prepared students who have greater potential to take on leadership roles when they graduate and enter the business world.

Developing an Organized Learning Framework

The first step in student engagement is helping them see the “big picture.” The authors introduce an overall framework for financial accounting in Chapter 1 and then apply this framework to specific topics throughout the text and in a summary **Chapter Framework** illustration in each chapter. Within each chapter, students will see this framework on display with mini-financial statements presented in the margin for each journal entry.

Fostering Decision-Making and Analysis Skills

Companies today cite decision-making and analysis skills as top desired skills among recent graduates. Students are given opportunities to see real business decision-making practices in each chapter's—**Decision Maker's Perspectives** and **Decision Points**. Instructors can help students build their Excel, Tableau, and data visualization skills using a wide variety of **Data Analytics** and **Excel** assignments that are auto-gradable in Connect. Finally, **General Ledger Problems** allow students to see the big picture of how information flows through the accounting cycle—letting them solve problems as businesspeople would, by analyzing the effect of transactions on the financial statements.

Helping Students Become Better Problem Solvers

Students check their understanding along the way by using **Key Points** within each Learning Objective and in-chapter **Let's Review** problems of the chapter's primary topics. These items prepare students to successfully complete the assigned end-of-chapter materials. Let's Review problems are complemented by videos. The **Common Mistakes** feature is a student favorite, helping them avoid mistakes that regularly trip up both learners and professionals.

Developing Real-World Perspectives & Career-Ready Students

The authors know that students are most engaged when they see real-world examples that are applicable to their lives and future careers. As the chapter's topics are being presented, references to real companies in the chapter opening **Feature Story** and other related companies help keep topics relevant. Instructors can assign **Real-World Perspective** cases including Great Adventures Continuing Problem, Financial Analysis, Comparative Analysis, EDGAR Research, Ethics, and Earnings Management. Each of these cases is auto-gradable in Connect, allowing additional decision-making practice for students and ease of grading for instructors.

Using Technology to Enhance Learning

Today's students live online and seek out videos to aid their learning. Spiceland *Financial Accounting* reinforces students' conceptual understanding with videos such as **Let's Review**, **Interactive Illustrations**, **Concept Overview**, **Chapter Framework** and **Applying Excel**. End-of-chapter exercises are supplemented with **Hints/Guided Example videos**, and additional online resources like adaptive-learning **SmartBook**.

DEVELOPING AN ORGANIZED LEARNING FRAMEWORK

An Organized Learning Framework: The Big Picture

With a wide variety of students enrolled in financial accounting courses, getting them interested in the content and making it enjoyable to learn can be challenging. Spiceland's *Financial Accounting* achieves this by helping students see the “big picture.” The authors introduce a simple overall framework for financial accounting—measure, communicate, make decisions—and then revisit and apply this framework throughout the text. This **organized learning framework** naturally fosters engagement by continually reminding students that accounting helps millions of people make informed business decisions.

An Organized Learning Framework: In Each Chapter

The framework of financial accounting is further reinforced within each chapter:

- New to the sixth edition, the authors include mini-financial statements with each journal entry. These figures continually remind students that every business activity that is *measured* is also *communicated* in the financial statements.
- New Chapter Framework illustrations have been added to the end of each chapter, providing students a flowchart visual through which they can see how the chapter's primary topics fit into the *measurement/communication/decision-making* framework of financial accounting. Each Chapter Framework includes five multiple-choice questions, with ten total questions assignable in Connect.
- A wide range of end-of-chapter assignments reinforce the *measurement* and *communication* functions of financial accounting.

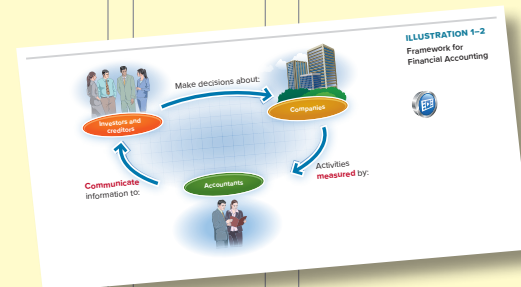
“Overall the chapters are very well organized so **that students would be able to build their foundation effectively.**”

—Jin Dong Park, Towson University

An Organized Learning Framework: Tying It All Together

To complete the *measurement/communication/decision-making* framework, Analysis sections are offered at the end of topical chapters (4–11). Using two real-world companies in each chapter, these sections are meant to highlight how the chapter's previous discussion of measurement and communication can be analyzed and used by decision-makers to understand a company's financial condition and performance. The Financial Statement Analysis chapter allows students to take a deep dive into these concepts by analyzing the financial statements of Nike and VF corporation.

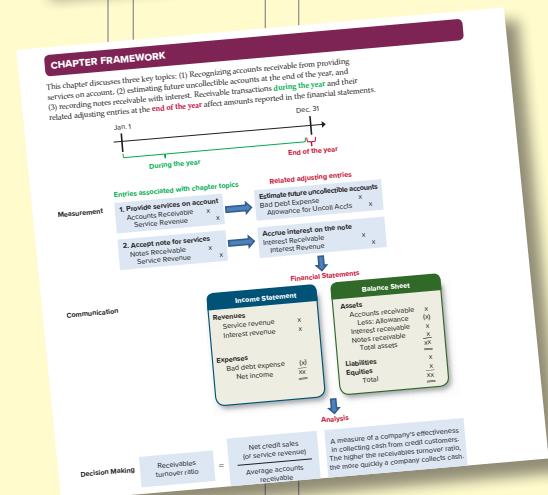
Finally, the book's chapter layout provides an overall framework to the topics of the course. After an overview of the framework of financial accounting in Chapter 1, the **accounting cycle chapters** clearly distinguish activities During the Period (Chapter 2) from End of the Period (Chapter 3). Chapters 4–10 cover specific topics in **balance sheet order**, followed by Chapter 11 cash flows and Chapter 12 financial statement analysis.



Example. To see how companies record credit sales, consider an example. On March 1, a company provides services to a customer for \$500. The customer doesn't pay cash at the time of service, but instead promises to pay the \$500 by March 31. The company has provided the service and is entitled to receive \$500 and will therefore record the following:

	Debit	Credit
March 1		
Accounts Receivable	500	
Service Revenue		500
(Provide services on account)		

Notice that instead of recording Cash, as in a cash sale, the company records another asset—Accounts Receivable—for the credit sale. Later, when \$500 cash is received from the customer, the company then records the increase to Cash. Also, Accounts Receivable is reduced because the customer no longer owes money to the company.



FOSTERING DECISION-MAKING & ANALYSIS SKILLS

In today's environment, business graduates are being asked more than ever to be equipped in analyzing data and making decisions. To address this need, each chapter includes **Decision Maker's Perspective** sections, which offer insights into how the information discussed in the chapters affects decisions made by investors, creditors, managers, and others. Each chapter also contains **Decision Points** highlighting specific decisions in the chapter that can be made using financial accounting information.

Decision Maker's Perspective

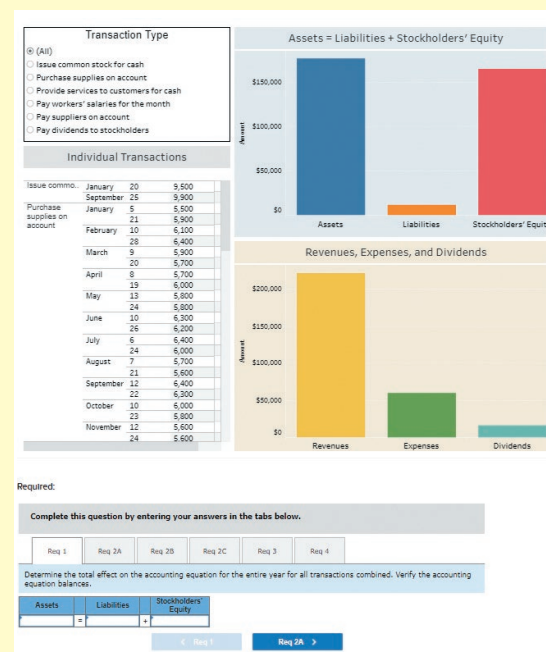
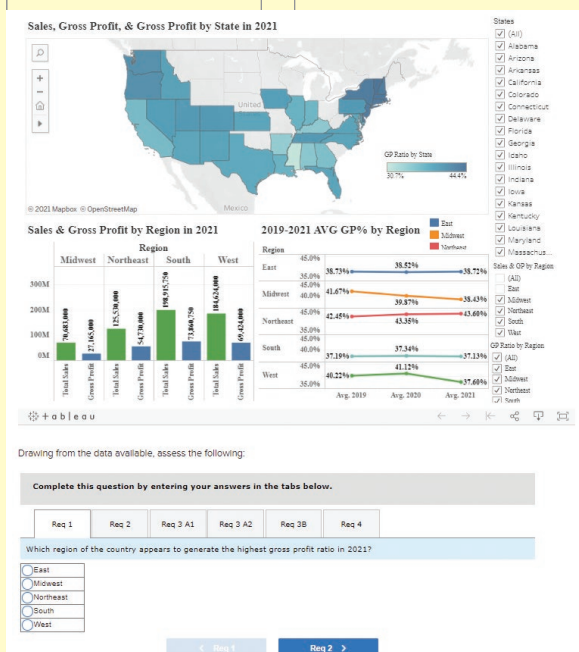
Investors Understand One-Time Gains

Investors typically take a close look at the components of a company's profits. For example, **Ford Motor Company** announced that it had earned a net income for the fourth quarter (the final three months of the year) of \$13.6 billion. Analysts had expected Ford to earn only \$1.7 to \$2.0 billion for that period. The day that Ford announced this earnings news, its stock price fell about 4.5%.

Why would Ford's stock price fall on a day when the company reported these seemingly high profits? A closer inspection of Ford's income statement shows that it included a one-time gain of \$12.4 billion for the fourth quarter. After subtracting this one-time gain, Ford actually earned only about \$1.2 billion from normal operations, easily missing analysts' expectations. This disappointing earnings performance is the reason the company's stock price fell.

New! Data Analytics assignments are provided with each chapter. Instructors can visit Connect to find a variety of auto-graded Data Analytics questions that introduce students to seeing data presented in the types of visual formats they'll see in today's business environments. These exercises have been thoughtfully developed and scaffolded to build data analytics exposure and skills. Assignable, auto-gradable materials include:

- **Data Visualizations** - Familiarize students with data visualizations. Students interpret data in a static visual to answer accounting questions.
- **Tableau Dashboard Activities** - Easily introduce students to Tableau. Students learn to gather the information they need from a live embedded Tableau dashboard - no prior knowledge of Tableau needed.
- **Applying Tableau cases** - Build student's data analytics skills. Students download an Excel file and build a Tableau dashboard with video tutorial guidance. Once they've completed their dashboard, they'll use it to answer auto-graded questions in Connect.



HELPING STUDENTS BECOME BETTER PROBLEM SOLVERS

Building Better Problem Solvers In honing analytical skills and becoming good problem solvers, it's crucial that students have the right tools and guidance to help them along the way—especially when learning the accounting cycle. The **accounting cycle chapters** clearly distinguish activities During the Period (Chapter 2) from End of the Period (Chapter 3). Chapters 4–10 cover specific topics in **balance sheet order**. Throughout the chapters, several features keep students on the right track as they learn the accounting process.

General Ledger Problems Expanded general ledger problems provide a much-improved student experience when working with accounting cycle questions with improved navigation and less scrolling. Students can audit their mistakes by easily linking back to their original entries and are able to see how the numbers flow through the various financial statements. Many general ledger problems include an analysis tab that allows students to demonstrate their critical thinking skills and a deeper understanding of accounting concepts.

The Great Adventures Continuing Problem progresses from chapter to chapter, encompassing the accounting issues of each new chapter as the story unfolds. These problems allow students to see how each chapter's topics can be integrated into the operations of a single company. Great Adventures problems are also available in McGraw Hill Connect's General Ledger format.



Let's Review sections within each chapter test students' comprehension of key concepts. These short review exercises, with solutions, are intended to reinforce understanding of specific chapter material and allow students to apply concepts and procedures learned in the chapter prior to attempting their homework assignment. Each Let's Review exercise also contains **Suggested Homework**, which enables instructors to easily assign corresponding homework. For the sixth edition, 22 **Let's Review Videos** show students how to solve the exercise and model that approach for related homework.

Let's Review

Bogey Incorporated has the following transactions during May:

May 1	Purchase a storage building by obtaining a loan of \$5,000.
May 6	Provide services to customers for cash, \$1,800.
May 12	Pay \$1,200 cash for advertising in May.
May 17	Repay \$1,000 of the amount borrowed on May 1.
May 25	Purchase office supplies for \$800 cash.

Required:
Indicate how each transaction affects the accounting equation.

Solution:

	Assets	=	Liabilities	+	Stockholders' Equity
					Common Stock Retained Earnings
May 1	+\$5,000		+\$5,000		
May 6	+\$1,800				+\$1,800
May 12	-\$1,200				-\$1,200
May 17	-\$1,000		-\$1,000		
May 25	+\$ 800				
	-\$ 800				
	<u>+\$4,600</u>	=	<u>+\$4,000</u>	+	<u>+\$ 600</u>

Suggested Homework:
BE2-2, BE2-4;
E2-2, E2-3, E2-4;
P2-1A&B, P2-2A&B

Let's Review

Bogey Incorporated has the following transactions during May:

May 1	Purchase a storage building by obtaining a loan of \$5,000.
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Solution:

	Assets	=	Liabilities	+	Stockholders' Equity
					Common Stock Retained Earnings
May 1	+\$5,000		+\$5,000		
May 6	+\$1,800				+\$1,800
May 12	-\$1,200				-\$1,200
May 17	-\$1,000		-\$1,000		
May 25	+\$ 800				
	-\$ 800				
	<u>+\$4,600</u>	=	<u>+\$4,000</u>	+	<u>+\$ 600</u>

Suggested Homework:
BE2-2, BE2-4;
E2-2, E2-3, E2-4;
P2-1A&B, P2-2A&B

Common Mistakes made by students and professionals are highlighted throughout each of the chapters. With greater awareness of the potential pitfalls, students can avoid making the same mistakes and gain a deeper understanding of the chapter material.



COMMON MISTAKE

When recording the interest payable on a borrowed amount, students sometimes mistakenly credit the liability associated with the principal amount (Notes Payable). We record interest payable in a *separate account* (Interest Payable) to keep the balance owed for principal separate from the balance owed for interest.

The **Flip Side** feature demonstrates how various transactions are viewed by each side. Including the “flip side” of a transaction—in context—enhances students' understanding of both the initial and the related transaction. Selected homework materials also include the Flip Side transactions, to reinforce student understanding.

Interest Receivable. We can see an example of accrued revenues if we review the flip side of transaction (2), which we discussed in the previous section as interest expense. The bank lends Eagle Soccer Academy \$100,000 and charges Eagle annual interest of 12% (or 1% per month) on the borrowed amount. Interest for the month of December is \$1,000 (= \$100,000 × 12% × 1/12). At the end of December, the bank needs an adjusting entry to record an asset for the amount expected to be received (Interest Receivable) from Eagle and to recognize revenue (Interest Revenue).

The bank's end-of-period adjusting entry is presented below.



Flip Side



KEY POINT

Adjusting entries are a necessary part of accrual-basis accounting. They are used to record changes in assets and liabilities (and their related revenues and expenses) that have occurred during the period but have not yet been recorded by the end of the period.

DEVELOPING REAL-WORLD PERSPECTIVES & CAREER-READY STUDENTS

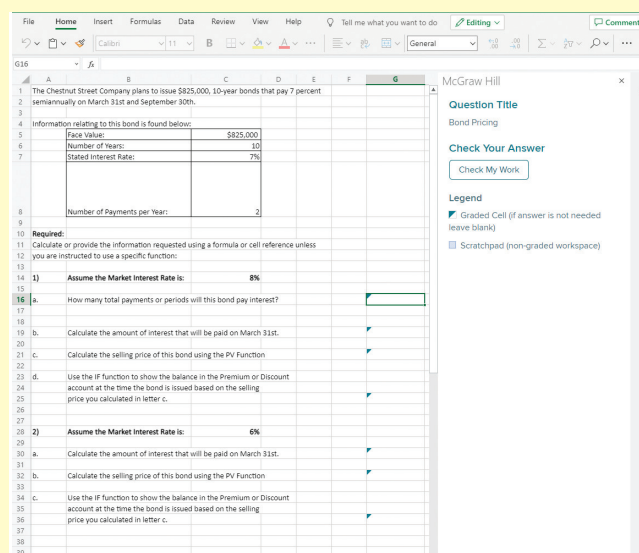
Students retain more information when they see how concepts are applied in the real world. Each chapter begins with a Feature Story that involves real companies and offers business insights related to the material in the chapter. As the chapter's topics are being presented, references to the companies in the Feature Story and other related companies help keep topics relevant. The authors understand that students are best engaged when the discussion involves companies that students find interesting and whose products or services are familiar, such as Apple, American Eagle Outfitters, Best Buy, Six Flags, Disney, and Zoom. In Chapter 12, full financial statement analysis is provided for Nike versus VF Corporation. The authors carry these real-world companies into the end-of-chapter material, asking students to analyze real-world situations.

The **Real-World Perspectives** section of each chapter offers cases and activities that ask students to apply the knowledge and skills they've learned to real, realistic, or provocative situations. Students are placed in the role of decision maker, presented with a set of information, and asked to draw conclusions that test their understanding of the issues discussed in the chapters. Each chapter offers an engaging mix of activities and opportunities to perform real-world financial accounting analysis, conduct EDGAR research, understand earnings management, address ethical dilemmas, and practice written communication. Ethics, Earnings Management, EDGAR and Financial Analysis cases are auto-gradable in Connect.

Financial Analysis: American Eagle Outfitters, Inc. & The Buckle, Inc. ask students to gather information from the annual report of American Eagle located in Appendix A and Buckle in Appendix B. **Comparative Analysis**—In addition to separately analyzing the financial information of American Eagle and Buckle, students are asked to compare financial information between the two companies. These questions are auto-gradable in Connect!

Excel activities and exercises help foster career readiness by offering students hands-on training in multiple ways:

- **New! Integrated Excel** assignments pair the power of Microsoft Excel with the power of Connect. A seamless integration of Excel within Connect, Integrated Excel questions allow students to work in live, auto-graded Excel spreadsheets – no additional logins, no need to upload or download files. Instructors can choose to grade by formula or solution value, and students receive instant cell-level feedback via integrated Check My Work functionality.
- **Applying Excel** features in each chapter help build students' Excel skills, showing them how Excel can be used to make efficient calculations and analysis. Applying Excel video solutions housed in Connect complement the feature, allowing students to view the power of Excel to analyze business scenarios.



USING TECHNOLOGY TO ENHANCE LEARNING

Connect and Spiceland's *Financial Accounting* are tightly integrated to continue honing students' conceptual understanding, problem-solving, decision-making & analysis skills.



All end-of-chapter items in the textbook that can be built into Connect have been included with feedback and explanations and many with **Hints/Guided Example Videos** to help students work through their homework in an effective manner.

ASSESSMENT & PRACTICE: END-OF-CHAPTER AND TEST BANK

Algorithmic Content & End-of-Chapter assignments

New algorithmic problems have been added, allowing students more practice and you more opportunities for students to demonstrate their understanding.

Extensive end-of-chapter assignments are available in the text and Connect:

- Self-Study Questions
- Data Analytics & Excel
- Review Questions
- Brief Exercises
- Exercises (set Set B in the test bank)
- Problems Set A & B (with Set C in the test bank)
- Real-World Perspectives
 - Great Adventures continuing case
 - Financial analysis cases
 - Ethics case
 - EDGAR Research case
 - Written Communication case
 - Earnings Management case

Using EDGAR (Electronic Data Gathering, Analysis, and Retrieval system), find the annual report (10-K) for Apple for the year ended September 28, 2019. Locate the "Consolidated Statements of Operations" (income statement) and "Consolidated Balance Sheets." You also may find the annual report at the company's website.

Required:
Determine the following from the company's financial statements:

1. What amount does the company report for accounts receivable? What does this amount represent?
2. What amount does the company report for accounts payable? What does this amount represent?
3. The company reports a single amount for "Other current liabilities" in the liability section of the balance sheet. What are some possible liabilities included in this amount?
4. What amount does the company report for common stock (including additional paid-in capital)? What does this amount represent?
5. Determine whether the company's total assets equal total liabilities plus total stockholders' (or shareholders') equity.
6. What amount does the company report for net sales? When a sale is made, does the company debit or credit the Sales Revenue account?
7. Do the company's total revenues exceed total expenses? By how much?

Complete this question by entering your answers in the tabs below.

Required 1	Required 2	Required 3	Required 4	Required 5	Required 6	Required 7
Accounts receivable						
The accounts receivable account represents the						

[< Required 1](#)
[Required 2 >](#)

Concept Overview Videos

Concept Overview Videos provide engaging narratives of all chapter learning objectives in an assignable, interactive online format. These videos follow the structure of the text and match specific learning objectives within each chapter of *Financial Accounting*. Concept Overview Videos provide additional explanation and enhancement of material from the text chapter, allowing students to learn, study, and practice at their own pace. Assignable assessment questions paired with the videos help students test their knowledge, ensuring that they are retaining concepts.

1 Required information
[The following information applies to the questions displayed below.]

If no-par value stock is issued, the corporation debits Cash and credits Common Stock. If par value or stated value stock is issued, the corporation debits Cash and credits two equity accounts—Common Stock at the par value or stated value per share and Additional Paid-in Capital for the portion above par or stated value.

Knowledge Check 01
On January 1, Year 1, Davidson Corporation issues 1,000 shares of \$1 par value common stock for \$20 per share. Complete the necessary journal entry for the issuance of common stock by indicating the relevant account names and dollar amounts below. If more than one account title is debited or credited, enter the account titles in their alphabetical order.

[View transaction list](#)

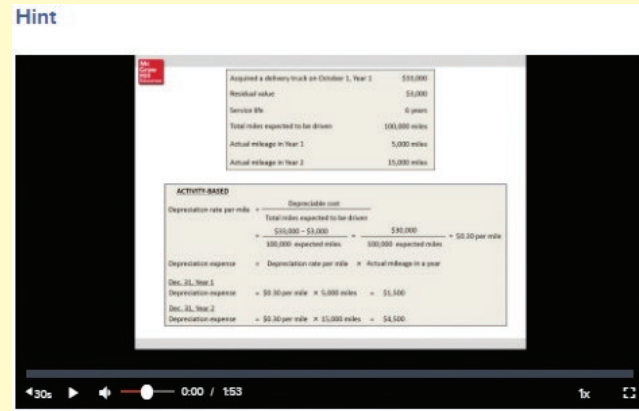
Journal entry worksheet

1

Record the issue of additional common stock.

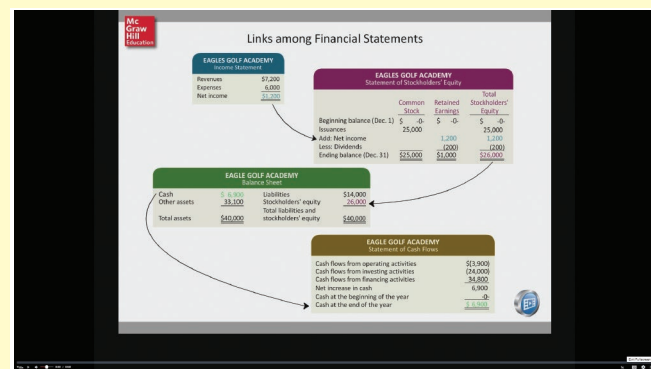
Hints/Guided Example Videos

Hint/Guided Example videos are narrated, animated, and step-by-step walkthroughs of algorithmic versions of assigned exercises in Connect. Presented to the student as hints, Guided Examples provide just-in-time remediation—and help—students get immediate feedback, focused on the areas where they need the most guidance.



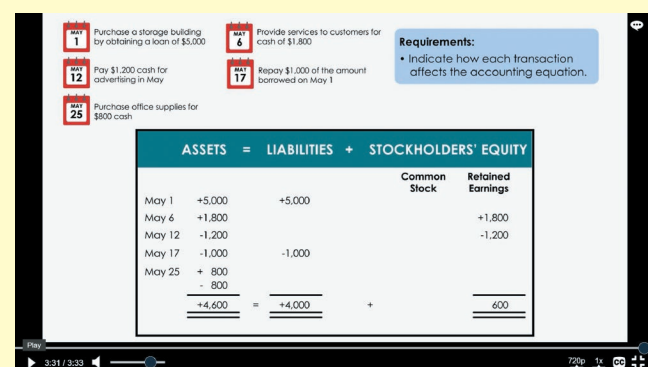
Interactive Illustration Videos

Interactive Illustrations provide video-based explanations of key illustrations in the chapter. These videos transform a static illustration in the text into a dynamic, step-by-step walk through of the illustration, deepening students' understanding of the concepts or the calculations shown.



Let's Review Videos

Let's Review videos relate to the Let's Review sections in the text, showing students how to solve certain exercises. In walking students through a particular scenario or question, these videos model how students can approach problem solving.



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NEW IN THE SIXTH EDITION

We've incorporated an enormous amount of feedback from over 700 reviewers, focus group, and symposium participants over the last five editions. The list of changes and improvements on the next few pages is testament to the many hours that reviewers spent thinking about and analyzing our earlier editions, helping us to make *Financial Accounting* the **best book of its kind**.

Overall Updates in the Sixth Edition:

- **Text was reduced** in many places to simplify and clarify discussion.
- **Feature stories, real-world examples, and ratio analyses** in each chapter were updated to the most recent year.
- **Financial statement effects** were highlighted in the margin of all journal entries.
- **Chapter Framework** illustrations at the end of each chapter were modified to include Analysis in most chapters.
- **Five self-study multiple-choice questions** were added to the Chapter Framework illustration in each chapter. **Five additional questions** are available online.
- **Great Adventures Continuing Case** adds content from each successive chapter to build a comprehensive set of financial statements.
- **Financial Analysis Cases** using American Eagle Outfitter (Appendix A) and Buckle (Appendix B) were updated for each chapter.
- **An auto-gradable EDGAR Research Case** was added to each chapter.
- **Ethics Cases** and **Earnings Management Cases** are now algorithmic and auto-gradable.
- **Written Communication Cases** were added to Connect to allow instructors the option of manual grading.
- **Integrated Excel, Applying Excel, Data Visualizations, Tableau Dashboard Activities, and Applying Tableau** are available online in Connect.
- **Revised illustrations** throughout the text to continue to offer clear and visual learning tools for students.
- **Usage data** from SmartBook and Connect were used in developing changes to the 6th edition.

CHAPTER 1:

- Revised the explanation of stockholders' equity in LO1-2 to focus on how those claims arise.
- Changed discussion of the statement of stockholders' equity in LO1-3 and the calculation of retained earnings.
- Revised Illustrations 1-6, 1-7, and 1-8 to make clearer the link between financial statements.
- The Great Adventure Continuing Case was modified to be auto-graded in Connect.

CHAPTER 2:

- Revised discussion of Illustration 2-6 to make clear the effects of debits and credits in the expanded accounting equation.
- Revised discussion to make clear the meaning of the balance of retained earnings in an unadjusted trial balance.

CHAPTER 3:

- Revised and reduced discussion in LO3-1 and LO3-2 to explain timing differences caused by accrual-basis accounting.
- Modified Illustrations 3-2 and 3-3 to differentiate revenue and expense recognition under accrual-basis versus cash-basis accounting.
- Modified adjusting entry illustrations to include related entries made during the year.
- Included a T-account in the margin beside each of the adjusting entries to

emphasize the effect on asset and liability balances.

- Expanded E3-7 to include transactions during the year.
- Revised and clarified the timing of accrual accounting in E3-8, E3-10, E3-12, E3-13, P3-1A&B, P3-3A&B, and P3-4A&B.
- Added BE3-21, BE3-22, BE3-23, BE3-24, and BE3-25 to include the financial statement effects of adjusting entries.
- Revised BE3-14, BE-18, E3-13, P3-3A, and P3-5B to exclude depreciation (several other assignments include depreciation).

CHAPTER 4:

- Changed the feature story to focus on Live Nation Entertainment.
- Expanded discussion of types of payments received from customer to more modern forms.
- Revised discussion of bank reconciliation to include more modern transactions and revised several related end-of-chapter assignments in a similar way.
- Expanded discussion of the reasons to explain cash holdings in the Analysis section.

CHAPTER 5:

- Revised the Feature Story to provide additional discussion of net revenues reported.
- Revised Part A in several places to emphasize revenue being reported for

the amount the company is entitled to receive from customers.

- Added BE5-2 for sales discounts and BE5-18 for notes receivable and interest.
- Added BE5-22, BE5-23, BE5-24, BE5-25, and BE5-26 to determine financial statement effects of transactions.

CHAPTER 6:

- Modified Illustrations 6-6 and 6-7 to make clear the calculation of ending inventory and cost of goods sold.
- Modified Illustration 6-9 to improve clarity.
- Added discussion in Part B to clarify how inventory transactions are recorded and reported in practice under FIFO and LIFO.
- Added BE6-15 to record adjusting entry for lower of cost or net realizable value.
- Added BE6-24, BE6-25, BE6-26, BE6-27, and BE6-28 to determine financial statement effects of transactions.

CHAPTER 7:

- Modified discussion of capitalizing versus expensing an expenditure in LO7-1.
- Modified discussion of purchased versus internally developed intangible assets in LO7-2.
- Created new Illustration 7-6 to demonstrate the difference in treatment between purchased and internally-developed patent.
- Created new Illustration 7-13 to demonstrate partial-year depreciation.

- Changed companies used in the Analysis section to Disney and Netflix.
- Added BE7-11 and BE7-17 to record depreciation.
- Added BE7-23, BE7-24, BE7-25, BE7-26, and BE7-27 to determine financial statement effects of transactions.
- Changed E7-4 to include various expenditures related to intangibles.

CHAPTER 8:

- Revised discussion of notes payable and associated interest (Learning Objective 8-2).
- Added discussion and journal entry for reclassifying current portion of long-term debt.
- Added BE8-9 to reclassify current portion of long-term debt.
- Added BE8-19, BE8-20, BE8-21, and BE8-22 to determine financial statement effects of transactions.
- Added E8-12 for recording long-term notes payable and reclassifying current portion.

CHAPTER 9:

- Revised Part A to include a simple overview of installment notes, leases, and bonds issued at face amount.
- Revised discussion of reclassification of current portion of long-term installment notes.

- Provided additional clarification of the meaning of discounts and premiums on bonds.
- Added carrying value to Glossary.
- Added BE9-4, BE9-5, E9-4, and E9-5 on installment notes.
- Added P3-9A and P3-9B on leases.
- Added E9-9 for comparison of installment note and lease.
- Added BE9-24, BE9-25, and BE9-26 to determine financial statement effects of transactions.
- Revised E9-1 to include a comparison of interest payments and dividend payments.

CHAPTER 10:

- Changed the feature story to Zoom.
- Modified Illustrations 10-3, 10-4, and 10-5.
- Added Key Point for retained earnings.
- Added discussion of Apple's recent 4-for-1 stock split.
- Changed Illustration 10-18 to include analysis of Citigroup's equity section of the balance sheet.
- Modified text to include a bullet list of items reported in the statement of stockholders' equity in Illustration 10-20.
- Changed the Analysis section to include Zoom versus Microsoft.
- Added BE10-10 and BE10-11.

- Added BE10-18, BE10-19, BE10-20, BE10-21, and BE10-22 to determine financial statement effects of transactions.
- Added E10-4, E10-9, and E10-10.
- Revised E10-2.

CHAPTER 11:

- Revised Illustration 11-8 and its related discussion.
- Clarified the discussion of the indirect method in LO 11-3 to tie directly to income statement adjustments and balance sheet adjustments.
- Added new E11-10 and E11-11 for investing and financing cash flows.

CHAPTER 12:

- Changed Feature Story to VF Corporation.
- Changed comparison to Nike versus VF Corporation throughout the chapter.

APPENDIX C:

- Added new Illustration C-11 to demonstrate effect of interest rates on present value and future value relationship.
- Added new EC-3, EC-4, EC-7, EC-8, EC-12, EC-13, EC-15, and EC-16.

APPENDIX D:

- Simplified the discussion of debt investments to include purchase of bonds at face amount as the primary example.
- Added new ED-10 for purchase of debt investment at face amount.



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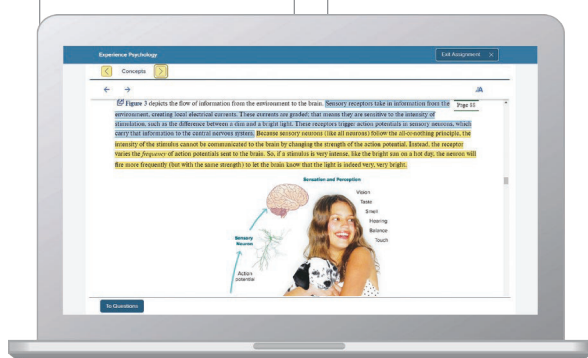
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A HEARTFELT THANKS TO THE MANY VOICES . . .

The version of *Financial Accounting* you are reading would not be the same book without the valuable suggestions, keen insights, and constructive criticisms of the list of reviewers below. Each professor listed here contributed in substantive ways to the organization of chapters, coverage of topics, and selective use of pedagogy. We are grateful to them for taking the time to read each chapter and offer their insights.

We also acknowledge those reviewers who helped in the genesis of this text with the first second and third edition reviews—we appreciate your efforts to this day!

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We also would like to acknowledge the many talented people who contributed to the creation of this sixth edition and thank them for their valuable contributions. Teresa Farough did a wonderful job accuracy checking our manuscript. Mark McCarthy of East Carolina University contributed a helpful accuracy check of the page proofs; we thank him for his speedy and insightful comments. We also appreciate the willingness of The Buckle, Inc., and American Eagle Outfitters, Inc., to allow us to use their companies' annual reports.

Thanks to Rachel Cox of Oklahoma State University for reviewing the Test Bank, and to Jeannie Folk of Northwestern University for revising the test bank and the PowerPoint. Helen Roybark of Radford University for accuracy checking the PowerPoint. Beth Kobylarz did an outstanding job as Lead Subject Matter Expert for the revisions to Connect; Mark Sears and Ashley Newton of the University of Oklahoma and all of the staff at AnsrSource contributed their invaluable expertise as Connect reviewers. Ashley Newton of the University of Oklahoma also did a wonderful job with the Concept Overview Videos and Applying Excel video resources.

We also appreciate the expert attention given to this project by the staff at McGraw Hill Education, especially Tim Vertovec, Vice President BEC Portfolio, Rebecca Olson, Executive Director; Noelle Bathurst, Senior Portfolio Manager; Lauren Schur, Marketing Manager; Christina Sanders, Lead Product Developer; Danielle McLimore, Assessment Product Developer; Kevin Moran, Director of Digital Content; Pat Frederickson, Lead Content Project Manager; Angela Norris, Senior Content Project Manager; Matt Diamond, Senior Designer; Traci Vaske, Senior Content Licensing Specialist; and Laura Fuller, Buyer.

SUPPLEMENTS WITH THE SAME VOICE

Last but not least, we thank the authors of *Financial Accounting*, who write all of the major **supplements**, including the Solutions Manual, Instructor's Manual, all end-of-chapter material, additional online Exercises and Problems. The test bank includes over 3,000 questions, including more than 1,900 multiple-choice questions and more than 1,125 other types of questions and problems. The authors actively engage in the development of ALL technology-related supplements, such as SmartBook, Interactive Illustrations, Let's Review videos, Chapter Framework videos, Applying Excel videos, Auto-Graded Integrated Excel, Auto-Graded Excel Simulations, and PowerPoints.



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CHAPTER

A Framework for Financial Accounting

Learning Objectives

PART A: ACCOUNTING AS A MEASUREMENT/ COMMUNICATION PROCESS

- **LO1-1** Describe the two primary functions of financial accounting.
- **LO1-2** Understand the business activities that financial accounting measures.
- **LO1-3** Determine how financial accounting information is communicated through financial statements.
- **LO1-4** Describe the role that financial accounting plays in the decision-making process.

PART B: FINANCIAL ACCOUNTING INFORMATION

- **LO1-5** Explain the term generally accepted accounting principles (GAAP) and describe the role of GAAP in financial accounting.

PART C: CAREERS IN ACCOUNTING

- **LO1-6** Identify career opportunities in accounting.

APPENDIX: CONCEPTUAL FRAMEWORK

- **LO1-7** Explain the nature of the conceptual framework used to develop generally accepted accounting principles.

SELF-STUDY MATERIALS

- Let's Review—Measuring business activities (p. 8).
- Let's Review—Communicating through financial statements (p. 17).
- Chapter Framework with questions and answers available (p. 31).
- Key Points by Learning Objective (p. 32).
- Glossary of Key Terms (p. 33).
- Self-Study Questions with answers available (p. 34).
- Videos including Concept Overview, Applying Excel, Let's Review, and Interactive Illustrations to demonstrate key topics (in Connect).

WHY STUDY ACCOUNTING? BECAUSE IT'S THE LANGUAGE OF BUSINESS

Some of you are reading this book because you are majoring in accounting, and it's obvious why you need to get a good understanding of this material. Others of you are not majoring in accounting. Perhaps you're planning a major in finance, management information systems, marketing, supply chain, or a major outside of business or just reading this book to learn more about accounting. You may be wondering if the material in this book will be important for you. To help you make that decision, consider the following.

Managers, investors, lenders, suppliers, customers, and many others make important decisions every day about a company. They make decisions related to how a company finances its operations, manages its operating costs, minimizes its risks, utilizes its resources, maintains its supply chain, and generates profits for its owners, to name just a few. To make good decisions, these individuals need timely and reliable information.

This is where accounting plays an important role in our society. The primary functions of accounting are to measure the activities of a company and communicate those measurements to help individuals make good decisions. The better the information they have, the better the decisions they'll make. Understanding accounting means understanding the *language of business*. When you speak that language, you'll be able to better communicate with others, make better decisions, help others make better decisions, and play a role in creating a more prosperous society.

You'll see in this book how accounting information helps tell a company's financial story. Telling this story involves critical thinking and professional judgment. These skills require a dynamic profession filled with individuals who are well-equipped to make business decisions and be part of any management team. Given the importance of business decisions in our society, there should be no surprise that demand for accounting information and for accountants remains strong. No matter what you choose as a major, if your goals are to make better business decisions, accounting will help you get there.

Feature Story



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PART A

■ LO1-1

Describe the two primary functions of financial accounting.

ACCOUNTING AS A MEASUREMENT/COMMUNICATION PROCESS

Welcome to accounting. A common misconception about this course is that it is a math class, much like college algebra, calculus, or business statistics. You will soon see that this is *not* a math class. Don't say to yourself, "I'm not good at math, so I probably won't be good at accounting." Though it's true that we use numbers heavily throughout each chapter, accounting is far more than adding, subtracting, and solving for unknown variables. So, what exactly is accounting? We'll take a close look at this next.

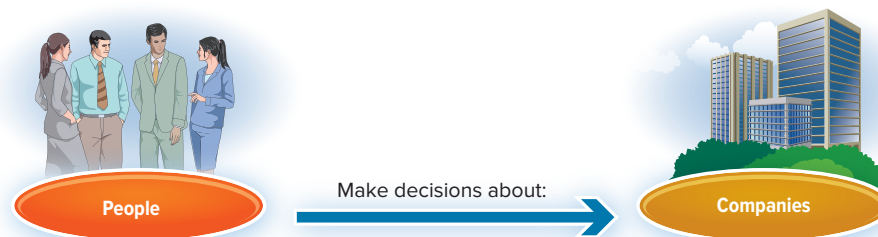
Defining Accounting

Accounting is "the language of business." It's the language companies use to tell their financial story. More precisely, **accounting** is a system of maintaining records of a company's operations and communicating that information to decision makers. The earliest use of such systematic recordkeeping dates back thousands of years to when records were kept of delivered agricultural products. Using accounting to maintain a record of multiple transactions allowed for better exchange among individuals and aided in the development of more complex societies.¹ In this book, you'll learn how to read, interpret, and communicate a company's financial story using the language of business.

Millions of people every day must make informed decisions about companies. Illustration 1-1 identifies some of those people and examples of decisions they make about the companies.

ILLUSTRATION 1-1

Decisions People Make About Companies



1. **Investors** decide whether to invest in stock.
2. **Creditors** decide whether to lend money.
3. **Customers** decide whether to purchase products.
4. **Suppliers** decide the customer's ability to pay for supplies.
5. **Managers** decide production and expansion.
6. **Employees** decide employment opportunities.
7. **Competitors** decide market share and profitability.
8. **Regulators** decide on social welfare.
9. **Tax authorities** decide on taxation policies.
10. **Local communities** decide on environmental issues.

To make the decisions outlined in Illustration 1-1, these people need information. This is where accounting plays a key role. As Illustration 1-2 shows, accountants **measure the activities of the company and communicate those measurements to others**.

Accounting information that is provided for *internal* users (managers) is referred to as **managerial accounting**; that provided to *external* users is referred to as **financial accounting**. In this book, we focus on financial accounting. Formally defined, the two functions of **financial accounting** are to measure business activities of a company and then to communicate those measurements to *external* parties for decision-making purposes.

As you study the business activities discussed in this book, it is important for you to keep in mind this "framework" for financial accounting. For each activity, ask yourself

1. How is the business activity being measured?
2. How is the business activity being communicated?

¹S. Basu and G. Waymire. 2006. Recordkeeping and Human Evolution. *Accounting Horizons* 20 (3): 201–229.

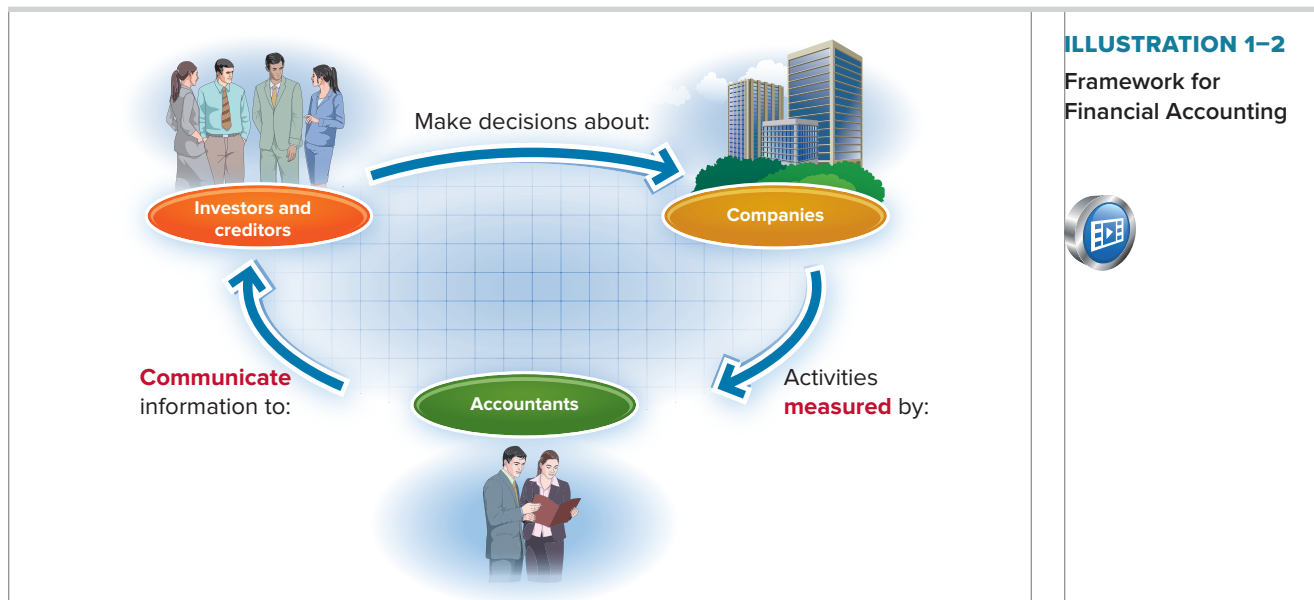


ILLUSTRATION 1-2
Framework for
Financial Accounting

These are the two functions of financial accounting. You'll better understand *why* this process exists by thinking about *how* the measurements being communicated help people make better decisions.

For example, **investors** want to make good decisions related to buying and selling their shares of the company's stock: Will the company's stock increase or decrease in value? The value of a stock is tied directly to the company's ability to make a profit, so what activities reflect the company's profitability? How should those activities be measured, and how should they be communicated in formal accounting reports?

As another example, **creditors** make decisions related to lending money to the company: Will the company be able to repay its debt and interest when they come due? How can debt activity be measured and how can it be communicated so that creditors better understand the ability of the company to have sufficient cash to repay debt and interest in the short term and the long term?



KEY POINT

The two primary functions of financial accounting are to measure business activities of a company and to communicate information about those activities to investors and creditors and other outside users for decision-making purposes.

User's Guide For learning objectives throughout this book, you will see boxed sections, like this one, titled *Key Point*. These boxed items will highlight the central focus of the learning objectives.

Measuring Business Activities

Let's first look at the typical activities of a start-up business. We'll do this with a simple example. Suppose you want to start a soccer academy. The "goal" of the academy is to provide lessons to develop junior players for top university programs and perhaps even one day to play in a professional league. Let's look at some initial activities of your new company, which you've decided to name **Eagle Soccer Academy**.

Let's assume you need about \$300,000 to get the business up and running. You don't have that amount of money to start the business, so you begin by looking for investors. With their money, **investors** buy ownership in the company and have the right to share in the company's profits. Each share of ownership is typically referred to as a share of common stock. You develop a business proposal, explaining your target customers, funds needed, expected profits, and benefits your company will bring to the community. You pitch your idea to

LO1-2

Understand the business activities that financial accounting measures.

several organizations around the city and sell 7,000 shares of common stock to investors for \$140,000 (\$20 per share). You sell 2,000 additional shares to your parents for \$40,000. You also purchase 1,000 of your own shares for \$20,000, giving you 10% ownership (1,000 shares/10,000 total shares issued). Your company has now received \$200,000 from investors.

To raise the remaining cash needed, you turn to **creditors**. Creditors lend money to a company, expecting to be paid back the loan amount plus interest. Impressed by your business proposal and ability to raise funding from investors, a local bank lends you \$100,000 with 12% annual interest, which you agree to repay within three years.

Now, with the \$300,000 of cash obtained from investors and creditors, your company buys equipment. This equipment costs \$120,000, leaving \$180,000 cash for future use. At this point, your company has the following resources that can be used for operations.

Cash	\$180,000	} Resources
Equipment	<u>120,000</u>	
	<u>\$300,000</u>	

Who has the claims to the company's resources? Answer: The investors and creditors. Creditors have claims equal to the amount loaned to the company, \$100,000. In other words, \$100,000 of the company's resources are promised to the local bank. Investors have claims to all remaining resources, \$200,000.

Creditors (local bank)	\$100,000	} Claims to Resources
Investors (common stock)	<u>200,000</u>	
	<u>\$300,000</u>	

We'll continue the example of Eagle Soccer Academy in more detail in a moment. For now, we can see that the company has engaged in financing and investing activities, and it will soon begin operating activities.

- **Financing activities** include transactions the company has with investors and creditors, such as issuing stock (\$200,000) and borrowing money from a local bank (\$100,000).
- **Investing activities** include transactions involving the purchase and sale of resources that are expected to benefit the company for several years, such as the purchase of equipment for \$120,000. With the necessary resources in place, the company is ready to begin operations.
- **Operating activities** will include transactions that relate to the primary operations of the company, such as providing products and services to customers and the associated costs of doing so, like rent, salaries, utilities, taxes, and advertising.

Types of Business Organizations Notice that you are both the manager and an investor of Eagle Soccer Academy. You manage the resources of the company on behalf of the owners (stockholders, in this case), while you are also an investor helping to align your interests with the other investors in the company. This is common in many start-up businesses. Mark Cuban, the owner of the Dallas Mavericks and a tech-savvy entrepreneur, refers to a manager who also owns shares in the company as having "skin in the game." Companies that issue shares of stock often form as corporations.

A **corporation** is a company that is legally separate from its owners. The advantage of being legally separate is that the stockholders have limited liability. **Limited liability** prevents stockholders from being held personally responsible for the financial obligations of the corporation. Stockholders of Eagle Soccer Academy can lose their investment of \$200,000 if the company fails, but they cannot lose any of their personal assets (such as homes, cars, computers, and furniture).

A **sole proprietorship** is a business owned by one person; a **partnership** is a business owned by two or more persons. If you had decided to start Eagle Soccer Academy without outside investors, you could have formed a sole proprietorship, or you and a friend could

have formed a partnership. However, because you did not have the necessary resources to start the business, being a sole proprietorship (or even one member of a partnership) was not a viable option. Thus, a disadvantage of selecting the sole proprietorship or partnership form of business is that owners must have sufficient personal funds to finance the business in addition to the ability to borrow money. Another disadvantage of being a sole proprietorship or partnership is that neither offers limited liability. Owners (and partners) are held personally responsible for the activities of the business.

A potential disadvantage of a corporation is *double taxation*: (1) the company first pays corporate income taxes on income it earns and (2) stockholders then pay personal income taxes when the company distributes that income as dividends to them. There are many complexities in tax laws, and these laws are subject to change. For certain types of corporations and in certain instances, corporations may pay a higher or lower overall tax rate compared to partnerships and sole proprietorships.

Because most of the largest companies in the United States are corporations, in this book we focus primarily on accounting from a corporation's perspective. Focusing on corporations also highlights the importance of financial accounting—to measure and communicate activities of a company for investors (stockholders) and creditors (lenders, such as a local bank). (A more detailed discussion of the advantages and disadvantages of a corporation is provided in Chapter 10.)

ASSETS, LIABILITIES, AND STOCKHOLDERS' EQUITY



What information would Eagle's investors and creditors be interested in knowing to determine whether their investment in the company was a good decision? **Ultimately, investors and creditors want to know about the company's resources and their claims to those resources.** Accounting uses some conventional names to describe such resources and claims.

Assets are the total resources of a company. At this point, Eagle Soccer Academy has two assets—cash of \$180,000 and equipment of \$120,000—equaling total resources of \$300,000. Of course, there are many other possible resources that a company can have, such as supplies, inventory for sale to customers, buildings, land, and investments. You'll learn about these and many other assets throughout this book.

Liabilities are amounts owed to creditors. Eagle Soccer Academy has a liability of \$100,000 to the local bank. Other examples of liabilities would be amounts owed to suppliers, employees, utility companies, and the government (in the form of taxes). Liabilities typically include claims that must be paid by a specified date.

Stockholders' equity represents the owners' claims to resources. These claims arise from two primary sources: (1) contributions by the owners themselves and (2) net resources generated by company operations. To this point, Eagle Soccer Academy has contributions from owners of \$200,000.

The **accounting equation** in Illustration 1-3 shows the relationship among the three measurement categories. The equation shows that a company's assets equal its liabilities plus stockholders' equity. Alternatively, a company's resources equal creditors' and owners' claims to those resources.

Assets	=	Liabilities	+	Stockholders' Equity
		(creditors' claims)		(owners' claims)
				
Resources		Claims to Resources		

The accounting equation for Eagle Soccer Academy would be

Assets	=	Liabilities	+	Stockholders' Equity
(resources)		(creditors' claims)		(owners' claims)
\$300,000	=	\$100,000	+	\$200,000

ILLUSTRATION 1-3

The Accounting Equation

Common Terms
Other common names
for net income include
earnings or profit.

The accounting equation illustrates a fundamental model of business valuation.

The value of a company to its owners equals total resources of the company minus amounts owed to creditors. Creditors expect to receive only resources equal to the amount owed them. Stockholders, on the other hand, can claim all of the company's resources in excess of the amount owed to creditors.

REVENUES, EXPENSES, AND DIVIDENDS

Of course, all owners hope their claims to the company's resources increase over time. This increase occurs when the company makes a profit. Stockholders claim all resources in excess of amounts owed to creditors; thus, profits of the company are claimed solely by stockholders. We calculate a company's profits by comparing its revenues and expenses.

Revenues are the amounts recognized when the company sells products or provides services to customers. For example, when you or one of your employees provides soccer training to a customer, the company recognizes revenue. However, as you've probably heard, "It takes money to make money." To operate the academy, you'll encounter many costs.

Expenses are the costs of providing products and services and other business activities during the current period. For example, to operate the soccer academy, you'll have costs related to salaries, rent, supplies, and utilities. These are typical expenses of most companies.

Net income is the difference between revenues and expenses. All businesses want revenues to be greater than expenses, producing a positive net income and adding to stockholders' equity in the business. However, if expenses exceed revenues, as happens from time to time, the difference between them is a negative amount—a **net loss**.

You'll notice the use of the term *net* to describe a company's profitability. In business, the term *net* is used often to describe the difference between two amounts. Here, we measure revenues *net* of (or minus) expenses, to calculate the net income or net loss. If we assume that by the end of the first month of operations Eagle Soccer Academy has total revenues of \$72,000 and total expenses of \$58,000, then we would say that the company has *net income* of \$14,000 for the month.

Dividends are cash payments to stockholders. We just saw that the first month of operations of Eagle Soccer Academy generated net income of \$14,000. From these profits, let's suppose the company decides to make a cash payment of \$4,000 to stockholders. The remaining \$10,000 of profits are retained in the company to help grow future operations. Thus, when Eagle has net income of \$14,000, stockholders receive a total benefit of \$14,000, equal to \$4,000 of dividends received and \$10,000 retained in the company they own.

Dividends Are Not an Expense. Recall earlier we defined expenses as the costs necessary to run the business to produce revenues. Dividends, on the other hand, are not costs related to providing products and services to *customers*; dividends are distributions (most often cash) to the *owners* of the company—the stockholders.

Let's Review

User's Guide Let's Review exercises test your comprehension of key concepts covered in the chapter text.

Suggested Homework:
BE1-4;
E1-2, E1-3;
P1-2A&B

Match the term with the appropriate definition.

- | | |
|-------------------------------|--|
| 1. _____ Assets | a. Costs of selling products or services. |
| 2. _____ Liabilities | b. Sales of products or services to customers. |
| 3. _____ Stockholders' Equity | c. Amounts owed. |
| 4. _____ Dividends | d. Distributions to stockholders. |
| 5. _____ Revenues | e. Owners' claims to resources. |
| 6. _____ Expenses | f. Resources of a company. |

Solution:

1. f; 2. c; 3. e; 4. d; 5. b; 6. a

In summary, the measurement role of accounting is to create a record of the activities of a company. To make this possible, a company must maintain an accurate record of its assets, liabilities, stockholders' equity, revenues, expenses, and dividends. Be sure you understand the meaning of these items. We will refer to them throughout this book. Illustration 1-4 summarizes the business activities and the categories that measure them.

Activities Related to:	Measurement Category	Relationship
<ul style="list-style-type: none"> Resources of the company Amounts owed Stockholders' investment 	<ul style="list-style-type: none"> Assets Liabilities Stockholders' equity 	Accounting Equation $(A = L + SE)$
<ul style="list-style-type: none"> Distributions to stockholders 	<ul style="list-style-type: none"> Dividends 	
<ul style="list-style-type: none"> Sales of products or services Costs of providing sales 	<ul style="list-style-type: none"> Revenues Expenses 	Net Income $(R - E = NI)$

ILLUSTRATION 1-4

Business Activities and Their Measurement

**KEY POINT**

The measurement role of accounting is to create a record of the activities of a company. To make this possible, a company must maintain an accurate record of its assets, liabilities, stockholders' equity, revenues, expenses, and dividends.

As you learn to measure business activities, you will often find it helpful to consider both sides of the transaction: When someone pays cash, someone else receives cash; when someone borrows money, another lends money. Likewise, an expense for one company can be a revenue for another company; one company's asset can be another company's liability. Throughout this book, you will find discussions of the "flip side" of certain transactions, indicated by the icon you see here. In addition, certain homework problems, also marked by the icon, will ask you specifically to address the "flip side" in your computations. (See Exercise 1-2 and its flip side in Exercise 1-3 for the first such example.)



Flip Side

Communicating through Financial Statements

We've discussed that different business activities produce assets, liabilities, stockholders' equity, dividends, revenues, and expenses, and that the first important role of financial accounting is to *measure* the relevant transactions of a company. Its second vital role is to *communicate* these business activities to those outside the company. The primary means of communicating business activities is through financial statements.

Financial statements are periodic reports published by the company for the purpose of providing information to external users. There are four primary financial statements:

1. Income statement
2. Statement of stockholders' equity
3. Balance sheet
4. Statement of cash flows

These financial statements give investors and creditors the key information they need when making decisions about a company: Should I buy the company's stock? Should I lend money to the company? Is management efficiently operating the company? **Without these financial statements, it would be difficult for those outside the company to see what's going on inside.**

Let's go through a simple set of financial statements to see what they look like. We'll continue with our example of Eagle Soccer Academy. Actual companies' financial statements often report items you haven't yet encountered. However, because actual companies'

LO1-3

Determine how financial accounting information is communicated through financial statements.

financial information will be useful in helping you understand certain accounting topics, we'll sample them often throughout this book.

INCOME STATEMENT

The **income statement** is a financial statement that reports the company's revenues and expenses over an interval of time. It shows whether the company was able to generate enough revenue to cover the expenses of running the business. If revenues exceed expenses, then the company reports *net income*:

$$\text{Revenues} - \text{Expenses} = \text{Net Income}$$

If expenses exceed revenues, then the company reports a *net loss*.

On December 1, 2024 Eagle Soccer Academy began operations by offering lessons to junior players. At the end of the first month of operations, Eagle Soccer Academy reports its income statement as shown in Illustration 1–5.

Common Terms
Other common names for the income statement include *statement of operations*, *statement of income*, and *profit and loss statement*.

ILLUSTRATION 1–5

Income Statement for
Eagle Soccer Academy

EAGLE SOCCER ACADEMY	
Income Statement	
For the month ended December 31, 2024	
Revenues	
Service revenue	<u>\$72,000</u>
Expenses	
Rent expense	5,000
Supplies expense	10,000
Salaries expense	31,000
Utilities expense	9,000
Interest expense	1,000
Other expenses	2,000
Total expenses	<u>58,000</u>
Net income	<u><u>\$14,000</u></u>

Here are some specifics about Eagle's income statement:

- **Heading**—The heading includes the company's name, the title of the financial statement, and the time period covered by the financial statement. Because Eagle began operations on December 1, this income statement shows activity occurring *from* December 1 *to* December 31, 2024.
- **Revenues**—Eagle provides soccer lessons and bills customers a total of **\$72,000** during the month of December.
- **Expenses**—Eagle has costs for business activities of **\$58,000** during the month of December. These are typical costs that we might expect of any company, such as rent, supplies, salaries, utilities, interest, and other items. Each of these costs is reported in a separate account. An **account** maintains a record of the business activities related to a particular item.
- **Net income**—Revenues *exceed* expenses (\$72,000 is greater than \$58,000), and thus the company has generated a profit for its owners of **\$14,000**.
- **Underlines**—In a financial statement, a single underline generally represents a subtotal (in this case, total revenues or total expenses), while a double underline indicates a final total (in this case, net income).

The fact that Eagle reports a positive net income is, in some sense, a signal of the company's success. The company is able to charge its customers a price higher than the costs of running the business. Do you assume most companies sell their products and services for a profit? It's not as easy as you might think. In recent years, companies such as **Tesla**, **eBay**, **Uber**, **Boeing**, **General Electric**, **Wayfair**, **Fitbit**, and thousands of others have reported net losses.

**KEY POINT**

The income statement compares revenues and expenses for the current period to assess the company's ability to generate a profit from running its operations.

Question	Accounting information	Analysis
How can I tell if a company is profitable?	Income statement	If revenues exceed expenses, a company has net income and is profitable.

Decision Point

User's Guide **Decision Points** in each chapter highlight specific decisions related to chapter topics that can be made using financial accounting information.

STATEMENT OF STOCKHOLDERS' EQUITY

The **statement of stockholders' equity** is a financial statement that summarizes the changes in stockholders' equity over an interval of time. Stockholders' equity arises from two primary sources—common stock and retained earnings.

$$\text{Stockholders' Equity} = \text{Common Stock} + \text{Retained Earnings}$$

1. **Common stock** (*external* source of equity) represents amounts invested by stockholders (owners) when they purchase shares of stock. The change in common stock over the period is shown as:

$$\text{Beginning Common Stock} + \text{New Issuances} = \text{Ending Common Stock}$$

2. **Retained earnings** (*internal* source of equity) represent *all net income minus all dividends over the life of the company*. The change in retained earnings over the period is shown as:

$$\text{Beginning Retained Earnings} + \text{Net Income} - \text{Dividends} = \text{Ending Retained Earnings}$$

Think of retained earnings this way. A company that has net income has generated resources for owners through its operations. Those resources can either be returned to owners for their personal use (dividend payments) or retained in the business for future use. From the company's perspective, we need to account for the total net income retained in the business. That's the balance of retained earnings. In each period, the beginning balance of retained earnings is updated for the current period's net income minus dividends to calculate ending retained earnings. This same calculation repeats each period.

Illustration 1–6 shows the statement of stockholders' equity for Eagle Soccer Academy.

EAGLE SOCCER ACADEMY Statement of Stockholders' Equity For the month ended December 31, 2024			
	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance (Dec. 1)*	\$ -0-	\$ -0-	\$ -0-
Issuance of common stock	200,000		200,000
Add: Net income for the period		14,000	14,000
Less: Dividends		(4,000)	(4,000)
Ending balance (Dec. 31)	\$200,000	\$10,000	\$210,000

*Beginning balances are zero only because this is the first month of operations for Eagle. Normally, beginning balances for Common Stock and Retained Earnings equal ending balances from the previous period.

ILLUSTRATION 1–6
Statement of Stockholders' Equity
for Eagle Soccer Academy

From the income statement

Accounting convention uses parentheses to signify an amount to be subtracted (such as dividends here).

User's Guide
Throughout each chapter, you will see sections titled **Common Mistake**. Information in these boxes will help you avoid common mistakes on exams, quizzes, and homework.

Here are some specifics about Eagle's statement of stockholders' equity:

- **Heading**—The statement of stockholders' equity reports the activity for common stock and retained earnings over an *interval of time*. Similar to the income statement, the period of time in this example is December 1 to December 31, 2024.
- **Common Stock**—When Eagle begins operations on December 1, the balance of common stock is **\$0**. This would be true of any company beginning operations. During December, Eagle issues 10,000 shares of common stock for \$20 per share, so the balance of common stock increases by **\$200,000**.
- **Retained Earnings**—Retained Earnings also begins the first month of operations with a balance of **\$0**. For the month of December, retained earnings increase by net income of **\$14,000** and decrease by \$4,000 for dividends paid to stockholders. We show the amount of net income in blue here to emphasize that it came from the income statement (Illustration 1-5). The ending balance of **\$10,000** represents all net income minus all dividends over the life of the company, which is only one month to this point in our example.
- **Total Stockholders' Equity**—The third column shows that the two components—common stock and retained earnings—add to equal total stockholders' equity of **\$210,000**.



COMMON MISTAKE

Dividends represent the payment of cash but are not considered an expense in running the business. Students sometimes mistakenly include the amount of dividends as an expense in the income statement, rather than as a distribution of net income in the statement of stockholders' equity.






KEY POINT

The statement of stockholders' equity reports information related to changes in common stock and retained earnings each period. The change in retained earnings equals net income less dividends for the period.

Statement of Retained Earnings. Notice the middle column of the statement of stockholders' equity in Illustration 1-6. This column sometimes is referred to as the *statement of retained earnings*. In practice, companies don't report retained earnings in a separate statement from common stock, so that's why we demonstrate the statement of stockholders' equity. Nevertheless, it's useful to see that this column highlights how net income (revenues minus expenses) from the income statement links to total stockholders' equity by adding to the balance of retained earnings.

Decision Point

Question 	Accounting information 	Analysis 
Was the change in stockholders' equity the result of external or internal sources?	Statement of stockholders' equity	When a company sells common stock, equity increases due to external sources. When a company has profits during the year in excess of dividends paid, equity increases due to internal sources.

BALANCE SHEET

The **balance sheet** is a financial statement that presents the financial position of the company on a particular date. The financial position of a company is summarized by the accounting equation (see Illustration 1-3):

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

As discussed earlier, this equation provides a fundamental model of business valuation. Assets are the resources of the company, and liabilities are amounts owed to creditors. Stockholders have equity in the company to the extent that assets exceed liabilities. Creditors also need to understand the balance sheet; it's the company's assets that will be used to pay liabilities as they become due. Illustration 1-7 shows the balance sheet of Eagle Soccer Academy.

EAGLE SOCCER ACADEMY Balance Sheet December 31, 2024			
Assets		Liabilities	
Cash	\$ 137,000	Accounts payable	\$ 23,000
Accounts receivable	27,000	Salaries payable	3,000
Supplies	13,000	Utilities payable	9,000
Equipment, net	118,000	Interest payable	1,000
Other assets	55,000	Notes payable	100,000
		Other liabilities	4,000
		Total liabilities	140,000
		Stockholders' Equity	
		Common stock	200,000
		Retained earnings	10,000
		Total stockholders' equity	210,000
Total assets	\$350,000	Total liabilities and stockholders' equity	\$350,000

ILLUSTRATION 1-7

Balance Sheet for Eagle Soccer Academy

Common Terms

Another name for the balance sheet is the *statement of financial position*.

From the statement of stockholders' equity

Here are some specifics about Eagle's balance sheet:

- **Heading**—The balance sheet reports assets, liabilities, and stockholders' equity at a *point in time*, in contrast to the income statement, which shows revenue and expense activities over an *interval of time*. For example, Eagle's income statement shows revenue and expense activity occurring *from* December 1 *to* December 31, 2024; its balance sheet shows assets, liabilities, and stockholders' equity of the company *on* December 31, 2024.
- **Assets**—These are the resources of a company. Eagle has total assets of **\$350,000**. *Cash* is a resource because it can be used to make purchases. *Accounts receivable* is a resource because they represent the right to receive cash from customers that have already been provided products or services. *Supplies* include resources used to run the soccer academy, such as paper, cleaning supplies, and soccer balls. *Equipment* is a resource that can be used to provide services to customers.
- **Liabilities**—These are the amounts owed by a company. Eagle has total liabilities of **\$140,000**. These include amounts owed to regular vendors (accounts payable), as well as amounts owed for other items such as employee salaries, utilities, interest, and bank borrowing (notes payable). Many liabilities are referred to as "payables," to signify amounts the company will "pay" in the future.
- **Stockholders' equity**—The difference between total assets and total liabilities of **\$210,000** represents stockholders' equity. Total stockholders' equity includes the amount of common stock plus the amount of retained earnings from the statement of stockholders' equity. We show the stockholders' equity items in purple here, to indicate they came from the statement of stockholders' equity (Illustration 1-6).
- **Accounting Equation**—Notice that the amounts listed in the "balance sheet" show that the accounting equation "balances."

The income statement is like a video (shows events over time), whereas a balance sheet is like a photograph (shows events at a point in time).

Total assets must equal total liabilities and stockholders' equity.

Assets (resources)	=	Liabilities (creditors' claims)	+	Stockholders' Equity (owners' claims)
\$350,000	=	\$140,000	+	\$210,000

**KEY POINT**

The balance sheet demonstrates that the company's resources (assets) equal creditors' claims (liabilities) plus owners' claims (stockholders' equity) to those resources on a particular date.

Decision Point

Question	Accounting information	Analysis
What are creditors' claims and owners' claims to the company's resources?	Balance sheet	The amount of total liabilities equals creditors' claims to the company's resources. The extent to which total assets exceed total liabilities represents owners' claims.

STATEMENT OF CASH FLOWS

The **statement of cash flows** is a financial statement that measures activities involving cash receipts and cash payments over an interval of time. We can classify all cash transactions into three categories that correspond to the three fundamental business activities—operating, investing, and financing.

- **Operating cash flows** include cash receipts and cash payments for transactions involving revenue and expense activities during the period. In other words, operating activities include the cash effects of the same activities that are reported in the income statement to calculate net income. Suppose Eagle received \$49,000 from customers, paid \$28,000 for salaries, and paid \$60,000 for rent.
- **Investing cash flows** generally include cash transactions for the purchase and sale of investments and long-term assets. Long-term assets are resources owned by a company that are thought to provide benefits for more than one year. Eagle had only one investing cash flow—purchase of equipment for \$120,000.
- **Financing cash flows** include cash transactions with lenders, such as borrowing money and repaying debt, and with stockholders, such as issuing stock and paying dividends. Eagle issued stock for \$200,000, borrowed \$100,000 from the bank, and paid dividends of \$4,000 to stockholders.

Illustration 1–8 provides the statement of cash flows for Eagle Soccer Academy. Inflows are shown as positive amounts; outflows are shown in parentheses to indicate negative cash flows. The final line in each section shows, in the right-most column, the difference between inflows and outflows as *net cash flow* for that type of activity.

**KEY POINT**

The statement of cash flows reports cash transactions from operating, investing, and financing activities for the period.

EAGLE SOCCER ACADEMY
Statement of Cash Flows
For the month ended December 31, 2024

<u>Cash Flows from Operating Activities</u>	
Cash inflows:	
From customers	\$ 49,000
Cash outflows:	
For salaries	(28,000)
For rent	(60,000)
Net cash flows from operating activities	\$ (39,000)
<u>Cash Flows from Investing Activities</u>	
Purchase equipment	(120,000)
Net cash flows from investing activities	(120,000)
<u>Cash Flows from Financing Activities</u>	
Issue common stock	200,000
Borrow from bank	100,000
Pay dividends	(4,000)
Net cash flows from financing activities	296,000
Net increase in cash	137,000
Cash at the beginning of the period	-0-
Cash at the end of the period	<u>\$137,000</u>

ILLUSTRATION 1-8
Statement of Cash
Flows for Eagle Soccer
Academy

Remember, amounts in parentheses indicate outflows of cash.

Included in the balance sheet

The total of the net cash flows from operating, investing, and financing activities equals the *net change in cash* during the period.

$$\text{Change in cash} = \text{Operating cash flows} + \text{Investing cash flows} + \text{Financing cash flows}$$

For Eagle, that net change in cash for December was an increase of **\$137,000**. That amount equals the sum of its operating cash flows of $-\$39,000$, investing cash flows of $-\$120,000$, and financing cash flows of $\$296,000$. We next add the beginning balance of cash. Because this is the first month of operations for Eagle, cash at the beginning of the period is zero. The ending balance of cash is the same as that reported in the balance sheet in Illustration 1-7. This reconciliation of the beginning and ending cash balances emphasizes that the statement of cash flows explains *why* the cash reported in the balance sheet changed from one period to the next.

Decision Maker's Perspective

The statement of cash flows can be an important source of information to investors and creditors. For example, investors use the relationship between net income (revenues minus expenses) and operating cash flows (cash flows from revenue and expense activities) to forecast a company's future profitability. Creditors compare operating cash flows and investing cash flows to assess a company's ability to repay debt. Financing activities provide information to investors and creditors about the mix of external financing of the company.

User's Guide Decision Maker's Perspective sections discuss the usefulness of accounting information to decision makers such as investors, creditors, and company managers.

THE LINKS AMONG FINANCIAL STATEMENTS

The four financial statements are linked, because events that are reported in one financial statement often affect amounts reported in another. Many times, a single business transaction, such as receiving cash from a customer when providing services, will affect more than one of the financial statements. Providing services to a customer, for example, results in



Photodisc/Getty Images

revenues recorded in the income statement, which are used to calculate net income. Net income, in turn, is reported in the calculation of retained earnings in the statement of stockholders' equity. Then, the ending balance of retained earnings is reported in the balance sheet. **Thus, any transaction that affects the income statement ultimately affects the balance sheet through the balance of retained earnings.** The cash received from customers will be reported as part of the ending cash balance in the balance sheet and as part of operating cash flows in the statement of cash flows.

Illustration 1-9 shows the links among the financial statements of Eagle Soccer Academy in Illustrations 1-5, 1-6, 1-7, and 1-8.

- Link [1] shows that net income from the income statement is reported in the statement of stockholders' equity as part of the calculation of retained earnings.
- Link [2] shows that after calculating the balance of retained earnings, the amount of total stockholders' equity can be reported in the balance sheet. Finally,
- Link [3] demonstrates that the balance of cash in the balance sheet equals the amount of cash reported in the statement of cash flows.

ILLUSTRATION 1-9**Links among Financial Statements**

[1] Notice that the amount of net income in the income statement reappears in the statement of stockholders' equity.

[2] Notice that the ending balance in the statement of stockholders' equity reappears in the balance sheet.

[3] Notice that the amount of cash in the balance sheet reappears as the ending cash balance in the statement of cash flows.


EAGLE SOCCER ACADEMY
Income Statement

Revenues	\$72,000
Expenses	58,000
Net income	<u>\$14,000</u>

EAGLE SOCCER ACADEMY
Statement of Stockholders' Equity

	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance (Dec. 1)	\$ -0-	\$ -0-	\$ -0-
Issuances	200,000		200,000
Add: Net income		14,000	14,000
Less: Dividends		(4,000)	(4,000)
Ending balance (Dec. 31)	<u>\$200,000</u>	<u>\$10,000</u>	<u>\$210,000</u>

EAGLE SOCCER ACADEMY
Balance Sheet

Cash	<u>\$137,000</u>	Liabilities	\$140,000
Other assets	213,000	Stockholders' equity	<u>210,000</u>
Total assets	<u>\$350,000</u>	Total liabilities and stockholders' equity	<u>\$350,000</u>

EAGLE SOCCER ACADEMY
Statement of Cash Flows

Cash flows from operating activities	\$ (39,000)
Cash flows from investing activities	(120,000)
Cash flows from financing activities	<u>296,000</u>
Net increase in cash	137,000
Cash at the beginning of the year	-0-
Cash at the end of the year	<u>\$ 137,000</u>

Test your understanding of what you've read so far. The Computer Shop repairs laptops, desktops, and mainframe computers. On December 31, 2024, the company reports the following year-end amounts:

Assets:	Cash	\$10,000	Revenues:	Service	\$65,000
	Supplies	8,000			
	Equipment, net	26,000			
Liabilities:	Accounts payable	4,000	Expenses:	Rent	6,000
	Notes payable	10,000		Supplies	14,000
				Salaries	40,000

Additional information:

- The balance of retained earnings at the beginning of the year is \$7,000.
- The company pays dividends of \$1,000 on December 31, 2024.
- Common stock is \$15,000 at the beginning of the year, and additional shares are issued for \$4,000 during 2024.

Required:

Prepare the (1) income statement, (2) statement of stockholders' equity, and (3) balance sheet.

Solution:

Let's Review



Suggested Homework:

BE1-7, BE1-8;
E1-6, E1-7, E1-8;
P1-3A&B, P1-5A&B

1. Income statement:

THE COMPUTER SHOP	
Income Statement	
Year ended Dec. 31, 2024	
Revenues:	
Service revenue	\$65,000
Expenses:	
Rent expense	6,000
Supplies expense	14,000
Salaries expense	40,000
Net income	\$ 5,000

2. Statement of stockholders' equity:

THE COMPUTER SHOP			
Statement of Stockholders' Equity			
Year ended Dec. 31, 2024			
	Common Stock	Retained Earnings	Total Stockholders' Equity
Beginning balance (Jan. 1)	\$15,000	\$ 7,000	\$22,000
Issuance of common stock	4,000		4,000
Add: Net income		5,000	5,000
Less: Dividends		(1,000)	(1,000)
Ending balance (Dec. 31)	\$19,000	\$11,000	\$30,000

3. Balance sheet:

THE COMPUTER SHOP			
Balance Sheet			
December 31, 2024			
Assets		Liabilities	
Cash	\$10,000	Accounts payable	\$ 4,000
Supplies	8,000	Notes payable	10,000
Equipment	26,000	Stockholders' Equity	
		Common stock	19,000
		Retained earnings	11,000
Total assets	\$44,000	Total liabilities and stockholders' equity	\$44,000

**KEY POINT**

All transactions that affect revenues or expenses reported in the income statement ultimately affect the balance sheet through the balance in retained earnings.

OTHER INFORMATION REPORTED TO OUTSIDERS

The financial statements are a key component of a company's *annual report*, the term most often used to describe the formal document detailing a company's activities and financial performance. As the name suggests, annual reports are provided by companies each year. Two other important components of the annual report are (1) management's discussion and analysis and (2) note disclosures to the financial statements.

The **management discussion and analysis** (MD&A) section typically includes management's views on significant events, trends, and uncertainties pertaining to the company's operations and resources. **Note disclosures** offer additional information either to explain the information presented in the financial statements or to provide information not included in the financial statements. For example, companies are required to report total revenues in the income statement, but they also often report revenues itemized by geographic region in a note disclosure. We'll discuss these items throughout this book. For now, if you'd like to see an abbreviated version of an actual company's annual report with financial statements, see Appendix A (**American Eagle Outfitters**) or Appendix B (**Buckle**) near the end of this book.

Making Decisions with Accounting Information

To this point, you've had a simple, first look at how companies measure and communicate financial information to external users. Subsequent chapters will provide an even more detailed view of this measurement/communication process. However, before proceeding, it's important first to consider why we are studying financial accounting. Does it matter? In other words, does the use of financial accounting information result in better business decisions?

One of the rewarding things about studying financial accounting is that it does matter! The concepts in this course have an impact on everyday business decisions as well as wide-ranging economic consequences. We'll see an example of this next and then more examples throughout the rest of this book.

Most prospering economies in the world today are structured around free markets. In free markets, firms are allowed to compete and customers are free to choose from a variety of products and services. From which company do you prefer to buy a laptop computer—**Dell**, **Hewlett-Packard**, or **Apple**? Competition among these companies helps determine the prices they charge customers and the amounts they spend on computer components, salaries, manufacturing and distribution facilities, warranties, research and development, and other business-related activities. Can these companies offer you the laptop computer you want for a price above their costs? If they can, they'll earn a profit and stay in business. If they cannot, they'll eventually go out of business. Because companies know they are directly competing with each other, they work harder and more efficiently to please you, the customer.

Successful companies use their resources efficiently to sell products and services for a profit. When a company is able to make a profit, investors and creditors are willing to transfer their resources to it, and the company will expand its profitable operations even further.

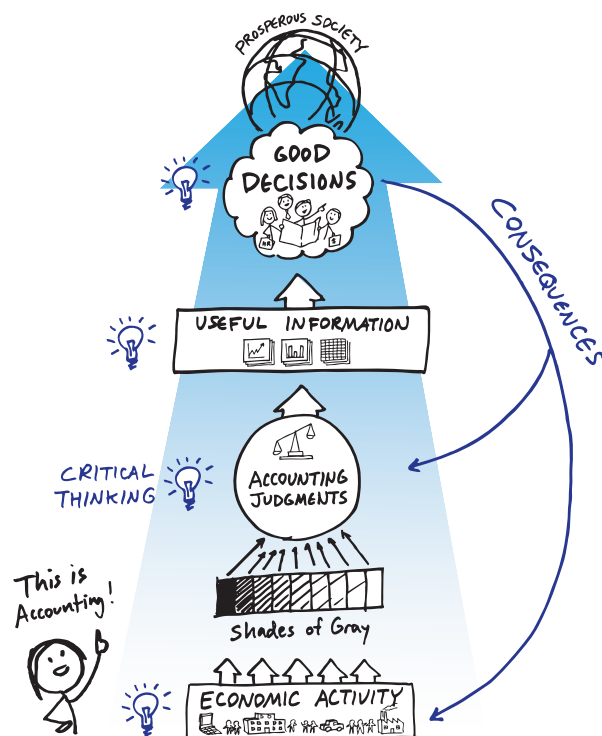
Unsuccessful companies either offer lower-quality products and services or do not efficiently keep their costs low. In either case, they are not profitable. When a company is unprofitable, investors will neither invest in nor lend to the firm. Without these sources of financing, eventually the company will fail. Clearly, you don't want to invest in an unsuccessful company and then watch your investment shrink as the company loses your money.

LO1-4

Describe the role that financial accounting plays in the decision-making process.

But how do investors and creditors know the successful companies from the unsuccessful companies? How do they get the information necessary to make good investment decisions that help develop a prosperous society? Here's where financial accounting enters the picture. **Investors and creditors rely heavily on financial accounting information in making investment and lending decisions.**

This idea has been visualized by the Pathways Commission of the American Accounting Association (pathwayscommission.org) in Illustration 1-10. Accounting serves an important role in a prosperous society by measuring economic activity and communicating useful information to help investors and creditors make good decisions. Throughout this book, you'll practice the judgment and skills necessary to produce accounting information, and you'll begin to see how this information is helpful in making good decisions.



This work is by The Pathways Commission and is licensed under a Creative Commons Attribution-NoDerivs 3.0 Unported License.

ILLUSTRATION 1-10

Pathways Commission Visualization: "THIS is Accounting!"

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KEY POINT

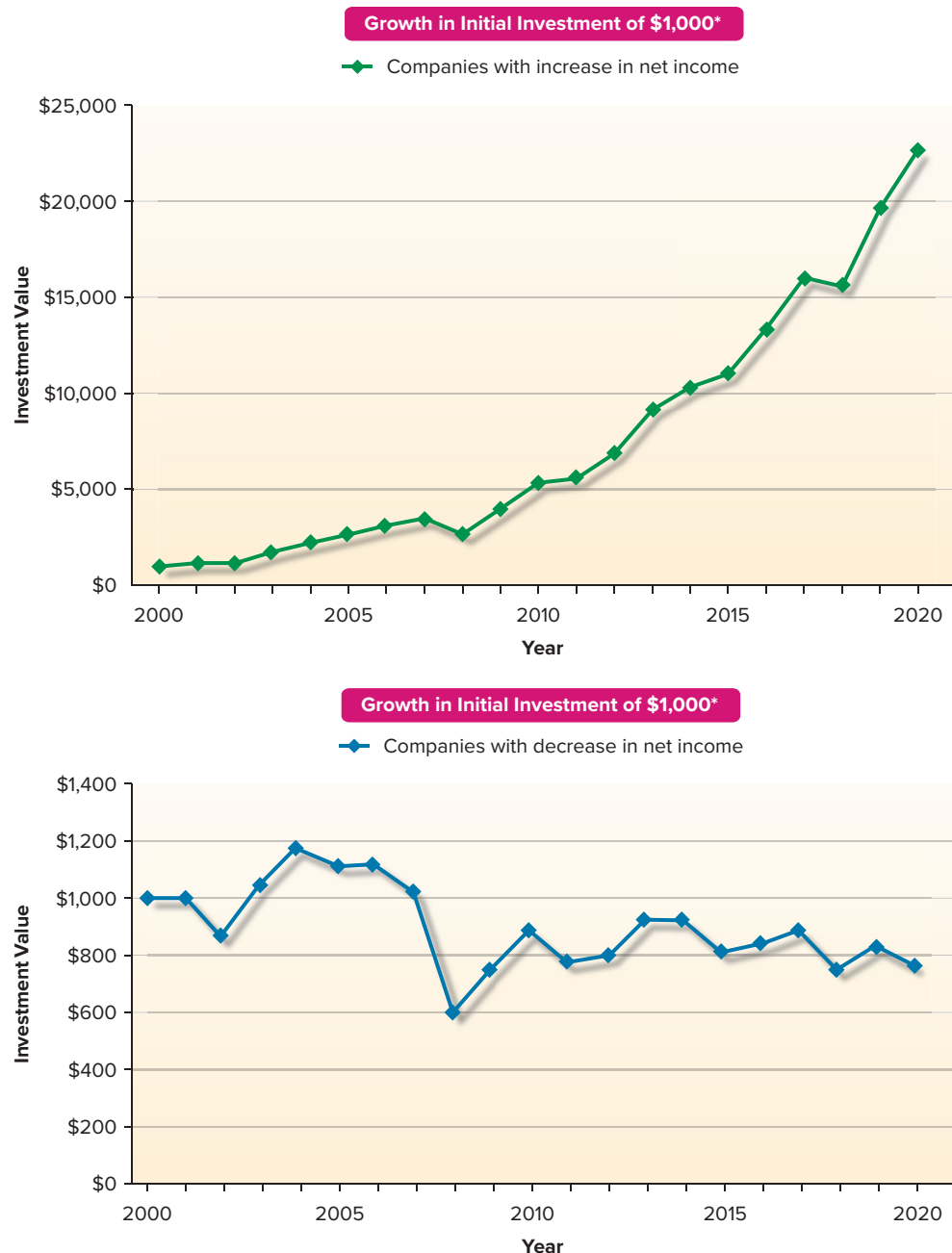
Financial accounting serves an important role by providing information useful in investment and lending decisions.

To demonstrate the importance of financial accounting information to investment decisions, we can look at the relationship between changes in stock prices and changes in net income over 20 years. As an investor, you will make money from an increase in the stock price of a company in which you invest (you can sell the stock for more than you bought it). So as an investor, you are looking for companies whose stock price is likely to increase. Is there a way to find such companies? Interestingly, there is: **No other single piece of company information better explains companies' stock price performance than does financial accounting net income**, the bottom line in the income statement.

What if you were able to accurately predict the direction of companies' changes in net income over the next year—that is, whether it would increase or decrease—and then you invested \$1,000 in companies that were going to have an *increase*? In contrast, what if instead you invested in companies that would have a *decrease* in net income? Illustration 1-11 shows what would happen to your \$1,000 investment over 20 years for each scenario.

ILLUSTRATION 1-11

Relationship between Changes in Stock Prices and Changes in Net Income over a 20-Year Period



*Amounts in this chart represent the investment growth based on the median stock return of each group each year. Companies included in this analysis are all U.S. companies with listed stocks, which averages about 6,000 companies per year.

You can see that if you had invested \$1,000 in companies with an increase in net income, your investment would have increased to \$22,729 over the 20-year period. If instead you had invested \$1,000 in companies with a decrease in net income, your \$1,000 investment would have shrunk to \$771 over this same period. This dramatic difference in the value of the investment demonstrates the importance of financial accounting information to investors. This book will provide you a thorough understanding of how net income is calculated and presented in financial statements. As you can see from the charts above, if you are able to predict the change in financial accounting's measure of profitability—net income—then you can predict the change in stock prices as well.

Investors and creditors also use information reported in the balance sheet. Consider a company's total liabilities, often referred to as *total debt*. Expanding debt levels limit management's ability to respond quickly and effectively to business situations. The "overhanging" debt, which involves legal obligation of repayment, restricts management's ability to engage in new profit-generating activities. Increased debt levels also increase interest payment burdens on the company. Failure to pay interest or to repay debt can result in creditors forcing the company to declare bankruptcy and go out of business. Understandably, then, investors and creditors keep a close eye on the company's debt level and its ability to repay.



KEY POINT

No single piece of company information better explains companies' stock price performance than does financial accounting net income. A company's debt level is an important indicator of management's ability to respond to business situations and the possibility of bankruptcy.

FINANCIAL ACCOUNTING INFORMATION

Recall that accounting serves two main functions: It (1) measures business activities and (2) communicates those measurements to investors and creditors so they can make decisions. Although this process might seem straightforward, some issues have been heavily debated, and the answers have changed over time. How do we measure assets? When do we record revenues? What do we classify as an expense? How should we present financial statements? Next, we'll take a look at factors that shape the measurement and communication processes of financial accounting.

Financial Accounting Standards

Because financial accounting information is so vital to investors and creditors, formal standards have been established. The rules of financial accounting are called **generally accepted accounting principles**, often abbreviated as **GAAP** (pronounced *gap*). The fact that all companies use these same rules is critical to financial statement users. It helps investors to accurately *compare* financial information among companies when they are making decisions about where to invest or lend their resources.

STANDARD SETTING TODAY

Financial accounting and reporting standards in the United States are established primarily by the **Financial Accounting Standards Board (FASB)** (pronounced either by the letters themselves or as *faz-be*). The FASB is an independent, private-sector body with full-time voting members and a very large support staff. Members include representatives from the accounting profession, large corporations, financial analysts, accounting educators, and government agencies.

Not all countries follow the same accounting and reporting standards. For example, accounting practices differ between the United States, the United Kingdom, and Japan. In recent years, the accounting profession has undertaken a project whose goal is to eliminate differences in accounting standards around the world. The standard-setting body responsible for this convergence effort is the **International Accounting Standards Board (IASB)**, as detailed in the box titled "What is the IASB?".

More than 120 countries have chosen to forgo their own country-specific standards and either require or allow International Financial Reporting Standards (IFRS) as their national standards. That movement, coupled with the convergence of U.S. GAAP and IFRS, caused many to predict that both sets of rules, or perhaps only IFRS, would be acceptable for financial reporting in the United States. Currently, however, that seems unlikely.

PART B

LO1-5

Explain the term generally accepted accounting principles (GAAP) and describe the role of GAAP in financial accounting.

For information about the activities of the Financial Accounting Standards Board, see its website, www.fasb.org.

For information about the activities of the International Accounting Standards Board, see its website, www.iasb.org.



INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

WHAT IS THE IASB?

The global counterpart to the FASB is the International Accounting Standards Board (IASB). In many ways, this organization functions like the FASB. The IASB's objectives are (1) to develop a single set of high-quality, understandable global accounting standards, (2) to promote the use of those standards, and (3) to bring about the convergence of national accounting standards and international accounting standards around the world. In 2002, the FASB and IASB signed the Norwalk Agreement, formalizing their commitment to convergence of U.S. and international accounting standards. The standards being developed and promoted by the IASB are called **International Financial Reporting Standards (IFRS)**. The FASB and IASB have made several efforts to converge U.S. GAAP and IFRS, although important differences remain. (For more discussion, see Appendix E.)



KEY POINT

The rules of financial accounting are called generally accepted accounting principles (GAAP). The Financial Accounting Standards Board (FASB) is an independent, private body that has primary responsibility for the establishment of GAAP in the United States.

STANDARD SETTING IN THE PAST CENTURY

Pressures on the accounting profession to establish uniform accounting standards began to surface after the stock market crash of 1929. The Dow Jones Industrial Average, a major stock market index in the United States, fell 40% over the period September 3 to October 29 that year. The Dow bottomed out in July 1932, after losing 89% of its value.

Many blamed financial accounting for the stock market crash and the ensuing Great Depression of the 1930s. At the time of the crash, accounting practices and reporting procedures were not well established, providing the opportunity for companies to engage in inaccurate financial reporting to enhance their reported performance. This led to many stocks being valued too highly. As investors began to recognize this, their confidence in the stock market fell. They panicked and sold stocks in a frenzy. The Dow did not reach pre-crash levels again until 1954.

The 1933 Securities Act and the Securities Exchange Act of 1934 were designed to restore investor confidence in financial accounting. The 1933 act sets forth accounting and disclosure requirements for initial offerings of securities (stocks and bonds). The 1934 act created a government agency, the **Securities and Exchange Commission (SEC)**. The 1934 act gives the SEC the power to require companies that publicly trade their stock to prepare periodic financial statements for distribution to investors and creditors.

While Congress has given the SEC both the power and the responsibility for setting accounting and reporting standards for publicly traded companies, the SEC has delegated the primary responsibility for setting accounting standards to the private sector, currently the FASB. Note that the SEC delegated only the responsibility, not the authority, to set these standards. The power still lies with the SEC. If the SEC does not agree with a particular standard issued by the FASB, it can force a change in the standard. In fact, it has done so in the past.

THE IMPORTANCE OF AUDITORS

For many businesses, there is a natural separation between those who run the business (managers) and those who own the business or finance operations (investors and creditors). This separation creates the need to ensure honest financial reporting. While it is the responsibility of management to apply GAAP when communicating with investors and creditors

through financial statements, sometimes those in charge of preparing financial statements do not always follow the rules. Instead, some purposely provide misleading financial accounting information, commonly referred to as “cooking the books.” The phrase implies that the accounting records (“books”) have been presented in an altered form (“cooked”). Managers may cook the books for several reasons, such as to hide the poor operating performance of the company or to increase their personal wealth at stockholders’ expense.

To help ensure that management has, in fact, appropriately applied GAAP, the SEC requires independent outside verification of the financial statements of publicly traded companies. Such independent examination is done by **auditors**, who are *not* employees of the company, but who are hired by the company as an independent party to express a professional opinion of the extent to which financial statements are prepared in compliance with GAAP and are free of material misstatement. If auditors find mistakes or fraudulent reporting behavior, they require the company to correct all significant information before issuing financial statements. **Auditors play a major role in investors’ and creditors’ decisions by adding credibility to a company’s financial statements.**

Illustration 1–12 presents an excerpt from the auditor’s report for **Dick’s Sporting Goods, Inc.** The auditor’s report indicates that the financial statements for the period mentioned have been prepared in conformity with GAAP.

Common Terms

The auditor’s report is also commonly referred to as the *auditor’s opinion*.

Dick’s Sporting Goods, Inc. Report of Independent Auditors

To the Board of Directors and Stockholders of
Dick’s Sporting Goods, Inc.
Pittsburgh, Pennsylvania

We have audited the accompanying consolidated balance sheets of DICK’S Sporting Goods, Inc. and subsidiaries (the “Company”) as of February 1, 2020, and February 2, 2019, the related consolidated statements of income, comprehensive income, changes in stockholders’ equity, and cash flows, for each of the three years in the period ended February 1, 2020, and the related notes (collectively referred to as the “financial statements”).

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of February 1, 2020, and February 2, 2019, and the results of its operations and its cash flows for each of the three years in the period ended February 1, 2020, in conformity with accounting principles generally accepted in the United States of America.

ILLUSTRATION 1–12

Excerpts from the Independent Auditor’s Report of **Dick’s Sporting Goods, Inc.**

To further enhance the credibility of financial reporting, Congress established in 2002 the **Public Company Accounting Oversight Board (PCAOB)**. The role of the PCAOB is to ensure that auditors follow a strict set of guidelines when conducting their audits of public companies’ financial statements. The PCAOB is a government entity that, simply stated, “audits the auditors.”

OBJECTIVES OF FINANCIAL ACCOUNTING

After measuring business activities and communicating those measurements to investors and creditors, what do financial accountants hope to have achieved? What benefit will their services have brought to users of financial statements? The FASB has explicitly stated the specific objectives of financial accounting. These objectives are presented in Illustration 1–13.

The first objective is specific to investors and creditors. In addition to those users, though, financial accounting information is likely to have general usefulness to other

ILLUSTRATION 1-13**Objectives of Financial Accounting****Financial accounting should provide information that:**

1. Is useful to investors and creditors in making decisions.
2. Helps to predict cash flows.
3. Tells about economic resources, claims to resources, and changes in resources and claims.

groups of external users, who are interested in essentially the same financial aspects of a business as are investors and creditors. Some of these other groups were discussed in Illustration 1-1.

The second objective refers to the specific cash flow information needs of investors and creditors. The third objective emphasizes the need for information about economic resources (assets) and claims to those resources (liabilities and stockholders' equity) and their changes over time.

**KEY POINT**

The primary objective of financial accounting is to provide useful information to investors and creditors in making decisions.

Underlying these three key objectives is a conceptual framework that is the foundation upon which financial accounting is built. We discuss the FASB's conceptual framework in detail in the appendix to this chapter.

An Ethical Foundation

Like all structures, accounting requires a strong foundation. For accounting, part of that foundation is the ethical behavior of those who practice its rules. You have probably encountered the topic of ethics in other business courses. **Ethics** refers to a code or moral system that provides criteria for evaluating right and wrong behavior. Investors, creditors, government, and the general public rely on general ethical behavior among those who record and report the financial activities of businesses. A lack of public trust in financial reporting can undermine business and the economy.

Public outrage over accounting scandals at high-profile companies increased the pressure on lawmakers to pass measures that would restore credibility and investor confidence in the financial reporting process. These pressures resulted in the issuance of what is commonly referred to as the **Sarbanes-Oxley Act (SOX)**, named for the two congressmen who sponsored the bill. The Sarbanes-Oxley Act provides for the regulation of auditors and the types of services they furnish to clients, increases accountability of corporate executives, addresses conflicts of interest for securities analysts, and provides for stiff criminal penalties for violators. These increased requirements have dramatically increased the need for good accounting and, at the same time, highlighted the value of accounting information to investors and creditors. We discuss the specific provisions of SOX in more detail in Chapter 4.

Important as such legislation is in supporting the ethical foundation of accounting, it is equally important that accountants themselves have their own personal standards for ethical conduct. You cannot, though, just go out and suddenly obtain ethics when you need them. ("I'd like a pound of ethics, please.") Rather, accountants need to *develop* their ability to identify ethical situations and know the difference between right and wrong in

the context of the accounting topics you will learn in this course. One of the keys to ethical decision making is having an appreciation for how your actions affect others.

When you face ethical dilemmas in your professional life (and indeed in your personal life), you can apply the following simple four-step framework as you think through what to do:

1. Understand the ethical decision you face.
2. Specify the options for alternative courses of action.
3. Identify the impact of each option on the stakeholders.
4. Make a decision.

For accountants, ethical decisions most often involve understanding how their actions affect amounts reported in the financial statements. Throughout the book, we will discuss some ethical decisions related to accounting and will make clear their financial reporting impact. These discussions will give you opportunities to practice some ethical decision making in a classroom setting. You can also practice applying the four-step framework to Ethical Dilemma (like the one below) or in Ethics cases located at the end of each chapter.



ETHICAL DILEMMA

Blend Images/Hill Street Studios/
Gifford Sun/Getty Images



You have been the manager of a local restaurant for the past five years. Because of increased competition, you notice you're getting fewer customers. Despite all your attempts to attract new customers and cut costs, the restaurant's profitability continues to decline. The restaurant owner tells you that if this year's profit is lower than last year's, you'll lose your job.

When preparing financial statements at the end of the year, you notice that this year's profit is lower. You know that by purposely understating certain expenses, you can falsely report higher profits to the owner for this year. That will allow you to keep your job for at least one more year and look for a new job in the meantime.

What should you do? What if you really believe the lower profitability is caused by factors outside your control? Would this make the false reporting acceptable?

User's Guide
Throughout the book, you will see boxed discussions of *Ethical Dilemmas*. These dilemmas are designed to raise your awareness of accounting issues that have ethical ramifications.

CAREERS IN ACCOUNTING

Whether you plan to major in accounting or not, this section is important for you. Accounting majors need to realize the many different options available upon graduation. Those who do not plan to major in accounting need a solid understanding of the many different business decisions involving accounting information.

After completing the first course in accounting, you will have some idea whether you enjoy accounting and might like to major in it. You will also find out through exams, quizzes, and homework whether you have the aptitude to be good at it. Realize, however, that besides being good at the technical side of accounting, you will need interpersonal skills such as working well in teams, making presentations to clients, and leading co-workers in complex projects. If you do major in accounting, the job prospects are numerous.

Demand for Accounting

One of the greatest benefits of an accounting degree is the wide variety of job opportunities it opens to you. With an accounting degree, you can apply for almost any position available

PART C



CAREER CORNER

Over 20,000 employees join public accounting firms in entry-level jobs each year, and thousands more go into other areas of accounting. While financial accountants learn how to measure business transactions and prepare financial reports, they also learn a great deal about the business itself. Because of this widespread business knowledge, accountants often play a key role on the management team. In fact, it should come as no surprise to learn that most chief financial officers (CFOs) started their careers as accountants.

Accounting, because of its dynamic and professional nature, offers an attractive career option. You can learn more about a career in accounting by visiting the website of the American Institute of Certified Public Accountants (www.aicpa.org). There, you can look under the *Career* link to find current information about job opportunities, salaries, work life for women, how to write a resume, how to interview, and other general career advice. You can also visit (www.thiswaytocpa.com). For salary and other job-related information, consult the website of the U.S.

Bureau of Labor Statistics

(www.bls.gov). There

are a wide variety of jobs in accounting and, therefore a wide variety of starting salaries, typically ranging from \$50,000 to \$70,000. The demand for accounting positions is expected to grow 6% per year for the next ten years.



Anton Vengo/Purestock/Superstock

to finance majors. However, it doesn't work the other way: Finance majors often lack the accounting background necessary to apply for accounting positions.

For the past several years, accounting has ranked as one of the top majors on university campuses. Because of their importance in our society, accountants are in high demand. And because of this high demand, accounting salaries are on the rise. Starting salaries are among the highest of all majors across the university.

Career Options in Accounting

The first big decision a student makes as an accounting major is the choice between a career in public accounting and a career in private accounting.

PUBLIC ACCOUNTING

Public accounting firms are professional service firms that traditionally have focused on three areas: auditing, tax preparation/planning, and business consulting. We already have discussed the role of *auditors* in attesting to the conformity of companies' financial statements with GAAP. *Tax preparation/*

planning is an increasingly important activity in the United States, as the complexity of tax laws related to personal and corporate taxes continues to increase. *Business consulting* is perhaps the most lucrative activity of accountants. Managers who want to better understand their companies' financial strengths and weaknesses often turn to public accountants for guidance. Who knows the business activities better than the one measuring and communicating them?

If you choose a career in public accounting, the next big decision is whether to work for one of the "Big 4" public accounting firms (**Deloitte**, **Ernst & Young**, **PricewaterhouseCoopers**, and **KPMG**) or one of the thousands of medium or smaller-sized firms. The Big 4 firms are huge, each having annual revenues in the billions. They audit almost all the Fortune 500 companies in the United States and most of the largest companies around the world, and they hire thousands of accounting majors each year. The thousands of smaller international, regional, and local accounting firms also hire thousands of accounting majors right out of college.

Most public accountants become *Certified Public Accountants (CPAs)*. You become a CPA by passing the four parts of the CPA exam and meeting minimum work experience requirements (in some states). Most states require that you have 150 semester hours (225 quarter hours) of college credit to take the exam. Becoming a CPA can provide a big boost in salary and long-term job opportunities.

PRIVATE ACCOUNTING

A career in **private accounting** means providing accounting services to the company that employs you. Every major company in the world needs employees with training and

■ **LO1-6**
Identify career opportunities in accounting.

User's Guide
Throughout the book, you will see sections titled *Career Corner*. These sections highlight a link between a particular topic and a business career, and thus are intended for both accounting majors and nonmajors.

experience in financial accounting, management accounting, taxation, internal auditing, and accounting information systems. Whereas working as a public accountant provides the advantage of experience working with a number of different clients, private accountants sometimes earn higher starting salaries. In fact, many accounting students begin their careers in public accounting, gaining experience across a wide array of companies and industries, and then eventually switch over to one of their favorite clients as private accountants. Other students take positions directly in private accounting right out of college.

Because of their special training and valuable knowledge base, both public and private accountants are expanding their roles to include the following: financial planning, information technology development, financial analysis, forensic accounting, information risk management, investment banking, environmental accounting, tax law, FBI work, management consulting, and much, much more. Illustration 1–14 outlines just a few of the many career options in public and private accounting. In addition, there are career opportunities in government accounting and education.

	Public Accounting (Big 4 and Non-Big 4)	Private Accounting
Who are the clients?	Corporations Governments Nonprofit organizations Individuals	Your particular employer
What are the traditional career opportunities?	Auditors Tax preparers/planners Business consultants	Financial accountants Managerial accountants Internal auditors Tax preparers Payroll managers
What other career opportunities are available?	Financial planners Information technology developers Financial analysts Forensic accountants Information risk managers Investment bankers Environmental accountants Financial advisors Tax lawyers	Information managers Management advisors Tax planners Acquisition specialists FBI agents Sports agents

ILLUSTRATION 1–14

Some of the Career Options in Accounting

**KEY POINT**

Because of the high demand for accounting graduates, wide range of job opportunities, and increasing salaries, this is a great time to obtain a degree in accounting.

CONCEPTUAL FRAMEWORK

The FASB establishes financial accounting standards based on a **conceptual framework**, which you can think of as the “theory” of accounting. In much the same way that our nation’s Constitution provides the underlying principles that guide the “correctness” of all laws, the FASB’s conceptual framework prescribes the correctness of financial accounting rules. Having a conceptual framework provides standard setters with a benchmark for creating a consistent set of financial reporting rules now and in the future. It also provides others with a *written* framework so that everyone understands the underlying concepts that accountants are to consider in preparing and interpreting financial accounting information.

APPENDIX

LO1–7

Explain the nature of the conceptual framework used to develop generally accepted accounting principles.

**KEY POINT**

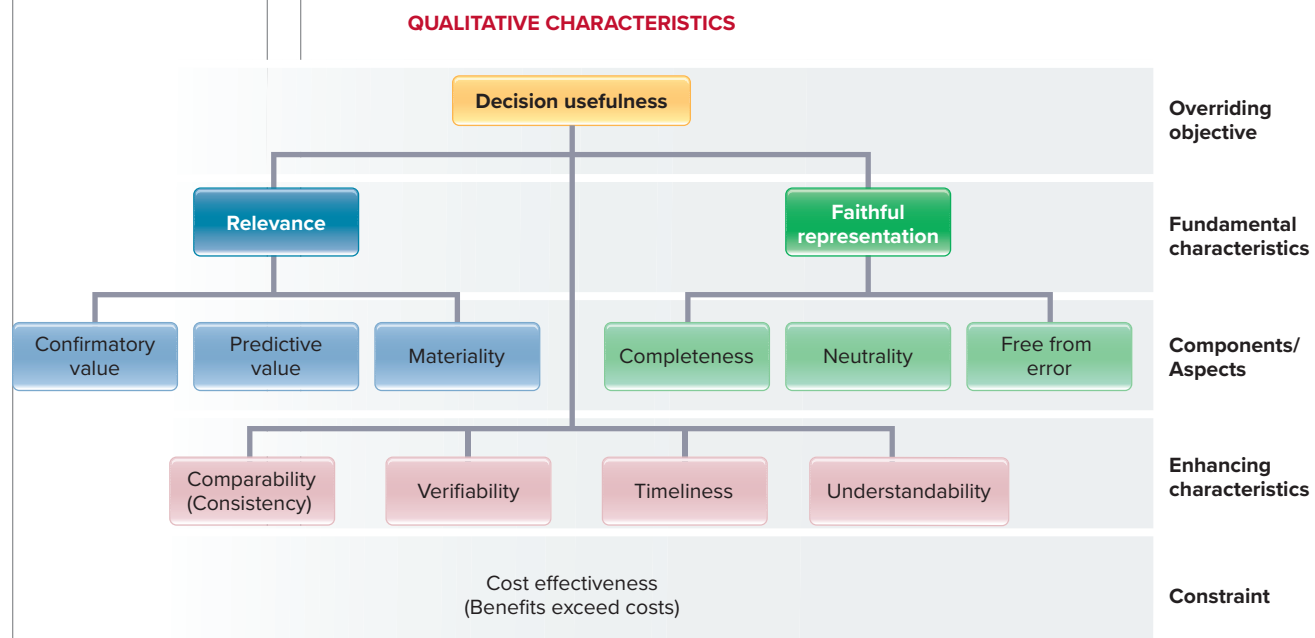
The conceptual framework provides an underlying foundation for the development of accounting standards and interpretation of accounting information.

In the chapter, we discussed the three objectives of financial accounting as outlined in the FASB's conceptual framework. Financial accounting should provide information that:

1. Is useful to investors and creditors in making decisions.
2. Helps to predict cash flows.
3. Tells about economic resources, claims to resources, and changes in resources and claims.

To satisfy these stated objectives, financial reporting of accounting information should possess certain characteristics to be useful. What are the desired characteristics? Illustration 1-15 provides a graphical depiction of the qualitative characteristics of useful financial information.

ILLUSTRATION 1-15 Qualitative Characteristics of Useful Financial Information



Notice that at the top of the figure is **decision usefulness**—the ability of the information to be useful in decision making. Accounting information should help investors, lenders, and other creditors make important decisions about providing funds to a company.

FUNDAMENTAL QUALITATIVE CHARACTERISTICS

The two fundamental decision-specific qualitative characteristics that make accounting information useful are *relevance* and *faithful representation*. Both are critical. No matter how representative, if information is not relevant to the decision at hand, it is useless. Conversely, relevant information is of little value if it does not faithfully represent the underlying activity.

Relevance. To have **relevance**, accounting information should possess *confirmatory value* and/or *predictive value*. Generally, useful information will possess both of these components. For example, the ability of **Nike** to report a positive net income confirms that its management is effectively and efficiently using the company's resources to sell quality products. In this case, net income has *confirmatory value*. At the same time, reporting a positive and growing net income for several consecutive years should provide information that has *predictive value* for the company's future cash-generating ability.

Materiality reflects the impact of financial accounting information on investors' and creditors' decisions. Unless an item is material in amount or nature—that is, sufficient in amount or nature to affect a decision—it need not be reported in accordance with GAAP. Based on the concept of materiality, Nike probably does not record all its assets as assets. Most companies record assets such as wastebaskets and staplers as *expenses*, even though these items will benefit the company for a long period. Recording a \$6 wastebasket as a current expense instead of a long-term asset for a multibillion-dollar company like Nike has no impact on investors' decisions. Thus, materiality is an aspect of the relevance characteristic with regard to values users deem significant in their decision-making process.

Faithful Representation. To be a **faithful representation** of business activities, accounting information should be complete, neutral, and free from error. *Completeness* means including all information necessary for faithful representation of the business activity the firm is reporting. For example, when Nike reports inventory in its balance sheet, investors understand it to represent *all* items (and only those items) that are intended for sale to customers in the ordinary course of business. If the amount reported for inventory includes only some of the items to be sold, then it lacks completeness. Adequate note disclosure is another important component of completeness. Nike must disclose in the notes to the financial statements the method it used to calculate inventory reported on its balance sheet. (We discuss alternative inventory methods in Chapter 6.)

Neutrality means to be unbiased, and this characteristic is highly related to the establishment of accounting standards. Because of the topic and the nature of the business, sometimes a new accounting standard may affect one group of companies over others. In such cases, the FASB must convince the financial community that this was a *consequence* of the standard, and not an *objective* used to set the standard. For example, the FASB requires that all research and development (R&D) costs be reported as an expense in the income statement, reducing the current year's net income. The FASB's objective in adopting this approach was not to weaken the financial appearance of those companies in R&D-intensive industries, such as telecommunications, pharmaceuticals, and software, even though that may have been an effect.

Free from error indicates that reported amounts reflect the best available information. As you'll come to find out in this course, some amounts reported in the financial statements are based on estimates, and the accuracy of those estimates is subject to uncertainty. Because of this, financial statements are not expected to be completely free of error, but they are expected to reflect management's unbiased judgments and due diligence in reflecting appropriate accounting principles.



KEY POINT

To be useful for decision making, accounting information should have relevance and faithful representation.

ENHANCING QUALITATIVE CHARACTERISTICS

Four enhancing qualitative characteristics are comparability, verifiability, timeliness, and understandability. **Comparability** refers to the ability of users to see similarities